FINANCIAL PARTNERS

VIEWPOINT

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Newsflash

A new month and the 78th issue of Viewpoint from FP.

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Market commentary

March can be divided into two distinct halves. After a strong start to the month, events in Cyprus – a country which represents less than 0.25% of total Eurozone GDP – halted the smooth upward progress of markets and acted as a reminder to investors that the Eurozone crisis is by no means behind us. Yet if there was a contagion effect it was essentially restricted to peripheral Europe. For the month as a whole the MSCI World index ended up by 2.3%, the S&P 500 index added 3.7%, and Japan finished up by 7% (returns in local currency terms). In contrast, stocks in the euro area were flat for the month, after falling by 3.6% following the announcement of the first Cypriot bailout plan in the middle of the month. Looking at the range of returns in Europe, Spain's IBEX index declined by 3.7% (after falling by 8.5% post the announcement), Italy slipped by 3.7%, whilst Greece and Portugal felt the effect of events in Cyprus even more acutely.

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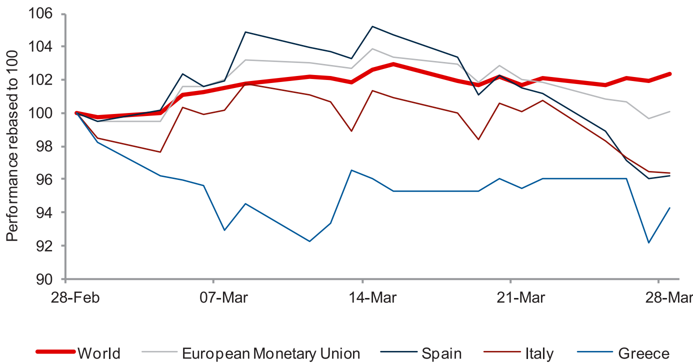
Figure 1: Equity markets react to events in Cyprus



The Cyprus effect was not restricted to equity markets. From the middle of the month, yields on peripheral European bonds rose sharply, with Spanish 10 year bonds adding 33 basis points (bps) to end the period at 5.1%; Italian bonds +20 bps to 4.8%; Portugal +50 bps to 6.4%, and Greece +200 bps to 12.5%. In contrast, yields on German 10 year government debt fell by 26 bps to 1.26%, within touching distance of their all time lows of 1.17% seen in early 2012. Other perceived 'safe haven' government bonds also saw yields move in: the US 10 year treasury yield ended the period just above 1.8%, down from 2.1% in the middle of the month; UK gilt yields fell to 1.7% from 2.1% pre Cyprus' announcement. In currency markets, the euro and the yen both fell by 1.8% versus the US dollar, although the latter's pace of decline appeared to slow over the period.

Figure 2: Bond markets witness a flight to perceived quality

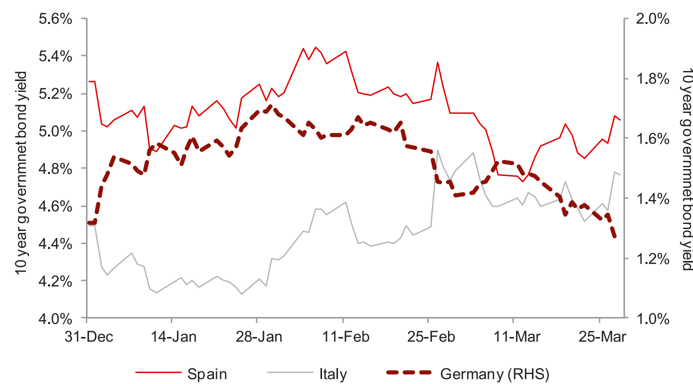
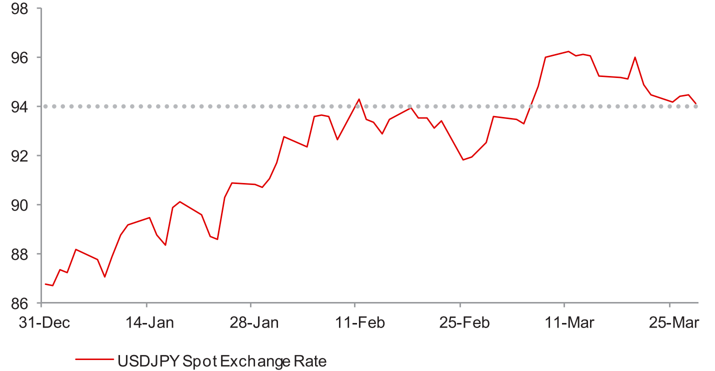


