Macro Roundup

QUOTEDDATA

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A collation of recent insights on markets and economies taken from the comments made by Chairmen and Investment Managers of investment companies – have a read and make your own mind up. Please remember that nothing in this note in designed to encourage you to buy or sell any of the companies mentioned.

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Global economy

From Hamish Buchan, Chairman, Personal Assets Trust : PNL

We are not 'gold bugs', committed to holding bullion for ever. But we believe that the preconditions for a secular bull market in gold remain in place. Negative real interest rates in all major currencies are likely to prevail for many years to come and the only prospect of positive real interest rates is from a spell of deflation, which the Federal Reserve is determined to avoid.

We are in the midst of an extraordinary and unprecedented monetary experiment which is unlikely to end well. More than five years after the financial crisis, interest rates remain at emergency levels (in the case of the UK, at a 300 year low) and there is little sign of an appreciable increase any time soon. Stock markets are back at their all-time highs (in nominal terms, at least), but valuations are overstretched and vulnerable, and we have yet to see the negative consequences of the US's tapering of QE on markets which have grown addicted to this sweet poison. Money printing has failed to secure the desired 'escape velocity' for western economies and corporate earnings have stagnated over the past two years. The disconnect between the economy and the stock market has become ever wider. Those piling into equities today may well be locking in very low prospective returns with commensurate high volatility and downside risk. Prudence will not always be punished. It is reckless behaviour that is ultimately penalised with permanent losses. Stock market bubbles make investors look foolish either before or after the peak. The last year gives no doubt as to where we stand.

From James Ferguson, Chairman Monks Investment Trust : MNKS

The period since what has become known as the Global Financial Crisis has been in many ways an abnormal one owing to the novelty of the policy responses. This has involved reducing interest rates to extremely low levels. For example, the Bank of England's policy rate is the lowest since it was founded in 1694. It has also involved the direct intervention of central banks in financial markets through the purchase of government bonds and various forms of asset-backed securities. There have been more conventional Keynesian style attempts to stimulate demand through government spending in some countries while other countries have adopted austerity programmes in an effort to rein in explosive growth in government debt. The United States has even managed to do both, initially combining pump priming at the Federal level with severe austerity at the State and municipal level and then cutting spending at the Federal level as a result of political deadlock.

The net result of these various actions has been extremely beneficial for the holders of most forms of financial assets, including shares, government and corporate bonds and property as well as for the value of substitutes such as fine art and other collectables. The more important benefit is probably harder to see, namely what the aggressive action of central banks, and to a lesser extent governments, prevented from happening. Were it not for these various interventions we could have been tipped into a vicious downwards spiral of the sort experienced in the 1930s. This at least is the argument advanced by those responsible for decisions that have punished prudent savers depending on income from deposit accounts or forced to buy unattractive annuities in order to bail out imprudent borrowers and lenders. With some signs of a return to more normal conditions emerging in a number of countries, most notably the United States, it appears to be only a matter of time before interest rates start to revert to more normal levels and the direct intervention in financial markets comes to an end. While this may promise some relief for small savers and pensioners, it raises a question about the future direction of financial asset prices that have been boosted by the abnormal policies in place over the last five years.

With this shadow hanging over markets it does not seem prudent to borrow money to invest in equities, especially as valuations are on some measures at the upper end of historic ranges. The alternatives to equity investment, however, tend to look much worse in terms of high valuations and consequent low expected future returns. The owners of equity in companies may rank last after the lenders have been paid what is due to them, but they also get to participate in the growth of cash flows whereas lenders are currently being promised very little for the use of their money and the risk of not getting all of it back. The return to normality may be delayed by the need to combat the risk of deflation taking hold in the Eurozone and by the acceleration of asset purchases by the Bank of Japan. The US Federal Reserve and the Bank of England have also indicated that they expect to move very gradually. It is therefore difficult to make a strong case for holding a large amount of cash at present and as a result we remain more or less fully invested, but not geared, with almost all of our investments in shares.

Our portfolio is diversified across a range of different types of shares, but is biased away from the very largest companies at present. This is a time of rapid change, when traditional business models face increased risk of disruption from new entrants, often making better use of the possibilities created by the internet, and our managers believe that there are better growth prospects among the disrupters than are generally to be found among the incumbents. In the short term, the share prices of the newer entrants tend to be more volatile, making returns on an annual basis less predictable, but the long run return should be better

From Richard Killingbeck, Chairman, Bankers Investment Trust : BNKR

Despite the lack of progress during the first six months of this year we remain positive towards equity markets in general. Corporate sentiment remains sound which continues to be demonstrated in corporate results, management statements and dividend increases. As has happened in the past equity supply in the form of new issues has helped fill some of the demand for equities at the margin but despite this we remain committed towards global equity markets as an asset class. Valuation levels are not excessive in most major markets and in some of the smaller markets recent falls have started to create some attractive opportunities.

From Alex Hammond-Chambers, Chairman, Hansa Trust : HAN / HANA

Not a lot has changed in respect of the external investment environment in the last year. Economic recovery is slowly happening - with an emphasis on "slowly". Large scale money printing (aka "quantitative easing") and ultra--low interest rates continue to provide liquidity in the financial market place, in an attempt to ease the debt repayment process and to finance continuing and large scale government deficits. It is a risky and unprecedented monetary strategy which may ease the pain of post financial crisis adjustment, but not necessarily address the root causes of debt accumulation in the first place. The risk is generally regarded as one likely to trigger serious inflation at some point in the future, but inflation has yet to emerge. This may be because of the powerful deflationary forces at work in some parts of the world. We will see but, in the meantime, printing money has proved to be good for the prices of many asset classes - most especially of equities. So - notwithstanding the risks inherent in printing money and in international confrontations - more of the same seems to be on the cards for the immediate future.

From Ben Rogoff, manager, Polar Capital Technology Trust : PCT

Despite weaker near-term data, we remain hopeful that 2014 will mark the first at or above trend growth year for the global economy post the financial crisis. Developed economies (forecast +2.2%) should account for three quarters of the growth acceleration this year as fiscal headwinds diminish in Europe and the US, while the UK and Japan are likely to grow above trend. While we expect monetary policy to invariably tighten, this process is likely to be shallow in the developed world with policymakers happy to remain 'behind the curve' as inflation remains contained (and below target in Europe, Japan and the US) due to slack labour markets (particularly within the Eurozone) and well-anchored inflation expectations. As such, we continue to believe that deflation rather than inflation remains the greater risk; as long as policymakers share this view, monetary policy should remain remarkably easy for the duration of 2014 with base rates in the US and Europe likely to remain at current (near zero) levels at least until 2015.

Underpinning our relative confidence in current global GDP forecasts is the US economy that is expected to reaccelerate to 2.8% in 2014 (2013: 1.9%) as the impact of fiscal tightening goes into reverse. The economy should also continue to benefit from modest further labour market improvement (unemployment having already fallen from c. 10% in 2009 to 6.7% today) and consumption, fuelled by the substantial household balance sheet repair that occurred last year. Although increased confidence should result in an improvement in capital spending (US corporate capital stock age is the highest since 1970) this is likely to be muted given structural changes such as low sales to inventory ratios, offshore production and technology deflation. More mixed recent economic data and core CPI that remains comfortably below the 2% Fed target should ensure that US monetary policy remains extremely accommodative with zero interest rate policy (ZIRP) likely to extend into 2015. As long as the Fed succeeds in "divorcing tapering from tightening", negative short-term interest rates, together with improving confidence, should see the US enter a more sustainable recovery phase.

Having represented the greatest source of systemic risk last year, Europe is forecast to be the greatest contributor to global growth in 2014 with GDP pegged at 1.2%(2013: -0.5%). As in the US, growth should be supported by less financial instability, reduced fiscal drag with export growth and a slower pace of private deleveraging likely to help too. However - and critical to our relatively sanguine view on likely monetary policy adjustments - the EU recovery remains fragile with unemployment not far from record highs while the stronger Euro and outsized EM exposure represent new risks to growth. With core inflation averaging less than 1% during the final quarter of our fiscal year, Europe still appears vulnerable to deflation. This, together with an under-capitalised banking system, should ensure further intervention as and when required, although this will be increasingly delivered via 'unconventional' tools as benchmark rates are just 0.25% today. In stark contrast, the UK recovery is in full flow with PMIs recently at sixteen-year highs and 2014 growth pegged at 2.9% (its fastest pace of growth in seven years) with BoE Governor Mark Carney having to furiously adjust interest rate policy seemingly in order to delay rate hikes.

