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the investor's choice

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Monthly Commentary 2nd September 2013

Both equities and bonds were down in August. Growing investor anxiety about US monetary policy was probably a bigger driver of the markets than the recent geopolitical worries. The latter make for impressive headlines but most often they have a less lasting effect on markets. US equities that have been driving developed markets higher this year suffered a not-insignificant 4% fall while the bond market as measured by the benchmark US government bond also fell as yields rose from 2.59% to 2.75%. Volatility in emerging markets continued with both equities and bonds falling. The biggest culprits were EM currencies which saw dramatic falls of 3% on average.

So are these falls a precursor to a new bear market in equities? Morgan Stanley recently posed a few questions to asses if this is the case, and they also provided the following answers:

(i) Is the Fed tightening? The Fed has emphasized that it is tapering, not tightening;
(ii) Is a recession looming? Morgan Stanley & Co. economists do not think so;
(iii) Is investor euphoria present? No; recent AAII (American Association of Individual Investors) polls show 29% bulls and 43% bears;
(iv) Are valuations stretched? No;
(v) Are the banks, transportation stocks, and Russell 2000 underperforming? No, they are actually meaningfully outperforming the S&P 500 year to date;
(vi) Are bond yield spreads widening? Not at present

So if we are not about to enter a bear market, is there enough fuel in the markets for them to climb the proverbial wall of worry? Again, Morgan Stanley strategists suggest the following catalysts for a long term bull market:

(i) Housing: Used to be a big drag on economy, now is a modest additive;
(ii) Energy: Shale was 2% of total gas production 10 years ago, now over 40%;
(iii) Restoration of US manufacturing (Coming back to Mexico as well; Mexico and the US are becoming increasingly interlinked);
(iv) Deficit Reduction: The US has halved the Federal deficit and it is dropping further due to GDP growth;
(v) Dollar Rally: a multiyear rally appears to be just starting, due to the energy boom, demographics and restoration of US manufacturing strength.

Even though we are quoting the latest MS research, our own analysis broadly agrees with their conclusions. There is, of course, no guarantee that it will be smooth sailing in the markets, and a more meaningful correction may yet happen. If it does, we believe it will be of relatively short duration and we are confident that a year from now, equity markets will be higher than they are today.

On the portfolio front we continue to shift from alternative funds to more traditional assets. Equity allocations are reaching our targeted levels. Within equities, emerging markets have a smaller allocation than developed ones. Our tactical positions favour small-cap funds globally, Japan and US Energy infrastructure. In fixed income we still prefer high yield and shorter-duration bond funds.

The Elgin analyst team