Figure 3: Japanese yen moves above USDJPY 94



Emerging markets (EM) were notably weaker than developed markets for the third month in a row, with EM equities declining by 1.7% in March, to leave them down by 1.6% for the year compared to gains of 7.7% for developed markets. Since equities began their latest rally in mid November, developed markets have added 15%, compared to 7% for EM.

Cyprus' predicament is a result of its substantial banking business, with banking assets amounting to eight times the country's national output. Cypriot banks lent substantial amounts of money to Greek banks and suffered significant losses as a result, leaving the country's two main banks needing huge capital injections. Cyprus has needed a bailout from its EU partners for over a year. Whilst the sums involved are small EUR 17 billion in total; a fraction of the amount lent to Greece Cyprus' European partners have been reluctant to bailout the country's many offshore bank account holders. The initial deal announced in mid March proposed that all depositors in Cyprus' two big banks should be 'bailed-in' to some degree, including insured depositors; i.e. those with deposits worth less than EUR 100,000. This proposal caused consternation amongst investors, representing, as it did, a major shift in policymakers' approach to bailing out peripheral Europe. Cyprus' parliament rejected the deal, pushing the country towards the brink of bankruptcy. A major crisis was avoided at the last minute, with a deal unveiled just before the European Central Bank (ECB) withdrew all liquidity support for Cyprus' banks. Under the terms of the new deal, insured depositors will be protected, whilst all uninsured depositors in the two big banks will lose a sizeable portion of their deposits - thought to be around 30% - to cover the EUR 6 billion of funds which Cyprus needs to raise in order to receive an additional EUR 10 billion from the Troika (the European Commission, the International Monetary Fund

Source: Bloomberg. Returns in US dollars unless otherwise stated. March 2013.

and the ECB). Cyprus' banks reopened on 28 March, subject to strict capital controls in order to avoid large capital flight. The retrenchment of Cyprus' financial sector will materially impact growth for many years to come, but given the country's relative size these effects have limited significance outside of Cyprus. What matters is whether the terms of the bailout, which 'bail-in' depositors, are likely to form a new template for intervention in future. Peripheral European markets reacted by selling off, in a sign that investors are beginning to discount some of this perceived additional risk into equity prices. There is a case to be made that Cyprus is a one-off due to its offshore banking status and alleged connections with money laundering, which the rest of Europe has been keen to address for some time. Nevertheless, there is a heightened risk of spill over from this latest crisis, leading to weakness in peripheral European banking paper, and equity and bond markets.

Whilst it is clear that the impact to date has been restricted to Europe, and specifically peripheral Europe, it is a timely reminder to investors that all is not well in the Eurozone. This has been emphasised by a series of disappointing data prints in recent months, with generally weak numbers from purchasing managers (the closely watched PMI series), and the downgrade of growth expectations for 2013. The situation has not been helped by the fact that Italy is still without a government, more than a month after the general election. It looks now as if there will have to be a re-run, prolonging the uncertainty and in turn the risk of economic weakness.

In contrast the US economy continues to run ahead of expectations, with unemployment now down to 7.6%, its lowest level since December 2008. With the manufacturing sector also showing signs of resurgence and consumer confidence on the up, commentators have begun to speculate that the Federal Reserve may accelerate plans to scale back its asset purchase programme (quantitative easing). Federal Reserve Chairman Ben Bernanke has continued to emphasise the importance of the programme, however, stating that the Fed will "keep providing support for the economy and see how things evolve".

