

TAM Outlook 2014

Equities higher, government debt uninspiring; more of the same?

The start of the long awaited withdrawal of Fed stimulus for the bond market is upon us and will have ramifications for global markets if handled badly. But, like an energy drink, the stimulating effects saw equity markets finish 2013 on a high from which they seem reluctant to come down.

It was inevitable that the Federal Reserve would begin to wean markets off the unprecedented $80 billion a month bond buying program built up over the past four years. Both the Federal Reserve and Bank of England will have to tread a fine line between withdrawing their stimulus and supporting a fragile economic recovery. With inflation targeting abandoned in favour of targeting lower unemployment, the appointment of Janet Yellen, an academic in the field of employment, is a reassuring change that bodes well for a steady transition to a self-sustaining recovery. Against this back drop we present our outlook for 2014.

Equity: OVERWEIGHT with a potential for both the macro recovery and corporate earnings

improvements.

Fixed Income: UNDERWEIGHT sovereign debt and OVERWEIGHT corporate debt as bond yields rise on both tapering and inflation expectations.

Property: NEUTRAL. Having been underweight throughout 2013 we now see potential opportunity

Commodity: UNDERWEIGHT. We retain our view that the equity (paper asset) to commodity (hard asset) switch has run its course over the last decade and do not see a relative opportunity in this asset class so long as China's economy continues to slow.

Absolute Return: OVERWEIGHT. The better quality market neutral bond and equity funds still provide strong positive comparatives against government debt markets.

In summary, considering all of the asset classes we are investing in for 2014, we are seeking to build on the successful approach of last year by getting the big calls right whilst achieving higher returns and lower volatility than the markets themselves.

2014: Echoes of 2013 and 2012 – we are in a bull market!

At a glance, global market sentiment today is eerily similar to that which prevailed a year ago as the worries of 2012 spilled over into 2013. Despite the FTSE 100 returning a respectable 5.8% in 2012, the market continued to dwell on Moody's downgrade of the UK's debt rating from triple-A, the fact that inflation remained stubbornly high and that disappointingly weak UK GDP data threatened to tip the UK into a triple-dip recession. Combined with a raft of global geopolitical concerns in the first quarter of 2013, one could hardly be blamed for thinking that the obvious thing to do was to hunker down in quality bonds and wait to see what happened.

For those that sat it out, it was a worrying time as equities continued to grind higher despite the unremitting media gloom. The FTSE 100 broke through 6,800 in May – a little over where it finished the year. There was brief respite for the equity bears who were vindicated in the summer months as Federal Reserve Chairman Ben Bernanke hinted that asset purchases could be reined in or "tapered" as early as the Autumn. This sent out some short term waves of panic as markets feared that it was too much austerity, too soon, but set in place the paradoxical situation where any bad news on the economy was actually good news for equities, as the decision to start easing the $80 billion a month stimulus was repeatedly kicked into the long grass by the Fed. Either way, as we said it would at the beginning of 2013, it took patience and conviction to stay overweight in equities, particularly at TAM where, in addition to the overweight, we shifted our equity bias towards small and mid caps stocks and away from the relative comfort of large cap income. We held onto our convictions and TAM clients enjoyed a thoroughly good year.

The FTSE 100 ended the year up at 6,749.09 with a raft of improving UK economic data giving Chancellor George Osborne plenty to be happy about following a challenging year. Combined with truly surprising

employment and payroll numbers out of the US, a palpable sense of optimism emerged in all corners of the market. The all time high reached by the Dow equity index (breaking above 16,500) and S&P500 (touching 1850) in the US forced investors to re-evaluate upwards in hindsight their overall view of the world and 2014 arrived with a sense of optimism absent for some time. But, in all honesty, any new bulls arriving after 58 months of a bull market were late to the party. As the markets drew to a close at year end, many other investors were nursing heavy losses in bonds, commodities and emerging markets. They had simply been wrong footed by a combination of economic growth and misreading central banks' actions.

