Uncertainty has been the watchword for investors over the past five years, and so far 2013 is proving no different – as the Cyprus bank bailout starkly illustrated.

However, the optimism with which we began the year has been vindicated – the troubled global economy is showing signs of improvement. Central bank policies in the US, Europe and Japan that are directly linked to growth are having a positive impact. As a result, several equity markets across the globe, including the FTSE 100, S&P 500 and the Nikkei, have reached levels not seen for five years. The sell-off in gold this year is symptomatic of investors’ renewed confidence.

But investors still face a huge amount of uncertainty and some tough challenges. There is no greater challenge than the one that confronts cash and bond investors. It is a challenge that we highlighted in our 2013 Outlook, Five Risks & Ten Opportunities.

Since 2008, consumer price indices have increased by 10 per cent in the US, 11 per cent in the eurozone and 19 per cent in the UK. In the same period, the return on cash has been almost zero, reflecting central banks’ ultra-low interest rates. Investors seeking the safety and liquidity of cash have suffered a quiet but significant destruction of their wealth. We expect this period of very low interest rates to continue, requiring investors to think again about their cash holdings.

In the past, risk-averse investors have also been able to rely on the perceived safety of bonds, but this dynamic is changing following the bond rally, which resulted in yields falling to record lows. Government bonds, which could once be relied upon to provide an income that was higher than inflation, can do so no more.

With these high-quality government bonds yielding less than inflation, the real wealth of investors in these assets is being steadily eroded. And as our leading article explains, high-quality bonds may not be equal to the task of preserving your wealth because there will be a point at some stage when yields will start rising and bond prices will fall. Meanwhile, we remain positive in our outlook for equities.

Investors cannot afford to stand still – the ramifications of the financial crisis continue to unfold. We are very mindful that investors may need to review their portfolios to ensure that they are still on course to meet their financial goals and objectives.

I hope you will find our Mid-Year Investment Outlook 2013 insightful, but remember that our Wealth Managers and Specialist Advisers are always on hand to help you gain additional insight as you review your options.

Gayle Schumacher
Head of Investment Office

Plan to preserve: investors looking to the perceived safety of cash and bonds to maintain their wealth should think again

~ Investors cannot afford to stand still – their real wealth is being steadily eroded
ond investors are moving into uncharted territory. The financial crisis and ensuing economic turmoil led to unprecedented demand for fixed income as investors moved to protect portfolios.

Demand for bonds sent prices rising and sent yields, which move in the opposite direction to prices, tumbling to record lows. It is this phenomenon that could have ramifications when the global economy begins to recover and bond markets return to normal. It’s a scenario we raised at the beginning of the year in *Five Risks & Ten Opportunities*. We highlighted that central-bank policies in Europe and the US would mark an end to a 30-year bond bull market – and that investors would have to be prepared for lower returns as a result.

Events are unfolding as we predicted. So far this year, government bonds (UK gilts, German bunds and US Treasuries) have delivered zero to modestly negative returns, while investment-grade corporate bonds have only performed marginally better. Investors hoping for returns of around the 4 per cent earned in recent years have been forced to invest in the high-yield bond sector.

Improving economic growth expectations in early 2013 influenced the poor performance of lower-risk bonds, with prices falling as demand waned. However, with renewed scares in Europe (Italy and Cyprus) and disappointing economic data from around the world, low-risk bond investors have relied on coupons (the interest on bonds) to drive total returns – yet these remain close to record lows.

The outlook doesn’t look any brighter, and at best we expect coupons to be the primary driver of returns for bond investors in the months ahead. While this modest positive performance may be reassuring to investors who rely on fixed-income returns, it masks a growing threat: the risk of capital losses.

Last year, the US Federal Reserve (Fed) announced policies directly linked to economic growth and employment – effectively shifting its policy focus from protecting against inflation to targeting growth. Japan has taken this approach one step further by targeting a higher rate of inflation to kick-start its troubled economy.

The Bank of England is soon expected to shift policies to have a

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<th>14.4%</th>
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more overt growth focus in spite of stubbornly high inflation in the UK economy. Similarly, the eurozone, with growth sputtering not only in the region’s troubled periphery but also in Germany, is expected to begin an easing cycle in earnest in the months ahead.

