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Newsflash

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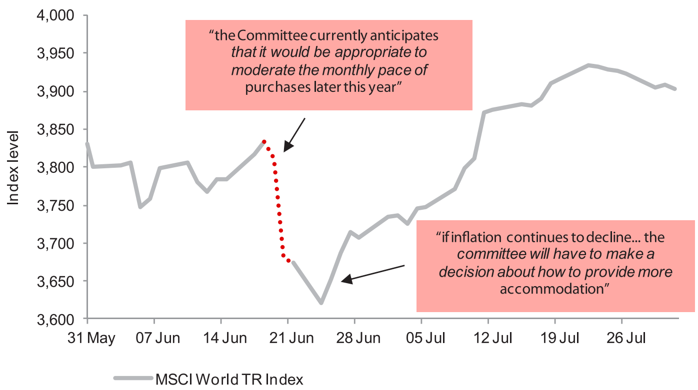
Market commentary

July saw a strong rebound by asset classes including equities, high yield and commodities, after the sell off that took place in late May and June. Developed market equities led the way and have now recovered the ground they lost during this most recent period of market weakness. June's sell off had been triggered primarily by talk from the US Federal Reserve (Fed) about reducing the rate of quantitative easing; in turn, the bounce back came after the Fed eased back on its hawkish rhetoric and other big central banks upped their forward guidance to allay investor concerns about a premature tightening of monetary policy.

Figure 1: Is 'Fed-talk' leading global equity markets?

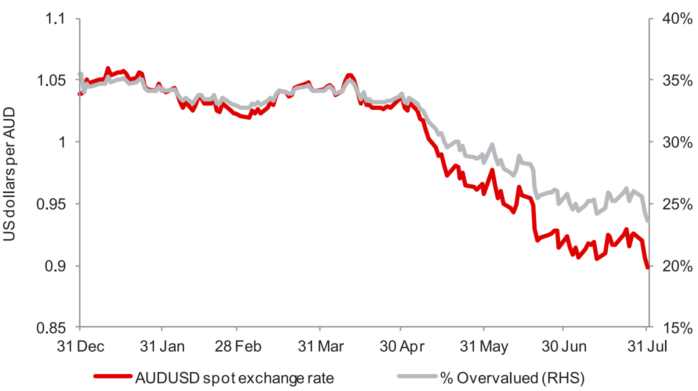


The MSCI World (developed markets) index returned 5.3% over the month, taking its year to date performance to 14.1% in US dollar terms. The US, which has led the way in recent months, returned 5%, behind the UK (6.8%) and Europe (5.5%). Japan continued its period of consolidation after the extraordinary rise in the previous six months, slipping by 0.2%, while Asia ex Japan also continued to underperform, rising by 3.3% to bring year to date returns to -1.5% in US dollar terms. Emerging markets managed a small rebound but continued their dramatic underperformance versus developed markets, rising by 1% in July to leave EM investors down by 8.6% year to date, compared to gains of 14.1% for developed markets.

Other traditional higher risk-return asset classes also rebounded. Commodities rallied into month end after falling sharply during the third week of July, with copper +2.2%, oil +4.6% and gold +7.3%, marking only the second month this year in which the precious metal has delivered a positive return. In fixed income markets, government bonds generally stabilised after the sharp falls seen in May and June, with US Treasuries down by 0.2%, UK gilts +0.8% and European government bonds +0.7%. Credit fared considerably better as sentiment improved, with US investment grade bonds adding 0.8%, US high yield +1.9%, European high yield +4.3% (in euro terms) and global convertibles +3.7%. EM bonds rallied over the month, albeit modestly with gains of 0.6%.

The most notable move in currency markets was the continued slide of the Australian dollar, down by 1.7% versus the US dollar, to take its year to date performance to -13.6%. Having been one of the most expensive currencies in the world the AUD is rapidly adjusting to a post commodity supercycle world and the reality of a sharp fall in activity in the economy as the mining industry shrinks (alongside an increasingly dovish central bank).

Figure 2: Underperformance leading Australian dollar towards fair value on the basis of OECD Purchasing Power Parity



The market's reaction to Fed 'tapering' warnings in May and June was dramatic, with bond yields rising across the world by around 1%. These moves represented an immediate tightening of monetary conditions and central banks spent July trying to allay the market's concerns about premature monetary tightening. With the economic recovery still in its infancy and debt levels remaining high across the developed world, central banks cannot afford a policy move which would choke-off the recovery before it becomes entrenched. For the first time in its 14 year history, the European Central Bank (ECB) offered guidance on the future path of interest rates, with the official communiqué stating that "The Governing Council expects key ECB interest rates to remain at present or lower levels for an extended period of time". The Bank of England followed suit, linking its interest rate policy to the unemployment rate.

In contrast to developed markets, monetary policy in a number of emerging markets continued to be tightened in response to weak currencies and resultant inflationary fears. India raised money market rates in July and tightened credit conditions for banks in order to stem currency weakness following similar action in Brazil, Turkey and Indonesia. This has been an important factor in the sustained underperformance of emerging market assets over the past 9-12 months. Equally important has been the deceleration of growth in EM, most notably in China. Here growth slipped further to 7.5% in the second quarter. Exports and imports both fell year-on-year in June, and most indicators appear to suggest that growth will remain under pressure. In response, China's authorities have been trying to bolster growth, whilst the central bank is taking further steps towards interest rate liberalisation. Faltering Chinese growth has been reflected in corporate earnings for companies in the developed world, with a number of major corporations including Apple, Coca-Cola and McDonalds all pointing to the negative impact of slower Chinese growth when they reported results.

