Market Perspective

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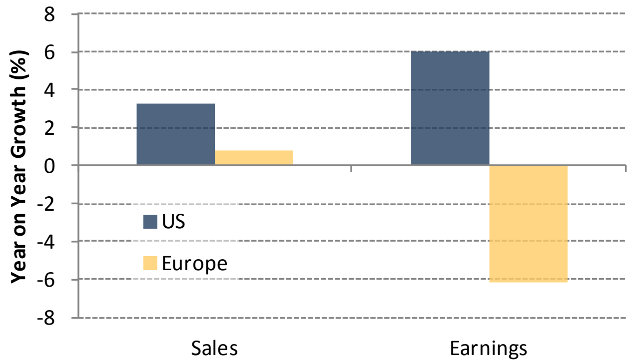
Investment Research

February: Discerning Returns

A fairly indiscriminate rally since November petered out in February with investors becoming more discerning about the assets they want to hold. Why this change in mood? Political, economic and corporate considerations have played their part.

The earnings season in Europe rather ran out of steam with around 51% of companies having beaten earnings estimates compared to the US where it was around 71%. This lack of earnings surprises was paralleled by a lack of growth. On average European companies saw their fourth quarter earnings shrink on a year-on-year basis, sales were a bit more positive.

Chart 2: Earnings season has been kinder to the US than to Europe ex UK



Source: Datastream/Brewin Dolphin

In addition to a robust corporate performance, the US also remains supported by economic data. Forward looking indicators such as survey data were almost unanimously positive. Our underlying theme of stronger construction, driven by the backlogs of household formation and new home construction in recent years, remained underpinned.

Perhaps tempering our housing bullishness is the weakness of house price momentum. Prices flat-lined in the final quarter of 2012. Housing activity is obviously weak over the winter and so holding ground is perhaps a reasonable result. It nevertheless raises the question of how sustainable last year's increases are likely to be.

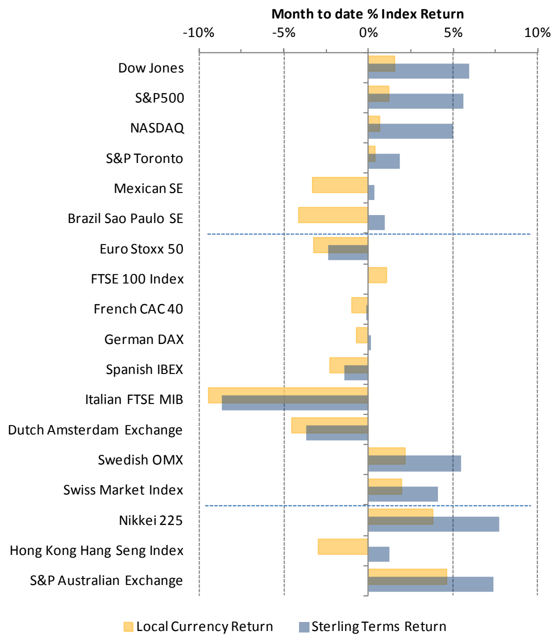
We expect the increase in home equity, experienced as a result of the last year's price growth, to open the mortgage market to new buyers and drive further increases. Thereafter we also see a strong feedback loop emanating from the recovery in construction activity as jobs growth and new household formation independently drive consumption, employment and ultimately further demand for housing.

Lack of progress in home prices would undermine that trend but we still see it holding firm.

A strong month on month gain (on a seasonally adjusted basis), the decline in home inventories to levels not seen since 1999, and ever falling mortgage delinquencies and foreclosures strengthened our conviction. The most obvious threat to this nascent recovery now stems from the demand destroying impact of sequestration cuts.

