



4TH QUARTER 2014

# KEY ISSUES SHAPING CURRENT INVESTMENT STRATEGY

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- 1 UK outlook: Equities remain vulnerable to ongoing political uncertainty**

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  - 2 Fixed income: The bond markets are waiting for interest rates to rise**

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  - 3 When bad news is good news: The eurozone has received its first dose of quantitative easing**

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  - 4 The hunt for yield: Diversifying strategies look attractive in a world of low returns**

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  - 5 What's in a name? Despite some setbacks this year Abenomics is showing signs of progress**

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# UK EQUITIES REMAIN VULNERABLE TO ONGOING POLITICAL UNCERTAINTY

- With the general election next May, political conditions are unsettled. Tight opinion polls and lack of clarity on the policies of the main parties make it difficult to assess the outlook for the UK.
- A Labour victory could see an increase in tax burdens, which could squeeze disposable incomes and in turn dampen consumer spending and economic growth.
- A Conservative victory could create uncertainty as David Cameron has promised to hold a referendum on EU membership in 2017.
- There are additional headwinds against the consumer in 2015 including the end of PPI compensation and restrictions on payday lenders.
- UK investors can mitigate the risks through a shift towards overseas earners, which could benefit from sterling weakness (figure 1). The FTSE 100 Index provides broad exposure to global growth (figure 2).

FIGURE 1

Companies with overseas revenues are likely to experience a pick-up in investor interest owing to sterling's recent weakness.

Source: Rathbones, DataStream

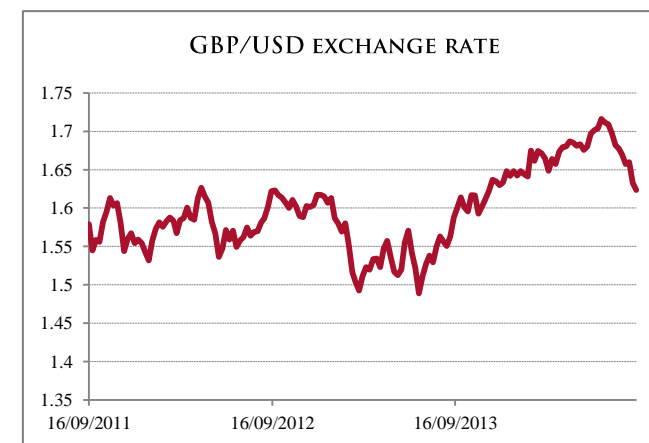
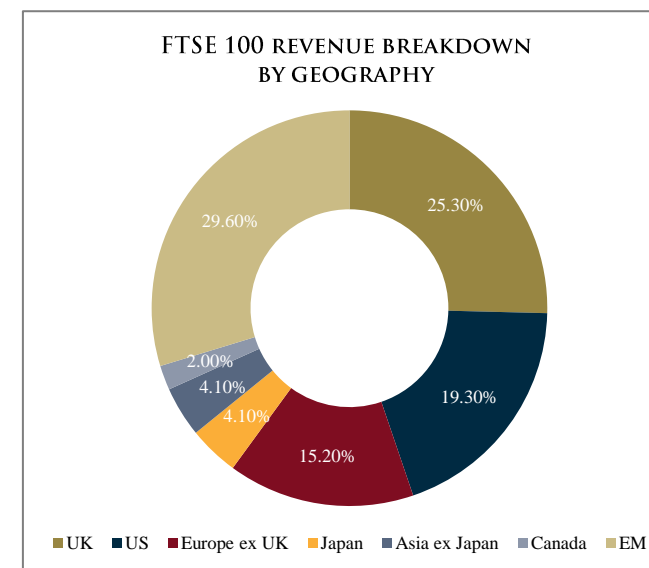


FIGURE 2

Around 75% of the revenues from companies in the FTSE 100 Index are generated overseas.

Source: Rathbones, Capital Economics, MSCI





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# THE BOND MARKETS ARE WAITING FOR INTEREST RATES TO RISE

- Following the rejection of independence by Scotland, the gilt market can return to speculation about when the Bank of England (BoE) will increase interest rates and by how much.
- Typically, interest rates would have started to rise by this point in the cycle but inflation has remained low. As a result, UK and US rates may peak at a lower level than in the past (figure 3).
- Closing the budget deficit is a key issue and could necessitate further spending cuts. If not, and government borrowing has to rise, an increase in gilt issuance would put prices under pressure.
- Liquidity has improved in the investment grade credit markets.
- Corporate bonds have outperformed gilts so far this year (figure 4). However, given the implications of higher interest rates for corporate balance sheets, we remain wary of companies borrowing to fund mergers and acquisitions.

FIGURE 3

Markets don't expect US interest rates to rise until well into 2015 – this is particularly late in the economic cycle, suggesting rates may peak at a lower level than in previous cycles.

