3RD QUARTER 2015

FIVE KEY ISSUES SHAPING CURRENT INVESTMENT STRATEGY

1	**European equities: the financial sector offers value**
2	**Gilts can have a portfolio insurance role even in a bear market**
3	**The Midas touch? The value of gold divides investors**
4	**Reduced liquidity: regulation may cause problems in credit markets**
5	**Slower growth in China has implications for its trading partners**

Looking for value in European equities

- Although eurozone GDP growth outpaced both the US and UK in the first quarter, recent figures suggest the economy could be struggling with both business and consumer activity falling.
- The deleveraging process appears to have stopped, but lending to small and medium-sized enterprises remains constrained, which may explain why hiring intentions surveys remain subdued (figure 1).
- The uncertain outlook for Europe's economy means we believe equity valuations and optimistic earnings expectations do not sufficiently compensate investors for the risks.
- Investors with an appetite for risk who are looking for an option on Europe's recovery could consider the financial sector, which provides a valuation discount to the wider market (figure 2). Although any sustained turnaround in this sector will rely on the implementation of robust banking reforms.
- But this opportunity comes with a health warning. Bank business models across the region are still struggling under the weight of regulation and a decade of misallocated loans.

Figure 1

Employment intentions are recovering but low

Loans for small and medium-sized enterprises remain constrained, which may explain why hiring intentions surveys remain subdued.

Source: Datastream, Rathbones Asset Allocation Strategy Research

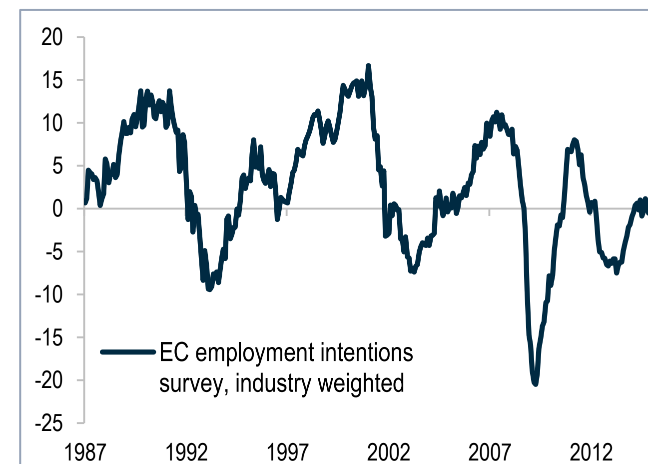
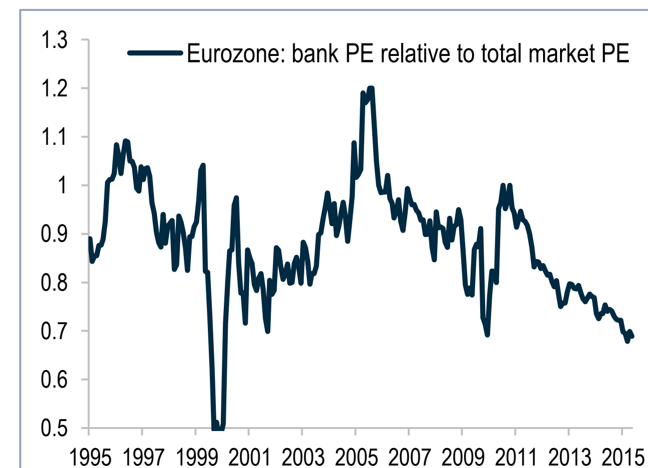


Figure 2

Banking sector p/e ratios are very depressed

Relative price-earnings (p/e) multiples in the banking sector have never been more depressed outside of a recessionary environment

Source: Datastream, Rathbones Asset Allocation Strategy Research



Gilts can have a role even in a bear market

- Despite warnings of a forthcoming multi-year bear market for UK gilts, we believe they still have a valid role to play as part of a balanced investment strategy.
- A portfolio comprising gilts could suffer mark-to-market losses in the short term, yet they continue to have a role as insurance against adverse equity market conditions.
- Providing interest rates increase gradually and the coupons are reinvested, gilts could generate a positive total return over the long term (figure 3).
- For certain long-term investors we can build laddered portfolios with gilts of different maturities. When yields are rising, we can reinvest maturing gilts to take advantage of the higher coupons available.
- History supports our view that gilts can still play a role in a bond bear market. Our analysis shows they returned an annualised 3% in nominal total return terms and improved risk-adjusted returns in a balanced portfolio in a previous bear market (figure 4).

