



5 KEY ISSUES SHAPING CURRENT INVESTMENT STRATEGY

- 1 Inflation versus deflation: the challenge facing central banks**

- 2 Investment Ryder Cup: will the US continue to beat Europe?**

- 3 High yield bonds: “time, gentlemen, please”**

- 4 Japan: different this time?**

- 5 Commercial property: central London offices are no longer the only game in town**



INFLATION VERSUS DEFLATION: THE CHALLENGE FACING CENTRAL BANKS

- Fearing a 1930s-style Great Depression, global central banks have adopted unorthodox policies, such as zero interest rates and quantitative easing (QE).
- With growth established in the US and now the UK, are the Fed and Bank of England being complacent about the risk of inflation by keeping rates low?
- Despite ultra-loose monetary policies, inflation remains muted: US inflation is only 1.2%, UK CPI is 2.1% and eurozone inflation is only 0.9% - these are well below their 2011 peaks (figure 1).
- One reason is that QE has been used to support commercial banks by rebuilding their balance sheets rather than lending to the wider economy.
- Governments and households are also deleveraging, which has restricted inflation. In addition, wage inflation remains low as there is still spare economic capacity, known as the 'output gap' (figure 2).
- The slowdown in China is likely to help keep inflation lower by suppressing commodity prices and dampening global demand.

Figure 1
Inflation has fallen steadily since 2011 in developed economies – is deflation the bigger risk?

Source: Rathbones, Datastream

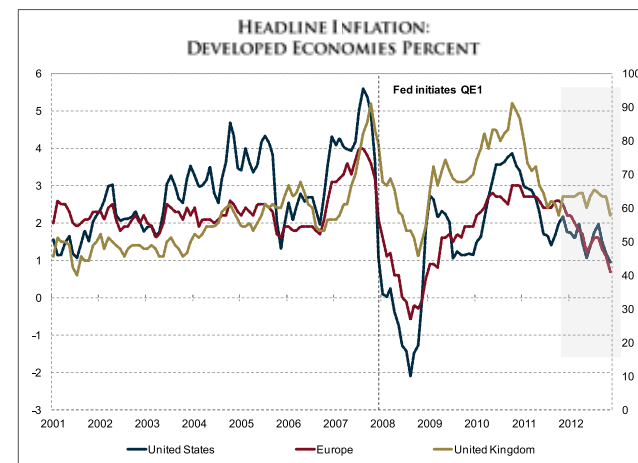
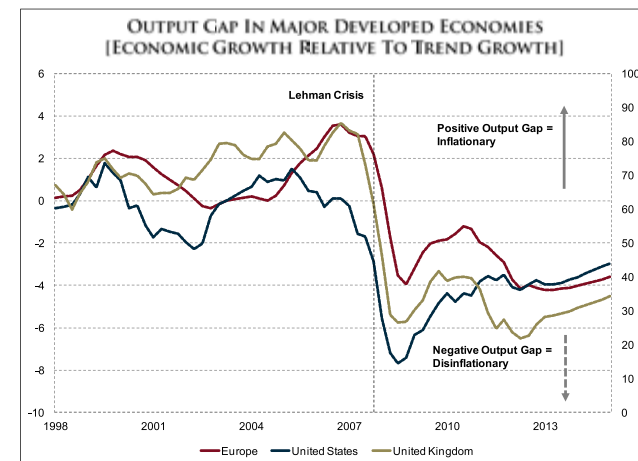


Figure 2
The 'output gap' remains negative, so there is significant capacity for further growth before inflation becomes a problem.

Source: Rathbones, Datastream





INVESTMENT RYDER CUP: WILL THE US CONTINUE TO BEAT EUROPE?

- US equities have performed strongly since the recession ended, driven by the economic recovery, supportive Fed policy and cheap energy from shale oil and gas.
- They now appear fully valued, particularly when compared to European equities, which are 25-30% cheaper than the US (figure 3). Should investors switch?
- We remain overweight US and underweight Europe – the fundamentals in each region are essentially unchanged and the Fed remains committed to achieving sustained growth through loose monetary policy.
- US equities can outperform further as the consumer recovery strengthens and fiscal policy shifts from restrictive to neutral – reduced uncertainty is likely to fuel capital spending by companies.
- The eurozone is likely to emerge from recession in 2014, but the recovery may be lacklustre with political and economic inertia continuing to hold back growth.
- The value in European equities is dispersed: ‘global’ companies are fully valued, whereas companies with domestic earnings appear cheap, but generally have poor revenue and earnings prospects.

Figure 3
Having outperformed since 2011, US equities are now significantly higher rated than European equities.