While Japan is also expected to grow above trend this year, GDP forecasts of c. 1.4% (2013: 1.5%) capture the impact of a recent (April) consumption tax hike that will obscure underlying improvements driven by strengthening private investment and export growth (substantially aided by Yen depreciation). However - evidenced by poor relative performance so far this year - there remains significant scepticism that "Abenomics" will end fifteen years of deflation with bears focusing on negative real wage growth and the lack of substantive structural reform. While it is too early to tell if PM Shinzo Abe's bold plan to end deflation will work, the early signs are encouraging as land prices have stabilised and wages have stopped falling for the first time in three years. With core CPI (+1.3% y/y in March) remaining well below the 2% target set by the Bank of Japan last year, further intervention looks likely, albeit perhaps not in the near term given the BoJ's optimistic view of the economy. For now, the most significant risk to our constructive view on Japan relates to EM weakness (16% of Japanese exports) and deteriorating relations with China (18% of Japanese exports) evidenced by Abe's controversial visit to the Yasukuni shrine and efforts to reinterpret the pacifist constitution.

Accounting for more than 20% of incremental global growth, China remains a key factor in this year's economic outlook. The decision to reduce China's growth target to 7.5% in 2012 (having averaged 10.4% GDP growth between 2003-12) represented a clear break from the past characterised by a desire to deliver more sustainable growth. While the move towards a market driven credit system, together with efforts by the new leadership to reign in the shadow banking system are to be applauded they are likely to come at a near-term GDP cost. Even though the shift in emphasis from quantity to quality of growth raises the risk of a 'hard landing', we still consider that outcome a 'tail risk' because modest inflation and government debt at just c. 65% of GDP afford the Chinese considerable firepower should growth undershoot the 7-8% rate required to absorb urbanisation.

Unfortunately, the same cannot be said for a number of other emerging markets, particularly those reliant on financial flows to support growth and fund current account deficits. While fear of tapering was enough to trip up economies with large negative balances (such as India), actual tapering has forced a number of additional countries (including Brazil, South Africa and Turkey) to raise interest rates to ameliorate the impact of adverse financial flows and currency weakness. The magnitude of rate hikes in Turkey (+4.25% to 12%) - an economy that a few years ago was recently growing at 8% but could only muster +4.3% in 2013 - made plain the distress adverse flows were causing and, in our opinion, laid bare how much of the recent EM boom was due to global liquidity caused by fiscal and credit stimulus in the developed world. Today those boom years look like ancient history because we are (hopefully) past the point of maximum stimulus in the developed world while it seems unlikely that China GDP will ever grow in excess of 10% again.

As we outlined last year, systemic risk has diminished due to decisive intervention previously taken by policymakers. While many structural balances remain unaddressed, these are unlikely to flare up while interest rates/sovereign spreads remain near lows. Although Europe is likely to remain a focus given its output gap (and the upcoming ECB Asset Quality Review) tail risks associated with the Euro have clearly diminished. US political risk has also receded following the bipartisan Federal deficit deal signed at the end of last year. Social unrest remains a concern, electoral gains made by right wing parties in recent European Parliament elections acting as a timely reminder of the risks associated with prolonged stagnation and elevated youth unemployment. Once again, geopolitical risk remains the most significant exogenous factor to consider this year. While the Middle East remains a potential tinderbox, a new source of risk has emerged in the form of a resurgent Russia intent on defending what it sees as its regional interests while keeping NATO at bay. Geopolitical risk also appears to be extending into East Asia as China and the US begin to behave more like rivals, while more hawkish governments in China, India, Japan and Korea may result in greater regional tensions and heightened possibility of a foreign policy 'mishap'. Additional risks to consider include currency wars, should countries target exchange rates for competitive purposes and global tax reform.

Although markets have got off to a good start, we are hopeful that equities will add to their gains during the remainder of the year. Further improvement in investor sentiment and risk appetite that has continued to drive the revaluation of risk assets has seen equity valuations expand significantly over the past twelve months, the forward PE on the S&P expanding to 15.7x today. As such, absolute valuations are no longer 'cheap' with most traditional measures of value slightly above longer-term averages. However, we have consistently argued against the wisdom of 'long term averages', particularly when adulterated by periods of limited relevance to the world today (high inflation, collective bargaining, exchange controls, pre-globalisation). This healthy scepticism also extends to long term valuation analysis that rarely considers that during the last thirty years the US economy has only spent 9% of the time in recession versus 40% prior to WWII, let alone the peace dividend, low inflation and the improved structural composition of the US equity market. Of course we understand why investors are reticent to publically embrace higher valuations, but we believe that PE expansion should be both anticipated and welcomed by investors early to a new secular bull market. More importantly - despite outpacing Treasuries by c. 40% last year - stocks continue to look attractive compared to most alternatives, particularly versus cash where negative real returns appear all but guaranteed.

With corporate cash flow as a percentage of GDP close to all-time highs and with US non-financials said to be sitting on $1.5tr in cash, stock buybacks are likely to remain at elevated levels having accounted for 68% of free cash flow less dividends and 3% of market capitalisation last year. Some of this excess cash is likely to fuel additional merger activity that - after a disappointing 2013 - has exploded into life this year with worldwide M&A already exceeding $1.1tr - only the third time since records began that deal activity has exceeded $1tr this early in the year. The return of mega-deals (such as AT&T's $48bn merger with DirectTV, Valeant Pharmaceuticals $53bn unsolicited bid for Allergan and Pfizer's aborted c. $100bn takeover of AstraZeneca), together with the potential return of private equity transactions (unspent commitments having risen for the first time in five years) should help further support equity valuations.

As we have moved further from the financial crisis, so 'echoes' have become more muted reflected in maximum drawdowns in US equity markets that have contracted every year since 2008. As we hoped, this has allowed for a more rational comparison between risk and risk-free assets resulting in significantly improved equity fund flows over the past year, at the expense of bond funds. The magnitude of this reallocation has surprised even those who anticipated it (ourselves included) resulting last year in (US) stocks outperforming bonds by the largest margin for at least forty years. While we do not expect "Act II" of the 'Great Rotation' to be nearly as dramatic, further reallocation appears likely given that in February 2014, global equity funds had suffered $100bn of net outflows since 2008 in contrast to $1.1tr inflows into global bonds funds. Although last year was a painful one for bond investors, ten year US Treasury yields troughed at 1.37% last year having peaked at 16% in 1981 which means that for many, "bonds have been a one-way bet all of their investing lives, just as equities (were) in the twenty five years from 1974-2000". As the global recovery gains firmer footing over the next few years, the fear of extremely low returns and/or negative real returns on cash should drive further rotation into equities, an asset class - lest we forget - that has outperformed bonds two thirds of the time since 1971.

That said, we expect our secular bull market thesis is likely to be tested at some point over the coming year since valuations already exceed long-term averages and because it is always easier to book profits than run winners! While we do not expect a significant setback, one is statistically overdue (10% corrections are said to occur on average every eighteen months during secular bull markets) while a number of equity markets appear a little extended versus their longer-term moving averages which may leave them vulnerable to seasonal profit taking. Investor sentiment has also recovered substantially (although it remains well below levels associated with complacency) while other contrarian indicators (IPO pipeline, M&A activity, mutual fund cash levels) point to modestly elevated risk of a pullback. Of course, the greatest risk to equity markets relates to loss of policymaker support given that since 2009 risk assets have been underpinned by the unusual alignment of interests between investors and policymakers. While recent turbulence in emerging markets suggests that monetary tightening (however gradual) was not priced in, we are hopeful that policy will remain 'data dependent' and somewhat 'behind the curve' in order to allow economic growth to become self-sustaining.

Although absolute valuations are no longer 'cheap', we are hopeful that global equities will add to their post-financial crisis gains over the coming year. Not only do long-term averages fail to capture the uniqueness of the present investment backdrop (record low interest rates, alignment of interests with policymakers, return of capital to shareholders) but - even after outpacing Treasuries by c. 40% in 2013 - stocks continue to look attractive versus most alternatives and especially so against cash where negative real returns appear certain. While we do not expect a significant setback, a number of equity markets look a little extended while a number of contrarian indicators and seasonality point to an elevated risk of a pullback that is anyway statistically overdue. However, the greatest risk to our 'secular bull market' thesis relates to the loss of policymaker support that has underpinned risk assets since 2009. On this count, we remain hopeful that the tightening cycle (that commenced with the tapering decision in December) will remain 'data dependent' with policymakers likely to remain somewhat 'behind the curve' for now.

