Monthly Commentary 2nd June 2015

May was flat for most equity markets, though the two outliers were Emerging Markets and Japan. The former gave back all their April gains and fell 4%, led by Latin America. The latter steamed ahead by another 5% as the Yen started to weaken once again. Sovereign bonds, especially in Europe, continued their slide but at a more moderate pace. Interestingly, while high-quality government bonds fell, High Yield bonds, that are considered more risky, hardly budged. Commodities also fell by a modest 3%. Finally in FX, sterling managed to give back almost all its post-election boost vs the USD while the euro also fell.

On Bonds

Like most other investment committees, we too are concerned that bond yields are too low and investors who rely on coupon-clipping will have to do with a famine-like diet. Yes, bond yields can still fall further (and some into negative territory), so more capital gains might be on hand. But that is more a game for speculators than investors, as a backup in yields can cause serious damage to portfolios with large weightings to conventional investment grade bonds.

Indeed, in a recent paper, the Merrill Lynch quantitative team expect annual returns from bonds in the next 10 years to be a meagre 2%.

In order to mitigate the risk of eventually higher rates, our investment committee has decided to increase our allocation to low-duration bonds, which are less sensitive to rises in rates. At the same time, we are keeping our 5% allocation to High Yield Bonds, across all portfolios.

We should also point out that in Europe at least, where the brunt of the bond selling occurred, we are not overly concerned of a bond crash as the ECB still has 90% of its bond buying left. This is massive ammunition and it is difficult to imagine how bonds can collapse with so much support.

On Equities

There is a lot of worry that when the Fed starts raising rates it will be the death knell for US equities. Yet we need to consider why the Fed will raise rates. In a period of benign inflation, it means that the economy is strengthening. This in turn is good for the equity markets. In the past, bull markets have not topped out until two full years after the first rate hike - and this is not expected until later this year. It is noteworthy that the average gain in those two years has been 33%.

But what of valuations? Aren't they too high, which would imply poor returns in the future? While valuations are elevated they are still well below the average of prior bull market peaks.

Additionally, valuations, as a metric, are not good at predicting short and medium term stock market moves.

One of our concerns however is that **equities might become more volatile**. So the upward march of the S&P 500 might suffer some setbacks. With this in mind, we shall be substituting part of our direct exposure to the US markets with a partially protected security which is tied to the S&P 500. This is a very simple 1-year product that will partake in 75% of the upside of the US markets but is fully protected if the markets do not fall by more than 15% in that period. We believe this is a pure risk management exercise which the current US market environment warrants.

What of European equities? Here we are more bullish as continuing QE, better corporate growth on both profit and revenue, higher domestic demand, more credit availability, a relatively weaker currency, and lower energy prices should continue to drive equity markets higher.

The Elgin Analyst Team