BERRY
ASSET MANAGEMENT PLC
A MEMBER OF THE BORDIER & CIE GROUP

Investment Update

Summer 2014

Balancing Act

Crossroads

Summer time volatility

It’s even tougher to borrow

Overview

Global stock and bond markets have ended the second quarter in rather mixed mood. On the one hand we have the positive influences of continued monetary stimulus, increased business confidence and good momentum in economic growth, whilst on the other there are concerns about the pace and extent of removing the stimulus and the continued geopolitical risks emanating from Ukraine and, more recently, Iraq.

Mark Robinson
Director
Chief Investment Officer

Modest returns have been made in the year to date from most asset classes. We expect to make further progress in the second half of the year but some caution is required: until now the monetary response from the West to stimulate economic growth has been relatively synchronised, but we are now seeing some differentiation between key economies. This makes the next phase of the economic and market cycle slightly less predictable and could introduce bouts of short-term market volatility - some economies are transitioning from external help to standing on their own two feet again, whilst for others help is still required.

However, whilst there are still several scars, the healing in the US and UK in particular appears well under way. This means that some of the oxygen masks, bandages and sticking plasters can now be removed with some greater confidence. The broader global recovery suggests that a good stockmarket commitment remains important, with perhaps more care now needed within bond markets as key policy decisions are made.

Mark Robinson
1 July 2014

Crossroads

It is becoming increasingly evident that we are at, or close to, some form of crossroads, where the US and UK economic recoveries in particular are such that they no longer require much external support. Whilst the US and UK authorities are keeping markets guessing about the exact timing and extent of a change in interest rate policy, we can be fairly confident that action will be taken sometime soon.

Opinion about whether it will happen before the end of the year varies, with consensus currently suggesting that it will be the UK authorities that will ‘blink’ first based around a stronger rate of economic growth and a need to cool the housing market. But whilst a bubble in the UK housing market is a concern, there are already signs of some cooling, with mortgage applications falling; restrictions currently being placed on banks’ lending practices should also help contain any further rise in prices.

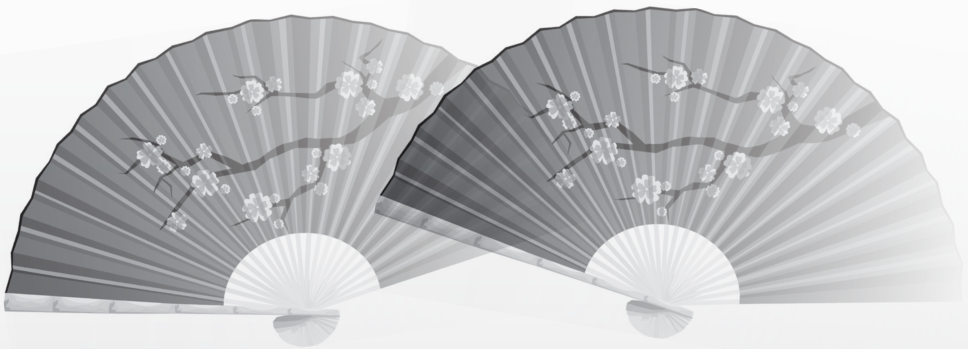
To us it seems that the US authorities may have become a little too dovish in their messaging about inflationary risks, with their reluctance to raise interest rates seemingly being influenced more by the dip in economic activity during the first quarter of the year. This stance is all rather puzzling, since data indicates that it was very likely a temporary ‘blip’ in activity brought about by poor weather in the new year. It could be that the Fed is, yet again, initially trying to control the economy through words rather than monetary deeds, but at some point this short-term rhetoric must give way to more tangible measures. The facts are that inflation is picking up and forward-looking business and consumer confidence indicators are now suggesting much greater optimism; there is strong activity in the primary and secondary housing markets and around 70% of US companies reported an increase in profits during the first quarter. These simple indicators suggest to us that US growth is being understated and that the Fed may be misreading the tea leaves. We may therefore see a rise in US interest rates sooner than markets currently anticipate. We believe this is likely to lead to a recovery in the US dollar from current levels, something that is leading us to remove any currency hedges that are in place on US funds.