Source: Rathbones, Datastream

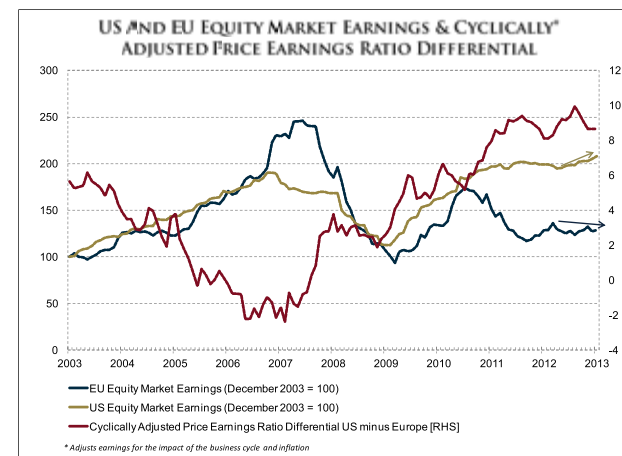
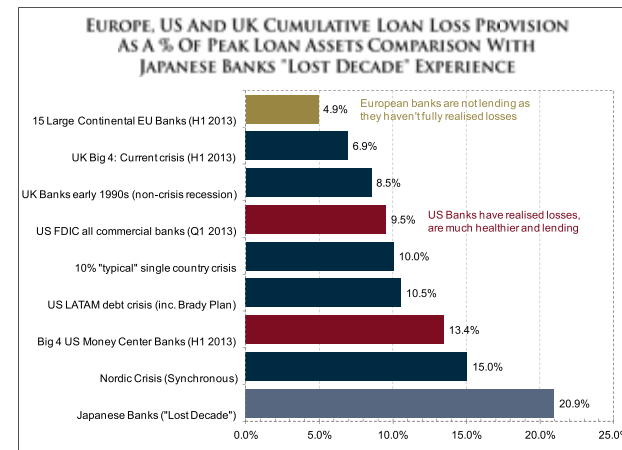


Figure 4
European banks are yet to recognise the full extent of their bad loans – this will restrict growth in future.

Source: Rathbones, Datastream





HIGH YIELD BONDS: “TIME, GENTLEMEN, PLEASE.”

- After several years of strong performance, we believe it is now time for a meaningful reduction in exposure to high yield bonds.
- High yield bonds have benefitted from favourable economic conditions and the hunt for yield across all asset classes, but now look expensive given increased leverage (figure 5) and looser covenants.
- Credit spreads (the difference in yield between government bonds and high yield bonds) are near 10-year lows (figure 6). Also, investment grade bonds are pricing in a similar rate of default to high yield bonds which leaves high yield vulnerable.
- Continuing optimism for high yield bonds would need: 1) interest rates to rise slowly, so weaker companies aren't stretched; and 2) spreads to tighten further. The former is likely, but it will be difficult for spreads to tighten further
- We have concerns about increased leverage in the high yield sector and the deterioration in the quality of underwriting for new debt issues.

Figure 5

Leverage in high yield bonds is close to peak levels, which is a cause for concern.

Source: Rathbones, Datastream

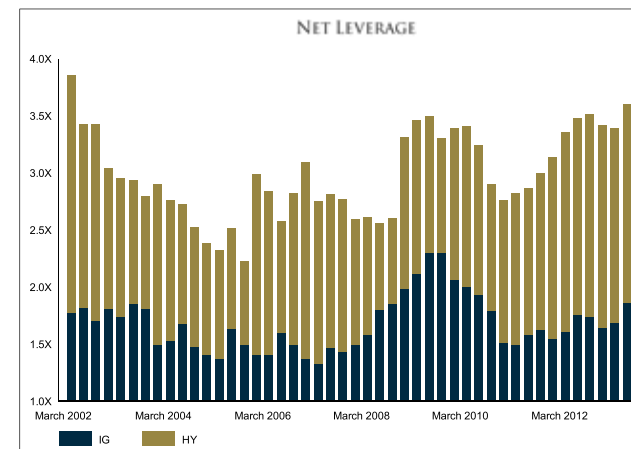
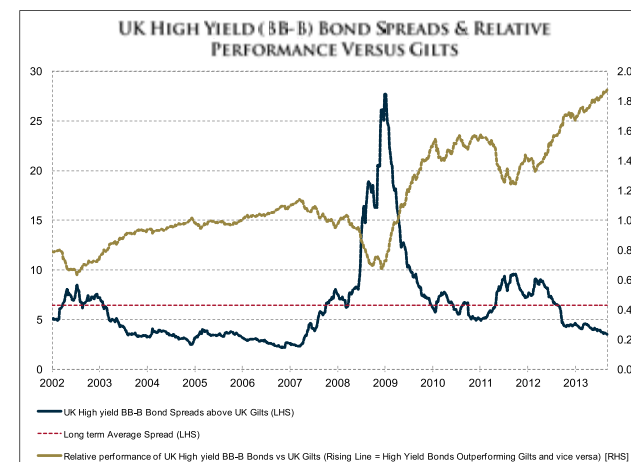


Figure 6

High yield bonds have performed strongly against gilts and credit spreads are now very low – another signal that holdings should be reduced.

Source: Rathbones, Datastream





JAPAN: DIFFERENT THIS TIME?

