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Monthly Commentary 2nd June 2013

Like in April, markets were mixed in May but with a decidedly downward bias. World equities were slightly down, with US and European equities up 1 to 2% and Emerging Markets down 3%. The big story of the month was in bonds, which got hammered. Benchmark yields (10-yr government bonds) rose substantially. For example, US Treasury yields rose 46 basis points, from 1.67% to 2.13%, which is a huge rise. Similar moves were observed in the UK and Germany. Investment grade corporate bonds fell sharply (3%), going into negative territory for the year. Commodities were not spared, falling more than 2%, with gold suffering another 6% drop. There were also large moves in the currency markets as the USD index rose almost 3%, at the expense of EM currencies, but also the Australian Dollar which tanked by almost 8%.

What do we make of these moves?

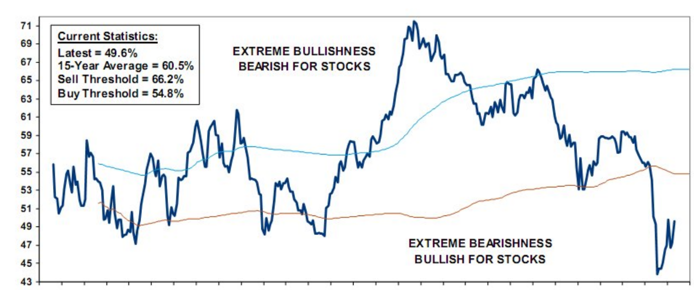
The US still seems to be in the driving seat economically. With all the talk of equities rising because of QE (Quantitative Easing), lately we have had a shift in leadership in the US markets with cyclical sectors (Industrials, Technology and Energy) doing better than defensive sectors. This is a good omen in the sense that markets anticipate that the economy is gaining momentum in its own right. Perhaps this is also the reason why markets wobbled last week, fearing that the Fed would start to reverse its extremely accommodative policies. This is also the reason that bonds had such a fall.

We are not of the opinion that the Fed will reverse course anytime soon, and we are also mindful of the continuing massive stimulus provided by the Bank of Japan. With the European economy unable to get out of its slumber, it might be a matter of time before the ECB joins the party. Finally, the Bank of England might also begin a new stimulus program as the new governor takes office in July.

As such there is, and probably will be, ample fuel to support riskier assets (read equities) as the year progresses. This is not to imply that corrections, as the mini one that we are undergoing now, will not create doubts and raise fears of a bubble. Indeed, in some areas like Southeast Asian equities, credit markets and Australian Banks, bubbles are forming, but this does not mean that these bubbles are about to be popped. Nor does it mean that most assets are overpriced.

An indicator that we have referred to in the past is the Merrill Lynch Sell Side Indicator, which is based on the average recommended equity allocation of Wall Street strategists as of the last business day of each month. Merrill has found that Wall Street's consensus equity allocation has historically been a reliable contrary indicator. In other words, it has historically been a bullish signal when Wall Street was extremely bearish, and vice versa. As of April 30th, this indicator, shown below, is still very bullish and implies a total return in the next 12 months of more than 20%. While this should never be used in isolation as a predictor of where markets are headed, it is nevertheless an indicator to keep in mind when making investment decisions.

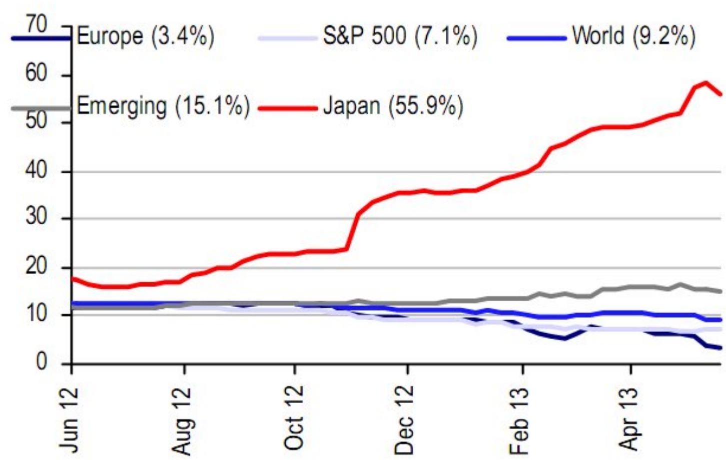
Chart 1: Sell Side Consensus Indicator (as of 30 April 2013)



Source: BofA Merrill Lynch US Equity & Quant Strategy

As for Japan, we still remain positive. With profit growth now expected to exceed 50% for this year, largely driven by the cheap yen, it is easy to see why the Japanese Market (which is still reasonably valued) has more upside. The recent correction should provide a good entry point for those with a 1-year horizon. Below is a chart from UBS that compares earnings growth for various regions.

Chart 5: EPS growth consensus estimates for 2013*



Source: IBES, MSCI, Datastream. * Note for Japan we use Y/E 03/2014

On the portfolio front we continue to gradually shift from hedge funds to more traditional assets. Equity allocations are reaching our targeted levels. Within equities, tactical positions favour small-cap funds globally, Japan and US Energy infrastructure. In fixed income we still prefer high yield.