Source: Rathbones, DataStream

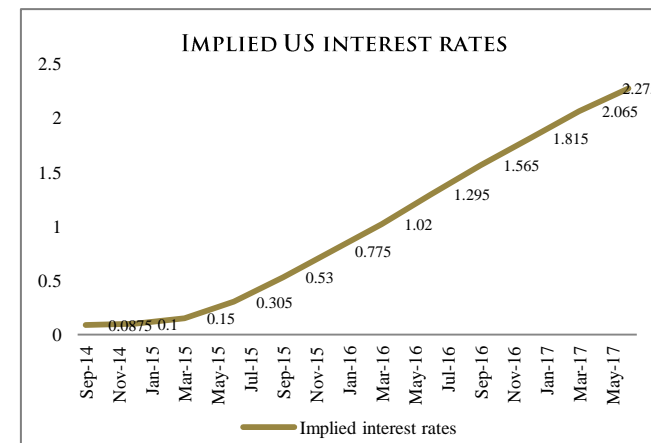
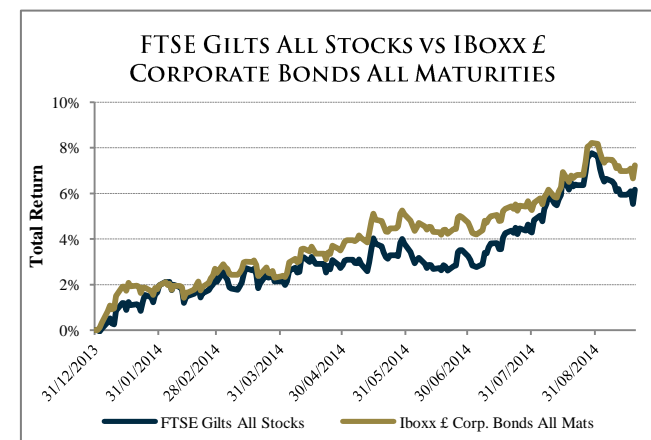


FIGURE 4

Corporate bonds have outperformed gilts so far this year.

Source: Rathbones, DataStream





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# THE EUROZONE HAS RECEIVED ITS FIRST DOSE OF QUANTITATIVE EASING

- The eurozone has now received its first dose of quantitative easing (QE) from the European Central Bank (ECB). The technical approach has differed from that of the UK and US.
- Economic growth across the region has been disappointing this year. It is hoped the ECB's latest measures will boost activity and increase the worryingly low rate of inflation (figure 5).
- UK and US investors tended to respond positively to bad news when QE was implemented. If Europe's economy remains weak, monetary stimulus is more likely, and the prospect of additional liquidity should push asset prices higher.
- European share valuations look attractive across various measures, particularly when compared with the US stockmarket (figure 6).
- However, we remain cautious of taking a short-term view. The eurozone economy faces strong headwinds including the lack of functioning institutions and mechanisms for resolving its problems and economic imbalances.

FIGURE 5

Inflation has fallen to a worryingly low level in the eurozone and the threat of deflation remains.

Source: Rathbones, DataStream

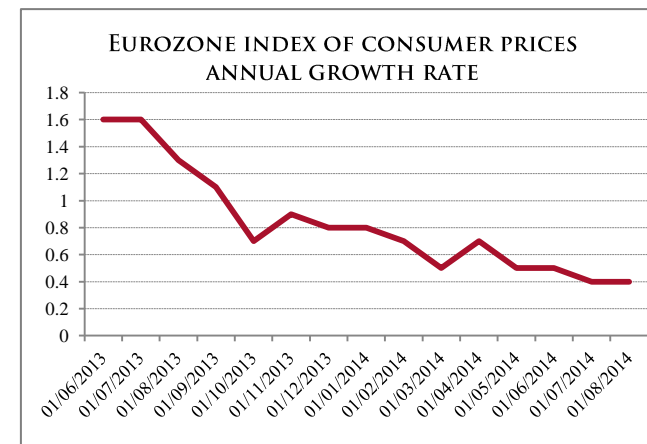
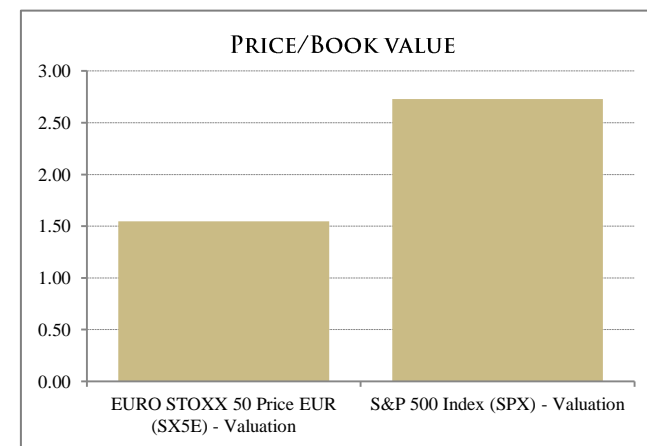


FIGURE 6

The Eurostoxx 50 Index is trading at more than a 40% discount to the S&P 500 Index on a price-to-book basis.

