

Reflections on a good year

Reflections on a good year "The recent trading environment has felt something like walking into a place and having a sense that something is wrong and dangerous but not knowing exactly what will happen or when". Paul Singer, Elliott Management

October has been quite an interesting conference season and a good opportunity to test the consensus view of markets running into Q4 and speculate about what might happen in 2014. And it all seems remarkably calm. The FTSE100 Index is sitting at an agreeable 6,800, the S&P 500 at 1,750 and the Gilt/Treasury yields are nicely corralled in their trading zone between 2% (another crisis) and 3% (hurrah for everything). S&P and Bloomberg have some soothing historical data too, showing that equities have risen in the final two months of the year 82% of the time since 1928 whenever the market had already risen 10% by October. But at times like this it's wise to break out of the comfort zone and ask whether the cosy consensus is luring one into a false sense of security. Furthermore, what opportunities will present themselves if the markets start to shift?

Most opinion understandably takes its lead from what's happening in the USA, particularly in the wake of the farce played out with a political stand-off over Obamacare and the budget. But for all the media drama, markets pretty much saw through the play acting, shrugged it all off, and the S&P500 went on to new highs. If the long term legitimacy of the US Government has been undermined, there's no immediate sign that markets are unduly worried about it. Will they be so sanguine when the debt ceiling debate kicks off again in February? It's hard to say. Sequestration, and having close to a million Government workers sitting at home unpaid, is no way to run an economy and the impact is starting to show. FT data out today shows that the US has now hit the lowest level of public investment since 1947 at just 3.6% of output, compared to the normal run rate of 5%. With road paving costing $60,000-a-mile every 10 years, as the FT reports, towns like Marlette in Michigan are pulverising their roads back into gravel as a long term solution to lack of funds over the next 20 years.

But the overriding mood in markets is still a positive one. Much of the exuberance (a "word" alert for followers of Alan Greenspan) would seem based on the assumption that the US, which was the first into the downturn, will drag the world up by its heels as it emerges as the first out. The liquidity pumped into the economy was earlier and bigger than anyone expected and it's a sobering thought, from an austere UK perspective, that the US has already halved its deficit and will do so again.

In addition to a couple of investment themes dominating some US portfolios, such as the quest for energy independence and housing recovery (although losing momentum), there is good news on the company earnings front. About three-quarters of the companies constituting the S&P500 Index have now reported and three-quarters of those have beaten their bottom line estimates. Over half have beaten their sales forecasts. On previous form, this is not in itself enough for a wholesale re-rating of equities, but does add to a rosy outlook to the fourth quarter, especially when the statisticians are backing you up.

For bonds, the outlook is a mixed bag. On the one hand, there is the constant voice of doom telling us all to dance near the door ready for a quick exit as soon as interest rates shoot up. On the other hand, a quick look at the yield curve reveals a steeper curve pushed up by expectations that rates will rise sooner than central bank forecasts as a result of central banks in the US and UK looking at unemployment rather than inflation. As both the Federal Reserve and Bank of England have now engaged in the spurious practice of forward guidance, we can speak of both in the same breath.

In this regard, the Federal Reserve was disingenuous in its guidance over whether 'tapering', the lowering of bond buying, would happen in September. Possibly they were tipped off that the debt stand-off was going to go down to the wire in October. But we will be watching the jobs data to see what the effect this actually had. If, as seems likely, the economy wasn't torpedoed, then the tapering is almost certainly

on in February or March. Some people are talking about "Tapril". Tacky, but it's probably true that the Fed will want to see a full set of green lights indicating proper economic momentum before they turn off the tap – the tap that cannot be turned back on again without a serious loss of face. Whether it's January or "Tapril", there is a consensus for a stronger dollar in 2014, although it does beg the question of "where is it, then?" in the here and now.

If we genuinely believed that the strong US dollar trade was on, an interesting investment would be Japanese equities. A stronger dollar means a weaker Yen. With the Nikkei seemingly stalled following the recent run up, renewed Yen weakness, being great news for Japanese exporters, would be too tempting for the traditional foreign investor to ignore despite obvious headwinds ahead for the third, and most difficult, arrow of reform. Of course, one would need to correctly hedge the currency to receive the full appreciate in the equity market.

In the UK, the Bank of England's focus on the unemployment rate could turn out to be a blessing in disguise. UK GDP growth could be as high as 2.5% in 2014 with corporate earnings way ahead of inflation at 4.5% or more. If the Bank of England has the opportunity to turn a blind eye to inflation around 3%, the ability to sit back and do nothing would be very welcome, provided that unemployment doesn't fall through floor – setting the scene for "proper" inflation. This could be Bank of England Governor Mark Carney's "get out of jail free" scenario. If, as they suspect, there is pent up capacity in the UK economy, then a pick-up in economic activity will be matched by only a modest pick-up in employment. It would mark the return to real income gains but at the expense of a polarising of income inequality which will form the basis of debate for the next election.

The problem facing asset allocators now is the gulf between thinking short term and long term. In the long term, still in the long shadows of the Lehman collapse, inflation is not really the problem. Markets are weighing up the relatively more weighty issues of slowing growth in China, the real state of the eurozone and an unexpectedly weak dollar causing some difficulty for emerging markets. The case for equities in the long term is that it is widely seen as probably the only asset class that can possibly deliver over the next ten years. Even if inflation picks up, which appears to be the consensus view, equities may not be the perfect hedge but they're a whole lot better than bonds - of any kind.

In the short term, we have not overly extended the overweight position in equities given the excellent performance TAM clients have enjoyed in the last 12-18 months whether they've been defensive or more adventurous. The eurozone has been unusually quiet and we cannot view recent positive headlines on the Spanish economy, for example, with anything other than bemusement. We would rather stay with the strategy that we have articulated many times that, within bonds, to not stray too far from Gilts

yielding around 2.7%, and to maintain high exposures to absolute return strategies that we believe can beat traditional fixed interest and inflation but low levels of risk.

Our equity strategy has been one of modest overweight in recent months but, within this, a higher exposure in smaller and mid-sized companies which we believe are under-appreciated by markets for their ability to continue to grow earnings and dividends. This has given most client portfolios a more UK domestic bias.

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