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SPRING NOTE
Enjoy the worry

9th April 2015

Analysts: Giles Rowe
Artur Baluszynski

Away from the Brexit, Grexit, deflation, National Debt and other scare stories, BP's latest look at future energy markets in 'BP energy outlook 2035', sets out the stall for equities.

Two trends make the argument. First, the direction of trade is reversing. Oil used to flow East to West. Now, thanks to the growth of US tight oil and expanding Asian markets, it is going West to a rapidly growing East. Second, the shape of demand is going to be fundamentally different over the next twenty years. The chart below shows a widening gap between GDP growth and lagging energy consumption. As energy takes up a smaller proportion of economic activity, thanks mainly to Asia entering a new phase of capital-lite development, the rest of the market should benefit, taking a bigger share of value. Good for tech, consumer, technology, transport and so on.

In the shorter run there are plenty of grounds for worry, with some long/short fund managers calling Armageddon. The failure of QE and all-time low interest rates to produce inflation in anything but financial assets is a nuisance, as it makes debt reduction harder. For democracies with high levels of national debt a steep rate rise is unpalatable but as long as markets do not force a sovereign debt re-pricing, low rates are likely to remain. We follow the QE unwinding process closely.

Equity prices are not unreasonable, banks are in better shape for any correction and even for lending, and right now equity, property and bond market bull trends remain in place. The background of worries is not unhealthy as it keeps sentiment in-line.

Chief Investment Officer

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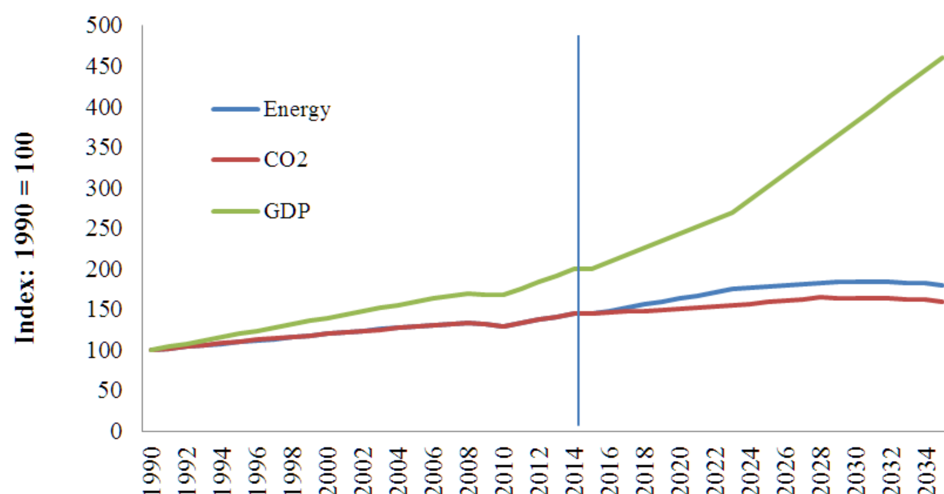

Chart source: BP energy outlook 2015

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EQUITIES

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EXUBERANT BUT STILL RATIONAL

Analysts: Giles Rowe
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With the Standard & Poors 500 Index (see black line in chart below) soaring above 2000 for the first time, the chart looks severely overstretched, a correction 'obviously' overdue. But it has been at record highs for over two years now. The green line on the chart below shows it is not excessively overvalued, especially compared to prior peaks, with an 18.4x current PER (green dotted line, right hand scale) and a 17.6x prospective one (red dotted line, right hand scale), well below prior peaks in 1999 and 2009.