As growth in the emerging world continues to slow, there was fresh evidence of a gradual and modest pickup in activity in the developed world during July. The US has managed to deliver reasonable growth despite a sharp fiscal contraction, with the effects of sequestration and fiscal tightening expected to take an estimated 1.5% out of GDP in the first half of the year. Although first quarter GDP growth was revised down again to 1.1%, Q2 GDP picked up to 1.7%. Most other indicators point

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

to a continuing steady improvement in activity: payrolls, a key indicator for markets given the Fed's focus on unemployment, were strong, retail sales grew by 0.4% in June, orders of durable goods rose by 4.2%, and housebuilding and house prices remain on a strong upward trend. The UK is showing increasing signs of strength, with second quarter growth well ahead of consensus expectations at 0.6%. Notably, conditions in Europe are also showing signs of modest improvement, with Euro area PMIs moving back above 50 for the first time in 18 months. The improvement was not reserved exclusively for Germany, with peripheral Europe also on an upward path, albeit from an extremely depressed base.

Further evidence of the early impact and success of Prime Minister Abe's reforms in Japan came with a positive CPI number of +0.2% year-on-year in June, the highest reading for a year, although the recovery is at an early stage. Importantly, the upper house elections in Japan gave Abe a clear majority and mandate for reform, giving control of both chambers of the Diet to the Liberal Democratic Party (LDP). This ensures that Abe has a full three years before the next election and a strong platform from which to push forward with the third of his 'three-arrows' policy, the much needed structural reforms and liberalisation of the Japanese economy. The market is waiting anxiously to see whether he will be able to enact such reforms, a feat which has eluded all previous PMs in recent years.

The issue which is likely to have by far the biggest impact on markets in coming months remains the decision to be made at the Federal Reserve about QE tapering. The decision to taper will be entirely data dependent, so the markets will remain highly sensitive to news on the economy and in particular on payrolls and unemployment. It is important to remember that the Fed will initially taper QE rather than stopping asset purchases outright (and so policy will remain very loose for another year at least), and that interest rates will not be raised for a further period, possibly as long as two years from now.

Against this background, and with developed world economies gradually picking up, the environment for equities remains supportive. Bond markets face a more difficult period, and have started out on the path to some form of interest rate normalisation. The sharp increase in yields on bonds in the past two months has discounted to some extent the initial QE tapering move but further rises in rates are highly likely in the next couple of years. It remains important to protect portfolios from these expected moves with a shortening of duration in fixed income and the use of securities such as floating rate notes which protect from interest rate rises.

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

Market performance

Asset Class/Region	Index	Currency	Month	Year to date
			To 31 July 2013	
Developed markets equities				
United States	S&P 500 NR	USD	5.0%	19.2%
United Kingdom	FTSE All Share TR	GBP	6.8%	15.9%
Continental Europe	MSCI Europe ex UK NR	EUR	5.5%	10.4%
Japan	Topix TR	JPY	-0.2%	33.1%*
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	3.3%	-1.5%
Global	MSCI World NR	USD	5.3%	14.1%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	2.4%	-9.3%
Emerging Asia	MSCI EM Asia NR	USD	1.3%	-5.4%
Emerging Latin America	MSCI EM Latin America NR	USD	-1.0%	-15.7%
BRICs	MSCI BRIC NR	USD	1.4%	-11.4%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	1.0%	-8.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.2%	-2.7%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.7%	-7.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.8%	-2.6%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.9%	3.3%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	0.8%	-2.4%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	2.0%	0.6%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.7%	0.8%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.8%	0.9%
Euro High Yield	BofA Merrill Lynch Euro High YieldConstrained TR	EUR	4.3%	5.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3%	0.9%
Australian Government	JP Morgan Australia GBI TR	AUD	0.7%	0.4%
Global Government Bonds	JP Morgan Global GBI	USD	1.1%	-4.7%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.2%	-3.2%
Global Convertible Bonds	UBS Global Convertible Bond	USD	3.7%	9.3%
Emerging Market Bonds	JP Morgan EMBI+	USD	0.6%	-8.8%

* estimate

Source: Bloomberg. July 2013.

Market performance

Asset Class/Region	Index	Currency	To 31 July 2013 Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	0.8%	6.6%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	8.1%	18.3%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	3.1%	2.6%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	-0.8%	7.6%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	-0.3%	-0.2%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	1.2%	3.6%
Currencies				
Euro		USD	2.2%	0.8%
UK Pound Sterling		USD	0.0%	-6.4%
Japanese Yen		USD	1.3%	-11.4%
Australian Dollar		USD	-1.7%	-13.6%
South African Rand		USD	0.2%	-14.2%
Commodities & Alternatives				
Commodities	RICI TR	USD	3.3%	-4.1%
Agricultural Commodities	RICI Agriculture TR	USD	-0.8%	-8.7%
Oil	ICE Crude Oil CR	USD	4.6%	-3.0%
Gold	Gold Spot	USD	7.3%	-20.9%
Hedge funds	HFRX Global Hedge Fund	USD	1.0%	4.2%
Interest Rates			**Current rate**	**Change at meeting**
United States	31 July 2013	USD	0.25%	-
United Kingdom	1 August 2013	GBP	0.50%	-
Eurozone	1 August 2013	EUR	0.50%	-
Japan	8 August 2013	JPY	0.10%	-
Australia	6 August 2013	AUD	2.50%	-0.25%
South Africa	18 July 2013	ZAR	5.00%	-

* estimate

Source: Bloomberg. June 2013.

Asset allocation dashboard

🟢 Positive	🟡 Neutral	🔴 Negative

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

Source: Momentum Global Investment Management June 2013

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