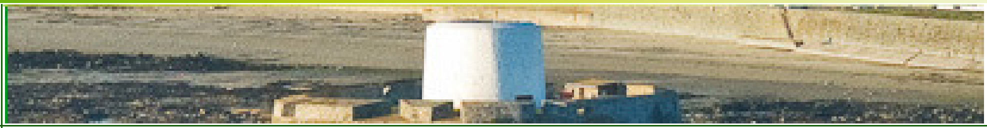
cannon asset management

newsletter

July 2014



Summary

We are now in the seasonally weak time of year for equities, so risk exposures should be reviewed. After last year's equity performances, markets may well struggle this year, especially at this juncture. We still think 5-10% corrections could occur, particularly if centred on corporate bond markets. Market corrections during the first quarter were in this range. We think equity markets are not over valued and remain in a bull market supported by economic growth.

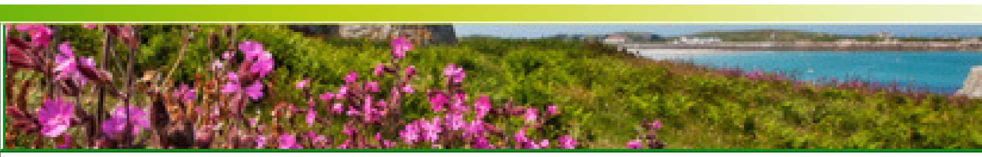
Tightening in China and the US remains the most significant development that markets must deal with for at least a year. Along with subdued European growth, they have led to unexpectedly weak inflation and a rally in bonds. However the US dollar has weakened and bonds of weaker Euro countries have rallied strongly, possibly laying a foundation for a correction in both of those markets.

Recently Russia appears to be backing away from confrontation over the Ukraine. US led sanctions have discouraged Russia which is trying to avoid a recession. Europe may yet suffer from higher cost energy as a consequence, particularly with recent developments in the Middle East.

Japan appears determined to revive its economy through cheap money and devaluation of the Yen. Though welcome, this policy may have an adverse impact on other exporting nations especially in Asia. Meanwhile, expectations for a weaker Euro and other stimuli in Europe are rising.

US growth may well surprise this year, being stronger than expected. We continue to believe growth may continue until 2018 and have a long term target of 4-5% for the US Treasury 10 year bond. Corporate bonds and high yield bonds remain vulnerable to inflation, earnings disappointments or M&A activity. Short term rates may rise in the next 12 months, both in the US and UK.

Markets



Fixed Interest

Most countries' long term interest rates have fallen over the past six months, due to low inflation and modest economic growth. However, we continue to think US recovery will affect most countries irrespective of their local circumstances. Also, if stimulus for the Euro area disappoints there could be a shock to weaker nations' bonds. Developed market short term rates should not rise until at least the end of the year, but may begin to reflect longer term rates after tapering of US Quantitative Easing is completed.

Short Rates

Currently US interest rates should be 1.59% (0.7% in March) 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 2.5% (2% in March), European rates are about are right for 10% unemployment assuming no price inflation. However, for non-core Euro countries rates are about 6% too high.

It is now clear that markets expect US short rates to rise significantly on a 2-5 year time frame, however Europe and Japan remain challenged and their rises could be delayed.

Longer Rates

Developed countries' 10 year bond yields have fallen from their lows last year and are beginning to reflect a longer term recovery. Long term rates of 4-5% on 10 year US Treasuries should be eventually expected. Their current yield is 2.60% compared to 2.97% in December. Weaker Euro zone government bonds have rallied strongly despite worse debts, high unemployment and poor improvement in deficits due to deflationary pressures. Modest anti-deflation measures could cause a further rally in the short term. However should stimulus or ECB actions disappoint markets then expect corrections.

Credit & Emerging Markets

Investment grade corporate bonds offer limited gains but are better value than other types, particularly government, index linked and high yield bonds. High yield bond yields have sunk, but remain above investment grade. Improving economies and profits make lower defaults more likely, but this is mostly reflected in yields.

Emerging market debt shows signs of improvement following last year's correction. Central banks and new governments have reset the prospects for these bonds but concerns about US tapering of Quantitative Easing remain. Bonds issued by soundly financed countries with good trade positions and foreign exchange reserves are safest.