Figure 3

This chart shows simulated performance for five-year gilts if interest rates rise by 0.5% a year for five years.

Source: Rathbones Asset Allocation Strategy Research

Positive total returns

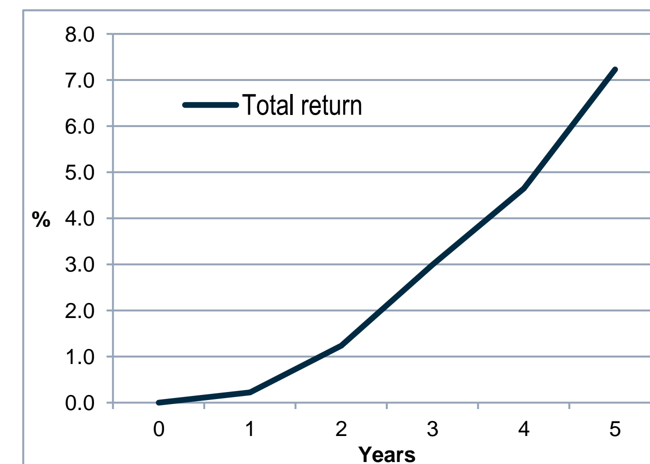
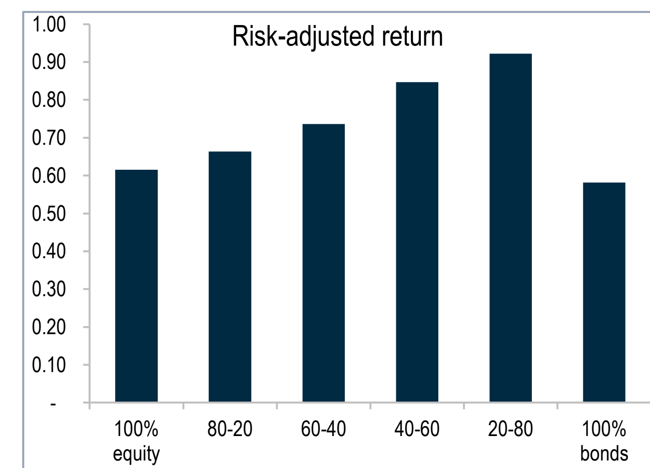


Figure 4

Our analysis shows an allocation to government bonds improved risk-adjusted returns during the 1954–82 bear market.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Performance for six asset allocations (1954-82)



Gold's role divides investors

- Gold's role as a financial asset divides investors. Some continue to see it as the ultimate store of value and a safe-haven against unexpected events, while others say it has no intrinsic value.
- Following the strong run between 2000 and 2011, gold has suffered steep losses over the past couple of years and prices have been struggling to recover. Is now the time to revisit this asset?
- A common belief is that gold offers a hedge against inflation. Yet our analysis shows gold prices are driven by real rates – the difference between interest rates and the rate of inflation (figure 5).
- Gold's property as a hedge against market collapses is also debatable. It protected value when equities fell after the tech bubble burst: but the price fell after the collapse of Lehman Brothers, owing largely to the liquidity crunch in the financial system.
- There are two main ways to invest in gold: buy the metal directly or buy the shares of mining companies. Gold mining equities can be volatile as they are not only influenced by the gold price (figure 6).