February's news

Chart 1: Earnings season has been kinder to the US than to Europe ex UK

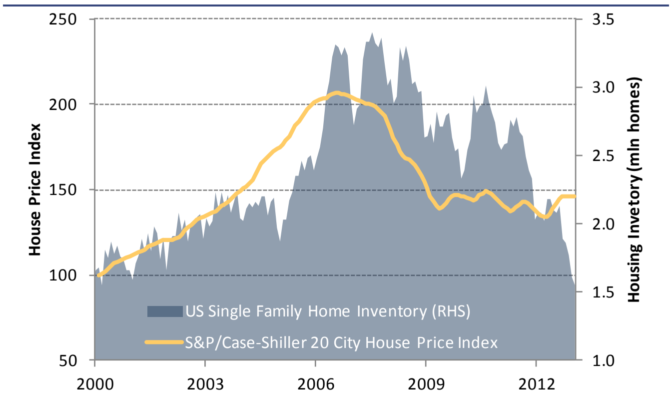


Source: Datastream/Brewin Dolphin

North America

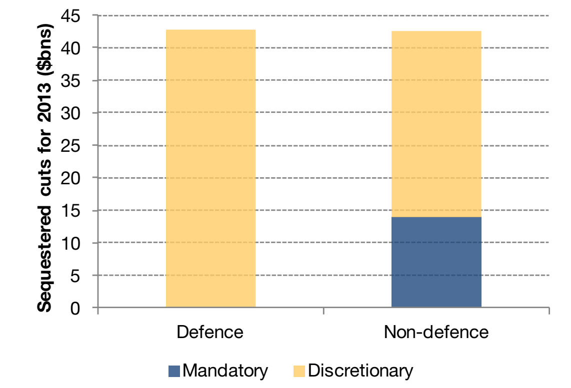
- In the US, the employment picture firmed through meaningful revisions to payroll growth in previous months. Ongoing Jobless claims reached their lowest level since June 2008, initial jobless claims have plateaued. Despite these broadly positive trends the unemployment rate ticked up slightly from 7.8% to 7.9%.
- Income growth held firm at 2.1%.
- Confidence indicators were particularly robust at a regional level (Chicago PMI, ISM New York) and national level (University of Michigan Confidence, ISM Manufacturing, Markit PMI).
- Durable goods and factory orders disappointed.
- New and existing home sales both beat expectations. Fourth quarter house prices were broadly flat.
- Mortgage delinquencies and foreclosures both plumbed new post-crisis lows.

Chart 3: US home prices could be stalling but inventories continue to decline…



Source: Brewin Dolphin/Census Bureau

Chart 4: Sequestration cuts for 2013 in the US, effective 1st March 2013



Source: Congressional Budget Office

Sequestration cuts became effective on 1st March 2013 and these, plus any lagged effect from the payroll tax hike on 31st December 2012, could undermine the strength of the housing recovery. We would expect increasingly frenetic market reactions to policymakers' statements on the need for fiscal consolidation, intensifying as the 27th March deadline for a new continuing resolution or budget approaches.

This is a hard deadline - unlike the 1st March effective date for sequestration. The difference is that sequestration will see phased defence cuts intensifying over the coming months. A failure to agree new appropriations would see the federal government go into shutdown.

A return to the risk on/risk off environment that was so challenging in 2012 now looks likely in 2013 – particularly in Europe. The inconclusive election result in Italy is a meaningfully negative event. The euphoric market reaction to Mario Draghi's speech about doing "whatever it takes" to eliminate convertibility risk may now appear to have over-extended itself.

Draghi's eventual panacea for the Eurozone, the potential for Outright Monetary Transactions, effectively means that those countries who follow virtuous paths can be saved from default no matter how harsh the slowdown caused by those austere policies might be. The problem is that, based on these results, the Italians appear reluctant to be saved.

Growth in Europe is still forecast to turn positive in the third or fourth quarter of 2013 but economists base early forecasts on trend growth rates before allowing them to drift towards more recent observations. Against such a background we would not wish to bet against a full year of contraction.