UK

From Mark Barnett, Portfolio Manager, Perpetual Income & Growth : PLI

2014 to date has seen the UK equity market struggle to find a convincing direction. Despite the well-publicised improvements in economic growth in the UK and US economies, the current valuation of the market represents a level which reflects this optimism and which may struggle to be maintained if the pace of earnings growth does not accelerate. Meanwhile, the outlook is likely to remain challenging for the foreseeable future due to a combination of elevated valuations and an environment of continued flat corporate profit growth - the recent earnings season was notable for the number of profit warnings from large corporates. The other significant reasons for caution over the near term are the impact of a reduction in the scale of asset purchases under the policy of quantitative easing in the US, uncertainty about the strength of economic growth in the developing world, especially China, and a heightened level of political risk both in a domestic context ahead of the UK General Election and internationally due to the Ukrainian/Russian situation. It is unlikely that the performance of the market in 2013 will be repeated in the current year.

Despite these concerns, there remain some pockets of value within the UK equity market. The key to navigating the near term is to remain highly vigilant about the strength of corporate performance and to remain judicious in portfolio selection. Companies that have proven ability to grow revenues, profits and free cash flow in this low growth world, coupled with management teams that are fully cognisant of the need to deliver sustainable, long term, dividend growth we believe offer the potential to deliver good risk adjusted returns over the long term.

From Hugh Twiss, Chairman, Invesco Income Growth : IVI

At the risk of being accused of becoming boringly repetitive, I find myself having to run this risk by again repeating my concern that the level of returns which we have seen in recent years may be harder to achieve in the year ahead. The world, both economically and politically, remains challenging and many markets are near their highs. However, there are still attractive companies to invest in.

From Ciaran Mallon, Portfolio Manager, Invesco Income Growth : IVI

The stock market's rise in the past two years, fuelled by monetary stimulus and central bank policy initiatives, has not been matched by an increase in forecast companies' earnings growth for the current financial year and beyond. Equity valuations are therefore no longer as cheap as previously. That said, within the market as a whole, I continue to find pockets of decent value, especially amongst the higher dividend payers. The UK stock market, as measured by the FTSE All-Share Index, has very nearly doubled over the last five years. Whilst I would not expect such performance to be repeated over the next five, I nevertheless feel confident that the current portfolio looks well placed to provide good long term returns for shareholders.

From Montanaro Asset Management Limited as managers of Montanaro UK Smaller Companies : MUT

Investors in UK Small Cap have now enjoyed two consecutive years of strong returns. A large portion of these returns have been the result of multiple expansion rather than an improvement in company earnings. The foundations of the bull market remain intact - bond yields remain exceptionally low and economic conditions have improved. However, for share prices to continue to advance, earnings growth has to be delivered. We remain confident in the ability of our companies to grow, as do the management teams in charge of them. After nearly two years of outperformance by low quality, value companies, the relative premium investors are paying for quality growth has fallen substantially. The Company is well positioned to benefit from a return of investor appetite for the highest quality UK Small Cap. As investors increasingly focus on earnings growth, they are likely to turn to quality companies that are more likely to deliver. We look forward to the next twelve months with confidence.

From Jonathan Cartwright, Chairman, BlackRock Income & Growth : BRIG

Since the period end the main concerns for markets have been continuing sluggish economic growth in Europe and uncertainties associated with the unrest in Ukraine and the Middle East. In the UK, extracts from the Bank of England policy minutes for May pondered whether `the more gradual the intended rise in Bank Rates, the earlier it might be necessary to start tightening policy'. We are mindful therefore that a return to more historically "normal" interest rates, however well flagged in advance, could lead to further short term volatility in markets.

From Adam Avigdori and Mark Wharrier, managers, BlackRock Income & Growth : BRIG

While the ending of quantitative easing in the US is likely to induce some volatility in equities and bond yields, we expect that inflation expectations and medium term GDP growth will remain modest, thereby limiting the risks of a substantial correction. Over the longer-term, recovering global growth and confidence about monetary policy, which will remain loose to allow economies to pay down fiscal deficits, is a positive backdrop for corporate earnings expectations and equity valuations.

From George B Burnett, Chairman, Henderson Opportunities Trust : HOT

Economic growth is solid in the UK and USA. Stock market sentiment can be fickle, and more recently, worries about Ukraine and now the Middle East has made some investors nervous. In the very short term this does not suit our positioning with the portfolio biased towards medium and small companies. We are now entering a phase where interest rates will start to rise in both the UK and the USA, albeit very gradually.

Asia

From Patrick Gifford, Chairman, Martin Currie Pacific : MCP

I remain optimistic that the current financial year should see positive returns. Economic growth is still to be found in the region and the pricing of markets is now well below historic averages. Growth is being supported by an acceleration in both the US and Europe and stable energy prices. The greatest economic risks are posed by the tendency for both China and Japan to flirt with deflation. However, both governments are clearly aware of the problem and determined to avoid this outcome. There are political risks whose magnitude and probability are very hard to evaluate. Markets have attempted to price them but they are binary so that this is a difficult thing to do. It does, however, seem reasonable to be optimistic about investment markets while remaining wary about politics. In the longer term, indeed, we remain confident that the continuing expansion of domestic demand and consumption throughout Asia makes a compelling case for investment in companies with strong balance sheets and solid earnings in the region.

From BDT Invest LLP, Investment Manager, The Establishment Investment Trust : ET.

There appears to be much broader acceptance of the fact that the recent rapid rates of growth in the Chinese economy are not sustainable although we still believe that many investors do not understand that this is a bullish development for the vast majority of countries, companies and consumers in the Asian region. Indeed we believe the policies emanating from the recently elected Chinese leadership, such as the reform of the Hukou system (internal migration controls), are extremely encouraging if admittedly long term in nature. While it will take a considerable length of time to work though the investment and credit excesses of the past decade, and it is unlikely that this process will be smooth, we are willing - for the first time in many years - to take a more constructive long term view of this massive economy.

It is much easier to retain our more positive view of Asia's other behemoth, India, following Narendra Modi's landslide victory in the recent Parliamentary election. India is not the only country where politicians calling for less not more government and pursuing policies that encourage rather than hinder entrepreneurs appear to be attracting support from voters! Early policy decisions, such as halving the size of the cabinet, illustrate that Mr Modi means business. Following an investment slump and a sharp deceleration in economic activity, we believe India is well positioned to enjoy a cyclical recovery over the next few years.

ASEAN markets, together with India, were hard hit in the third quarter of 2013 as talk of tapering gathered pace. We remain particularly bullish in the Philippines which is fast becoming the poster child of Asia with its rapid, domestically driven, economic growth and stable democracy with an energetic and popular President. The same cannot, unfortunately, be said for Thailand where the twelfth military coup since 1932 and the third in the last twenty five years has drawn instant, widespread and predictable criticism not all of which we agree with. There is a strong argument that, as was the case at the time of previous coups, Thailand is in desperate need of a firm hand on the tiller and the initial economic policy steps taken are encouraging. The country remains uniquely positioned to take advantage of the rapid economic development in Burma and Indochina and we retain a positive long term view.

Global economic growth remains, by and large, elusive apart from a few hot spots as investment spending remains lacklustre and income growth is minimal. Short term interest rates may rise but deflationary forces remain extremely powerful - excess capacity in China, elevated household debt levels across the OECD and elevated leverage in the European banking sector to name but three. In this environment, your Manager continues to believe that a portfolio focussed on growing consumption and infrastructure spending across Asia will generate competitive returns over time.

From David Shearer, Chairman, Aberdeen New Dawn : ABD

While there may be periods of further volatility, in the last few months, markets have started to recover across the region. Many corporates appear to have navigated the cyclical slowdown with their fundamentals intact and valuations look reasonable when compared to developed markets. The prospect of higher interest rates, if economic growth recovers significantly, could impact earnings however, a return to 'normal' monetary policy would ensure that markets recognise quality companies with sound fundamentals.

From Aberdeen Asset Management Asia as managers of Aberdeen New Dawn : ABD

Global growth prospects remain patchy. The US seems to be gaining some momentum, but European recovery appears more tenuous, with deflation an imminent threat. Hence, monetary policy could diverge. China should moderate further as it transitions from an export-led to a consumption-fuelled economy. Countries relying on the mainland to buy their goods may be adversely affected, given the Chinese government's newfound tolerance for slower albeit more inclusive and sustainable growth.

Political tensions could also hurt demand, but the recent coup in Thailand has brought temporary stability after a period of uncertainty. The military has begun the process of approving stalled investment and infrastructure projects, which should help reignite growth. In India, voters are expecting big changes, having ushered in a new government with a clear majority. The local market has already outperformed the region so far in calendar 2014, with the more cyclical and capital-intensive stocks doing particularly well on expectations of future infrastructure spending.

