

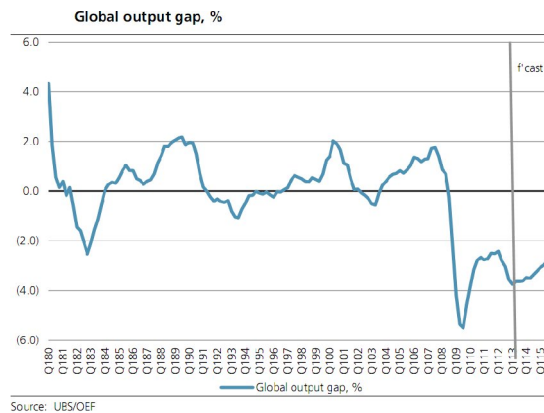
Monthly Commentary 5th November 2013

Both equities and bonds were up in October as the last-minute agreement in the US Congress to postpone the debt ceiling debate until early next year proved to be a green light for the markets to head higher. If anything, investor anxiety about the US government shutdown and debt ceiling might have done sufficient short-term damage to the US economy to further postpone the tapering of the Fed's QE program - hence the market upswing.

On Inflation

Commodities did not follow other assets higher, and dropped a meaningful 3% in October, with US crude oil leading the way lower. Eurozone October inflation shocked economists as it came in at 0.7%, below that of Japan! Could it be that there are no inflationary pressures? Indeed, measures other than falling commodity prices seem, for the time being, to corroborate this.

For example, by virtually any measure, both US and global spare capacity remains high. The global "output gap" as shown below, is still firmly in negative territory. The US output gap is even worse.



What does this mean for the markets?

We'll answer in a roundabout way, focusing on the Fed (the US Central bank). They have repeatedly stated that they are very much committed to defending their 2% PCE Deflator target (the PCE Deflator is the Fed's favourite inflation measure) "from below as well as from above". As shown in the chart below, the current level is now below their "comfort" zone,





This might imply that QE tapering might be further away than markets expect. It almost certainly implies that the Fed will keep short-term interest rates close to zero for a very long period. We believe that this bodes well for risk assets.

Another reason to be optimistic is that there is a growing chorus of articles that point to an imminent pullback in equities.

FT: US equities trade at "sky-high" valuations

FT: Equity markets have one foot in the grave

WSJ: The market's December taper fear is only going to get worse

This does not smack of euphoria to us. So while a pullback at any time could be expected, there is little to suggest that it will be anything but temporary.

On the portfolio front we have concluded our shift from alternative funds to more traditional assets. Equity allocations have reached 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.
