Elgin asset management

investment commentary monthly

Monthly Commentary 4th May 2015

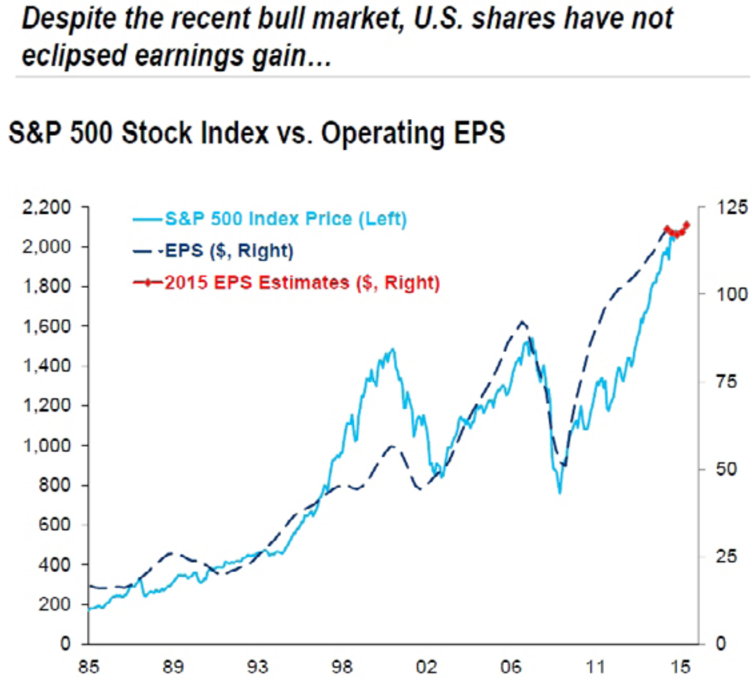
April was a mixed month for the markets. US equities were largely flat, while Eurozone equities fell and Emerging Market ones, led by BRC (Brazil, Russia and China) did very well. There were however some big reversals in the trends as the trades that had proven to be big winners in the year to date reversed in a meaningful way. The almost universal one-way bets that had worked up to now, caused a lot of pain for many investors. These included sizeable falls in the USD, developed-market government bonds and the German stock market, coupled with a huge rise in the price of oil.

Why this reversal? If one was to read the mainstream press, the biggest culprit was the accumulation of negative data on the the US economy. As a result, the argument goes, the Fed would delay raising rates. It also implies that with China sputtering, the Eurozone out of life support - but not exactly able to run - the only other source of global demand (US), is struggling.

We are not as pessimistic. Taking one major region at a time, below are the reasons:

The US

We still expect a steady expansion in the US economy as the current economic cycle still seems only middle-aged, despite its current (long in the tooth) 6-year duration. For example, there is still plenty of available labour, and there is a way to go to reach full capacity. At the same time lower energy costs (despite the recent rises, oil prices are at almost half their levels of a year ago) and continuing low rates are a boon to the consumer, who drives most of the economy. There is also room for a pick-up in capital spending, which has been below par for many years, as well as continuing strong M&A activity as companies make better use of their huge cash piles through acquisitions. M&A volume as a percentage of total market capitalisation is still 40% below the average, indicating that there is a lot further to run for M&A. The market usually peaks 8 months after the crest in M&A activity. **In the end, all this should feed into stronger earnings growth, which is the single biggest driver of the markets.** The chart below from Citigroup shows the close correlation between earnings growth and market performance.



Sources: Standard & Poor's, Haver Analytics, Citi Private Bank as of April 2015.

Eurozone

Markets pulled back from their recent highs as the Euro strengthened versus the USD and bond yields surged (from admittedly very low levels). Many think the markets ran too far too fast and that the anaemic EU fundamentals do not justify further gains. **While we agree that markets moved too fast and were more than due a correction, we do not think that this is it.** Euro strength can partially be explained by the large inflows from abroad into Eurozone equities. Nevertheless, the big bazooka of QE is still ongoing and for a while longer. The massive extra liquidity, with credit becoming more easily available across the board can only be a good thing for both the economy and the markets.

China

Policymakers in China have acknowledged the dual problems of local government debt and overcapacity, and their policy response to both has been commendable. They have been making changes to their capital markets so that they can more easily absorb defaults. At the same time, investment (which is a disproportionately large part of their economy) is becoming more targeted and effective. Both their fiscal and monetary policies are addressing China's structural imbalances in a "slower growth" environment. As for their markets, they have been on a tear this year, up more than 80%. Yet, they do not seem to be in bubble territory yet as company valuations are not super-inflated. **In fact the Chinese market is still 20% below its previous peak, yet corporate earnings are almost 60% higher than they were then.**