Overall, we believe Asia continues to offer many attractions. The region has been through similarly trying periods in the past and the current cycle is no different. Once this phase turns, consumption is expected to recover, buttressed by favourable demographics and rising middle-class aspirations. The region also offers world-class businesses. Over the short-term, earnings-per-share growth at 7-8% might not be stellar. But given our longer-term investment horizon, we are optimistic. Despite the recent run-up, valuations remain reasonable at around 12-13 times earnings.

China

From Anthony Bolton, outgoing manager of Fidelity China Special Situations : FCSS

At the time of writing, stock market valuations in China are very cheap relative to their historical levels on most measures, sentiment is very negative and the local `A' share market has been in a bear market for over four years. These factors all suggest that now should be a time to be positive about the market outlook as much of the bad news is already discounted in prices. Hong Kong-listed medium and smaller-sized companies still appear very cheaply-valued against their mainland-listed peers. I expect this valuation gap to close in the future as more mainland money is allowed to invest in Hong Kong and we have recently seen measures that should act as a catalyst to these flows. Of course, China is not without risks and I have mentioned the longer-term challenges on the political and social front often in my previous reports. I believe there has to be more reform on this level over the next decade. Also the Japan-China relationship and events in North Korea must be watched as they could destabilise developments in the shorter-term.

From Dale Nicholls, incoming manager of Fidelity China Special Situations : FCSS

Much focus has been on China's ability to meet the government's short-term (*growth*) target of `around' 7.5%, and investors are generally sceptical. I agree that it will be tough to reach this target, and would much prefer to see the government take this target down to a more realistic level. It is well documented that the government wants to drive a structural change in its economic model from one that is reliant on investment and exports to one driven by consumption. Due to this structural shift we should expect economic growth to fall from the heady days of year-on-year double digit growth, but this should also be welcomed as consumer-driven growth is less volatile and more sustainable. Also, credit growth has supported much of the rise in investment and this is clearly not sustainable and can lead to issues for the financial system down the road. Therefore, I would be more than comfortable to see growth in the 5-6% range. This is still an enviable growth rate in a global context and a good environment for individual companies to grow. This is particularly true for companies that lie within areas of the economy that the government wants to grow at a faster rate than the general economy, such as consumption.

Total borrowing in China has rapidly expanded in the last five years, taking it from around 120% of GDP to over 200%. History teaches us that such expansions usually end in significant non-performing assets, particularly in areas where the mal-investment has been most severe. I expect the same in China and this is the main reason why the Company does not hold shares in Chinese banks. We are already seeing some well publicised defaults and I believe the sooner authorities start dealing with the problem the better. However, a Lehman style financial crisis is highly unlikely. In my view, a key factor in defining a financial crisis is a significant contraction in liquidity and credit, but there are significant deposits supporting the system and, importantly the government is the bank's majority shareholder and it can create liquidity if needed.

This all sounds like bad news for China, but the questions we need to ask are what does it mean for the earnings of individual companies and how much is priced into valuations? What many miss about China is the huge bifurcation in operating performance between the state-owned enterprises ("SOEs") and the private companies - the latter have recorded far superior earnings growth and returns on equity over the last five years, and this has been reflected in stock performance for these two groups. The reform agenda that has been announced will only serve to accelerate this performance gap. Last November's Third Plenary presented the blueprint for a wide range of bold and far-reaching reforms that will help transform China's economic and social scenery.

At the time of writing, there has already been interesting developments with regards to the reform agenda and we have seen changes including ongoing interest rate deregulation, new banking licenses to private banks, the formation of free trade zones, the first case of a state-owned enterprise seeking private company participation (Sinopec) and the proposal of a Mutual Market Access pilot programme. This last initiative is interesting in terms of being a potential catalyst for closing the many valuation gaps that exist between Mainland China-listed and Hong Kong-listed shares.

This type of regulatory support is beneficial for "new China" areas of the market, such as consumption and healthcare, which also have the most interesting growth drivers underpinning them. Furthermore, the Company can exercise its ability to invest in private companies as the environment for China's entrepreneurs should only see improvement over the coming years. Against this backdrop I currently favour companies in the consumer discretionary, information technology and healthcare sectors given their long-term growth potential relative to other industries.

That said, some of the more mature areas of the market cannot be ignored. Much has been made about recent reforms and how this will level the playing field between SOEs and private companies. The assumption is that private companies have been given a freer rein to grow and eat into the market share of the SOEs. While I am a firm believer that "new China" is where I want to be positioned, I think the general disregard for all SOEs is creating opportunities to buy some good companies with high barriers to entry who can actually benefit from reforms. For instance, a move for more market-orientated pricing mechanisms means that SOEs who were previously restricted in their pricing by government policy should be able to raise prices. This should benefit the railway industry, including companies such as Guangshen Railway, which has not been able to raise passenger prices since the mid-1990s.

From Origo Partners : OPP

While there are clearly significant challenges facing Chinese policy makers in the short term, we believe there is much reason for optimism with regards to the Chinese economy over the medium to long-term. Unlike many other countries, China has the capability to make rapid and significant interventions in markets to ensure its targets are met. China's ratio of government debt to gross domestic product is low and therefore, in the event of a significant crisis, the Government has considerable financial firepower to maintain the economy in a healthy state. It could be argued that, equity markets have partially priced in a soft-landing as shown by improving ratings of Chinese companies across the world. Nonetheless, the market for small cap offerings, in particular for natural resource related companies, is still extremely soft and will take time to recover.

Emerging Markets

From Advance Emerging Capital limited as managers of Advance Developing Markets : ADMF

The major concerns of 2013 (tapering and its effects on the "Fragile Five" of Brazil, India, Indonesia, South Africa and Turkey) have now given way to the fallout from Russia's annexation of Crimea. The immediate reaction has been reasonable considering the potential gravity of the situation, no doubt helped by the already high risk premium applied to Russian equities. Our sense is that, irrespective of the strength of Russia's position, its ambitions are neither as hostile nor as expansive as the Western media has portrayed. Even if we are right, there is scope for further bouts of volatility. Outside of Eastern Europe, there remains a busy schedule of elections over the rest of the year (Brazil, Indonesia and Turkey are still to hold elections before November), which is likely to restrain investor enthusiasm until such events have passed without incident.

Looking at emerging markets more objectively, we view the recent weakness in markets as an opportunity. Earnings downgrades have abated and have, in certain geographies, turned positive. Valuations are therefore attractive and have prompted increased attention from investors at the same time as outflows from emerging market funds have tailed off. Sharp daily moves in specific markets on only marginally positive news are consistent with oversold conditions and bode well for the rest of the year if investors' concerns abate more sustainably. More than one commentator has advised "caution, not abstinence" when investing in emerging markets at present.

Ukraine

From Dragon Ukrainian Properties : DUPD

The Ukrainian Economy:

Ukraine has entered one of the most turbulent periods in its history with a significant impact on the country's economy. In 2013, GDP growth declined to 0.0% y/y from 0.2% y/y in 2012. Private household consumption was the only component with a positive contribution to GDP; it is, however, losing steam. Exports have declined for two consecutive years as demand for steel, Ukraine's key export commodity, remained depressed. Unfavourable external conditions resulted in the current account shortfall increasing to 8.9% in 2013 from 8.4% of

GDP in 2012. Recent political turbulence and unprecedented tensions with Russia, which continue to run high following the annexation of Crimea in March 2014, have resulted in yet larger uncertainty, further curbing both local and foreign investment.

On a positive note, the recently agreed USD 17 billion 2-year stand-by loan programme with the International Monetary Fund ("IMF") provides long-awaited support for government and central bank's financing needs and also paves a way to economic reforms, which should result in an improved investment climate and positive structural changes in the Ukrainian economy in the mid-term, although a tighter fiscal policy may squeeze near-term growth. The IMF loan will also unlock aid from other international lenders, with the total Western support package for Ukraine estimated at USD 27 billion, covering a substantial share of government debt service and gas import purchases for the coming two years and stabilising the banking sector.

Despite the prospective support from the IMF and other lenders, numerous challenges remain ahead. The current instability is lowering consumer confidence and spending, while CPI is likely to soar to 14-16% in 2014 from 0.5% in 2013 following a sharp Hryvnya devaluation and surging gas prices for both household and industrial users.

Albeit with weak near-term growth prospects, the country's long-term economic potential is one of the strongest in the region. The consensus forecast sees Ukraine's long-term GDP growth at 4.3%, trailing only Turkey and Kazakhstan. Adequate progress on structural reforms and cessation of conflict with Russia are key prerequisites for the first signs of economic recovery.

