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Asset Management

Viewpoints
FROM CHAIRMAN JIM O'NEILL

Are Things That Good?

Even with my often optimistic mood, I never quite expected to be asking this question. However, with January 2013 ending with a rather spectacular performance in the markets, the mood continuing at least for the start of February, and importantly, some rather positive data from many parts of the world, perhaps it is relevant. As I had been expecting, things are certainly starting to look quite a bit better. At some point, the question posed above is going to become very real, since I believe a/ some equity valuations are starting to not seem overly cheap, b/ there are challenges ahead (as discussed in my last Viewpoint) which now include currency issues and, c/ of course, if things are that good, then major developed market bond yields, in particular the US, are on the way up which could create fresh issues.

Further Key Data Improvements.

As anyone who follows these things would expect, as a result of the current easiness of the global financial conditions, we have started 2013 with a number of shorter term leading economic indicators for January turning more positive. This latter development has allowed the markets to pay little attention to many negative, albeit remarkably diverse, Q4 2012 GDP reports, coming from Germany, Japan, the UK and the US.

Amongst the most important indicators for this recent improvement, many of which I have highlighted for their importance before, I would include:

1. Korea's January trade data showed a much better than expected 11.8% rise in exports. Given Korea is the first country to report, this is a great barometer for what will follow elsewhere, and a sign that world trade is on the rise.
2. The world's manufacturing confidence indices, as measured by the JPM global PMI rose quite sharply in January by 1.4% to 51.5, suggesting the improving trend seen in Q4 has accelerated.
3. Within these, a number of critical areas to the world economy turned in impressive PMI/ISM prints led by the US of course, with a sizeable bounce to 53.1 from 50.2. While not all components impressed in the US release, the key new orders index rose notably, as it did elsewhere in the world.
4. The Euro zone final PMI rose quite sharply to 47.9, with improvements virtually everywhere with the notable exception of France (and a set back from a large previous bounce in Ireland). Germany is back up to 49.8 and of perhaps greater encouragement, Italy in particular, but also Spain and Greece showed varying degrees of improvement. Although of course, we can't lose sight of the level still being quite low.
5. While the China official PMI was a touch softer than expected at 50.4, the well-regarded HSBC China PMI rose sharply to 52.3 and there is a suspicion that a broadening of the sample size in the official survey might have affected the result.
6. Back to the US, something that really caught my attention was the December personal income report, which showed a huge rise in incomes on the month, almost definitely helped by early receipt of dividends and bonuses. However, the eye-catching part was the associated news that the personal savings rate was reported at 6.5%. Four and a bit years on from the depths of the crisis, if this were the "new" level, it

would be a huge change, and yet another indication that the US has adjusted quite impressively and as needed.

7. And finally, back to China where it was reported that the 2012 Balance of Payments current account came in at $214 bn, which on my calculations, is “just” 2.6% of GDP. This suggests that China is very different than it was in 2008 and before.

However, every week it is possible to find some data disappointments. The UK PMI slowed to 50.8 adding to a belief that the UK can always be relied on to disappoint these days, although given the bounce the previous month and where the UK has been, this is “not bad”. Japan also reported some slightly disappointing data but given the forward looking nature of markets and given the policy issues there, this was merely a sideshow.

So Close Our Eyes, Go On Holiday Until May?

Maybe this is the easiest thing to do. Certainly lots of the proprietary indicators linked to the highest frequency data I have become accustomed to using, suggest that the absolute rise of equities and the relative outperformance of equities versus bonds is set to continue.

Against that backdrop, some of the moves since November have been so large, one could easily imagine some corrections. Of course, these days when these things happen they usually shake our confidence.

The media is hugely focused on the “Great Rotation” idea, something which I focused on in my first Viewpoint for 2013, and lots of analysts are now citing the sizeable weekly flow of funds data as either confirmatory signs or in some cases, a reverse indicator. Personally, I have a bit more sympathy with the reverse indicator notion, although my core belief is that the markets will follow where both valuation and cyclical momentum lead us, and to get too wrapped-up in fund flow data is dangerous.

As I did discuss with a number of people last week, while I did and still do expect more rotation from bonds to equities, this doesn’t in itself suggest that equities will certainly continue to rally. I have learnt repeatedly through my career to not get to too excited about following fund flow data, as interesting as it is, since it is no guarantee of asset price movements. Or put differently, it is more likely that asset price performance leads to shifts in asset allocation, rather than the opposite.

The other point I would also like to mention, is according to one of the more cautious valuation techniques I have learnt to follow, so called CAPE (Cyclically Adjusted Price Earnings), the US market is certainly not cheap today, and neither are Australia nor Mexico (see table below). Such a cautious approach does not mean these or any markets will stop rallying but it is a sign to be careful and that these markets could be especially vulnerable to disappointing and surprising news.

Many other markets do remain quite cheap, including the other seven of our so-called Growth Markets, as well as Japan and much of continental Europe. This explains why, as I have been suggesting, I would still concentrate my bullishness there.

Other Things That Caught My Eye.

Lots of interesting things going on all over the place as usual, and the following caught my attention this past week:

1. There was a notable decline in the Korean Won, the Taiwan Dollar and other Asian currencies last week. This might be a coincidence but it might also, which I believe is likely, be linked to the weakness of the Yen. If true, this is an additional reason why the Japanese currency decline is becoming more and more dependent on Japanese monetary policy truly driving this. It is quite interesting that over the weekend the Japanese Finance Minister mentioned that the Yen decline is a consequence of their policy, rather than the policy itself. Going forward, I suspect this aspect is going to be getting more focus from policymakers elsewhere.
2. It is most interesting to read that both Nicolas Anelka and Didier Drogba have already returned from China to Europe to extend their football careers, suggesting that all is not well with this part of the “new“ China. It seems as though aspiring Chinese clubs are not quite prepared to pay up for marketing talent as some of the hype had suggested.
3. In contrast, the one and only David Beckham turning up at PSG was a master stroke for both him and the Qatari owners, and I don’t recall ever seeing such a Parisian love affair with anything British.

UK House Prices and the London Dilemma.

The FT had a fascinating as well as a somewhat scary article on Saturday, highlighting the extraordinary gap growing between London and rest of Britain. I have discussed this before, and as if we didn't have enough challenges in the UK, over the medium to long term, this is a huge challenge for the next generation and many less advantaged. A particularly eye-catching part of the story was that an affluent Surrey suburb called Elmsbridge has a housing stock whose value is bigger than the whole of the city of Glasgow. Not far behind this in terms of shock factor, the 10 most expensive London boroughs have a housing stock equivalent to that of North Wales, Scotland and Northern Ireland put together. I don't know what the solution could be (becoming a nation of Germanic style renters?) but I had joked in late November to the Westminster Property Association that perhaps they had more reason to consider a referendum than Scotland. Perhaps the rest of the country might like that!

Sporting Legends.

Another great win for United at the weekend with Mr. Rooney starting to answer some of his critics down by the River Thames at Fulham. I had the pleasure of being there before dashing off to Shepherd's Bush for a reunion of the one and only "Family" with Roger Chapman in fine voice. And for those of you from either my generation or earlier or even Leicester, their appearance was introduced on stage by the equally legendary Frank Worthington.

Anyhow here's to the mood and spirit of January 2013 markets living on and surprising everyone, perhaps even me!

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>> **Cyclically Adjusted PE Ratios**

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