Japan's Three Arrows

Japan is one key world economy that has been languishing in the recovery stakes for an exceptionally long time. However, after more than two decades of economic troubles and failed initiatives to stimulate growth, Japan does at last appear to be showing more promise following the re-election of Shinzo Abe as prime minister in late 2012. His 'three arrows' of fiscal stimulus, monetary easing and structural reforms, known as 'Abenomics', are some of the boldest, pro-growth, measures the country has ever seen.

These are designed to reflate the economy and extract it from the mire that has plagued it since the bursting of its asset price bubble in the early 1990s.

The first two 'arrows' were centred on quantitative easing and fiscal reform, with a return to 2% inflation being one of the key objectives. These initiatives appear to have been a success, with the Japanese stockmarket responding strongly last year, albeit from an extremely low base. The third 'arrow', fired in June last year, was slightly off target but Abe has reloaded and the second shot seems to have landed closer to the bull's-eye, being seen as more decisive and far reaching in terms of stimulating growth. The planned structural reforms include reducing corporate taxes and removing obstacles in the labour market, which should help boost wage growth and consumer spending. Additional positives include a stable political backdrop and initiatives to introduce greater corporate discipline and reforms to archaic labour laws, all of which have contributed to the failure of previous stimulus packages. We think this time things will be different and believe now is the right time to begin a reallocation to Japan.



Summer time volatility

We should perhaps expect some form of summer volatility in markets driven by geopolitical tensions, but conditions for business profitability, increased capital expenditure and corporate activity all suggest that any turbulence will be short-lived, just like it has been during other recent periods of uncertainty.

Even though there is some concern about the pace and exact timetable of policy change, markets so far appear to be absorbing the prospect of higher rates quite well: 10-year UK gilt yields, for example, have been hovering just below 3% for several months now, a sign that bond investors are not, currently, being panicked.

There are, however, mutterings amongst some fixed income managers that funds investing in bonds should apply exit charges to prevent a run on bond funds when the monetary cycle does turn. Whilst such measures may provide some protection, caution needs to be exercised as the mere fact that bond market participants are talking about such measures clearly indicates that some pressures are building.

“markets so far appear to be absorbing the prospect of higher rates quite well”

It’s even tougher to borrow

The recent announcement by the Bank of England’s Financial Policy Committee that banks should be testing borrowers’ mortgage affordability by reference to a potential 3% rise in base rates over a 5-year period, indicates that significantly higher interest rates are unlikely.

But this is predicated on inflation remaining under some sort of control. We believe that restraining inflationary forces once economic growth really takes hold will be far from an easy task, particularly after one of the biggest financial experiments in history. This continues to point us towards asset classes that can combat inflation - we believe this means a continued high allocation to stockmarkets, depending on risk appetite, and good commitments to commercial property and index-linked bonds. Furthermore, it also means allocations to flexible equity and bond funds that can adjust quickly to the next phase of the business cycle as time is called on this unprecedented monetary response to the financial crisis.

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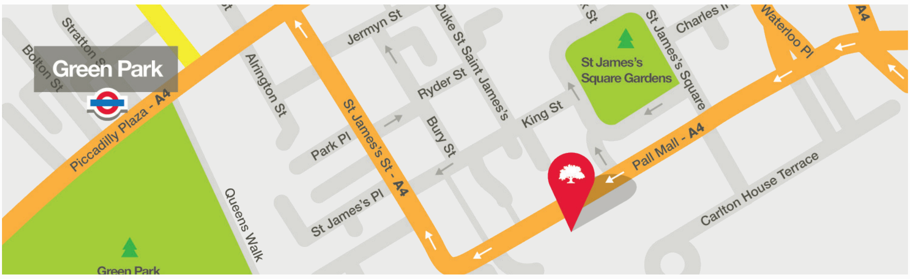

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