Figure 5

Using 10-year US index-linked government bonds as a proxy for real rates reveals that they are negatively correlated with gold prices.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Different directions

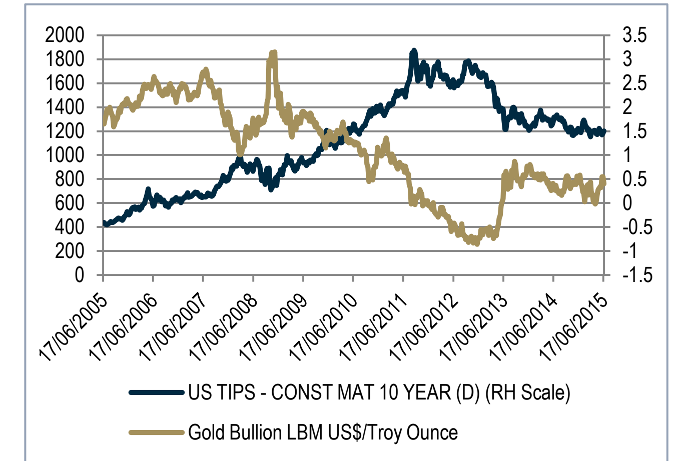
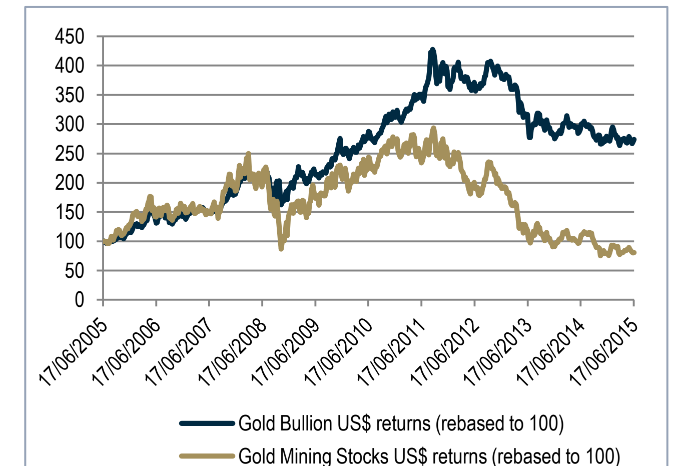


Figure 6

Gold mining equities have underperformed physical gold substantially over the past 10 years.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Relative performance



Liquidity has reduced in credit markets

- Fixed income trading desks at large investment banks have pulled back from their market-making activities due to increased capital requirements and restrictions on proprietary trading (figure 7).
- There are concerns about a liquidity squeeze, meaning a mass sell-off could trigger a credit crisis. There are several worrying signs: bid–offer spreads have widened and average daily dealing volumes have fallen (figure 8).
- Despite this shift in the structure of the secondary corporate bond markets, conditions remain calm at present, but volatility could increase due to the lack of liquidity.
- In particular, an increase in interest rates could affect retail corporate bond funds, some of which now manage multi-billion dollar portfolios.
- However, investors are unlikely to sell heavily unless interest rates rise rapidly, which central banks will want to avoid. Meanwhile, asset managers say they are prepared for the eventual reversal in bond prices as well as any shocks.

Figure 7

Banks are less willing to make markets in corporate bonds because tighter regulations have made bond trading less profitable.