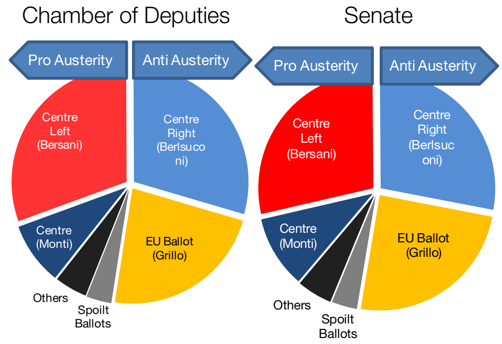
Weak demand from the Eurozone continues to hinder the UK's recovery. Following the loss of the prized triple A rating investors placed greater emphasis on the dilemma of whether to diversify away from fixed interest and into other asset classes – the so-called *great rotation* – or stick with the ballast of fixed interest holdings.

There remains limited evidence of this great rotation so far, with non-equity asset sectors still retaining the lion's share of flows. And in the end, despite the downgrade, bonds had a reasonable February as the news was trumped by talk of negative interest rates from Bank of England Deputy Governor, Paul Tucker.

Europe

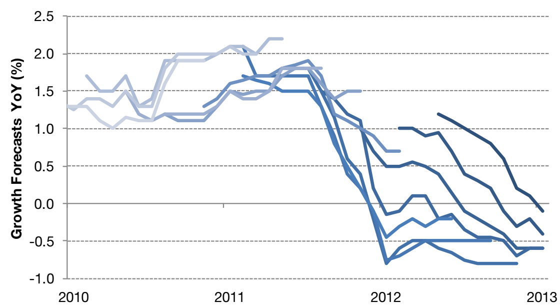
- European PMIs were reported as in line or weak for February. The most obvious pockets of disappointment were French services and Italian manufacturing.
- Industrial production was weak in France although consistent with the current trend of weakness. On a seasonally adjusted basis there were signs of stabilisation in Italy (industrial orders are also reported for Italy and remain extremely weak).
- German factory orders and trade both indicated reduced activity.

Chart 5: Both houses of the Italian parliament saw popular votes against austerity…



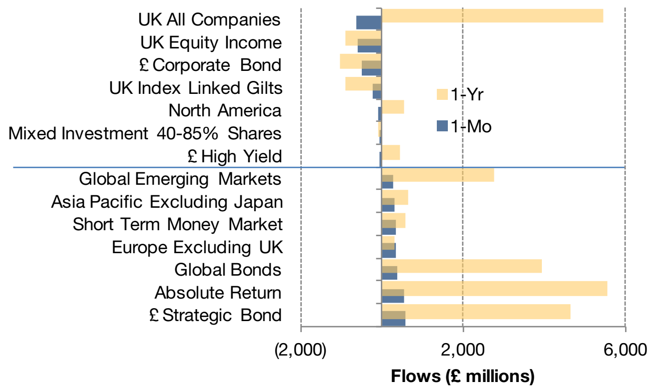
Source: Brewin Dolphin, Italian Ministry of the Interior

Chart 6: Economists' Eurozone growth forecasts tend to start at trend and drift towards recent observations



Source: Consensus growth forecasts, Brewin Dolphin

Chart 7: Bonds may be being sold but more as a result of indecisiveness than a positive allocation to equities...



Source: Morningstar

Tucker's comments underlined the importance of not betting against the central bank and demonstrated that, in a fiat currency system, interest rate expectations matter more than credit risk.

In the harder currency environment of the Eurozone, Italian debt holders were given something of a rude awakening by the political debacle and consequently many fled to safe havens such as gilts.

Developed market funds continue to flow to the emerging markets, giving body to fears of currency wars from emerging market central bankers. Emerging market equities in general have been rather underwhelming as a way of playing the global recovery, suffering as they do from relatively poor capital discipline, wage inflation, higher funding costs and more inflation fighting rhetoric from China.

From a bondholders' perspective, higher interest rates means higher yields attracting funding from yield-starved western investors. For these flows not to cause excessive currency appreciation central banks need to accrue them as currency reserves which must then be sterilised by higher interest rates to avoid causing higher inflation. The reserves, meanwhile, are recycled into the developed markets where they fund the deficits of fiscally profligate countries like the UK and US.

