INSIGHTS

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Global Tactical Asset Allocation 2014 Outlook

More Of The Same

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I entered 2013 feeling relatively cautious, particularly towards equities. The global economy was still fragile given both the excessive amounts of outstanding debt and the high dependence on liquidity. The magnitude of the on-going private sector de-leveraging (in the developed economies) plus public sector fiscal tightening, were also major concerns.

The risk, I felt, was that all would weigh on corporate earnings and sentiment. While I recognised that equity valuations were broadly in the neutral to expensive range, I was concerned they did not offer a sufficient "margin of safety". In the event, there was not only a broadening and deepening of the US private sector recovery but also a stabilisation in the situation in Europe. This performance bettered my expectations.

The stronger US growth, while being broadly positive for US and developed world risk assets, did put upward pressure on real interest rates and the dollar. The resulting modest financial tightening coupled with relatively disappointing (albeit still high) emerging market growth data, periodically undermined the expensive (and thus vulnerable) emerging market assets throughout the year.

With hindsight, I could have been more aggressive on my equity positioning.

I had positioned our funds with a preference for developed market equities (particularly Europe) over those in the emerging markets. Relatively low valuations and growth momentum in the developed economies attracted me.

Broadly this strategy worked well given the relative out-performance of the developed markets. Unfortunately, for relative valuation reasons, I did not overweight US equities, opting, instead, to gain a US exposure via high yield corporate bonds. Both rose, but US equities increased more.

In aggregate, 2013 was a good year. I finished 2013 relatively well, with the funds that my team and I manage mostly outperforming their benchmarks.

As we move into 2014, the consensus anticipates that the long awaited move to above trend growth in the developed markets will occur, thus spurring private consumption and investment. I would broadly agree. While this will likely be led by the US and UK, European growth momentum appears to be improving.

Improvement in the developed markets should provide some support for the emerging economies. But there is probably less scope for improvement in the latter given they generally have less spare capacity, more inflation and declining terms of trade (as commodity prices fall).

Despite the anticipated improvements, the consensus does not expect the major central banks to change their easy monetary policies any time soon. But many anticipate some reduction in the US Federal Reserve Board's asset purchase program this March 2014.

I am not so convinced. I suspect that the broad message from the US Federal Reserve Board (and elsewhere) will likely remain that financial conditions will stay easy until strong growth is assured.

Combination of easy money and improving growth should underpin confidence in developed economy equities.

If so, the combination of still-easy monetary policies and improving growth should, on balance, remain positive for developed economy equities and risky assets such as high yield bonds. In short, the dynamics that lay behind my 2013 fund positioning look set to continue into 2014. The issue then becomes value.

Markets, however, could again experience bouts of doubt. I am braced for "summer of 2013" repeats as investors discount a potential rise in US rates on stronger growth.

Similar to 2013, the markets I see as being most vulnerable to this possible shift are in the emerging market world. As I noted above, many emerging markets (South East Asia and Latin America, for example) not only look expensive but also have limited spare capacity, more inflation and excessive credit growth. These factors are contributing to rising external imbalances, which increase their dependence on foreign capital inflows.

As such, rising interest rates could negatively impact these markets as most have yet to make the required adjustments.

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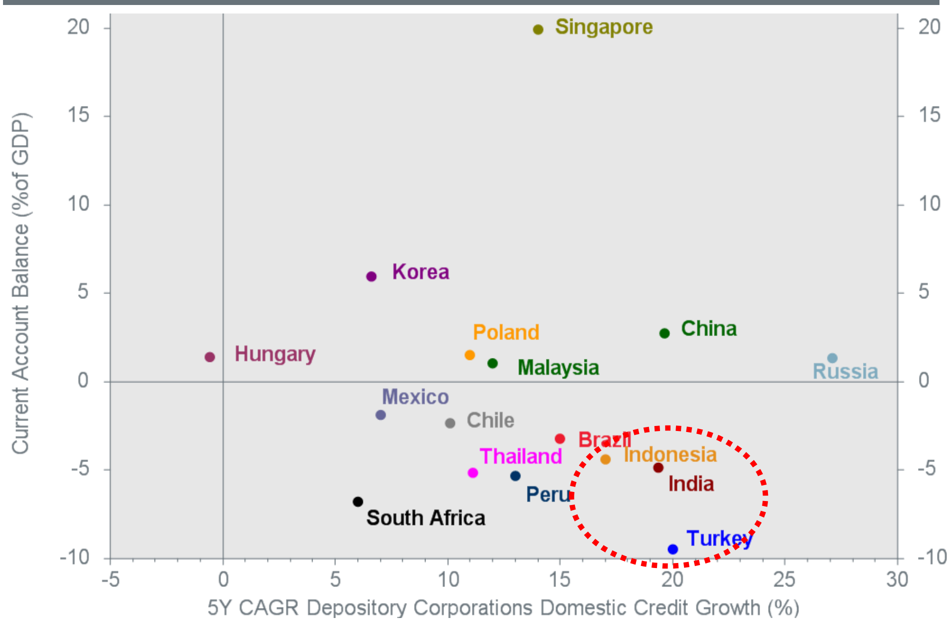
Chart 1 : Emerging markets most reliant on external funding are vulnerable to a liquidity crunch!