The Real Estate Market

The Ukrainian real estate market is seeing low investment activity, flat rents and high yields in all sectors. The market's fundamentals have remained unchanged with Kyiv still lagging behind Central and Eastern European peers in terms of supply and maintaining significant structural growth potential. Despite the decline in total construction output in 2013, due to the drop in non-residential segments, residential construction continued its steady recovery (+7% y/y). Residential space deliveries increased by 20% in 2013 and were the highest since 2008. Residential stock per capita in Ukraine reached 24 m(2) , still far below the EU average of 35 m(2) per capita, suggesting strong demand potential, although currently demand is still depressed by low household confidence and the subdued mortgage market. In 2013, apartment sales in Kyiv decreased by 8% y/y due to the weak secondary market (-16% y/y), while the primary sales inched 3% up on the back of attractive acquisition structuring offers from developers.

Commercial property sectors remain "tenants' markets" with landlords forced to provide rental discounts in an attempt to retain existing lessees and struggling to attract new ones amidst growing vacancies. Retail property is in better shape compared to the office and industrial sectors, enjoying close to full occupancy levels, due to steady growth of retail trade turnover throughout the past four years. The retail property sector in Kyiv also remains the most lucrative segment of the local market in the longer term, being greatly under-saturated, with per capita shopping centre space at half of that in Warsaw.

Overall, the real estate market in Ukraine is in a state of great uncertainty and is looking forward to macroeconomic stability before seeing new investments and strengthening demand across all property sectors.

Russia

From Lysander Tennant, Chairman, JPMorgan Russian Securities : JRS

The events in Ukraine are likely to dominate the outlook with the threat of widening sanctions against Russian individuals and companies by the West. Despite the shadow cast over the Russian market from political events, current valuations in Russia look attractive with relatively high dividend yields. Positive developments include buoyant energy markets, reviving consumer confidence and increasing capital investment. It is hoped that the election of a new Ukrainian Government in late May 2014 led by President Poroshenko will bring a measure of peace and stability to the country. The EU and USA have pledged the Ukraine a significant financial support package which will ease its short-term debt servicing requirements.

From Oleg I. Biryulyov, Investment Manager, JPMorgan Russian Securities : JRS

We believe that there will be a gradual but peaceful resolution of the Ukrainian situation. Based on this premise, we believe that valuations in Russia are attractive. Shares are trading close to levels last seen during the 2008-2009 period of the global financial crisis, whilst clearly the current general economic environment is much improved. The Russian dividend yield will be one of the highest in the world, as distributions have not tracked the general decline in the market. Elevated oil prices, some recovery of consumer confidence, rejuvenated state-led and private investments, which have rebuilt depleted inventories, are all expected to result in rapid economic growth from current exceptionally low levels. All in all, Russia again presents a mixed picture: a considerable investment opportunity albeit without a clear period of time to realise and capitalize on that potential.

The Russian government is likely to use all available tools to stimulate economic growth in the second half of 2014 and throughout 2015. That may include adjustments to the cost of state-related funding and guarantees, state-led investments in infrastructure and some tax adjustments. Development of the Far East and Crimea regions will be clearly prioritized, and as recently seen in Sochi, Kazan and Vladivostok, the Russian state is capable of delivering large scale infrastructure projects on time. World Cup 2018 will come into focus as an investment theme after this year's World Cup in Brazil.

Unfortunately privatisation will be postponed for some time due to current market valuations. This will delay diversification of the Russian equity market and restrict its representation and depth. However we believe that the reduction of state presence in the economy will remain a long-term strategy for the Russian Government.

We believe that the long-term fundamental case for the Russian equity market is still intact and continues to provide ample opportunity for active fund managers to add value.

Healthcare

From Sir Martin Smith, Chairman, Worldwide Healthcare : WWH

Despite recent profit taking in the biotechnology sector and also some well-publicised concerns raised by a U.S. congressman over drug pricing and the predictable debate that this ignited about high drug prices, and also high share prices, our Investment Manager continues to believe in the fundamentals of the sector. In particular, it believes that the portfolio is well positioned to benefit from such factors as low valuations, the continued rise in the prospects for emerging markets and also continued mergers and acquisitions activity, as we have seen recently following Pfizer's high profile, but unsuccessful, bid for AstraZeneca.

From Sam Isaly, manager, Worldwide Healthcare : WWH

Overall, the fundamentals for therapeutic companies have not been this strong in nearly 15 years. An inflection point we identified last year continued into the year under review, namely resurgence in Research and Development (R&D) output. The lifeblood of pharmaceutical and biotechnology companies is new products, and pipelines and new product launches have not been this exciting since the late 1990's.

Pharmaceuticals

Large capitalisation pharmaceutical companies are finally through the worst part of their patent cliffs. Exciting new drugs across many therapeutic categories are fuelling investor interest, in particular the generalist investor. M&A and corporate activity has spiked and is unlocking shareholder value. Finally, investors are seeing a return to growth for this previously moribund sector.

However, the sector is not without its issues. First, not all companies in this space are created equal. In fact, the group is rather heterogeneous in its membership. Some pipelines are clearly superior and others clearly inferior. Not all companies are now devoid of present or near term patent expirations. Thus, while the growth outlook for the group is accelerating, not all are enjoying the renaissance to the same degree.

Then there is valuation. Once a dominant argument to be long the group, given depressed multiples on an absolute and relative basis, average valuations have moved up in excess of 50% over the last two years. Thus, one must be much more selective in large capitalisation pharmaceutical companies, rather than simply "owning the whole group". Pipelines, catalysts, growth, new product launches, valuation, management, business development, patent expirations, potential M&A, and corporate activity all must be weighed when considering stock selection here. Macro factors also must be considered, in particular the global yield curves as a rising interest rate environment could facilitate some rotation out of the high yielding large capitalisation pharmaceutical stocks.

Biotechnology

For the stated cautionary reasons above, we prefer large capitalisation biotechnology stocks as our overweight strategy in therapeutics. The main positive is the same: the best new product flow in years. Moreover, the profitable biotechnology companies possess better growth prospects and more attractive valuations.

First, the latest new product introductions have been truly innovative and have met with immediate commercial success. This is a reversal of a trend from only a year ago, when it was in vogue to "short the launch". But (*some*) recent launches have been blockbusters right out of the gate. Second, pipelines are robust, providing plenty of clinical catalysts. History shows that stocks re-rate higher with positive pipeline news flow. Third, valuations, while higher, are more compelling than ever. March of 2014 saw some profit taking in the biotechnology sector, understandable given the multi-year run of outperformance. However, this correction has created an opportunity. Specifically, forward looking price-to-earnings ratios for the group are now lower than their large capitalisation pharmaceutical brethren. This is the first time this has happened, and considering the differing average growth profiles (+20% for biotechnology and +5% for pharmaceutical companies), the investment opportunity here is literally unprecedented.

Emerging Biotechnology

Biotechnology companies, regardless of capitalisation, continue to be a leading source of innovative new drugs. Emerging biotechnology stocks performed strongly during the year as the fundamentals of the sector remain strong. Clinical and regulatory news will continue to be critical to catalyse sector performance going forward.

Important Phase III results are expected from a number of companies this year across a host of therapeutic categories, including cystic fibrosis, pulmonary arterial hypertension, and atherosclerosis. Additional areas of high interest to investors include haematological malignancies, orphan diseases, and immuno-oncology.

Investor enthusiasm for emerging biotechnology stocks led to a large amount of recent Initial Public Offering (IPO) activity. During the 2013 calendar year and the first three months of 2014, there were 62 new biotechnology IPOs, with many performing strongly. This has broadened the investable biotechnology universe, and allows the funding many of new approaches to treat disease.

Global Generics

Although the global generic market environment remains healthy, the U.S. and Asian markets appear particularly well-positioned in our view for several reasons. In the U.S. market, the FDA has stepped up efforts to remove non-compliant and India-based generic manufacturers from the marketplace. Ensuing product shortages have enabled favourable pricing trends that could persist for several quarters. Throughout Asia, economic expansion, favourable demographics, supportive governmental policies, and other contributing factors continue to drive robust generic utilisation in many regions. Conversely in Europe, although generic utilisation continues to climb, some significant pricing erosion has emerged in some major markets which is concerning.

We still favour the larger global generic players, especially those with emerging branded franchises. Further consolidation of the generic industry is likely and we believe some of the small and mid-sized U.S.-based players are attractive targets. We have reduced exposure to India-based manufacturers in response to the FDA's strong regulatory stance and heightened scrutiny.