We enter 2014 with client portfolios positioned as follows:

Equity markets: OVERWEIGHT. While valuations have caught up with corporate earnings forecasts, we believe equities have further to run in 2014 and we expect the FTSE to decisively break up through 7,000. As in the previous few years, optimism should be contained for there will be periodic setbacks, the catalyst for which could be any number of well flagged issues that are waiting in the wings. Money flowing between cash, bonds and equities will almost certainly outweigh arguments about valuations from time to time and whilst we will continue to make investments for the longer term, it will be necessary to keep an eye on short term technicals and act if we decide that the opportunity justifies the risk.

We believe that the potential for both the macro recovery and corporate earnings in the USA, from which the UK markets undeniably take their lead, have been underestimated. This will ultimately support high valuations, as long as the recovery is not so strong as to materially accelerate the unwinding of loose monetary policy. It's understandable that pundits are questioning relatively high valuations, equity markets having just experienced a "melt up". But it is normal for valuations to move up before an improvement in earnings and stocks. It should be remembered that the in the context of the 6 years since the pre-crisis summer of 2007, share price/earnings ratios are at the top of a range around 10 to 15 times earnings. But, if you've been around and investing since the 1980's, as we have, the more normal range is 12 to 25 times.

In the UK, if company profit margins are stable and companies can cope with the impact of the inevitable need to hire and invest, the steady pick up in the economy will be good for confidence and there should be no need for interest rate hikes to be brought forward. It will be a delicate balancing act for the Bank of England as well as the Federal Reserve and investors will require patience and nerve to reap the full rewards.

Continuing a couple of themes from 2013, we expect to stay invested within the UK with a small and mid cap bias and with a lower exposure to overseas markets than in previous years, although there have emerged some opportunities in currently unpopular areas that we are keeping a close eye on.

Fixed Income markets: UNDERWEIGHT sovereign debt, OVERWEIGHT corporate debt. Our call for an underweight positioning in Gilts was vindicated in 2013 as the 10-year Gilt bond yield broke free from sub 2%, a level we considered "return-free risk", to finish the year at 3%. Given the extraordinary levels

of Gilt issuance, one could make the case for yields to be higher still in the longer term. But, as we have pointed out before, they're not going to get there in a straight line so long as Gilts retain the perception of a safe haven whenever a renewed sense of crisis springs out of left field to spook markets. On fundamentals, we do not expect inflation, or the lack of it, to have as big a hold over the direction of bonds in 2014, Indeed, the Fed and Bank of England have long since stopped worrying about inflation, being much more interested in employment statistics when considering their next move for interest rates or reigning in stimulus. We may look again at bonds in emerging markets now that the impact of rising rates among the G7 has been factored into bond prices amid the big tapering debate. Further weakness could present a tactical opportunity. The actions of the central banks in China and Europe, the ECB, and whether they follow in the footsteps of the script the Fed has written will be key not only to their own markets and currencies but to the prospect of global growth and support for equities.

Property: NEUTRAL. With UK commercial property on the rise and rental income rising faster than expected, we are considering re-entering this asset class in 2014. As with bonds, the extent to which the property market is affected by the prospect of rising interest rates is clearer now than it was a year ago. The recovery in capital values is quite broad based but we believe that yields could be resilient in the face of a re-rating.

Commodities: UNDERWEIGHT. We reiterate that the decade long switch from paper (equity) assets to hard (commodity) assets has run its course. There will always be short term opportunities if global, and particularly Chinese, growth picks up faster than expected. But, failing a dramatic change in the way the Chinese central bank manages the economic slowdown, we believe that commodities will continue to be negatively impacted with inevitable knock on effects to the economies of countries like Australia and mining stocks here in the UK.

Gold is more usually discussed in connection to the US dollar, which would probably be considered to have been stronger in 2013 if the Euro hadn't been stronger still. Nevertheless, gold had a bad year last year, falling 17%, following on from a choppy 2012 when the dollar bulls fought those expecting hyperinflation and the end of global money. The US dollar appears to have turned the corner in the last quarter of 2013, however, and the risk to those holding gold would appear to be that the US economy improves faster than expected and interest rates rise earlier, boosting the dollar. As we said in 2012, "gold is an unnecessary hedge against an unlikely threat and priced in a currency which has historically been deemed a better safe haven than the metal itself."

