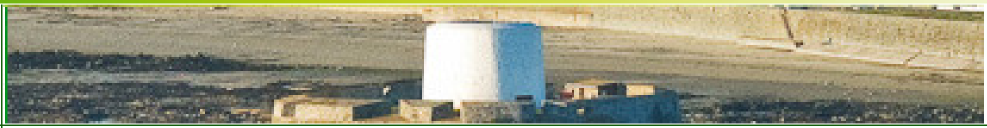
cannon asset management

newsletter

March 2014



Summary

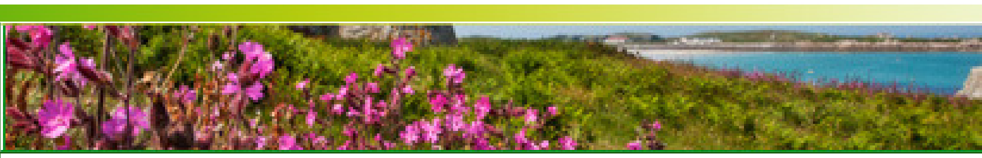
Tightening in China and the US are the most significant developments that markets must deal with currently. The impact on weak Emerging Market economies and members of the Euro could set off another period of market corrections. Japan appears determined to revive its economy through cheap money and devaluation of the Yen. Though welcome, this policy could have adverse impact on other exporting nations especially in Asia.

The Ukraine's predicament is virtually irrelevant to the world economy, except that sanctions against Russia could produce unintended consequences for Europe. We have already taken profits on a short term trade in a Russian equity for some clients.

US growth may continue to run until 2018 and longer dated bond interest rates are rising towards our long term target of 4-5% (10 year bond). Corporate bonds and high yield bonds remain vulnerable to inflation, earnings disappointments or M&A activity.

Eventually surprises will unsettle equity markets and reversals of 5-10% could occur, particularly if centred on corporate bond markets. The equity market corrections during December, January and (perhaps) March were of this magnitude but were short lived. We think this is because markets are not over valued and remain in a bull market supported by economic growth.

Markets



Fixed Interest

Most countries' long term Interest rates are rising due the US economic recovery, irrespective of their local circumstances. Developed market short term rates should not rise until at least the end of the year, as tapering of US Quantitative Easing must be completed first.

Short Rates

Currently US interest rates should be 0.7% higher based on long term inflation, real return and unemployment inputs. It is possible that these input estimates are too high, not reflecting weak tax revenues and low labour participation rates.

Our estimates of UK short rates indicate that they remain too low, by about 2%. European rates are about 1.5% too high for the current unemployment level of 12% and are about right for 10% unemployment assuming no price inflation.

Longer Rates

Developed countries' 10 year bond yields have fallen from their highs last 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 2.60% compared to 2.97% in December.

Credit & Emerging Markets

Generally corporate bonds offer limited gains, particularly as government bond yields rise, narrowing their interest rate spread with corporate bond yields. High yield bonds offer limited value too, as yields have sunk. Improving economies and profits make lower defaults more likely, but increasingly this is reflected in yields.

Emerging market debt was badly hit in May and June last year due to concerns about

US tapering of Quantitative Easing. Bonds issued by soundly financed countries with good trade positions and foreign exchange reserves continue to be oversold. These issues still have potential but the timing of their recovery is uncertain.

Bond Themes & Ideas

The great bull market in bonds since 1979 is probably now over. Bond rallies for government bonds will occur however if economic performance deteriorates, depending upon prevailing yields. A panic could erupt about individual European countries due to deflationary stresses (please see below). Corporate bonds may be vulnerable depending upon the nature of any slowdown, earning disappointments or takeovers. Simply holding low yielding bonds is not our preferred strategy and we expect longer rates to eventually increase further..