Our long-term view of the Japanese generic drug market is still positive. Japan possesses the fastest growing generic drug market in the world due to significant secular upside from government efforts. While uncertainty plagues the non-familiar investor, the looming fiscal year promises to be the most dynamic in history.

Medical Devices

While macroeconomic improvements over the past 12 months have led to an increase in the number of procedures carried out and also pricing pressure stabilisation, we see headwinds going forward, such as the lack of a material positive inflection point in unit growth, a dearth of innovation, and continued pricing pressure. In addition, valuations across the sector are no longer inexpensive on a historical basis and/or relative to the broader market.

Healthcare Services

"Obamacare" made headlines during the year mostly for all of the wrong reasons. But despite its widely publicised startup troubles, the ACA should benefit those companies levered to health care coverage expansion.

It is still early in the implementation of ACA; the expansion of coverage should improve the profitability of hospitals, which were previously uncompensated for care provided to uninsured patients. Additionally, hospitals may also stand to benefit from higher utilization as individuals with new subsidised insurance demand more services.

Life Sciences Tools and Diagnostics

As we head towards 2015, our sentiment remains positive, underpinned by visibility in genomic research, innovation, and the subsequent commercial uptake. Select corporate action items will likely catalyse further outperformance in large capitalisation life sciences tools. We continue to be wary of reimbursement risks.

Emerging Markets

We continue to believe that investing in healthcare in emerging markets is a long-term, secular play. Aging populations, rising income levels, and increasing healthcare spending as a percentage of GDP are the three key drivers underpinning the growth of healthcare markets in these regions for the next few decades. Additionally, we believe technology innovation could emerge as next growth driver in a longer time horizon.

As we move towards 2015, we expect Chinese private hospital stocks to continue the momentum observed in the second half of this year and continue to outperform next year, driven by favourable government policy initiatives and early growth stage of the industry. Established private hospital players in the ASEAN region* could outperform again after taking a pause during the year. Industry consolidation and M&A activities in emerging markets should continue to play out for our picks in both acquirers and acquisition targets.

Property

From Picton Capital Limited as managers of Picton Property Income : PCTN

It is self evident on a number of levels that we are operating in improving market conditions. Firstly there are increasing signs of renewed investor interest following the marked re-pricing since 2007, in particular in markets outside of London that until recently have not shown signs of recovery.

Secondly, occupier markets, albeit at a slower rate, are starting to show positive signs of recovery against a backdrop of the very limited creation of new space since the onset of the financial crisis.

We are already witnessing a period of upward price movements as some of the very pessimistic assessments of occupier markets are now proving to be more positive than first thought. This is leading to further upward valuation movements but not necessarily leading to income growth at this stage.

Looking a little further ahead, we expect rental growth to become more widespread, particularly in sub-sectors where supply is constrained through a lack of development in recent years.

Finally we are seeing the easing of credit conditions and there would appear to be a much more competitive lending market for the real estate sector than has been the case for many years, which is extremely helpful for creating more normalised conditions.

Consensus forecasts for total returns are positive over the next two to three years, driven by an improvement in GDP forecasts, an improved rental market outlook and an expectation that there will be yield compression for secondary commercial property.

Resources

Mongolia

From Origo Partners : OPP

There were a number of positive developments in Mongolia in 2013, which have normalised the political situation after a turbulent 2011 and 2012. The new Government, voted into power in first half of 2013, has taken a more pragmatic and balanced approach with regards to foreign investment. The implementation of the New Security Law, the removal of the controversial Mining Law, and progress with regards to the 106 licenses previously revoked are all to be welcomed. Yet, while positive developments are being made on the ground, investor sentiment towards the resource sector in general, and in respect of Mongolia based assets in particular, is muted. We remain cautiously optimistic that this may change, in particular if a resolution is found in respect of the Oyu Tolgoi dispute.

Uranium

From Keith Watson, manager, Geiger Counter : GCL

Unfortunately the promising industry news flow during the first half year has not been sustained. In particular, the pace of Japanese reactor restarts remains glacial while a recent local court ruling against the restart of two reactors located at Oi further sapped investor enthusiasm for the fuel. Following the modest US$2/lb grind upwards in the U_3O_8 spot price from late September 2013 to US$36/lb in February 2014, uranium has retreated 22% to US$28/lb.

Immediate action to curtail mine supply such as Areva's decision to halt development of its Imouraren mine, Paladin ceasing production from its Kayalakera mine 6 months earlier than anticipated and Cameco halting development of its Millennium project are supportive, helping to address short-term market imbalances. Importantly, Rio Tinto's recent remarks on the marginal viability of its Rossing mine, illustrates industry inertia to respond to the new price environment with potentially deeper production cuts may be limited, particularly as the protection afforded by higher priced term sales falls away.

On a positive note the introduction of more stringent carbon emission controls in China, as the nation seeks to reduce chronic air pollution, should underpin expansion of the regions nuclear generating capacity, a process made easier by the nation's standardised reactor designs. Proposals announced by the US Environmental Protection Agency should also underpin the future role of the nuclear industry to provide reliable base load power as the nation similarly recoils from coal fired power generation.

Green

From Charlie Thomas, manager, Jupiter Green : JGC

After a strong calendar year in 2013, the stock market is struggling to make headway. Company earnings need to catch up with market expectations in some sectors and there are several areas of general uncertainty in the outlook: tapering of quantitative easing in the US and geopolitical tensions in Ukraine, for example. We therefore would not be surprised to see further market volatility in coming months.

Nevertheless, increasing economic competitiveness, greater investment in technology and a general tightening of environmental policy worldwide provide a measure of confidence about the long-term outlook for the environmental sector. We have been impressed by the way environmental technologies are being adopted as part of the wider economic recovery in the West, especially in the area of energy efficiency. LED lighting, for example, is forecast to account for 45 per cent. of the global lighting market in 2016, up from just 4 per cent. in 2010 , while energy efficiency in cars has become a key selling point in the reviving auto sector. As mentioned earlier, energy efficiency is a key investment theme in the Company. Meanwhile, we are starting to see increased investment by China's authorities in areas such as renewable energy, water infrastructure and food sustainability projects.

During the period under review, the Intergovernmental Panel on Climate Change's (IPCC) released three important reports that constituted its 5th assessment of climate change. The first of these was Climate Change 2013: The Physical Science Basis, a landmark report in which showed for the first time that scientists are 95 per cent. confident that global warming since the middle of the 20th century has been caused by human activity.

The follow-up reports, Impacts, Adaption, and Vulnerability and Climate Change 2014: Mitigation of Climate Change, highlighted significant shortcomings in the action taken so far to deal with the many risks associated with climate change and asserted that the world is generally unprepared for its effects. However, the overriding conclusion of the latter was that the goal of limiting global warming to 2degC is still attainable, although only if urgent action is taken: the use of low carbon energy would have to triple or quadruple by 2050. Importantly, the mitigation report attempts to dispel the concern that tackling the causes of climate change will be prohibitively expensive. It estimates that a transition away from fossil fuels to renewable energy and a broad increase in energy efficiency would cut a mere 0.06 per cent. out of an assumed global economic growth rate of between 1.3 per cent. and 3.0 per cent. per annum.

For this to be achieved, decarbonisation and improved efficiency would have to occur across a number of industries. The electricity sector would have to make the most profound adjustments to decarbonise production processes, which would result in a cut in revenues for coal and oil producers. Changes would also need to occur in areas such as transport, buildings, heavy industry and agriculture. Absent from the reports were the benefits of cutting greenhouse emissions, such as increased energy security and reduced pollution.

While the IPCC's findings suggest that the goal of limiting global warming is attainable, it will not be achieved without a significant change in investment patterns and international cooperation. We will be monitoring what impact these reports have on government policy and business strategy, but have already noted increased debate over climate adaptation and mitigation following the recent extreme weather events in the US and UK.

These reports add weight to our central investment thesis that environmental investing is about investing in the long-term structural growth of the global economy. Most notably, the report highlights the advances made in the area of renewable energy, where a maturing industry whose technology is a cost effective alternative to conventional energy sources and can be used at a significant scale. In 2012 alone, alternative energy accounted for half the new electricity capacity added globally and the rapid acceleration of renewable use and suggested improvements to energy efficiency bode well for our investments in these areas.