Absolute Return: OVERWEIGHT. The low volatility of the absolute return investments delivered modest returns but comfortably beat the Gilt index which fell around 2%. We added to this asset class in Q4 last year, investing in absolute return funds with equity based strategies which we believe will deliver return materially above Libor.

Some thoughts on 2013 - A review of the core TAM calls

The man with the plan? – February 2013

In the wake of the UK losing its AAA status, does the Bank of England governor elect have what it takes to get the UK economy moving quickly?

The arrival in the UK of ex-Bank of Canada Governor, Mark Carney, has stoked a flurry of excitement from economists and the media ahead of his appointment as Governor of the Bank of England this coming June. While Sir Mervyn King keeps his seat warm until then, Mr. Carney has been doing the rounds and giving some hints as to what role he believes the Bank should be playing in the midst of a fragile economy and what policy changes he might be making as a result. His first important appointment was the most daunting; a grilling from the UK's Treasury Select Committee – something that could have put him off UK press conferences for life. The session did begin with some rather awkward questions about his salary from a sceptical panel of MPs with a point to make, but his deft handling of the discussion limited further "banker bashing" and his confident yet respectful performance appeared to win over MPs from the left and right; offering to adopt a more open dialogue with MPs about internal Bank of England discussions – all part of a "new look". Furthermore, inflation targeting will be more flexible in the future and, whilst he stopped short of making firm predictions about the UK's growth potential, it was clear that stimulating the UK economy will be higher up the agenda. It was, in short, a polished performance in front of intense media scrutiny hanging on every word.

Mr. Carney has already dismissed talk of a dual-mandate and growth is clearly now the name of the game in this new cooperative approach with the Government, and with their eyes on an election in 2015. It may take the form of some GDP targeting although it's unlikely that anyone will admit as much in the months ahead in order to downplay any sense of major upheaval. Nevertheless, Gilts are starting to struggle in the wake of this new reality and, whilst we do not expect them to entirely lose their relative attraction as a safe haven during periods of volatility, we have no intention changing this stance as TAM portfolios enjoy a strong start to the year.

As keen Federal Reserve watchers, we identified the change of leadership as a significant event that would boost market sentiment initially but would deliver a marked change in emphasis from the Bank of England. Some may have harboured doubts about the appointment of a man who, by luck it may be argued, presided over The Bank of Canada through the Lehman crisis and had turned down the job offered by Chancellor George Osborne on more than one occasion. But accept he did. And with his arrival came a commitment to tell it like it is along the same lines of "forward guidance" adopted by the Federal Reserve under Ben Bernanke. Unfortunately, the differences between the Bank of England and the Fed are too different to work in practice and Mr. Mark Carney had to adapt quickly to the demands of the UK press. But what has become clear is that he has a more pragmatic approach to supporting the banking system and a less rigid way of gauging when the time is right to raise interest rates.

Levels of unemployment continue to dog the Government and the lingering fear of interest rates having to rise is not lost on UK voters ahead of an election in 2015. It would be extremely damaging if the Bank of England were to raise interest rates in response to a resurgent economy. But Mark Carney's salvation may lie in the production capacity of UK businesses. If the productivity gap in the UK, which is notoriously difficult to measure, really does allow for both the manufacturing and service side of the

economy to pick up without a massive drop in unemployment, then the need to raise rates will be avoided and will represent something of a "get out of jail free" card to a central banker trying to stimulate an economy without the hindrance of raising interest rates.

Red herring alert – April 2013

As news of erroneous fish stocks entering the food chain across the US and Europe appear to have attracted little attention, so too have a few red herrings that have recently entered the headlines which have threatened to derail the rally in equities. Last week, while the financial news stations ran 24 hour commentary and discussion about whether the Cyprus bailout could lead to a disastrous bank run across the eurozone, the S&P 500 index of leading shares hit an all time high in the USA with just one stock, Apple, holding it down…

….As we have stated before, we believe the time has passed to panic and seek out yield at any price. We acknowledge there are serious geo-political threats and we maintain some balance against short term setbacks where appropriate. But technical and macroeconomic analysis are not exact sciences and very little of the bad news is new news. It is important to remain as vigilant against red herrings as it is to be prepared for genuinely negative developments. On balance, we consider short term sell offs in equities, driven by negative sentiment, to be good entry points to add to equity exposure within portfolios.

