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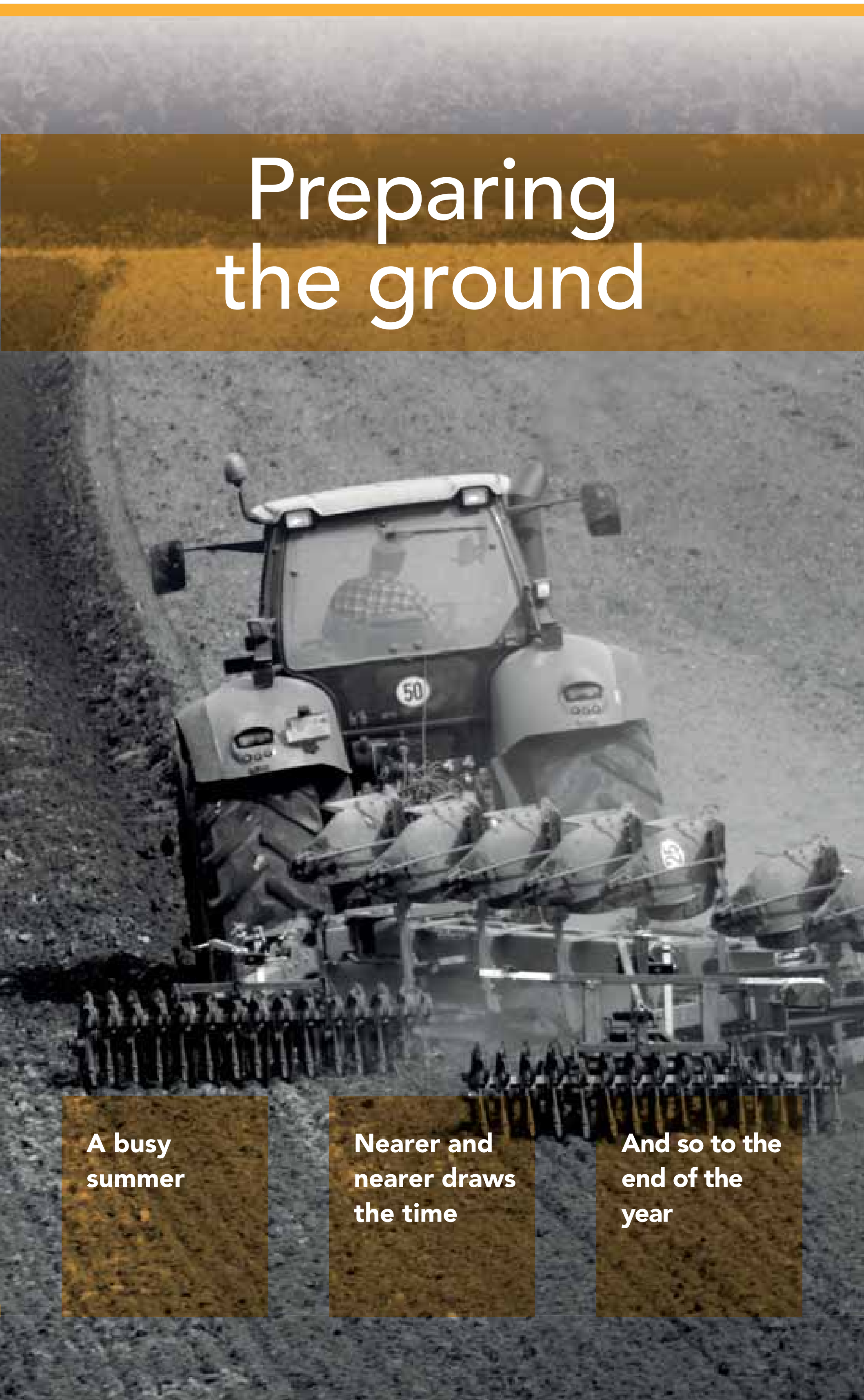
Investment Update

Autumn 2014



Preparing the ground

A busy summer

Nearer and nearer draws the time

And so to the end of the year

Overview

Mark Robinson
Director
Chief Investment Officer

Global markets have ended the third quarter in rather sombre mood, with barely any change being recorded in local currency terms. Year to date returns are also quite modest in comparison to those made in 2012 and 2013, a reflection that we are now entering, in most cases, a more mature phase of the post-financial crisis recovery in asset prices.