Private Equity

From Jonathan Carr, Chairman, Aberdeen Private Equity : APEF

Over recent years, global private equity funds have, in aggregate, continued to see a marked increase in the value of their unrealised investments. There are many reasons for this including an increased volume of funds raised and invested, increases in corporate valuations and, in many cases, valuation gains from operational transformation. However the rate of increase has also been influenced by a steady rise in average holding periods for these companies by their private equity owners. We have now seen early signs of holding periods shortening and a commensurate increase in the flow rate of private equity exit events. This bodes well for improving private equity internal rates of return ("IRR"), and, also greater confidence in the asset class on the part of investors.

There are many on-going challenges that the listed private equity sector has in broadening demand from existing shareholders, however with portfolio realisations running at high levels, and many of those at premiums to last marked valuations the sector has continued to deliver good underlying news flow. Likewise, with secondary market transactions([ii]) selling at much closer levels to fair market value than last year, continuing wide discounts in the listed private equity fund of funds space remain an anomaly.

Technology

From Michael Moule, Chairman, Polar Capital Technology : PCT

In developed equity markets calendar year 2013 produced very little earnings growth but a big increase in the valuation of the average company. Further upward progress in equity markets is heavily reliant on evidence of sustainable sales and earnings growth, leading to increased individual price risk if this is not forthcoming. For both top down strategists and bottom up stock pickers the five year old bull market is showing signs of maturity reflected in new issues volumes, hostile takeovers and sector rotation. Globalisation, the internet, and flexible labour markets are helping keep inflation low, and the slow speed of economic recovery in the USA and Europe leaves little appetite for a material increase in interest rates. Thus equities may remain the asset of choice for longer than usual with a rare, but possible "euphoria" leg to ensue.

Fortunately the global technology sector has a cycle of its own making with the internet seemingly unstoppable in its voracious inroads into the everyday life of business and individuals. There is consequently no shortage of exciting new companies for our managers to assess but product life cycles and patent protection appear to get shorter, and sifting the few winners from the myriad of losers is no easy task.

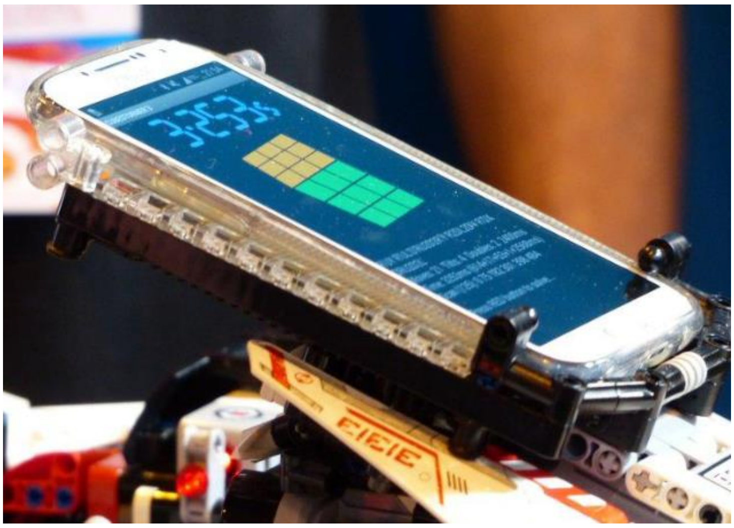
From Ben Rogoff, manager, Polar Capital Technology Trust : PCT

Worldwide IT spending is estimated to reach $3.8tr in 2014, an increase of 3.1% below current expectations for 3.6% global GDP growth. In the past, we might have characterised a forecast below global GDP as conservative. However - after 2013, the first year we can recall when IT budgets essentially failed to grow absent a recession - our sense is that there is not nearly as much pent-up demand for enterprise technology as incumbent suppliers and their supporters suggest. Instead we suspect new cycle deflation is the most likely culprit with China-related weakness playing a significant supporting role. As such, while there could be a cyclical rebound should the global economy/CIO confidence improve, any recovery in capital spending is likely to prove muted. With low single digit IT spending growth entirely at odds with computing and storage needs that continue to grow inexorably, further reallocation of budgets in favour of cheaper next-generation technologies and vendors looks all but assured. This reallocation is being accelerated by the migration of computing workloads from the enterprise to the Cloud such that the 'new technology cycle' appears to have entered a second, more pernicious phase with many of these new technologies beginning to replace, rather than augment existing solutions.

As with the broader market, the technology sector re-rated during the past year leaving it trading on 15.1x next twelve months earnings, broadly in line with longer term averages. Once the sector's significant aggregate net cash balance is considered, absolute valuations look more attractive although much of this cash is held offshore and therefore subject to (significant) tax if repatriated. As in previous years, market cap weighted measures of value continue to be flattered by a number of inexpensive large-caps. Although sector valuations may drift higher with the broader market, it is difficult to argue for a substantial sector re-rating following a year when overall IT spending failed to keep pace with global GDP. Fortunately, a number of incumbents have at least acknowledged their slowing growth profiles by returning an increasing portion of their excess cash/cash flow via buybacks (the sector reducing its shares outstanding by 2% in 2013) and dividends, such that our benchmark today boasts a 1.7% dividend yield. This trend looks likely to continue given strong cash flow generation and bloated balance sheets, the top twenty five technology companies sitting on $832bn of cash and investments at the end of 2013.

While improved capital discipline has buttressed incumbent valuations, it has done nothing to alter our view that enterprise computing is looking increasingly anachronistic. Even without the Cloud risk and associated new cycle deflation, the PC market appears to be in secular decline, smartphone growth is likely to slow substantially in the years ahead while China appears to be transitioning from a key end market for mature technologies into a more potent competitor. The emergence of Chinese competition represents an entirely new risk to incumbent companies that are increasingly likely to undershoot already lacklustre industry growth rates. For instance, while Intel-based server units (x86 servers) should grow c. 2% this year, the top four Chinese vendors are expected to increase their market share from 6% to c. 9% at the expense of the 'big three' (Dell, HP and IBM) where units will contract more than 8% y/y. Rising tensions over cyber espionage following the NSA/Snowden affair appears to be accelerating this trend, China said to be advising its banks against the use of IBM servers.

We strongly refute those who claim a late 1990s re-run or 'second technology bubble'. Not only do the statistics comprehensively fail to support the parallel but the charge also fails to acknowledge that high growth, disruptive technology companies addressing large market opportunities rarely trade cheaply, particularly when they are investing for growth. Instead, we believe that the increasingly apparent bifurcation in sector fortunes, together with supportive M&A activity, allowed the valuation 'elastic' between the sector's 'winners' and 'losers' to become stretched. Incumbents such as IBM and EMC appear increasingly beleaguered by the new cycle, the shift to cloud computing and slowing emerging market growth.



The new technology cycle continues to be underpinned by three core themes: Internet infrastructure, broadband applications and mobility, with 'big data' playing an increasingly supportive role. As in prior years, this view is well supported by a recent Gartner annual CIO survey that revealed 'analytics', infrastructure and Cloud as three of the top five IT priorities this year. Having come of age during 2013 (evidenced by the Adobe model transition and the CIA decision in favour of Amazon), Cloud adoption looks set to accelerate with share of workloads expected to reach 17% this year with incremental units of compute and storage moving decisively in favour of public clouds that by 2016 could account for up to half of overall cloud computing. Already said to be worth more than $47bn, worldwide public cloud IT services are expected to reach $107bn by 2017.

The shift towards hybrid and public cloud computing is likely to prove extremely problematic for existing vendors because incremental capacity is added beyond the enterprise where the clearing price is vastly lower, $1 spent at Amazon Web Services (AWS) is estimated to be equivalent to between $4-12 of traditional IT spending. As workloads and IT budgets are increasingly diverted towards the Cloud, new cycle deflation is likely to intensify pressuring incumbent vendor shares and business models that are "incompatible with public cloud". Public cloud deflation is also likely to be felt within the firewall as organisations increasingly ape 'web scale' architectures pioneered by Internet companies that emphasise software centricity, commodity hardware and homogeneity allowing companies like Facebook to boast a ratio of better than one engineer per 1m users.

Broadband applications remain core beneficiaries of this new cycle deflation with growth supported by smartphone usage (mobile accounting for 25% of total Internet traffic) and benign penetration rates in key categories such as online advertising, e-commerce and SaaS. After a watershed year, the outlook for online advertising looks assured given that Internet and (surging) mobile usage accounts for 45% of US media consumption but just 26% of advertising dollars. This mismatch - worth $30bn in the US alone - is likely to come at the expense of the print and TV formats, the latter (a $236bn global market) so far having been remarkably resilient to the offline to online shift. While Google should continue to benefit from market growth (and the proliferation of the Android-based devices) incremental spending is likely to gravitate towards new formats, such as local (Yelp) and social (Facebook, Twitter etc.) advertising due to their increasing reach and superior ROIs.

