cannon asset management

newsletter

October 2014

Summary

Markets continue to struggle this year but we think equity markets are not over valued and remain in a bull market supported by economic growth. Equity markets have corrected towards the quarter end, between -2.2% (Europe) to -9.4% (China) currently though Europe did correct by 8.4% earlier in the quarter and recovered. This is within the range we expected given our views above.

Tightening in China and the US continues as previously mention and will do so for at least a year. Along with disappointing European growth, this has led to weak inflation and continued support for most bonds. High yield bond markets corrected during the past quarter after becoming fully valued.

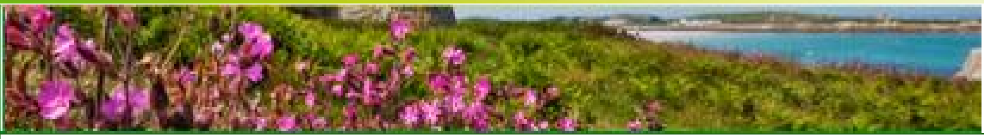
Russia appears determined to undermine the Ukraine, resulting in continued escalation of sanctions from the US and EU. Europe has proven surprisingly firm but the US is particularly tough, targeting Russia’s largest bank and gas supplier. Europe will suffer reduced exports and probably higher cost energy as a consequence.

European growth is deteriorating due to poor Euro zone policies which is increasing pressures on individual countries’ finances. Expectations for a weaker Euro and stimuli in Europe are rising as a consequence. Britain’s dismemberment is resolved for now but a general election still leaves uncertainty for investors as the UK’s economy strengthens.

Japan appears determined to revive its economy through cheap money and devaluation of the Yen. However tax increases are offsetting these policies. Asian markets are falling due to political unrest in Hong Kong.

US growth has surprised, being stronger than expected. We continue to believe growth may continue until 2018 and we 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 9 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 Euro zone nations’ bonds. Developed markets’ 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 1.86% (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 3.5% (2% in March), European rates are about right for 9% 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 are better value than other types, particularly government, index linked and high yield bonds. High yield bond rates have sunk, but remain above investment grade. Improving economies and profits make defaults less likely, but this is mostly reflected in yields.

Emerging markets have rallied 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 building in Europe. The misguided austerity and monetary policies of the Eurozone continue to damage the continent and individual countries, in some cases on a scale last seen in American during the 1930's.

Shrinking levels of bank lending within the Eurozone (due to bank stress tests) is not yet complete, so this process will continue. At last Germany is being affected and policy may change at the margin as a result. However this will take significantly more radical measures from the ECB, to which Germany will object. Vocal opponents to current policies are now appearing in mainstream French parties as next year's election looms. Even in Germany an anti Euro and anti EU parties have achieved over 10% in two state elections. However, Italy remains the greatest beneficiary of either leaving the Euro or a change in policies.

Tapering of US central bank bond purchases is successful so far, with no panic over bond prices but this could still occur. We expect tapering will be completed by the end of the year, particularly as there is no evidence it is damaging the US recovery.

An increase of short term rates within 9 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. Since August markets have retraced their gains. The results are: FTSE 100 down 4.6%, S&P 500 down 3.2% Russell 5000 off 4.1%, the MSCI Europe ex UK down -2.2% (but following an 8.4% fall & recovery earlier in the quarter), MSCI Asia ex Japan off 8.5% and the MSCI China index down 9.4%.

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 value due to sell offs since May 2013. GMO's estimates up to 3.2% in real returns at end of May 2014, on a 7 year view as of August.

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 stocks are yet to really perform.

UK Equities

UK equities are cheap compared to the US and takeovers are now occurring, inflating equity prices. UK companies may be less attractive to US corporations after America takes action against re-locating head offices overseas, however. The potential for a Labour election victory in 2015 is worrying 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 strong but based mostly on higher consumer debt and may be disturbed by politics.

European Equities

There are initial signs of deflation being addressed by policy makers and Russia may not avoid a recession despite ratcheting 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 of Yen devaluation which 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%. 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 an equity rally 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 10.3 times next year's earnings.