Headline returns do, however, mask some short-term bouts of market instability, mostly induced by geopolitical uncertainty and the markets' preoccupation with interpreting extremely short term trends in economic data.

In the case of the UK, however, it was the prospect of a 'yes' vote on Scottish independence that caused the greatest threat to market confidence during the summer – in the end it was not as close as the opinion polls had predicted, but we could have done without all the uncertainty and volatility in stock, bond and currency markets. We should probably expect further political influences on both the market and currency over the coming months, particularly as the UK General Election draws closer.

In general, though, it is somewhat reassuring that investors seem to be coping quite well with the smörgåsbord of risks that surround markets. But we do need to stay alert to matters such as China's economic growth trajectory, and any further downward adjustment to it, as well as the reaction from bond and equity markets to the imminent withdrawal of stimulus from the US economy in particular. On the positive side, however, the fact that the post-financial crisis economic recovery (with the exception of the eurozone) has reached a point where the monetary stimulus can be toned down should provide encouragement and support for markets for the remainder of this year, particularly since market valuations are not overly stretched and ample stockpicking opportunities remain.

Mark Robinson

1 October 2014

A busy summer

Depending on risk appetite and specific client objectives, we have spent a busy summer period making adjustments to portfolios to cope with the next phase of the economic and market cycle. This has included, where appropriate, alterations to US stockmarket exposure, the reintroduction of a commitment to Japan, additions to 'alternative' investments and a reduction in gold which has not, rather frustratingly, exhibited its traditional safe-haven attributes during recent stockmarket volatility.

We were particularly pleased to have adjusted US fund exposure to remove sterling currency hedges - these had previously protected US investments from dollar weakness, yet threatened to act as a drag on performance during any dollar recovery. Our prediction that the US dollar's weakness was overdone has proved correct, with the currency rallying by around 6% versus the pound in the past quarter.

It is still very early days for Japan, but we are confident that the range of fiscal, monetary and structural measures will begin to bear fruit soon.

Nearer and nearer draws the time

The timing and extent of rising interest rates continues to be at the forefront of investors' minds. Understandably, many are quite nervous over this looming change in interest rate policy and removal of stimulus. But even though the monetary backdrop for the US, the world's largest economy, and the UK are on the cusp of some change, the pace and scale of interest rate rises is still expected to be very modest, at least initially.