Source : JP Morgan, IMF and Thomson Reuters Datastream as at 12 December 2013

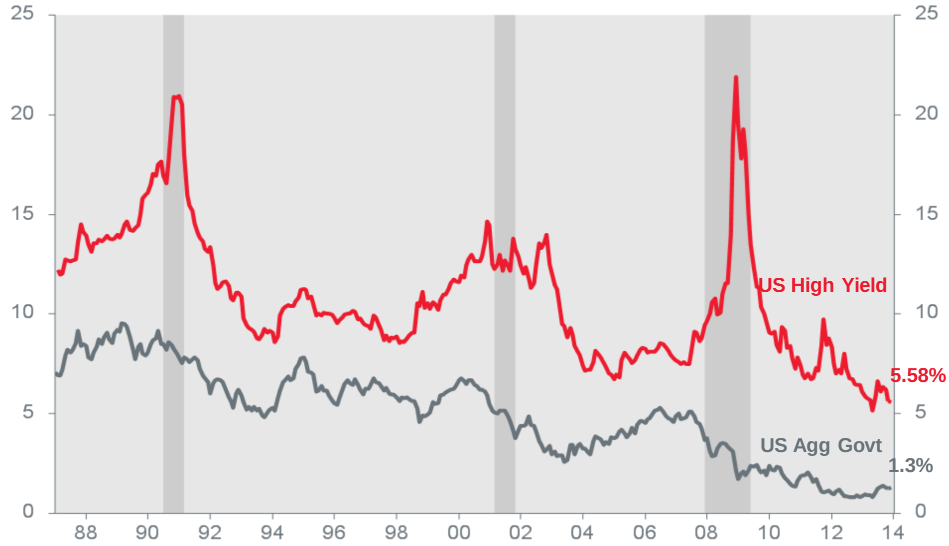
I am not tarring all emerging markets with the same brush; I do see selected opportunities. China, for example, and China adjuncts (such as Brazil and emerging Europe), are already well advanced in the adjustment process; growth expectations and lower market valuations already reflect, in large measure, the more challenging global macro conditions.

But these are the exceptions. My general concern remains that emerging market underperformance has further to run. Indeed, I fully expect it to be exacerbated by periodic dollar strength or rising real rates.

Bond story is not over yet … yields on corporates continue to look attractive.

For the most part, I expect 2013's "yield" story to extend into 2014. Generally better growth, low inflation and accommodative monetary policies create yield friendly environments. Moreover, corporate balance sheets are generally robust, funding requirements are low and credit spreads remain around their historical averages.

Chart 2 : US high yields offer a good yield pick up over sovereigns



Source : Barclays US Corporate High Yield Index and Barclays US Aggregate Govt. Index from Thomson Reuters Datastream as at 12 December 2013. Shaded area denotes NBER defined recessions

The major risks I see are not only those periodic shifts in policy expectations to which I referred above, but also growth disappointing those investors having relatively elevated expectations.

In conclusion, I began 2013 overweight both attractively valued developed market equities (Europe, for example), and selected allocations to the cheaper cyclical equity markets (such as emerging Europe and Korea).

In a nutshell.

Following 2013's rerating, equity valuations seem neutral overall but remain attractive relative to government bonds. Broadly, my funds are neutrally positioned between equities and bonds, but within equities, I remain overweight European equities and selected cheaper cyclical markets (including the mining and metals sectors). Within bonds I still prefer corporate credits (particularly high yield bonds) relative to sovereigns.

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