In Europe recapitalization of banks remains to be addressed. The current round of stress tests are forcing some re-structuring of impaired loans but March's agreement on a Euro banking union agreement leaves countries vulnerable to this and any new crisis. Consequently Europe faces great challenges and the potential for a "Japanese" future if the European Central Bank cannot intervene and other policies remain unchanged.

Deflation is stalking Europe, causing unemployment and de-industrialisation threats to Spain, Portugal, France and Italy - but particularly in the latter two due to uncompetitive employment costs. (Shrinking levels of bank lending due to bank stress tests should weaken economies further.) Countries most exposed to Emerging Market exchange rates and deflation – Cyprus and Greece for example - may require further crisis measures. Anti-Euro sentiment is building but may now be leading to compromises. An economic shock and market panic could destabilise the Euro zone, resulting in rapid currency and interest rate changes for member countries, including Germany.

Tapering of US central bank bond purchases has not yet caused another panic, but may do so at some point. We expect tapering will be completed by the end of the year, provided it is not damaging the US economic recovery. An increase in short term rates in about one year's time cannot be ruled out if tapering is successful.

Equities

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

Markets may go higher on improved cyclical profits underpinned by economic recovery, increased dividend yields, share buy backs from historically low levels, increased debt to enhance equity returns, increased M&A activity and reduced pension liabilities due to bond and equity market gains.

Enduring gains will depend upon rising earnings rather than the expansion of the price earnings (PE) multiples of recent years but markets could move to over valuation through further expansion of current PE multiples.

Cyclicals remain important going forward and smaller companies are more expensive than 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.

Emerging Markets are better valued due to sell offs since May 2013. GMO's estimate is now 4.1% in real returns at end of February 2014, on a 7 year view.

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 poor wage growth, low inflation and lower government spending will continue to impede the economy.

UK Equities

UK equities are cheap compared to US or most other equity markets but the potential for a Labour election victory in 2015 is disturbing long term investors. The March budget forecasts about a 6.6% government deficit and little improvement in government debt for years. This is despite much improved growth, unemployment, retail sales and consumer & business confidence. Domestic growth is still fragile, based mostly on yet more consumer debt.

European Equities

Little has changed except for Russia creating uncertainty about the future, though there are initial signs of deflation being addressed by policy makers. Europe remains relatively cheap compared to the US. Multinationals are most attractive. However, the Euro and government finances could make this quite eventful.

Japan Equities

Prior devaluation of the Yen benefited equities and the economy. Japan appears to have engineered lower deflation at last - inflation for 2014 is expected to be 1.2% and 5 years expectations are above 2%. Growth is picking up and equities could rally more but gross debt remains high relative to GDP which could cause significant problems.

Emerging Markets Equities

Emerging market company profits have 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 Developed market profitability leaving the markets good value. FTSE EM index is now on 9.6 times next year's earnings.

Economic Outlook

Global growth of 3.5% this year is possible with higher growth in 2015. The US should see 3.2%, UK 2.7% Eurozone 1.1%, Emerging Markets 5.1%.

Mixed data from the US and China (the largest source of global growth) is part of the adjustment process of maturing US growth and restructuring of Chinese growth. Europe and Japan are the global laggards which may have the biggest impact on global growth. The normalisation of US interest rates is placing stress on other economies.

China remains a large risk as the government tries to reduce lending, increase domestic consumption and introduce market forces to domestic debt markets. The country risks a significant economic shock and is the largest source of global growth. (See Themes and Ideas below.)

Europe has stabilised but we remain unconvinced that growth is robust, despite improving leading indicators and strong exports demand. The Ukraine's predicament is virtually irrelevant to the world economy, except that sanctions against Russia could produce unintended consequences for Europe. With poor strategic underpinnings to the Euro, much could still go wrong in a slow fashion. Deflation pressures are not easing; Euro strength and poor lending growth mean the continent may yet experience a decade of little growth. Lending in southern Europe needs to recover and competitiveness improve.

