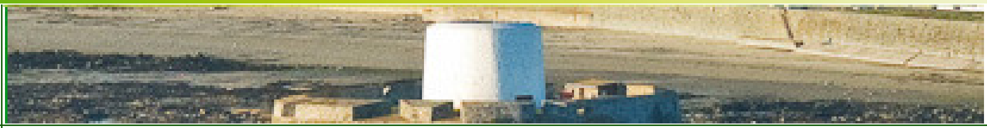
cannon asset management newsletter

January 2013



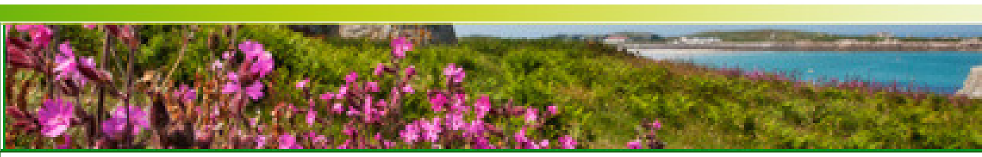
Summary

Little has changed around the globe over the past thee months and so our comments below are broadly similar to our last commentary. Our strategy remains the same apart from minor changes. We have added some points and updated the commentary where appropriate.

The long term direction of interest rates is clear as the US economy normalises, albeit to a lower pace of growth than prior to 2008. Interest rates are going up and this is causing a return of capital that fled from the concerns of the developed world following the credit crisis. 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. The adjustment will not be a smooth process and reversals can be expected periodically. Even US economic prospects are weak and not robust.

Equity markets are roughly fully valued and enduring gains will depend upon rising earnings rather than the expansion of the price earnings (PE) multiples which have been the source of recent gains. Cyclicals are therefore important going forward. Only Emerging Markets appear relatively cheap at the moment. Even so, a move to over valuation is entirely possible through further PE multiple expansions.

Markets



Fixed Interest

We are in a global interest rate tightening environment based on a US economic recovery. Weak growth means set backs or shocks are quite possible, so price trends will be punctuated by spasms of sudden bond price changes.

Short Rates

Currently US interest rates appear near optimal based on long term inflation, real return and unemployment inputs but are too low based on current inflation and unemployment forecasts. It is possible that current forecasts are too high, not reflecting weak tax revenues and low labour participation rates.

Estimates of UK short rates indicate that they are too low, by about 2%. European rates were lowered in November but remain too high for the current unemployment level of 12%. At 10% unemployment (the IMF forecast) results in current rates being about right for the Euro area but there is little sign of improvement.

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. Their current yield is 2.97%.

Credit & Emerging Markets

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

Emerging market debt was badly hit in May and June due to concerns about US tapering of quantitative easing. Bonds issued by soundly financed countries with good trade positions and foreign exchange reserves have been oversold. These issues still have the highest potential return of any region.

Bond Themes & Ideas

The great bull market in bonds since 1979 is probably now over. Bond rallies will occur however if economic performance deteriorates. Consequently simply holding bonds (which rise in value due to falling inflation, falling interest rates and the maturing of bonds while held) will not work as effectively as before. We expect longer rates to increase, steepening yield curves but capital losses will be offset by maturing bonds. Credit spreads have narrowed as non-government bonds have so far been less affected by increases in government yields.

The correction of prices in May and June was part of the above process which left few bonds unscathed. It is interesting to note that even highly active managers struggled and were shocked at the drop in all fixed income instruments. Actual tapering of US central bank intervention has not caused a further panic, but cash may be the only safe asset during a future correction.

In Europe, a fiscal and banking union is required for the Euro along with economic reforms. However, most parties are failing to address these strategic issues without an immediate crisis. Consequently unemployment and de-industrialisation are grinding away in Spain, Portugal, France and Italy - but particularly in the latter two due to uncompetitive employment costs. Anti-Euro sentiment is building, led by French and Italian political parties, which may ultimately lead to compromises and reform. Alternatively, an economic shock could lead to another market panic. In either case, all economies may be subject to rapid currency and interest rate changes, including Germany.