Interestingly, 2013 was notable for the things that did not happen as well as those that did. Angela Merkel's re-election hinged on containing the eurozone crisis until the elections in September – something many thought impossible. But through various twists and turns and a political determination within the eurozone to hold things together at any cost, bailouts for Cyprus, Portugal, Greece and Spain failed to derail the equity rally. There was no Greek exit from the Euro and bond yields in the troubled Mediterranean states did not go through the roof.

Nor did the euro crash amid all the rampant speculation about an imminent breakup. In what must surely rank as the cheapest ever currency intervention, the Euro stayed propped up through a combination of factors. Firstly, the ongoing assurance from ECB President Mario Monti that he would do "whatever it takes" to protect the Euro from breakup. In addition, unlike the Federal Reserve and the Bank of England, the ECB did not embark on outright quantitative easing to flush the system with liquidity, thus keeping the Euro relatively strong against the US dollar and Sterling. This wasn't particularly good news for an embattled eurozone trying to export its way out of trouble. Italy did not suffer political collapse in the wake of the political demise of Silvio Berlusconi and a wave of protest votes in the election. Neither North Korea or the island dispute between China vs Japan sparked military conflict.

In the US, the political stand off didn't lead to a melt down over the debt ceiling negotiations or knock 4% off US GDP, nor did the shut down of Government agencies later in the year. Indeed, even when the US Department of Labor closed, unable to publish the closely watched non-farm payroll data in December, the market shrugged it off and rolled on to new all time highs.

Our Red herring alert note was published in April, identifying a number of concerns that appeared to be preoccupying the headlines even as the market enjoyed a positive first quarter. What really mattered was the economy.

Sell in May and go away? Not today… - April 2013

The pernicious school of thought advocating selling in May and going away has, in these short sighted times, built up something of track record. In the last four years, equity markets have been shaken out of their complacency by any number of scare stories circulating around the markets in the first few weeks of Spring.

There are some unavoidable seasonal factors penned in the diary at this time of year and the US earnings season, which we are halfway through, can be a tricky time despite the fact that it is arguably the least important of the four. But this year is different. On the last day of April, the S&P500, the main US index of leading shares, reached an all-time high. It effectively raises the stakes should any bad news break from left field during an otherwise positive earnings season sprinkled with mildly positive macroeconomic news. On the first day of May, the London FTSE100 followed the euphoria, posting a 0.4% gain to over 6,450. But this is not how we see the market unfolding in the months ahead. Investors are more concerned with the relative valuations between the two asset classes rather than on the absolute levels. However unpalatable they may be, those seeking yield (pension funds for instance) are being pushed up the risk curve or, ultimately from bonds and into equities. This has the look and feel of a market feeling compelled to capitulate and buy just to keep up with benchmarks – something we do not believe in at TAM where we offer the flexibility to hold cash. Could global equities sell off by 5% or more based on any number of economic and geo-political threats around the world? Absolutely.

The May sell off, like the daffodils, came late in the month but did see 5% knocked off US equities and, briefly, even more off UK shares, as Federal Reserve Chairman Ben Bernanke hinted that asset purchases could be reined in or "tapered" as early as the Autumn. It was a nervous time for many, particularly as Gilts were also falling, but we saw the sell off as an overreaction to some pretty punchy price movement technicals which rarely last long. Ultimately, the wholesale slaughter of the bulls never happened and, save for some smaller, bouts of selling in early August and again in late September, the S&P index went on to a record high by year's end.

Overheated summer daze – August 2013

"…and the stock market has its best week since July…Take that, Karl Marx". From the film "Uncle Buck" 1989.

What a scorcher! And the weathers not too bad either. Murray is champion, Froome is victorious and the cricket is all sewn up. For those yet to depart on holiday, the stock markets aren't looking too shabby either. The FTSE100 Index has recovered to a respectable 6,525 and the S&P500 index is at all time record -+`high. Even the bond markets are behaving themselves, with US yields approaching 2-year highs

and Gilt yields sitting in a Goldilocks range around 2.35% and new Bank of England Governor, Mark Carney, telling us what we want to hear. What's not to like?

