2014: a year full of surprises?

Investors started the new year with certain unshakable convictions: that the American economy was going to bolt out of the starting gates, equity returns would far outstrip bonds, and Janet Yellen, the new chairman of the American Central Bank, was going to be even more unorthodox in her approach to monetary policy than her predecessor Ben Bernanke. But as it turns out, in the first quarter, bonds performed significantly better than equities, American growth has been a big disappointment, and Janet Yellen has dared to openly talk of an interest rate increase. Is this a temporary situation that has been exacerbated by investors' one-sided positioning, or have there actually been fundamental changes?

1) Disappointing American growth

Rather than shifting into higher gear, economic indicators fell well short of expectations (Graph 1). The exceptionally severe winter weather was consistently blamed for every unpleasant surprise. But isn't it a bit odd that not a single economist seems to have been able to factor this into their forecast?

Graph 1: evolution in positive and negative surprises in the economic data compared to the consensus expectation (>0 = more positive surprises; <0= more negative)

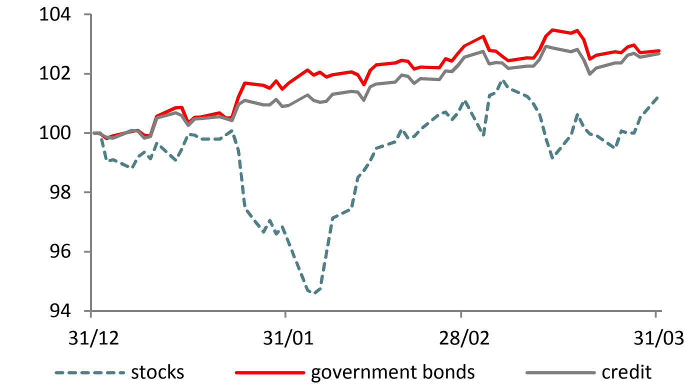
Source: Bloomberg

We suspect that a number of factors are at the root of this delayed growth, none of which seemed particular cause for alarm at first sight, but which have collectively led to the effects observed.
The weather certainly played a role, as did the uncertainty and difficulties surrounding the launch of "Obamacare" (the new American health insurance system) which caused the business world to adopt a cautious approach. In addition, the increase in the long-term bond yields in the fourth quarter needed to be accommodated, which unquestionably had an impact on the residential real estate market.

However, despite the disappointing first quarter, we remain optimistic. We regard the above factors as essentially temporary in nature and insufficient to stifle growth. Leading indicators such as real money growth point towards a strengthening economy by the end of the second quarter. Moreover, bond yields have fallen (see below) which means that the greatest economic and financial risk for 2014 – an abrupt rise in interest rates – has shifted to the background. In summary, we can conclude that the American economy is yet again undergoing a period of slower than expected growth, but it should be able to recover within the next few months.

2) bonds outperforming shares

Graph 2: equity returns versus bond returns



The (unrealistic?) consensus among investors and the resulting stock-heavy positioning and underinvestment in bonds, combined with the disappointing macro data, led to an unexpectedly strong performance for bonds.

But we very much doubt that this trend will continue for long, and we generally have a sense of déjà-vu: in 2013 bond yields also initially fell until early May, when the pessimistic outlook for growth (see also Graph 1) proved unfounded and yields – boosted by the hint from Ben Bernanke that the monetary policy would be normalised – soared.
By limiting the term of the bonds in the portfolio to maximum five years, we have not been able to take full advantage of the decrease in interest rates. However, this does restrict the interest rate sensitivity of the bonds to just 3% (for every percentage point that rates rise or fall), which means that a potential rise in rates will have only a limited impact.

The major difference with last year is that the deflationary trend was then less pronounced. Nevertheless, we do not currently see sufficient indicators to suggest a clear risk of deflation, although we are certainly watching inflation figures very closely in the Eurozone. However, this deflationary trend does mean that despite the lower interest rates, we still prefer bonds in the Eurozone rather than in the United States.