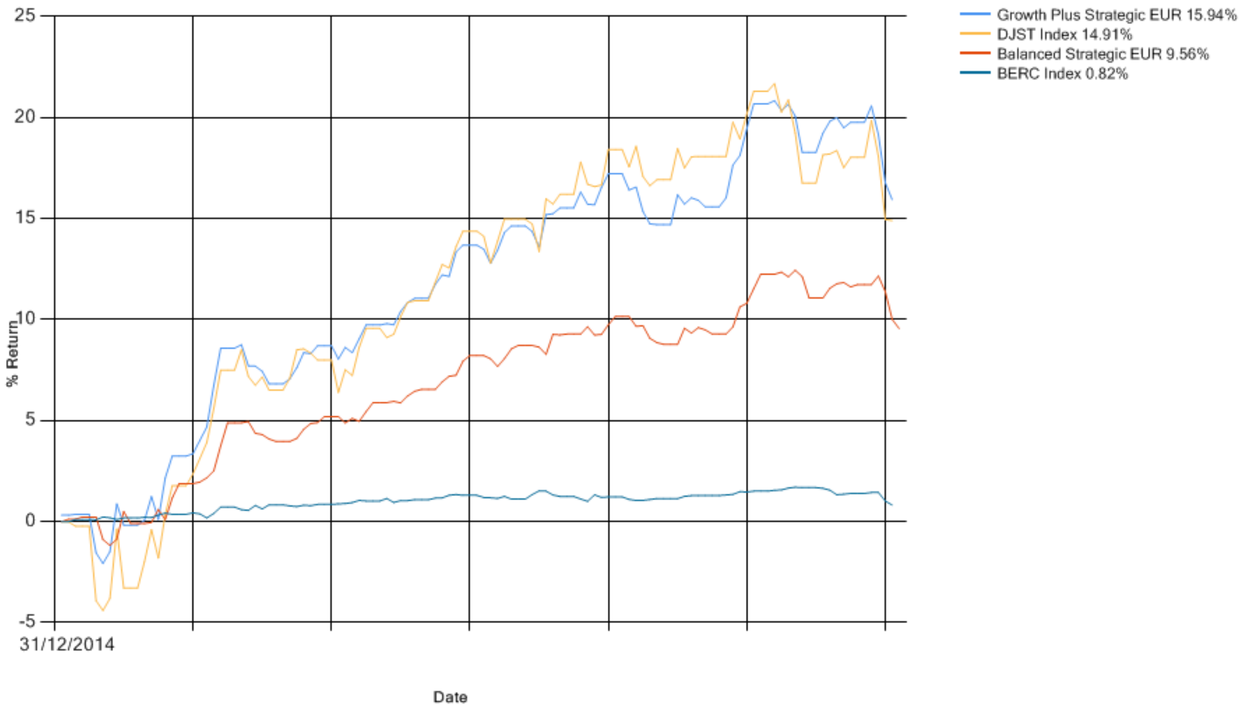
Russia

Who cares? Despite its vast oil and gas reserves, Russia continues to be a very small player in the global economy…