Surging mobile usage is also helping support e-commerce - worth $260bn in the US last year - with mobile commerce ('m-commerce') growth of 100% y/y helping overall online spending maintain a mid-teens growth trajectory, underpinned by modest penetration rates of retail sales at 8% and 10% in the US and Western Europe respectively. Increased smartphone usage is also continuing to drive extraordinary growth of new applications that are capable of changing user behaviour and reinventing markets as diverse as Cloud storage, recruitment, travel and video. In addition, high-profile private companies such as Airbnb (accommodation), Uber (taxis) and Spotify (streaming music) are also helping to "reimagine industries". Intense M&A and investment activity looks set to continue as incumbent Internet companies look to both defend and extend their leadership positions.

We expect smartphone growth to slow substantially in the years ahead now that global penetration exceeds 55% (and greater than 70% in developed markets among 18-54 year olds). As such, 2013 was probably the zenith for smartphones with units exceeding 1bn (+43% y/y) although the shift towards lower end devices and emerging markets meant that revenues 'only' increased 25%. The combination of deteriorating mix, sharply slower unit growth this year (+24% y/y) and disruptive new entrants has seen us further reduce our smartphone (and tablet) exposure as it will not be easy for incumbents to navigate slowing industry growth. Interesting applications include mobile remittance, geo-fencing and location-based services. For now, risks around electronic payments should continue to drive upgrades of existing point of sales (PoS) terminals. While we do not know which monetisation model will prevail, adoption of mobile wallets should help accelerate the move from cash to card which benefits networks.

(*re*) Big data: (a term used to describe data that is forecast to grow fifty fold between 2010 and 2020); driven increasingly by Internet usage, smartphones and other "connected" devices. Although the market for big data is expected to be worth $16bn this year, incumbent vendors of compute, storage and business intelligence software are unlikely to benefit because vastly cheaper tools are required to store, process and extract value from 'low grade' datasets. Insight derived from 'big data' is allowing the technology industry to penetrate adjacent markets at an accelerating rate, supplanting experience based on sample sets with algorithms and population data. As more and more physical objects are connected to the Internet (26bn by 2020, excluding PCs, tablets and smartphones), the so-called 'Internet of Things' will become a vast additional data source to be tapped for insight, while 'big data' analysis will, in turn be the "cornerstone of the success of the Internet of Things

Security: cyber-attacks have become both more frequent and more sophisticated while new threats such as malware and denial of service (DoS) attacks make existing defences based on the network perimeter look increasingly like the Maginot Line, c. 1939. In addition to high profile attacks on companies such as Target (in which 40m card readers may have been compromised) and most recently, eBay (large scale loss of personal data), cyber-crime is becoming increasingly state-sponsored with the Pentagon in May 2013 accusing the Chinese of widespread cyber espionage against US targets. One month later the NSA/Snowden scandal broke, making plain the scale of cyber spying conducted by departments of the US government (as well as GCHQ in the UK). The increasingly hostile threat environment is likely to underpin a security market expected to exceed $72bn this year (+8.7% y/y)

(*re*) Moore's Stress: a term used to describe the increasing difficulty faced by the semiconductor industry in keeping to 'Moore's Law' (an observation made by Intel co-founder Gordon Moore that transistor counts on semiconductor circuits double every two years). While this may undermine the historic relationship between capital investment, lower prices and volume growth that has underpinned the industry since the 1970s, Moore's Stress is likely to continue benefiting semiconductor production companies as chip manufacturers to introduce more complex processes ('steps') as they shrink nodes.

The combination of rising manufacturing complexity and supply side consolidation appears to be introducing some long-overdue capital discipline to an industry that (excluding Intel) destroyed c. $47bn in shareholder value between 1996 and 2009. Early signs of structural improvement are most evident in the memory market where DRAM prices rose 91% on a volume weighted basis last year, despite lacklustre PC volumes.

3D printing: (which enables the creation of objects through 'additive manufacturing' directly from three-dimensional digital designs). While near-term expectations may be ahead of themselves, the growth profile of the industry is impressive having grown worldwide at a c. 25% CAGR over the last twenty-five years. However, the recent excitement about 3D printing relates to the idea of 'direct digital manufacturing' which should materially expand the opportunity from c. $2.2bn in 2012 to $10.8bn by 2021 with functional parts already accounting for 28% of the market.

We continue to believe that the cycle has entered a second, more pernicious phase now that new technologies (epitomised by cloud computing) have begun to substitute rather than merely complement existing ones. While a number of legacy companies have enjoyed significant PE expansion over the past year (aided by their decision to 'bless' the Cloud), this feels entirely at odds with our view that enterprise computing is looking increasingly anachronistic given the "dramatic acceleration to the Cloud over the last six to nine months". While incumbent valuations could continue to drift higher, earnings progress is likely to be constrained by modest IT spending growth, new cycle deflation and the emergence of Chinese competition. In contrast, we expect next-generation companies to continue meeting or exceeding expectations as recipients of reallocated budgets and/or beneficiaries of new, untapped pools of technology spending as the sector permeates into other industries, such as marketing and travel.

We have been surprised by the magnitude and breadth of the recent high growth de-rating process. So far, the exodus from high growth stocks has been divorced from next-generation fundamentals. While we cannot know when this sentiment-driven adjustment will run its course, the present divergence between fundamentals and share price performance cannot persist indefinitely.

To those who claim the current de-rating process represents the bursting of "another tech bubble" we (politely) suggest they re-examine the facts, rather than to lean lazily on an intellectually beguiling but ultimately fallacious parallel between today and the late 1990s. In terms of overall technology valuations, there is clearly no case to make as the sector today accounts for c. 19% of S&P500 market capitalisation and earnings, in contrast to 35% and <15% respectively at the March 2000 highs. Although headline next-generation valuations appear less compelling, high growth disruptive technology companies are never easy to value, particularly when incumbents are trying to reinvent themselves. In hindsight, the increasingly apparent divergence in sector fortunes (together with supportive M&A) allowed the valuation gap between 'old' and 'new' to become extended which the current bout of profit taking has substantially addressed. A resurgent IPO market is also cited as evidence of another bubble. Again, the parallel is weak; while recent IPO activity has been robust, there have only been c. 66 technology debuts since the end of 2012 as compared to 431 global technology IPOs between 1999-2000, with capital raised 73% below the 1999 watermark. Rather than a return to peak levels, IPO activity (like equity valuations) has merely recovered to (just above) long-term averages, obscured by years of sub-trend activity in the same way that the first decent summer, after years of poor weather, may feel like 1976 even if the statistics fail to support it.

Debt markets

From Paul Manduca, Chairman, Henderson Diversified Income : HDIV

The low default environment continues to be very supportive but spreads have compressed a long way and some credit valuations are getting a little stretched. Consequently, whilst income returns will continue to be strong, capital growth will be harder to achieve as both our bond and loan investments look fully valued. It still seems unlikely that interest rates will rise before the end of this year so there will continue to be a preference for fixed rate bonds over floating rate secured loans for the time being.

From John Pattullo & Jenna Barnard, Portfolio Managers, Henderson Diversified Income ; HDIV

After a strong first 6 months we feel some credit valuations are getting a little stretched. The default environment continues to be very supportive but spreads have compressed a long way. We sense that the majority of returns, going forward, will be provided from the yield. Most commentators expect a pick-up in USA activity post the extreme winter weather while the inflation and default environment remains remarkably subdued. The other slightly contradictory economic policies we need to manage are the impending interest rate cut and quantitative easing programme in continental Europe compared to a reducing QE programme in America versus an expected interest rate rise in the UK.

From TwentyFour Asset Management as managers of Twenty Four Income Fund : TFIF

Since year end the market has focussed on indications that the suggested capital weightings for insurance companies and pension funds investing in this asset class (*asset backed securities*) were to be reduced. While this has now happened, the consensus from participants is that they are still overly punitive when contrasted against how other comparable asset classes have been treated. This may leave scope for increasingly accommodative capital weightings in the future.

Fundamental performance of the underlying deals has been biased towards improvement. Clear forward guidance in the UK on interest rates linking the base rate to a number of metrics (including employment, wage growth, spare capacity and unit labour costs), and with it, the expectation of wage inflation and more efficient corporate results as gains in productivity feed through, leaves us expecting to see the underlying assets performing more strongly before the central bank raises rates. In addition the ECB seems increasingly likely to invoke further economic stimulus and a rate increase is further off there than in the UK, again supporting performance.