When the focus on *deflation* begins to appear excessive, this is exactly when hedging against *inflation* becomes cheaper. That is why we also recently purchased an inflation-linked Italian bond.

3) Janet Yellen not so unorthodox
Based on her reputation as a major supporter of the Federal Reserve's highly unorthodox policy, it was widely expected that the arrival of Janet Yellen would be accompanied by a further increase in the money supply at the slightest sign of economic trouble. But meanwhile, it has become clear that the threshold for the Fed to retreat from the normalisation process now underway is much higher than expected, and that as chairman of the Central Bank, Yellen intends to pursue a more moderate course. Thus, at a meeting in March, she indicated that the benchmark interest rate could be raised within six months of the end of money creation, which should mean around mid-2015. A few months ago, such a statement would have been enough to considerably disrupt the financial markets. But since Yellen also indicated that interest rates will be kept lower for longer than in a normal economic cycle, combined with the fact that markets are increasingly realising that the period of free money cannot last forever, the impact was limited to a slight drop in stocks and an increase in short-term bond yield.

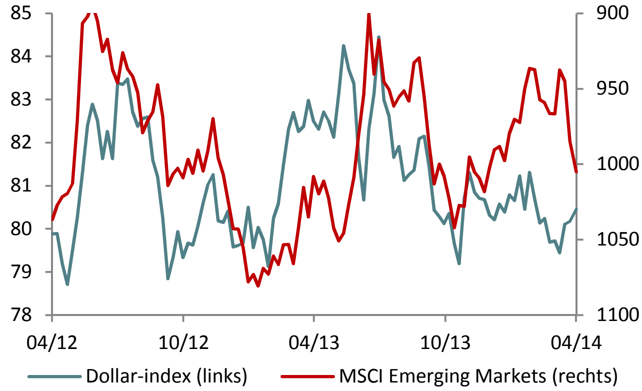
Due to this stance by the Fed, short-term American bonds (two-year term) have become unattractive and the position has therefore been sold and already partially replaced by a five-year term (see above). However, we nevertheless see this evolution within the Federal Reserve as highly positive. One of the major risks for the financial markets, in our view, would have been a loss of credibility for the Fed if they were to withdraw from the normalisation process in the face of the slightest doubts about economic growth. They now appear determined to stand by their position, and this should only benefit their reputation – and the financial markets as a result. Which is not to say that there are any guarantees that the exit from this historically unprecedented situation will be perfectly smooth, but in any case, it is a positive start.

Strategy

In the equity portfolio, the greatest adjustment was the divestment in Japan. The Japanese stock market not only lost 7% in value since New Year, but it was above all the extreme volatility and strong correlation with the Japanese yen which led to this decision. From a tactical point of view, we will consider a new position either when the equity market becomes less dependent on the weakening of the currency, or when the Japanese Central Bank decides to pursue an even more aggressive policy.

Like the other surprises, the weaker dollar in the first quarter turned out to be more of a blessing than a curse. After all, it brought welcome relief for the growth countries after the sharp correction in January. However, since we consider this weaker dollar to be only temporary, we fear that excessive optimism about stock market performance in the growth countries would be premature: a stronger dollar often puts pressure on shares in the growth regions (Graph 3).

Graph 3: trend dollar index (left) versus MSCI EM (inverted scale; right)



Source: Bloomberg; Buysse & Partners

We have picked a number of attractive individual stocks which have lagged behind the stock market rally in recent months. These include Umicore, Koninklijke BAM, and SBM Offshore as well as the Bank of Ireland. As we expect to see a further rise in bond yields, we have also purchased AXA and SPDR US Banks ETF, since both of these move in line with interest rates.

Our strongest conviction remains the economic recovery in the Eurozone, which is reflected in the portfolio with 22% equities and 30% bonds issued in euros. The specific accents on the banking sector and Italy have already greatly contributed to returns thanks to the strengthening of the economic and financial situation in the single currency zone. As this positive trend may continue and valuations remain attractive, we intend to uphold these strong convictions.

Jan Leroy, CFA
Director B&P Capital Protection Fund