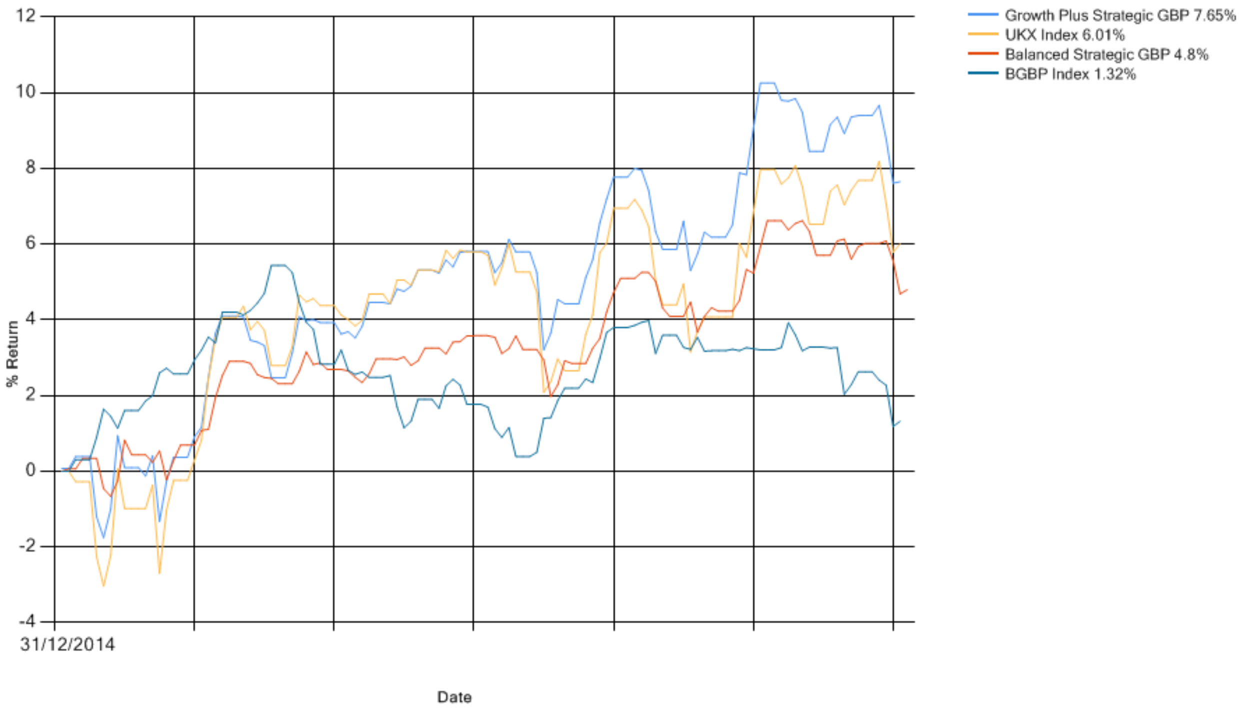
Elgin Portfolios YTD assessment

All of the above reasons keep us with a slight tactical overweight to equities., as we have not rebalanced our allocations despite the equity component outpacing the other asset classes in our portfolios.
At this stage it makes sense to take stock of how our strategies have performed so far in 2015. The three charts below show how our Balanced (approximately 50% in equities) and Growth Plus (95% in equities) strategies have fared versus the respective equity and bond benchmarks. In the case of equities we use the S&P 500 (USD), Euro Stoxx 50 (EUR) and the FTSE 100 (GBP), and for bonds we use the relevant Bloomberg Investment Grade Bond Indices in those currencies.

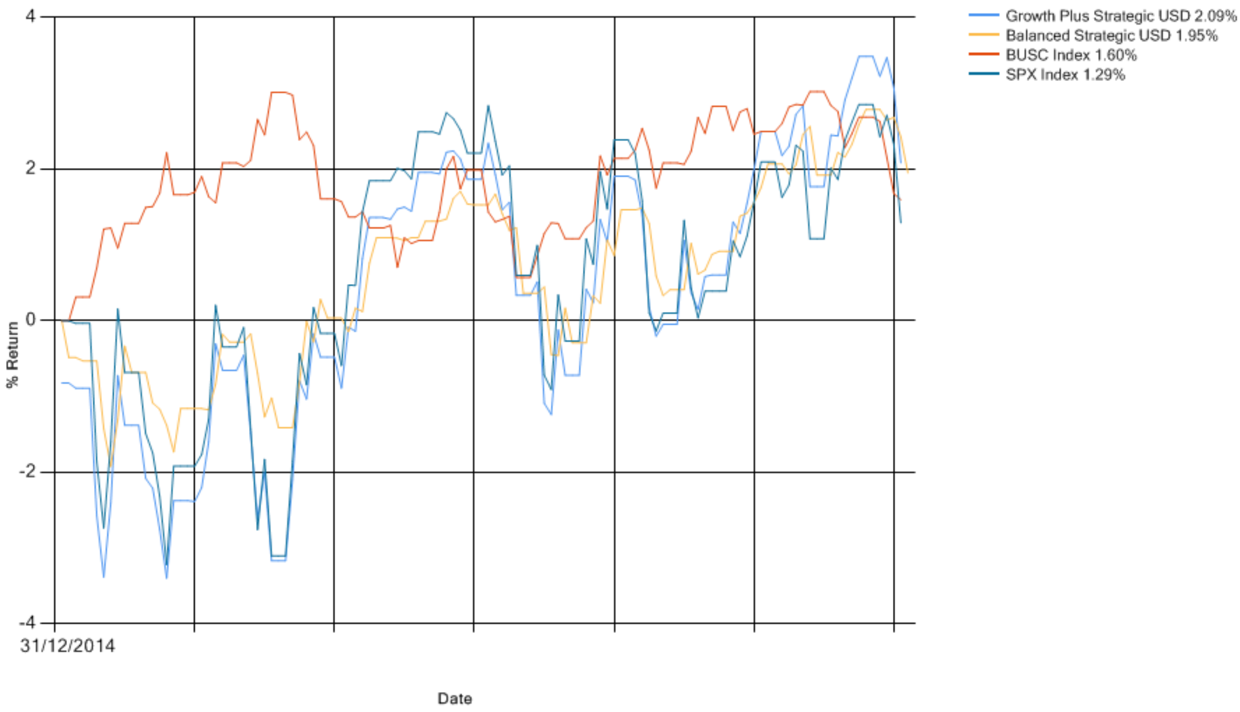
As you can see below, in all cases, our strategies have been robust. Both our strategic allocations (to low cost index trackers or superior long-only funds) and our tactical deviations (to our favourite equity themes) have served our clients well. You will notice that the balanced portfolios have performed very well, with much lower volatility (risk) than the markets.



Elgin EUR Balanced and Growth Plus strategies vs EUR Equities and Bonds



Elgin GBP Balanced and Growth Plus strategies vs GBP Equities and Bonds



Elgin USD Balanced and Growth Plus strategies vs USD Equities and Bonds

In all of the above cases, the Elgin Growth Plus strategies did better than the respective equity benchmarks. The Balanced strategies were closer to the equity rather than the bond indices.

So while a volatile summer might be on the way, we still believe that the macro backdrop favours equities, especially when compared to bonds.

The Elgin Analyst Team