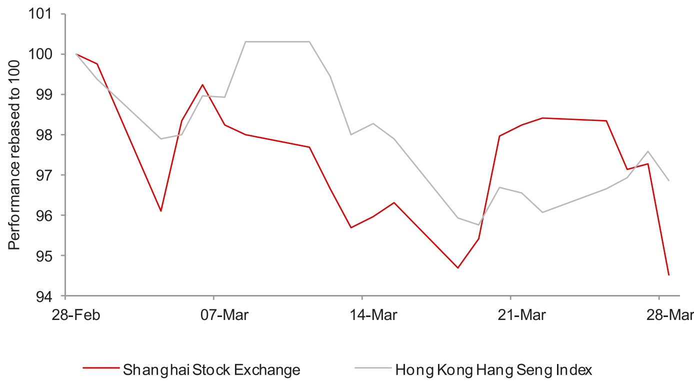
Japan continued to perform well last month, with confirmation of Haruhiko Kuroda's appointment as the new governor of the Bank of Japan (BoJ). In a particularly dovish set of remarks, Mr. Kuroda said that he will do whatever it takes to defeat deflation, and is open to the idea of buying longer dated Japanese government bonds (JGBs) alongside other aggressive easing measures. 10 year JGBs yields duly fell to 0.5%, a decade low for the benchmark rate, and the equity market continued to rally hard.

News from the UK economy was mixed last month. Chancellor George Osborne stuck resolutely to his austerity programme in his Spring statement, whilst admitting that faltering growth has extended the time it will take for public debt to fall to target levels. Notably, the Chancellor loosened the Bank of England's mandate to target inflation, indicating that there should be a greater focus on employment and growth when economic conditions are tough, as is the case at present. Markets can look forward to further monetary easing when the new Bank governor (Mark Carney) takes up office in June, especially with the economy apparently stagnating, although several indicators, such as employment and business confidence, suggest a gradual pick up as we move through 2013. Hence it appears that inflation is being downgraded in importance, and whilst the impact of this decision may not show up for some years, it is extremely likely to have an impact in the long term.

In a sign of growing concerns about the impact of US monetary policy on asset values (notably property) in countries closely linked to the dollar, Hong Kong, Singapore and China all imposed tough conditions on property lending and speculation, including increased down payments, mortgage rates and lending controls, as well as additional taxes on purchases. The Chinese stock market weakened by 5% during the month, whilst Hong Kong's Hang Seng index fell by 3%.

Source: Bloomberg. Returns in US dollars unless otherwise stated. March 2013.

Figure 4: Asian equity markets react to new measures to contain asset price growth



Markets have enjoyed a strong run in the past six months and the fundamental backdrop certainly appears to have improved, with tail risks substantially reduced. Recent events, however, serve to remind investors that serious problems remain, not least of all in Europe. While Cyprus may represent an exceptional case, the response of policymakers has heightened concerns that future bailouts will involve much greater private sector participation than seen previously. While Cyprus remains in the euro, a euro deposited in a Cypriot bank account may not be equivalent to one held elsewhere, a situation that would only be remedied by a full banking union. In addition, the process of deleveraging and rebalancing which has been underway since the global financial crisis burst has some time to run yet. This will keep growth relatively subdued and competitive conditions for companies will remain tough. A period of consolidation in markets appears to be underway, which is arguably a healthy development given their recent strength.

Source: Lipper Hindsight / Bloomberg. Returns in US dollars unless otherwise stated. December 2012.

