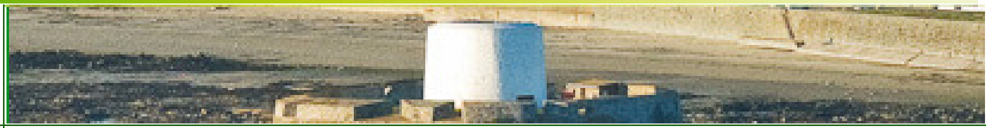
cannon asset management

newsletter

September 2013

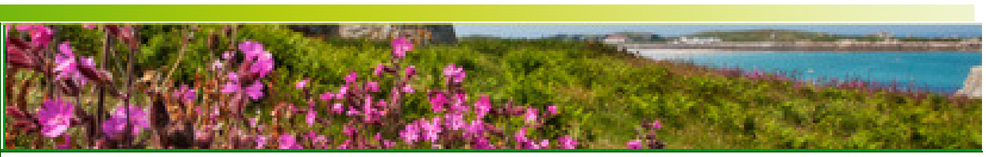


Summary

The long term direction of interest rates is clear as the US economy normalises, albeit to a lower rate of growth than prior to 2008. Rates are going up and this is going to cause reversal of capital flows that fled from the concerns of the developed world following the credit crisis. Obviously problems still exist in the US, Europe, UK and Japan but other economies will have to compete for capital, particularly with reference to US markets and returns. This will not be a smooth process and reversals can be expected periodically.

Equity markets are roughly fully valued and further gains will depend upon rising earnings rather than the expansion of the PE multiples, which has been the source of recent gains. Cyclicals are therefore important going forward. Only Emerging markets appear relatively cheap at the moment.

Markets



Fixed Interest

We are in a global interest rate tightening environment based on a US economic recovery. The path will be punctuated by spasms of bond price changes, rather than a smooth trend.

Short Rates

Currently US interest rates appear near optimal based on long term inflation, real return and unemployment inputs. However, forward rates are too low once inflation and unemployment forecasts are considered. These inputs are probably too high, not reflecting weak tax revenues and labour participation rates.

Estimates of UK short rates indicate that they are too low, by about 2%. European rates are too high however, but this depends upon the assumed level of employment. The target of of 10% (IMF forecast) unemployment results in current rates being about right for the economy as a whole given current level of circa 12%.

Longer Rates

Developed countries 10 year bond yields have fallen from their highs earlier in the year but are beginning to reflect a longer term recovery. Long term rates of 4-5% on 10 year US Treasuries should be expected.

Credit & Emerging Markets

Generally corporate bonds offer limited gains. An exception are high yield bonds which do not reflect lower expected default rates. Improving economies and profits make these lower default more likely and returns better than expected.

Emerging market debt was badly hit during May and June with the change in sentiment about bonds. Bonds issued by soundly financed countries with good trade positions and FX reserves have been oversold. These issues have the highest potential return of any region.

Themes & Ideas

The great bull market in bonds since 1979 is probably now over. Bond rallies will occur if economic performance deteriorates however. Consequently investment managers who were successful during the bull market may struggle to adapt to this new world. Simply holding assets (which rise due to falling inflation, falling interest rates and the reduction of bond maturities) will not work as effectively as before.

Equities

Broadly speaking equities are about fair value and only emerging markets look under valued on 5 and 10 year views - though estimates vary. The region with the best returns is likely to be emerging markets, due to sell offs since May. (GMO estimates 6.9% real returns on a 7 year view.) Also smaller companies have run up and now offer lower returns relative to large companies in many developed markets.

The US remains the most expensive equity market on a 5 year view and roughly fair value on 10 year figures. Switzerland is also expensive, per the ten year figures and the UK is expensive on 5 year but not 10 year figures.

Outlook

Quantitative easing is likely to be gradually withdrawn in the US, depending upon economic performance, commencing sometime in the next 12 months. An increase in short term interest rates by central banks is not currently likely: long term interest rates are rising, anticipating recovery. If carried out carefully eventual interest rates increases may not impact equities adversely, as normal interest rate levels should sustain economic growth for longer.

The UK may also experience a similar process but with a time lag behind the US which might be beyond 12 months. The UK pace of normalisation will be in part determined by whether the Euro experiences further crisis moments which cause economic activity to fall again from currently stabilizing levels. Also Domestic politics is starting to deter investment (possibly deliberately) which could dampen returns.

In recovering developed economies the focus is on moving from exports and non-cyclical investments to more domestic and cyclical companies. The opposite is true for developing economies, which will come under funding stress due to the renewed stability and attractiveness of developed market assets.

US Equities

US household net worth is rising, housing market is in about its second year of recovery and debt servicing costs remain low. The cyclical side of the US economy is in recovery. Government deficits should improve, but the higher taxes and lower spending will continue to impede growth. Some sources think this will lift next year adding 1.5% to GDP!

UK Equities

Unemployment, consumer & business confidence and retail sales are all improving. Domestic growth appears to be taking hold at last, but this is still a fragile domestic recovery. A close election in 2015 is already disturbing long term investors however.

Europe Equities

European economic activity seems to be improving with higher PMI figures, lower unit labour costs (relative to Germany) and improving trade balances in key peripheral countries. After 18 months of recession, economies appear to be stabilising.

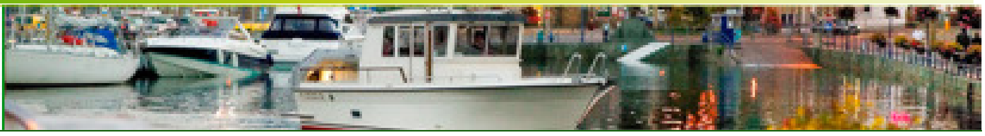
Japan Equities

Japan appears to be engineering a reduction in deflation, with inflation now running at -0.10% pa. Growth is picking up but gross debt remains high relative to GDP.

Emerging Markets Equities

Emerging market profitably has fallen relative to developed markets over the past 2-3 years. Equity market returns since December 2012 have fallen about 20%, outpacing the decline in profitability leaving the markets good value. MSCI EM index is now on 10.1 times earnings and is below its 27 year average.

Contact Us



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