This relationship may work well for the west but the developed markets lose money on the interest rates paid to sterilise foreign exchange intervention.

The practise is also causing a circular expansion in external debt as the west lends to the east and the east lends back to the west. The benign way for this external debt build-up to unwind would be through gradually rising yields in the western world. Any sharp convergence of developed and developing market interest rates, however, has the potential to prompt developed market investors to repatriate their holdings.

Of course the existence of those reserves ought to provide reassurance that it is "different this time". But the well established precedent for such crises in the emerging markets means this is a key risk to monitor.

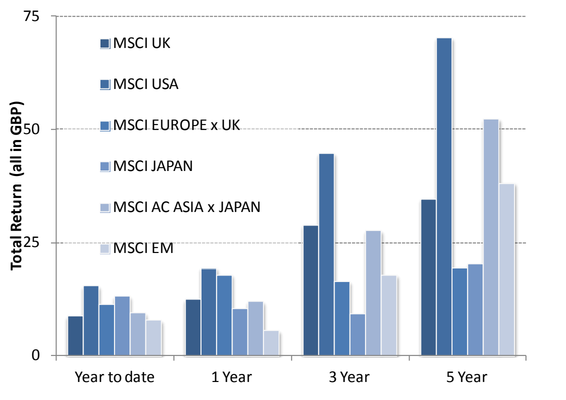
UK

- PMIs were positive for UK services but disappointing for construction and manufacturing.
- Inflation remains was unchanged, above target but within acceptable bounds.
- The unemployment rate ticked higher and wage growth remained modest.
- Mortgage activity remains at extremely depressed levels.
- House prices rose but mortgage approvals and the RICS house price balance both declined.

Asia

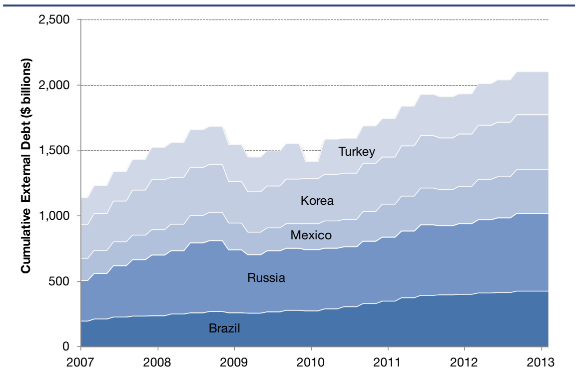
- China's manufacturing PMIs were modestly below expectation but within the margin of error. The services sector showed signs of improvement. The contraction in Chinese FDI continued. CPI was unchanged at a modest 2%. M1 and M2 money expanded rapidly.
- Industrial production in India was disappointing but the PMIs show a trend of improvement.
- The South Korean trade balance remains robust but, as in the case of China, this is on the back of imports declining faster than exports.

Chart 8: Emerging markets have seen plenty of flows but returns have lagged the major markets...



Source: Brewin Dolphin/Datastream/MSCI

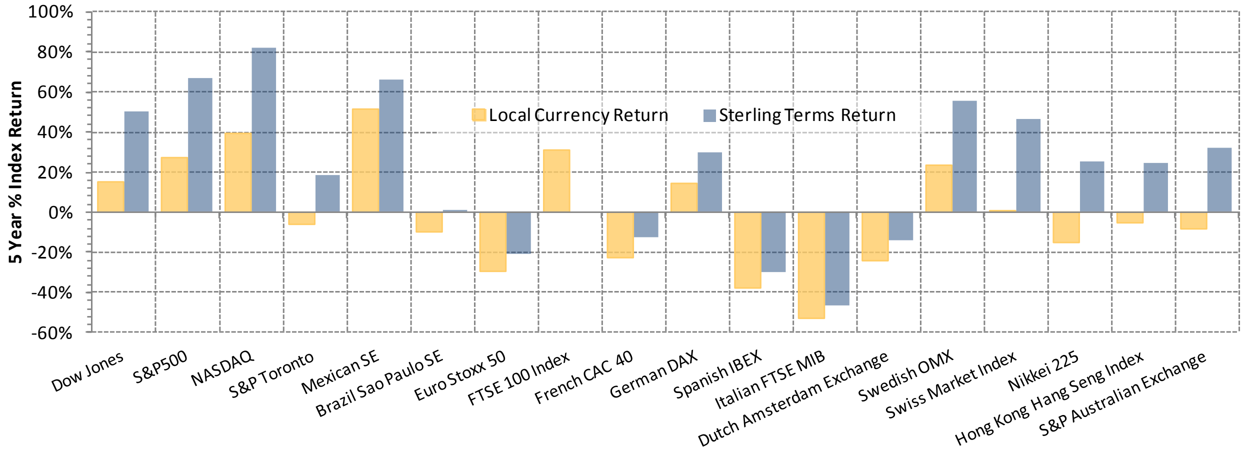
Chart 9: External debt in the emerging markets is expanding as western investors search for yield...