As of February producer price indices in most of the Euro area and outside it are now negative to flat, a clear sign of danger. In the last two weeks Germany central bankers, politicians, the ECB and the IMF seem to be addressing the deflationary threat. Bundesbank officials are softening their views, Italy's requests for greater spending are being heard with sympathy and EU regulations are changing to support more lending to smaller firms. These are early signs Europe may be addressing deflation threats to the peripheral countries and the Euro.

Japan is now trying to move into a second phase of its recovery and expansion. Further central bank easing will be limited, but it is important for inflation to take hold and growth increase further. Reforms are now required to the economy.

Emerging markets will likely become more diverse in their prospects. Sound economies will prosper, but weak ones will suffer. This is a more normal state of affaires compared to the past 6 years.

Themes & Ideas

Little change - our views evolve, usually slowly as events unfold and we tend to follow a value philosophy which results in measured changes in portfolios. Here are some of our thoughts.

China, Debt & Growth

China has approximately 200% debt to GDP and its borrowing is expanding at twice the rate of economic growth. Mathematically, it is possible for borrowing to grow at its current pace without the country's debt becoming unsustainable. Policy makers need to re-balance away from exports & investment to consumption from savings. They are trying to do so, in part through less government influence and more market influence in banking & debt markets.

However, this adjustment carries large risks due to the quality of past lending - many loans are unlikely to be of good quality. Much lending was made in an overheated property market, for unwise public infrastructure or to loss making companies. Unwinding such lending is fraught with difficulty as we have seen in Western economies. An added complication is the priority of the Communist party to remain in power based on rising standards of living. A reformed banking and welfare system could release significant savings for domestic consumption but a banking crisis would make matters worse.

Developed Market vs Emerging Market Equity Themes

We are looking into investments in healthcare in these countries as it is more stable than other sectors and yet grows significantly above Western rates.

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 Emerging economies, which are under stress due to the renewed stability and attractiveness of Developed market assets.

Emerging Market Spending & Stock Values

Emerging market weakness is causing 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. As these trade balances correct, local sourcing is needed, presenting investment opportunities.

Large imbalances exist within the Euro area between Germany and Southern Europe. These imbalances are now correcting with the collapse of economic activity in the South. China remains in surplus with Europe and the US.

Improved government finances, lower unemployment and higher consumer spending should be seen in deficit countries with time. Surplus countries should experience the opposite effect, if domestic consumption does not replace export demand. Turkey, the Ukraine and South Africa are examples where currency devaluation is part of the correction process.

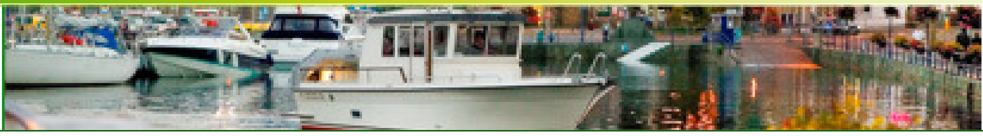
BRICs& Global Growth

Jim O'Neill, formerly of Goldman Sachs, coined the term BRIC, but his concept has been misunderstood. He identified countries that were 3% of global GDP or could be within 20 years, making them important.

The European and US economies amount to about half of global GDP, though with slow growth rates. The largest fast growing economies should produce twice the growth of these mature economies. Exporting to the second group will help pull Western economies out of their stupor, provided the difficulties of individual high growth economies, such as China, do not undermine that strategy.

By extension, current US tightening, Japanese currency devaluation and European austerity needs to avoid causing a ***<u>general crisis</u>*** among the other half of the world's economy particularly with China attempting to re-balance its economy at the same time.

Contact Us



Address: Cannon Asset Management Limited
Kingsway House, Havilland Street
PO Box 393
St Peter Port, Guernsey
Channel Islands
GY1 3FN

Tel: +44 1481 726141
Email: Investments@cannonhouse.com
Web: www.cannonhouse.co.za