- Japan is increasingly attractive as ‘Abenomics’ begins to deliver results. This was the radical package of ultra-loose monetary policy, huge fiscal stimulus, and widespread social and economic reforms that was announced by new PM Shinzo Abe following the December 2012 general election.
- What is different this time? 1) Proper coordination between the Ministry of Finance and Bank of Japan; 2) the unprecedented scale of QE – equal to the US Federal Reserve’s, but over two years not five; and 3) Japanese banks have now recognised their previous losses and repaired their balance sheets, so they are passing on the stimulus.
- So far, reforms have been limited, but Mr Abe has the broad political support to make meaningful supply-side changes to trade, energy, healthcare and the role of women in the workplace.
- Early signs are encouraging: Japanese inflation is now in positive territory and rising (figure 7), and exports will be boosted by expected further weakness in the Yen reversing years of weak exports because of Yen strength (figure 8).

Figure 7
After years of deflation, Abenomics is finally delivering inflation to the Japanese economy – the 2% target no longer seems over-ambitious.

Source: Rathbones, Datastream

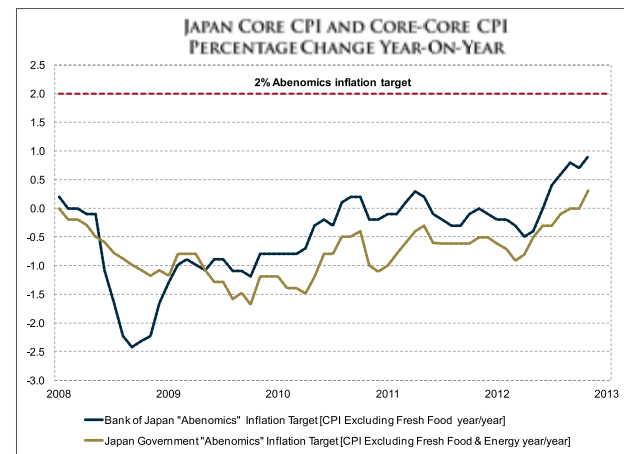
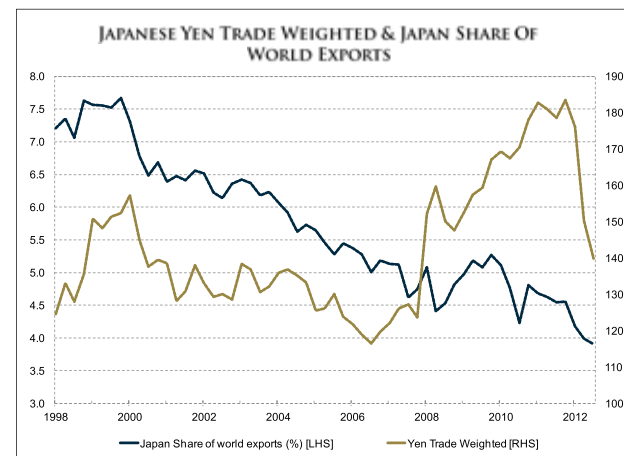


Figure 8
Yen strength was a factor in Japan’s declining share of world exports – recent and future Yen weakness is expected to reverse this decline.

Source: Rathbones, Datastream





COMMERCIAL PROPERTY: CENTRAL LONDON OFFICES ARE NO LONGER THE ONLY GAME IN TOWN

- The performance of commercial property has been mixed in recent years – prime central London office property has been driven by international investment and yields are touching 2006 lows, yet secondary and tertiary property in the provinces has been very weak.
- Interest in London remains strong – over the last six months, there has been 10.9 times more equity looking to invest than assets to purchase. However, although values are nearing their 2007 peaks, they still look attractive to international investors in local currencies.
- Central London has been strong because of the lack of construction in absolute terms and relative to previous cycles. Finance has been restricted and speculative development virtually non-existent.
- High yields outside London and a more broad-based economic recovery have attracted investment to the better regional markets – vacancies and yields have fallen and rental growth is increasingly achievable.
- Property company shares are trading at premiums whilst direct investment and property funds have idiosyncrasies which can catch out investors. Property should be seen as a long-term investment.

Figure 9
Since the recession, the yield gap has widened between prime London and regional commercial property – this is starting to close.

Source: CBRE

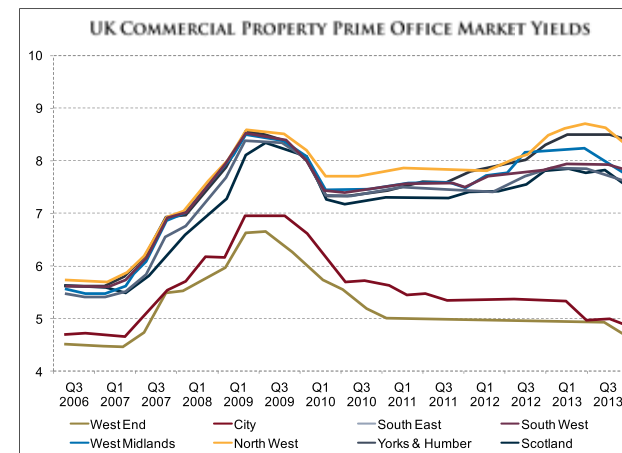


Figure 10
The economic recovery is becoming more broad-based, reducing vacancies in regional retail property.

Source: Capital Economics