Economic Outlook

Estimates of growth have been reduced since our last newsletter. Global growth of 3.4% this year is forecast with higher growth in 2015. The US should see 1.8-2.8%, UK 2.9-3.2%, Eurozone 0.8-1.1%, Emerging Markets 4.6%. (Sources, IMF, OECD)

US data is becoming unambiguously robust despite some fundamental weakness of the economy and government finances. The last quarter's growth managed 4.2% per year equivalent. China (the largest source of global growth) is facing the collapse of over-extended property speculation as part of its adjustment to a more mature economy. 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 rein in lending, increase domestic consumption and introduce market forces to domestic debt markets. The country risks a significant economic shock from property lending in particular, though many activities are vulnerable. The next 12 months are promising to be eventful.

Deflation pressures are increasing and activity falling in the Euro zone. France, Germany and Italy are all showing signs of economic contraction or plummeting confidence (a pre-curser to the former). A lost decade of growth similar to Japan remains a significant risk. Whether Europe has stabilised is questionable and we remain unconvinced that growth will take hold with current policies. So far only very modest measures, such as lowering rates by 0.10% this month have been taken. Russian sanctions are a further drag on the region.

The UK is looking better as time passes. Growth is the best in the OECD, it now has lower wage costs than Spain and employment is growing at a rapid rate. Though wages are not improving, this is an excellent result. However, the government remains in deficit and political uncertainty is a drag on investment particularly with a possible Labour led government from next May.

Japan's second, more testing phase of recovery is stumbling. VAT tax rises have poleaxed consumer spending, threating its expansion. Further central bank easing will be limited so it is important for inflation to take hold. The government has stated that business should pass on higher revenues in the form of wage increases and further tax increases will be made.

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.

A Renewed Great Britain?

It is now obvious that significant change will occur in the UK due to the recent referendum on Scottish independence. Don't expect British politics, UK financial markets or the pound to be the same.

In short, the no vote was only marginal and the Scottish nationalist will not regard the vote as the end of the matter. For the Labour parity, it presents a credibility problem for if it tops the polls in the UK's May election. The party will likely be seen as soft on Scotland due to its heavy dependence on Scottish members of Parliament. The Conservatives are using the promised constitutional change tactically, forcing Labour onto the defensive and moving to the right in protecting England within the UK. A more federal government structure is likely to emerge between England, Scotland, Wales and Northern Ireland.

The Europe and the Euro

The Euro is one of the great unresolved issues in world economics. It hangs over the region's prospects & politics like a sword waiting to fall. The Euro was and is a political project, which the European "establishment" is clinging to in desperation.

It was supposed to lead to greater European integration, eventually full political, fiscal and banking union. It has been a disaster due to these unresolved issues, though they are not the root of its problems. It was also supposed to generate significant economic benefits, which are now totally overwhelmed by lost economic output in many countries. This in turn is discrediting the Euro and the whole governing class of the EU.

If left unresolved, there are the possibilities of defaults on national debt, a lost decade of growth, a generation of vast unemployment and social ills, resentment between Euro zone members and political disintegration of the whole project. Currently, leaders of national governments in Europe are coming under threat from anti EU parties, even in Germany, so change may yet occur.

The Euro's fundamental problem is the "one size fits all" interest rates and economic policy applied to economies with different levels of productivity, wealth and labour market flexiblity. It is worsened by the lack of Euro zone institutions to address the differences, such as fiscal transfers, a banking union and ultimately a single elected body representing the whole area rather than the national governments currently calling the shots.

In any event, completed or new institutions may not achieve change. There are examples of countries where their regions have taken decades and even hundreds of years to align economically. The best example of this is Italy, where the north of the country has transferred wealth to the south ever since Italy came into being in 1861. In Germany, the former East Germany remain poorer than the West after 24 years together.

It is possible that the Euro will continue in its current incarnation, inflicting enormous damage on member states and their populations but there is also the possibility that it will change. Until there is change – which will require brave and enlightened national leaders - the costs of the Euro will continue to grind upwards in the form of social damage and lost growth. In any event, the deeper economic problems in many countries will endure, similar to Italy's southern regions or Canada's Maritime provinces. (I recommend Roger Bootle's "The Trouble with Europe" for detail analysis.)

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 over the past six years. An added complication is the priority of the Communist party to remain in power based on rising standards of living. (The party members have enriched themselves from the current growth model. Turkeys voting for Christmas?) 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.

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