Bond Themes & Ideas

Deflation is still a concern in Europe. Disastrous austerity and monetary policies of the Eurozone have brought about unemployment and contraction equal to or even greater than the American experience in the 1930's for some countries. Some bond managers view the currency zone as another Japan. Countries outside the Eurozone are now feeling the effects of this deflationary policy.

Shrinking levels of bank lending within the Eurozone (due to bank stress tests) should ensure that this process continues. Belatedly action has been taken, such as greater scope for deficits in Italy, Spain and France. Also the ECB is using more radical measures such as negative overnight interest rates, however deflationary policies still dominate.

There is a danger that ECB action will be tested, resulting in spikes in interest rates for the likes of Italy, Spain and Greece. Reversing official complacency and the forces created over the past six years is difficult. Youth unemployment is staggering in many countries, event compared to awful levels of general unemployment. Accumulated debts are worse now than ever and deficits are still threatening governments' solvency.

Tapering of US central bank bond purchases is successful so far, with no panic over bond prices but this may still occur. 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 within 12 months cannot be ruled out if tapering is successful, most likely impacting short term bond values. Currently markets expect short term rates to match those of 5-10 year maturities within 2-5 years. The UK may be among the first to tighten, following statements by the Governor of the Bank of England.

Equities

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

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. Earnings growth may be emerging as the new driver for US returns and low quality small company valuations may be supplanted by quality firms within the small company space.

Whilst there has been a correction in smaller companies' values, they remain more expensive than large companies. US high quality stocks are better value than other sectors, but prospective returns remain 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 estimates up to 4.4% in real returns at end of May 2014, on a 7 year view.

US Equities

Government deficits should improve and wages are growing, however low inflation and lower government spending will continue to impede the economy. 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 but quality & growth stock are yet to really perform.

UK Equities

UK equities are cheap compared to US and takeovers are now occurring, inflating equity prices. 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 higher consumer debt.

European Equities

There are initial signs of deflation being addressed by policy makers and Russia will avoid a recession despite modest economic sanctions. Europe remains relatively cheap compared to the US. Multinationals are most attractive. However, the Euro and government finances could disrupt this view, possibly making domestic firms preferred.

Japan Equities

The recent sales tax rise has hurt growth efforts. 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 year 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

These represent best value, particularly in China. However the timing of recovery is unclear, due to the slowing of the Chinese economy. We hope that the next 6 months may mark the end of this period of uncertainty. FTSE EM index is now on 11 times next year's earnings.

Economic Outlook

Global growth of 3.6% this year is possible with higher growth in 2015. The US should see 2.8-3.2%, UK 2.7-2.9% Eurozone 1.2-1.4%, Emerging Markets 4.9%. (Sources, IMF, OECD)

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 below.) The next 12 months will be telling.

Deflation pressures are not easing in the Euro zone and nearby countries. There is a possibility that this could take hold and be difficult to eliminate, as Japan has demonstrated. Europe has stabilised compared to the past several years, but we remain unconvinced that growth is robust despite improving leading indicators and strong export demand. With poor strategic underpinnings to the Euro, much could still go wrong in a slow fashion. Lending in southern Europe needs to recover and competitiveness improve. Euro strength and poor lending growth mean the continent may yet experience a decade of little growth.

Japan is moving into a second, more testing phase of its recovery and expansion. Further central bank easing will be limited so it is important for inflation to take hold. Higher sales taxes initially spurred consumer spending in the short term but this has now reversed as the taxes came into effect. The government has stated that business should pass on higher revenues in the form of wage increases.

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 affairs 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.

End of the Great Bond Bull Market

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. Please see our bond comments for current details.

A panic could erupt about individual European countries due to deflationary stresses (please see above). Japan could also suffer a massive fall in government bond values due to its poor growth and deficit spending. Corporate bonds may be vulnerable depending upon the nature of any slowdown, earnings disappointments or takeovers. Simply holding low yielding bonds is not our preferred strategy and we expect longer rates to eventually increase further. Short term rates should now increase toward longer rates as quantitative easing (QE) is stopped.

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 impossible for borrowing to grow at its current pace without the country's debt becoming unsustainable. Policy makers are re-balancing away from exports & investment to consumption from savings. They are trying to do so, in part through less government influence, less corruption 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. China's trump card is massive accumulated trade surpluses to relieve pressures in the short term – but this would mean significant US treasury sales!

Developed Market vs Emerging Market Equity Themes

We are looking into investments in healthcare in developing countries, since 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 less 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 existed 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 ***general crisis*** 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