Market performance

Asset Class/Region	Index	To 29 March 2012		
		Currency	Month	Year to date
Developed Markets Equities				
United States	S&P 500 NR	**USD**	3.7%	10.4%
United Kingdom	FTSE All Share TR	**GBP**	1.4%	10.3%
Continental Europe	MSCI Europe ex UK NR	**EUR**	0.9%	5.6%
Japan	Topix TR	**JPY**	7.0%	21.5%*
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	**USD**	-0.5%	7.0%
Global	MSCI World NR	**USD**	2.3%	7.7%
Emerging Market Equities				
Emerging Europe	MSCI EM Europe NR	**USD**	-1.7%	-2.6%
Emerging Asia	MSCI EM Asia NR	**USD**	-2.3%	-1.4%
Emerging Latin America	MSCI EM Latin America NR	**USD**	0.0%	0.9%
BRICs	MSCI BRIC NR	**USD**	-2.7%	-3.0%
Global Emerging Market	MSCI EM (Emerging Markets) NR	**USD**	-1.7%	-1.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	**USD**	0.1%	-0.2%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	**USD**	0.3%	-0.5%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	**USD**	0.0%	-0.1%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	**USD**	1.0%	2.9%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	**GBP**	1.8%	0.7%
UK Corporate (Investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	**GBP**	1.6%	1.6%
Euro Government Bonds	Citigroup EMU GBI TR	**EUR**	0.7%	0.4%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	**EUR**	0.5%	0.6%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	**EUR**	-1.2%	-1.2%
Japanese Government	JP Morgan Japan Government Bond Index TR	**JPY**	1.3%	2.5%
Australian Government	JP Morgan Australia GBI TR	**AUD**	-0.2%	-0.1%
Global Government Bonds	JP Morgan Global GBI	**USD**	-0.3%	-2.8%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	**USD**	-0.3%	-2.0%
Global Convertible Bonds	UBS Global Convertible Bond	**USD**	1.3%	3.5%
Emerging Market Bonds	JP Morgan EMBI +	**USD**	-1.0%	-3.3%

* estimate

Source: Bloomberg. March 2013.

Market performance

Asset Class/Region	Index	Currency	To 29 March 2013	
			Month	Year to date
Property				
US Property Securities	MSCI US REIT TR	**USD**	2.8%	7.8%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	-0.1%	3.2%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	-0.2%	0.7%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	**AUD**	-2.9%	5.0%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	2.9%	8.5%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	**USD**	2.3%	6.3%
Currencies				
Euro		**USD**	-1.8%	-2.8%
UK Pound Sterling		**USD**	0.2%	-6.5%
Japanese Yen		**USD**	-1.8%	-7.9%
Australian Dollar		**USD**	2.0%	0.2%
South African Rand		**USD**	-2.3%	-8.3%
Commodities				
Commodities	RICI TR	**USD**	0.4%	0.2%
Agricultural Commodities	RICI Agriculture TR	**USD**	-1.1%	-1.5%
Oil	ICE Crude Oil CR	**USD**	-2.8%	-1.0%
Gold	Gold index	**USD**	1.2%	-4.6%
Hedge Funds	HFRX Global Hedge Fund	**USD**	0.7%	3.1%
Interest Rates			**Current rate**	**Change at meeting**
United States	20 March 2013	**USD**	0.25%	-
United Kingdom	4 April 2013	**GBP**	0.50%	-
Eurozone	4 April 2013	**EUR**	0.75%	-
Japan	4 April 2013	**JPY**	0.10%	-
Australia	2 April 2013	**AUD**	3.25%	-
South Africa	20 March 2013	**ZAR**	5.00%	-

* estimate

Source: Bloomberg. March 2013.

Asset allocation dashboard

Positive	Neutral	Negative

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Positive
European equities (relative to developed)	Neutral
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Neutral
Emerging market equities	Positive
Fixed Income	
Government	Negative
Index-linked (relative to government)	Negative
Investment grade (relative to government)	Positive
High yield	Neutral
Loans	Positive
Emerging market debt	Neutral
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Hedge funds	Neutral
Property (UK)	Neutral
Currencies	
Dollar	Neutral
Euro	Negative
Yen	Negative
Emerging market currencies	Neutral

Source: Momentum Global Investment Management March 2013

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