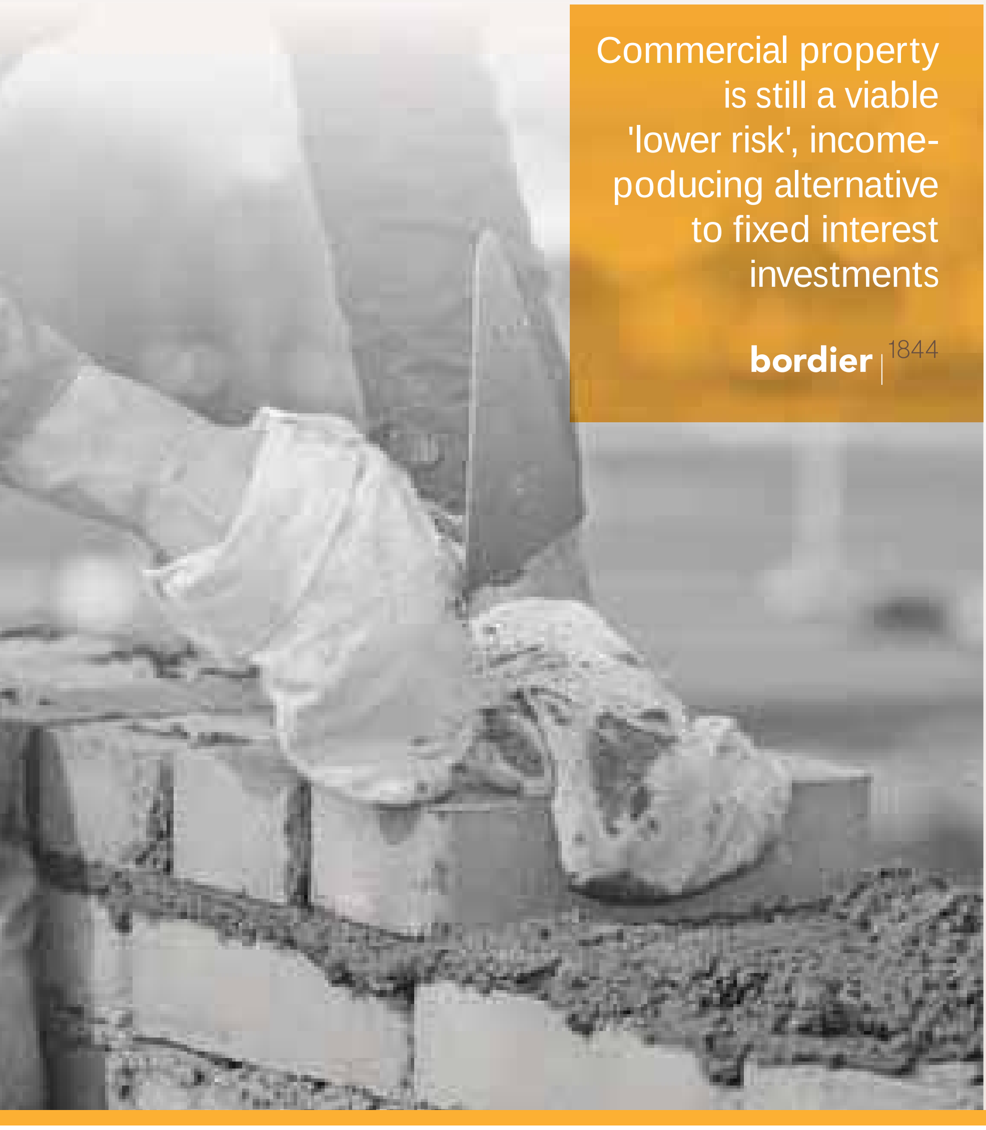
Talk of higher interest rates is already having an impact on one very tangible measure of economic and consumer recovery, namely the housing market – new and existing home sales in the US, for example, have begun to tail off and there are signs of some cooling in the hot-spots of the UK market too, with mortgage approvals down by around 20% since the start of the year. Some natural adjustments are therefore already being made to areas that have been big beneficiaries of this extended period of low interest rates, without any actual action having been required. Add to this a still fragile consumer environment, along with low levels of inflation and wage growth, and it is easy to see why the authorities do not need to rush immediately to alter policy.

We may see a small upward adjustment to UK interest rates this autumn and a tap on the US brakes could come by the end of the first quarter of 2015. But any initial changes are more likely to be a message to markets than a real threat, and are unlikely to have any meaningful impact on where investors' capital is allocated – banks, squeezed by regulators to improve their capital ratios, are likely to be very tardy in raising savings rates for investors, and bond markets are already factoring in very modest and slow changes to monetary policy.

We can therefore expect a further period of broad support for stockmarkets as capital continues to be directed away from cash and bond markets and into an asset class that still offers reasonable value and, in many cases, solid (and growing) dividend appeal.

Bricks and mortar

Commercial property is still a viable ‘lower risk’, income-producing alternative to fixed interest investments, and is working very well in terms of providing attractive levels of total return. This asset class could be a recipient of further capital if the bond environment turns sour, but it too needs watching closely, as although tenant strength and income streams should improve as the economic recovery gains momentum, capital values will ultimately need to adjust to a rising interest rate environment.



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And so to the end of the year...

We enter the final quarter of the year with some guarded optimism. All things considered, stockmarkets actually still seem quite an attractive place to invest for the foreseeable future. Valuations are not particularly elevated relative to their longer term averages and markets are still underpinned by an extended period of monetary stimulus.

They are also supported by improvements in economic activity that are the very reason why certain key monetary authorities are now in a position to alter their strategy. As we have noted, the need for stimulus has become unsynchronised, with areas such as the eurozone still requiring assistance to stave off deflationary forces and reignite activity – this is clearly a delicate situation, but not necessarily bad news for stock and bond markets. Perhaps more important than anything, though, at present is understanding the underlying drivers and threats to business success within each market: as highlighted by the plight of the dominant players in the UK supermarket sector, astute stock and sector decisions are as important as ever. Actively managed, rather than passive, approaches to investment are therefore likely to continue to produce better results, particularly in a world of low inflation and low interest rates, where expected returns themselves may continue to be satisfactory, but quite modest.

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