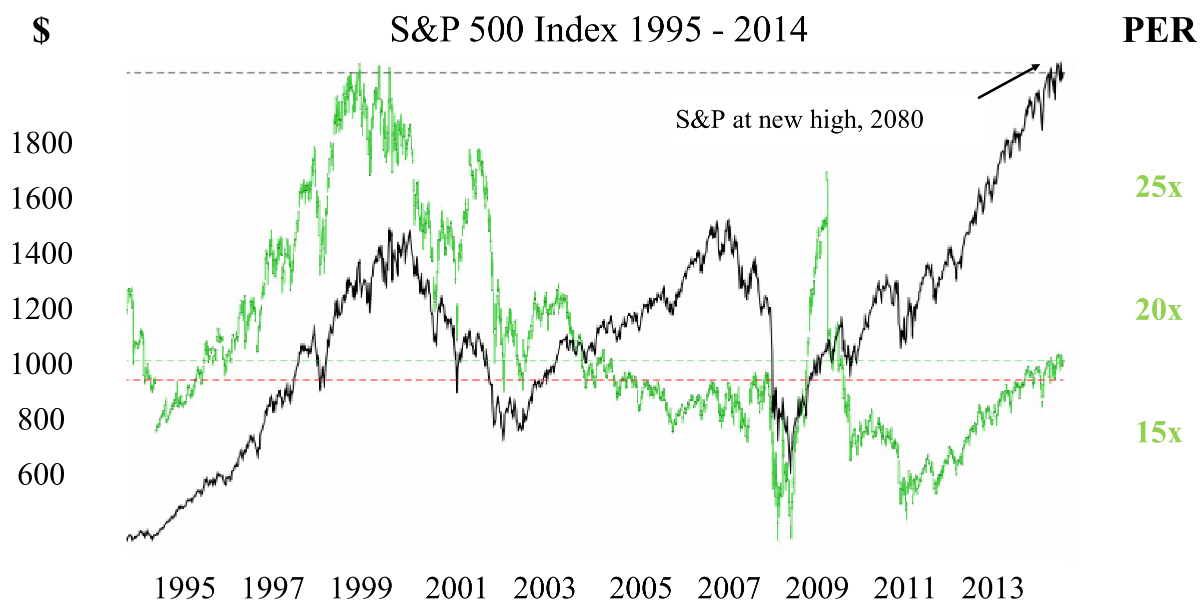
This gives a prospective 5.7% estimated forward Earnings Yield for the S&P, not expensive. We look across a group* of major markets and take their average PERs, Earnings Yields, Dividend Yields and Prices to Book in the table below. This shows measures for this year (Actual), the next results (F12), then one and two years out (FY+1 and FY+2), based on consensus Bloomberg estimates.

	Actual	F12 Est	Y+1 Est	Y+2 Est
PER	17.6x	16.2x	13.5x	12.2x
Earnings yield	6.2%	6.5%	7.7%	8.5%
Dividend yield	2.5%	2.6%	2.8%	3.0%
Price/NBV	1.8x	1.7x	1.6x	1.4x

Data Sources: Bloomberg

In a year or so the heat has come out of PE Ratios and Price to Net Book Values, with yields significantly higher and implied valuations much cheaper. These do suggest demanding earnings growth rates, some 10%+ p.a., which should be treated with caution. But even half this growth delivers a 15x or 16x PER in a couple of years, well below average levels in the chart below.

Of course there are well flagged near term risks, but they are not based on value.



Data sources: Bloomberg , Chart source: Bloomberg

* *FTSE All Share, S&P500, Bloomberg Europe 500, Hang Seng, Kospi, Nikkei, MSCI Emerging Markets*

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BONDS

9th April 2015

IT'S COMPLICATED

Analysts: Giles Rowe
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In January last year, most economists surveyed on Bloomberg expected 10-year US Treasury bonds to deliver negative returns with the yield expected to rise to 3% or 3.5% from about 1.7%, prices falling accordingly. In general, we agreed with this outlook but fortunately decided to hedge our bets by keeping some duration. Uncertainty about Europe and mixed data coming from the US and China pushed the yields back to 2% by December 2014.

With another strong year for fixed income securities, it is clear now that most economists have got it wrong for three consecutive years. The Fed recently confirmed improving market conditions but also downgraded US growth forecasts from 3% to 2.3%-2.7%.

In March this year, we took profits on our medium and long term US treasuries, keeping the proceeds in US$. If the US economy grows fast while government bond yields decline, rates may need to be jerked upward fast. With bond prices so high, there is little cushion against a sharp correction. Any rise in interest rates will be painful for both nominal and index linked long term government bonds. There is still room for uncertainty about when the first move is going to be made.

The substantial decline in the oil price should benefit the rest of the economy but with improving employment, growth could lead to inflation. Inflation protection is now expensive.

The US high yield market has depth and liquidity but has been caught up in the global commodity sell-off. For our more aggressive clients we continue to hold selected high yield US$ bonds, which we believe will continue to pay interest and redeem at par at maturity.

History tells us that emerging market debt is not the place to be when the US starts hiking interest rates, although this time not all EM economies are equal. Commodity importing countries tend to have good balance sheets and in a growing world a strong US$ should provide further stimulus. But for commodity exporters like Brazil and Russia a rising US$ and higher US$ loan rates could hurt. We are selective in emerging market debt investments, aiming to be adequately compensated for taking higher risk.