In short, the extent of the central-bank easing is likely to bring risks, including rising interest-rate volatility (see panel, right), and changing expectations of future inflation – both of which influence bond returns.

Long-term inflation is the enemy of bonds because the purchasing power of the bond’s fixed interest rate, known as the coupon, will fall. It is also the enemy because expectations of rising inflation lead to investors demanding higher yields, which pushes bond prices lower. Such a scenario could leave investors nursing capital losses if they do not hold on to bonds until maturity.

For example, investors may recall that in early 2009, yields on US Treasuries rose sharply (and prices fell) as expectations for inflation over the following two years rose. This resulted in an 11 per cent decline in the prices of 10-year US Treasuries over the period. In other words, investors do not need inflation to actually change to feel the impact – simply the change in expectations will be enough to hurt returns.

Inflation expectations for the next 10 years are at a record low, but given the dismal yields on bonds, investors are getting little compensation for any uptick in inflation. A similar situation arose last July following action from both the Fed and the European Central Bank. US Treasury yields rose nearly half a percentage point, resulting in negative total returns for investors. German bunds and UK gilts also lost investors money.

We face a similar situation today. To address the key issue of rising long-term interest rates requires a reordering of priorities when it comes to managing risks.

Long-term inflation is the enemy of bonds because their purchasing power falls.
We started the year looking for equities to outperform bonds, and this has been reinforced lately as the debate has shifted at the US Federal Reserve (Fed) towards the need for more quantitative easing (QE), not less. We expect the extra money to find its way into riskier assets such as equities.

The US central bank has cranked up QE (bond purchases) each time its preferred measure of inflation has dipped below 1.5 per cent (see chart). Though the potential for such aggressive and unconventional monetary stimulus to fuel long-term inflationary pressures is a concern, this policy was first put in place during the financial crisis to avoid a deflationary spiral that might mimic the Great Depression.

With inflation subdued at around 1.5 per cent, we believe the risk of deflation remains the dominant concern at the Fed, and QE is here to stay for the foreseeable future.

Instead of targeting investment-grade corporate bonds directly, we believe investors can replicate their returns with less volatility and liquidity risk by combining 'risk-free' government securities with quality high-yield corporate bonds (which have credit-quality ratings that are below investment-grade bonds).

However, this strategy alone will do little to protect capital should bond yields rise more persistently. A focus on absolute returns (delivering inflation-beating performance), floating-rate notes (bonds linked to money market rates) and inflation-linked bonds makes sense.

In the past, investors have looked to mitigate the risks from more volatile equity markets through fixed-income investments – a strategy that made sense given the perceived lower risks of the long-term interest rate outlook.

However, we suspect this dynamic will reverse because there are now greater risks around the interest rate outlook. We think exposure to this specific risk should be reduced in exchange for a slightly higher exposure to equity market risks.

The message is clear: Investors need to reassess their risk-management priorities. The low returns from fixed-income so far this year indicate to us that the 30-year bond bull market has come to an end and we see a less benign stage ahead: negative total returns from lower-risk bonds.
The precious metal still has a role to play

Gold’s allure is fading fast as investors become increasingly optimistic about the prospects for the global economy. Not even the Cyprus crisis could tempt investors back.

Having reached a peak of $1,920 per troy ounce in 2011, gold is no longer a one-way bet. There was a long list of reasons to recommend it: near-zero interest rates across most of the developed world; debasement of major currencies through quantitative easing (QE) and the threat that this would fuel inflation; the possibility of a eurozone breakup; and the potential for a sell-off in risk assets if the US fell over a ‘fiscal cliff’.

But gold’s appeal has faded on several counts. Fears of an imminent eurozone breakup have subsided, the US fiscal cliff has been largely averted and the global economic recovery has shown some signs of stabilising.

The rampant inflation that some foresaw in a world awash with dollars, euros, yen and sterling hasn’t materialised. Indeed, global inflation is falling, and unless this trend reverses, gold will struggle to get anywhere near its peak. We don’t envisage higher inflation this year, unless it is triggered by geopolitical tensions in the Middle East, which could lead to a surging oil price.