So TAM has decided to bank the profits now while the stock market charts are pushing technical highs. This move will only bring client portfolios back into line with benchmarks. It does not alter our thoughts on bonds or equities in the longer term but we believe this is a prudent move which may afford clients the chance to sit back and enjoy this hazy summer in a daze of relative contentment.

From the beginning of 2013, and having taken advantage of the May sell-off, TAM equity weightings were pushing the absolute top of our risk limits. This was due in part to the performance of the market but also to the performance of the equity investments above and beyond the market itself, particularly in the UK. This was a nice problem to have but prudence had to prevail and we took the decision to de-risk client portfolios closer to benchmarks. By year end, this consolidation, born out of necessity, was quite clearly the right thing to do and we were very pleased to report that as 2013 came to a close, every core equity investment in client portfolios had outperformed the equity benchmark in addition to putting in an impressive gain in absolute terms.

Conclusion

More of the same in 2014 – but just a little more restrained?

The Fed has now confirmed that they will finally taper in January under new Federal Reserve Chair, Janet Yellen. But from where we're sitting, this was old news as far back as November. Tapering was coming and it didn't really matter much if it was Christmas or a Springtime "Tapril". The only debate going on behind the closed doors of the Fed is the timing of real interest rate hikes if the economy continues to improve apace, as it did in the fourth quarter of 2013.

Ben Bernanke was at pains to drive home the message that tapering does not mean monetary policy tightening. And so, whilst a rise in bond yields is most likely, the Federal Reserve is determined to convince us all that they will keep interest rates at zero for as long as it takes. As Bernanke put it, the Fed won't even consider using rate policy unless "all goes well". Futhermore, in case we're in any doubt that the Fed is now tracking fundamentals other than inflation, he added "the Committee believes it will be necessary to keep short-term interest rates low "well past the time" when the unemployment rate falls below 6.5%. Ben Bernanke, in final press conference as chairman of The Federal Reserve:

"If incoming information broadly supports the Committee's expectation of ongoing improvement in labour market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labour market and inflation as well as its assessment of the likely efficacy and costs of such purchases".

So this does not mean that QE is now consigned to the dustbin of history. Janet Yellen takes over the

wheel of the Federal Reserve with a reputation for a dovish approach to the management of the economy. Her appointment, not without some controversy at the time, and not Obama's first choice, is an interesting one given her background. Where Ben Bernanke was an academic of the aftermath of the 1929 crash, Janet Yellen is a Keynesian economist whose decisions may be guided with a greater emphasis on unemployment rather than inflation. In 1995, on the Board of Governors at an FOMC meeting, she said that letting inflation rise could be a "wise and humane policy". In the here and now, perhaps Bernanke's last press conference gave some indication of how Yellen will carry on. Emphasising her endorsement of the tapering move, when asked why job growth had not been stronger in recent years, he said "People don't appreciate how tight fiscal policy has been".

We therefore enter 2014 with a broadly positive view on equities intact, together with our now familiar negative view on sovereign debt. Overweight positions on equities will be quite modest, for we have exposure to excellent investments that comprehensively outperformed their relevant indexes in 2013 but with lower risk. But, as we continue to invest for the long term, we will be alert to any short term opportunities that arise if we believe that the risk/reward is fully justified.

This document is not intended in isolation as an offer or solicitation or recommendation to use or invest in any of the services or products mentioned herein. Investors should be aware that the value of the portfolio and the income from it can go down as well as up so you may get back less than you invested. Past performance is not necessarily a guide to future returns. The value of investments denominated in foreign currency may fall as a result of exchange rate movements. The investments and services referred to in this document may not be suitable for all investors and, if in doubt, you should seek qualified independent financial advice. Any opinions, expectations and projections within this note are those of TAM Asset Management International Limited, represent only one possible outcome and do not constitute investment advice.

TAM Asset Management International Limited is regulated by the Financial Services Commission of Mauritius and is an authorised Financial Services Provider regulated by the South African Financial Service Conduct Authority.