Source: Rathbones, DataStream





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## DIVERSIFYING STRATEGIES LOOK ATTRACTIVE IN A WORLD OF LOW RETURNS

- Before the financial crisis it was not unreasonable to expect an annual return of around 5% by investing in the relative safety of cash and government bonds. Yet since 2010 the returns from cash have failed to keep pace with the rate of inflation (figure 7).
- The risk-free rate (the yield on 10-year gilts) is just 2.5% at the moment. Meanwhile, inflation-linked bonds are relatively unattractive because the real return is negative (figure 8), although they offer protection against an unexpected increase in inflation.
- These low yields are encouraging investors into other asset classes. Equities are a popular choice but there are concerns that valuations look stretched.
- We prefer securities, strategies and asset classes where performance has a low correlation to equity markets but that can still generate positive returns through the business cycle.
- Our research and selection process is identifying talented alternative investment managers with the skills and resources to exploit market anomalies.

FIGURE 7

It used to be easy to preserve the real value of your wealth without taking any risk but those days are over.

Source: Rathbones, DataStream

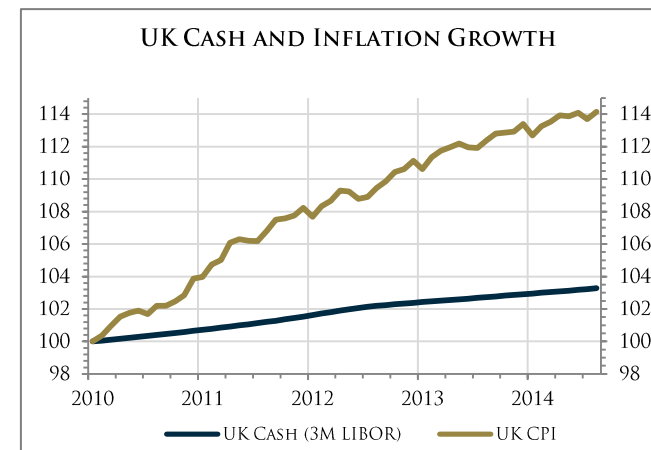
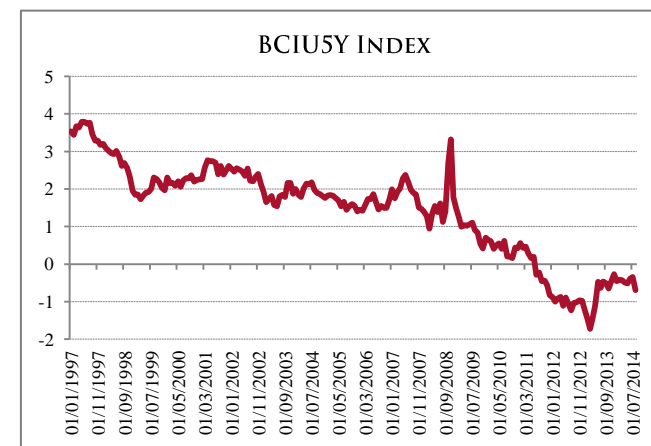


FIGURE 8

The real yield of UK inflation-linked bonds fell dramatically after the financial crisis and has not recovered.

Source: Rathbones, Bloomberg





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## JAPAN: DESPITE SOME SETBACKS THIS YEAR ABENOMICS IS SHOWING SIGNS OF PROGRESS

- ‘Abenomics’ describes the three measures prime minister Shinzo Abe has implemented to kickstart the economy – increased fiscal spending, loose monetary policy and structural reforms.
- So far this year there have been setbacks in the performance of the economy and stockmarket. A sales tax increase on 1 April was blamed for a large contraction in growth (figure 9).
- This contraction was, however, less than expected and we continue to believe Abenomics represents a credible long-term strategy – there have been some clear signs of progress recently.
- One of the key tenets of the reforms is the need for wage growth to help push up inflation, which appears to be having an impact (figure 10).
- There are ongoing discussions about allowing Japan’s Government Pension Fund to increase its domestic equity allocation. With ¥127 trillion (around £715 billion) in assets, any shift is likely to boost the Japanese stock market.

FIGURE 9

The pace of economic growth in the third quarter is likely to determine whether the Bank of Japan will carry out further monetary easing.

Source: Rathbones, DataStream

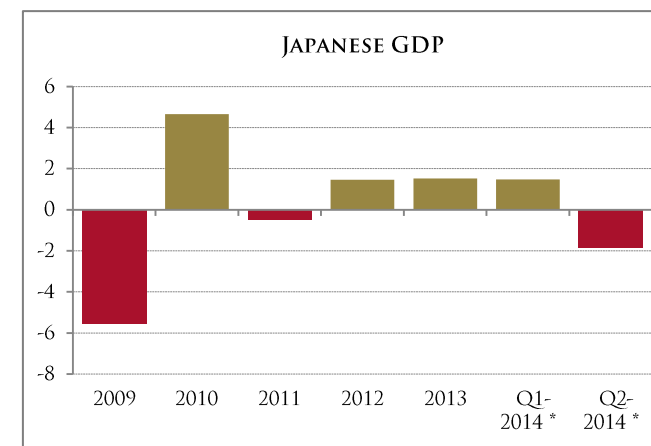


FIGURE 10

After years of stagnation, wages in Japan have begun to increase this year, which should help to push up the rate of inflation.

Source: Rathbones, DataStream