Gold doesn’t generate an income, but given the low yields on most safe-haven government bonds, this hasn’t detracted from its appeal – but that could change. We expect bond yields to rise as the global economy recovers, making gold less attractive.

Despite its fall from grace, gold has shown resilience. As exchange-traded fund (ETF) investors have cut their exposure to gold, tactical investors have used price dips to stock up on bullion. Bargain hunters in India and China have also looked to buy cheaper jewellery. This offers some comfort to gold bugs, who will be keeping a close eye on the impact of any further QE. If it fails, investor confidence will quickly disappear.

WHAT IT MEANS FOR YOU

We have been reducing our exposure to gold in many of our portfolios in favour of risk assets, such as equities, since last autumn. Yet gold continues to have its place in some portfolios, albeit on a lesser scale. Its value is intrinsic and its price can move independently of many financial assets – in certain cases it may rise as they fall. This is why gold has proven over time to be a good hedge against risks – known and unknown. With risks, such as the impact of QE, still remaining, gold justifies its place in a diversified portfolio.
ABENOMICS: AN INFLATED STRATEGY?

Japan investors reap rich rewards from new policies

Policymakers have been behind the extraordinary rise in the Japanese equity market – and they are not finished yet. They triggered the rally by ‘bullying’ the Bank of Japan (BoJ) into adopting an explicit inflation target and buying huge amounts of government bonds through quantitative easing (QE).

There is still much to look forward to as Prime Minister Shinzo Abe continues to drive his aggressive economic policies, better known as Abenomics. For instance, a package of spending increases, principally on infrastructure, is planned in the summer.

We don’t believe that Japanese equities are expensive, despite the rally. We have seen significant upgrades to corporate profit forecasts as companies and analysts start to see the impact of the government’s actions. While corporate profit forecasts are rising, estimates from economists are about 10 percentage points higher than those from company analysts. But we believe that the bigger-picture view from economists will prove a more accurate prediction of the future. And as analysts and companies get more excited about future profitability, we expect the equity market to rally further.

Many investors will insist that they have seen it all before – Japan is known for its false dawns. Yet this time the mood is different and Abenomics appears to have substance. Consumer confidence is improving and, crucially, surveys show an increase in inflation expectations. The more inflation people expect, the more likely they are to return to the shops before prices rise. It is also noticeable that employers are starting to pay bonuses and increase wages. The ripple effect could be significant to the upside. With higher income comes greater confidence and, with inflation thrown in, it could all add up to a prolonged equity rally for Japan.

WHAT IT MEANS FOR YOU

We are aiming to capitalise on opportunities within specific sectors, since the weaker yen, resulting from Abenomics, will benefit companies with significant exposure to foreign revenues. This is why we prefer exporters – industrial and car manufacturers in particular. The BoJ’s actions should also support the banking sector, while the end of deflation could invigorate the property market.

WHAT IT MEANS FOR YOU

Given an uncertain economic outlook, we think high-yielding emerging-market bonds look better than equities as a way of getting exposure to the developing world for now.
THE INVESTMENT STRATEGY COMMITTEE

Our three Chief Investment Officers make up the committee and, collectively, they are responsible for establishing our view on economies, financial markets, asset classes and investment strategy.

Gary Dugan

CHIEF INVESTMENT OFFICER, ASIA AND THE MIDDLE EAST

Based in Singapore, Gary is responsible for Asian-based discretionary portfolios. He draws on a 30-year career in wealth management for his role as CIO and has held a number of key positions in the industry.

Norman Villamin

CHIEF INVESTMENT OFFICER, EUROPE

Norman has more than 18 years of experience managing wealth, both on an advisory and discretionary basis. Based in Zurich, he is responsible for US dollar, euro and Swiss franc-based discretionary portfolios.

Alan Higgins

CHIEF INVESTMENT OFFICER, UK

With a high-profile career in portfolio management spanning 20 years, Alan is responsible for the management of the UK-based discretionary portfolios. In conjunction with the other CIOs, he also helps shape our investment decision-making.

INVESTMENT STRATEGISTS

Pierre Bose | James Butterfield | Rajesh Cheruvu | Brian Jackson | David Lewis | Rashmi Suthanthi

Georgios Tsapouris | Lindsey Wright

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