Equities

Broadly speaking equities are about fair value and only Emerging Markets look under valued on 5 and 10 year views - though estimates vary.

Emerging Markets are better valued due to sell offs since May. GMO's estimate is now 3.4% in real returns, at end of November 2013 on a 7 year view. Developed markets' smaller companies are relatively expensive and offer lower returns compared to large companies. US high quality stocks are better value than other sectors, but prospective returns are below both Emerging Markets and the 6.5% long term real return of US equities. International equities continue to offer better value than their US counterparts.

US Equities

US household net worth is rising, housing is in a 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 taxation, poor wage growth, low inflation and lower spending will continue to impede the economy. Some sources think flat tax rates in 2014 will add 1.5% to GDP this year!

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 based mostly on yet more consumer debt. An election in 2015 is already disturbing long term investors. UK equities are cheap compared to US equities.

European Equities

Europe remains relatively cheap compared to the US, so this is probably the time to consider increasing equity exposure there, particularly in global multinationals. However, the Euro and government finances could make this quite eventful.

Japan Equities

Japan appears to be engineering a reduction in deflation, inflation is 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.

Economic

Quantitative easing is now gradually being withdrawn in the US as of December but

Outlook

remains dependent upon economic performance. An increase in short term interest rates by central banks is not currently likely: long term interest rates are rising, anticipating recovery and affecting investment particularly housing. If carried out carefully, interest rate increases may not impact equities adversely: normal interest rate levels should sustain economic growth for longer. Nevertheless, US growth is fragile and a shock could damage both the recovery and equity values.

The UK is lagging the US. There are signs that tightening of money supply will take the form of lending restrictions and capital requirements for banks rather than interest rate increases. The UK recovery appears to be accelerating due to housing and yet more consumer indebtness. The UK pace of normalisation will be in part determined by whether the Euro experiences further crisis events and a fall in economic activity from currently stable levels. Domestic politics are starting to deter UK investment which could dampen investment decisions.

Deflation could yet prove catastrophic for the Eurozone and some member countries. Since September the ECB has lower interest rates but they remain too high. Low inflation in Western and Eastern Europe, high accumulated deficits, low growth and continuing deficits are toxic, particularly for countries like France, Italy and Spain. As large constituent economies of the Euro Zone, their issues must be addressed. France is a lynch pin for the whole of the Euro and EU, so a long running crisis is not over.

Germany's long term growth forecast of 1.0-1.5% cannot rescue other members in aggregate and the new coalition government has no appetite to complete a true currency union. Increased political opposition to austerity in hard pressed countries may undermine the entire Euro project, with repercussions dependent upon how any exits are managed. Nationalist popularity in France and Italy is the first sign of this new phase to the Euro crisis.

Despite the foregoing, European economic activity is currenty 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. Though improving most countries, remain uncompetitive vs Germany and the world, particularly Italy and France.

Themes & Ideas

Developed Market Equity Themes

For recovering developed economies the investment focus is moving from exports and non-cyclical investments to more domestic and mid cycle companies. The opposite is true for developing economies, which are under stress due to the renewed stability and attractiveness of developed market assets.

Emerging Market Spending & Relative Value

Emerging market weakness is starting to cause surprises in the performance of firms with heavy growth exposure to that part of the world. This may prove to be an excellent buying opportunity for this long term structural growth theme.

Global Re-Balancing

Large current account deficits exist between countries, where imports displace domestic goods or services. Over the longer term this cannot continue. Either competitiveness of importing countries must improve or their currency devalues to re-balance these trade relationships. At the moment there are large imbalances within the Euro area between Germany and Southern European economies. China is in surplus with Europe and the US. When these trade balances correct, local sourcing is needed, presenting investment opportunities. Rebalancing should improve government finances, unemployment and consumer spending in deficit countries. Surplus countries should experience the opposite effect, if domestic consumption does not replace export demand.

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