Source: MarketAxess, SIFMA and Rathbones Asset Allocation Research

Out of the market

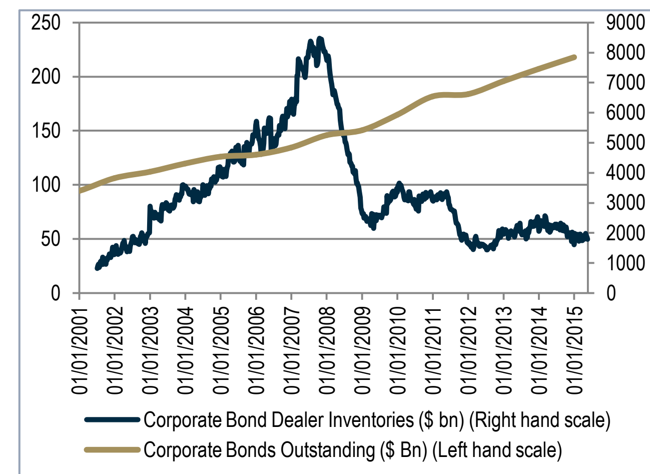
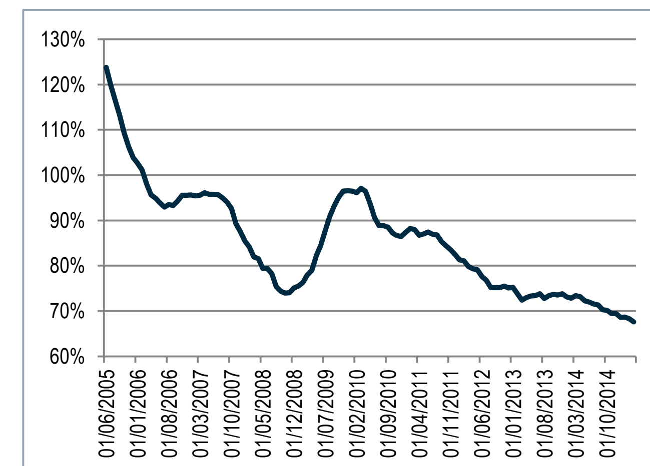


Figure 8

Turnover is defined as the sum of monthly trading volumes relative to the total amount outstanding over the past 12 months.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Bond trading turnover has fallen dramatically



CHINA'S TRADING PARTNERS COULD SUFFER

- Although China's stock market has soared over the past 12 months (figure 9), the country's pace of economic growth is slowing. The recent setback is not wholly surprising considering the frenetic pace of the rise. Equities are likely to remain volatile as the authorities intervene to bring stability to the market.
- There are implications for China's trading partners across Asia and Latin America (figure 10).
- To stimulate growth, the People's Bank of China has cut its benchmark lending rate three times over the past year and loosened other monetary policy measures.
- The export sector requires a boost and China could loosen the US dollar peg to allow the renminbi to depreciate, which would antagonise trading partners.
- Chinese import volumes fell by an estimated 7% on the year in the first quarter. A weaker renminbi would lead to either even weaker import growth or currency devaluations from other countries.
- The key countries at risk are Australia, Korea and Brazil, which send more than 20% of their total exports to China. The emerging markets that are most immune include India, the Philippines and Thailand, but they remain vulnerable to domestic political risks.

FIGURE 9

Global asset prices geared into China have decoupled from the Shanghai stock market.

Source: Datastream, Rathbones Asset Allocation Strategy Research

A CHINESE EQUITY BUBBLE?

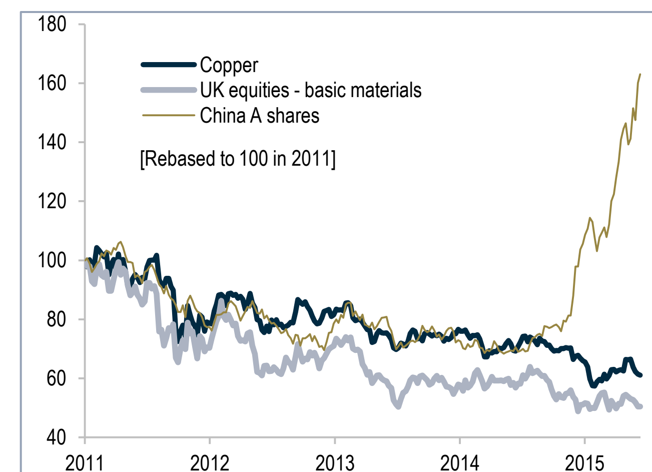


FIGURE 10

Many countries throughout Asia and other emerging markets are exposed to any slowdown in trade with China.

Source: Datastream, Rathbones Asset Allocation Strategy Research

TRADING RELATIONSHIPS