Data sources: Bloomberg , Chart source: Bloomberg

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COMMODITIES

9th April 2015

UNLOVED

Analysts: Giles Rowe
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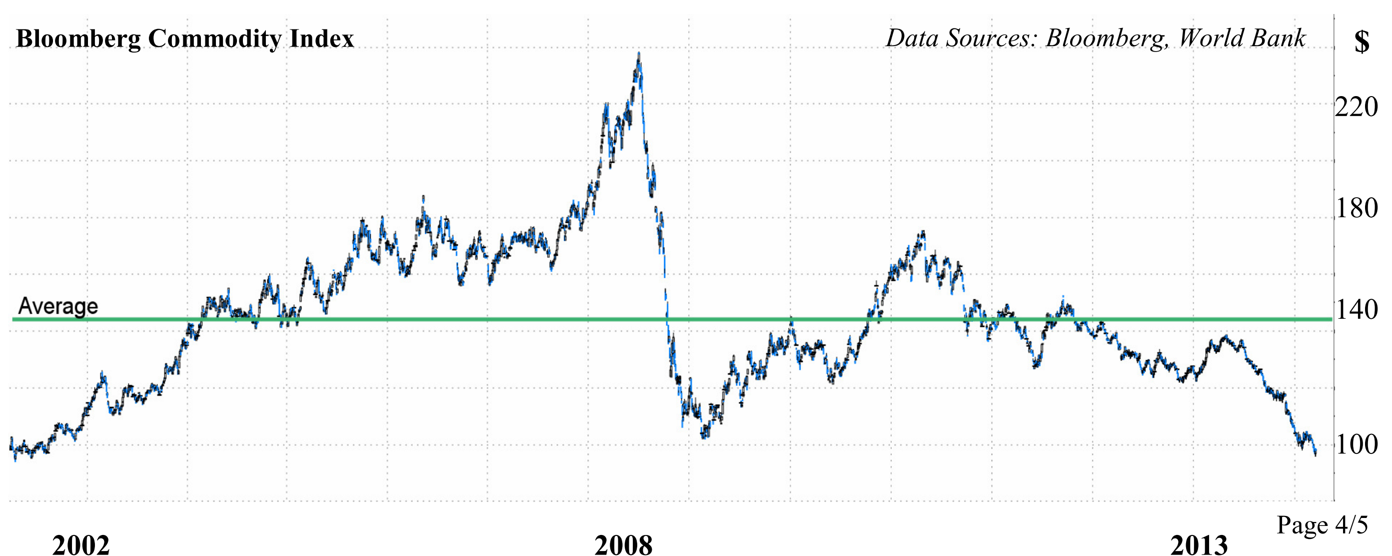
The combination of a stronger US$, increasing supply and a slowing Chinese economy are holding oil and most base metals at lows. Oil's fall so far is c. 50%, below previous records of a 67% fall in 1985/86, and 75% in 2008.

The World Bank and many analysts expect commodities to continue their decline this year. Bloomberg's commodity index is now trading significantly below its fifteen year average and is approaching 2001/2002 levels. The bear case is that commodity markets are re-pricing to allow for the new reality of slower global growth, including reduced consumption in China. The U.S Energy Information Administration (EIA) has recently reported that about 60% of total U.S. oil storage is filled, a jump from 48% a year ago. Europe is at 90%, while South Korea and Japan maybe at 80%. Shortage in storage space could further depress the price of oil, encouraging consumption. Long term, technology advances threaten to translate into more efficient energy use.

The bull argument is based around the self correcting nature of most commodities. Base metals, gas, grains and now oil are all trading at price levels that are signalling producers to cut production. This comes at a time when global growth is starting to pick up and workers' wages are improving. Most companies are already cancelling the development of new projects all over the world. Shell and Stat Oil alone have recently cancelled nearly $10bn. capex and the mining industry is expected to cut its investments by 17% in 2015. This should eventually decrease supply. The longer the oil or metal price stays near or below marginal production cost, the higher the eventual supply shortages and price spikes.

We continue our tested approach to commodity investing, buying stocks of low cost producers with strong balance sheets and experienced management, securing at least some dividend income. For most of our clients we continue to hold Rio Tinto and Randgold Resources and for our more aggressive clients we will stick with Premier Oil high yield bonds. We sold most of our energy stocks just before the big sell-off last year and continue to screen for value.



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