Source: Brewin Dolphin/World Bank

Appendix

Chart 10: Five year returns in sterling and local currency terms



Source: Datastream

	Asset Class	Short Term Outlook (<12m)	Short term rationale	Long Term Outlook (>12m)	Long term rationale
Debt	Cash	Negative	Real rates remain negative	Negative	No immediate prospect of interest rate increases
Debt	Conventional gilts	Negative	The market offers poor value	Negative	Gilts offer poor value which is offset to a limited extent by low cash rates and equity correlations
Debt	Index Linked Gilts	Neutral	Break even rates have recovered following the announcement that RPI will not be changed	Neutral	RPI will reflect higher taxes and weak currency but wage pressures remain deflationary
Debt	Corporate bonds	Positive	Very tight spreads have widened during the recent risk rally, raising overall yields	Neutral	Yields remain modest in absolute terms but are suppported by structural demand for bonds
Debt	Emerging market debt	Neutral	Spreads remain vulnerable but fears over currency wars could cause a retreat	Neutral	Modest room for spread contraction and fully valued currencies
Equity	UK Equities	Neutral	Performance has been strong, warranting a pause	Positive	Dividend yields and strong capital discipline suggest markets remain good value
Equity	US Equities	Positive	Earnings growth has been underpinned by strong fourth quarter earnings	Positive	Improvements in wealth and income support smaller risk proemia and higher equity prices
Equity	Europe ex UK Equities	Positive	The transition to a post-crisis world is allowing strong equity and currency gains	Positive	Improving lending conditions and reduced labour market rigidity support further growth
Equity	Japan Equities	Negative	We fear for rising risk premia or a retracement of recent currency weakness	Negative	The current econmic revival could do more harm than good
Equity	Asia ex Japan Equities	Positive	Multiples are modest	Positive	Earnings growth should reflect positive demographics
Equity	Emerging Markets	Neutral	Policy dilemmas regrading growth and inflation continue to weigh on risk premia	Positive	Earnings growth should reflect positive demographics
Alternatives	Absolute Return	Neutral	Low cash carry, the challenges of risk on risk off and a shortage of trending markets has weighed	Neutral	Trending strateiges could see their time come again as risk on/risk off is left behind
Alternatives	UK Property	Negative	Rents look static, vacancies at risk of rising and little economic impetus for improvement	Positive	Underbuilding will lead to a shortage of quality commerical property in the UK in the long term
Alternatives	Oil	Neutral	Modest improvements in the demand outlook and geopolitical risks underpin oil prices	Neutral	A modest increase in the supply/demand balance should cap further gains
Alternatives	Precious metals	Negative	Lack of carry and momentum may weigh on the gold price	Negative	Lack of carry and momentum may weigh on the gold price
Alternatives	Industrial minerals	Negative	Supply should weigh on prices as iron ore is above marginal cost and copper mine supply increases	Neutral	Growth will support further industrial metal prices although the pace of industrialisation will slow

Important Notes:
Main source of information: Datastream, Bloomberg

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