**What's in store for investors in 2014? We look back at the winners and losers in 2013 and summarise our views for the year ahead.**

It's been a busy year. **Despite many potholes along the way**, including potential war with Syria, a plummeting gold price, the Italians voting to elect a comedian as president, the bailing out of a fourth Eurozone country (Cyprus) and a US Government shut down for the first time in 17 years, **2013 has nonetheless been a good year for most equity markets**.

**US equities have been particularly strong**, with the S&P 500 reaching an all-time high, closing nearly 30% higher for the year. **Yet this is despite the breakdown in May of the Federal Reserve's (Fed) advance warning policy** (forward guidance), when Bernanke surprised the markets by announcing that the much anticipated tapering of quantitative easing (QE) would commence imminently, only for him to confuse investors further by U-turning in September by reversing this earlier "guidance".

**QE has definitely been the talking point of 2013** and the markets have spent the last 12 months dancing to the Fed's tune. **However** after all of the uncertainty throughout 2013 surrounding this key policy tool, **Bernanke's decision in December to finally begin the process of 'tapering' by reducing QE from $85bn to $75bn a month was shrugged off by investors** (QE fatigue maybe?) and equity markets reacted well to the news. This was a great relief to us. Having been firm advocates of reducing QE for the whole of 2013 due to our anticipation that the US economy would be stronger than generally expected, **our greatest fear was that the inevitable tapering of QE would be a surprise to most** and that markets would dip on the news. **Thankfully investors have so far been sanguine about the implications of the Fed printing less money** and perhaps this is partially due to Bernanke's pledge to keep short term interest rates at close to zero until US unemployment is "well past" 6.5%, emphasising a continuation of highly accommodative monetary policy. But then we can't be sure because it's not really his gig anymore and he will pass the reins to Janet Yellen on the 31st January 2014.

In any case, **the decision to taper confirms that the Fed is now comfortable that the US economic recovery is underway** and recent economic data certainly seems to support this idea. The latest figures show that US unemployment fell to a 5-year low in November of 7% and the US economy grew at its fastest pace since 2011 between July and September, recording annualised growth of 4.1%.

**More than once this year markets have been affected by bad news being good news and vice versa**, **with investors reacting to poor data by driving equities higher** (on the premise that bad data means that QE will be in place for longer, further inflating bond and equity prices).

**2013 was not good news for the US Dollar against Sterling**, which although down only 1.4% for the year, has lost nearly 10% against Sterling since its highs in July and this has weighed on performance for UK investors as Dollar based assets are now worth less in Sterling terms. **However this relative weakness has been caused by increasingly positive news about the UK recovery** and UK economic data has been incredibly strong in 2013. **We expect the US Dollar to recover in 2014** as further tapering of QE is introduced and as the US economy "catches up" with the UK.

**New Year, new chairman for the Federal Reserve. In reality it's a case of "out with the old, in with the old" as institutional investors expect Yellen to adopt the same approach to monetary policy as Bernanke.**

The Fed was not the only major central bank to change the guard and **this year saw the appointment of Mark Carney** as the new governor of the Bank of England (BoE). **It wasn't the best of starts** for the former governor of the Bank of Canada, as his own brand of "forward guidance" confused investors even more than his counterpart in the US. During his first press conference, **Carney sought to appear strong by confirming that he would keep interest rates at current levels** until unemployment falls below 7%, **but immediately reserved the right to raise rates if inflation picked up** – all very confusing. In the short term the FTSE 100 declined but since then, strong economic figures, coupled with unemployment at lows not seen since 2009 have helped drive the FTSE 100 higher over the year.

So **the two key developed markets, US and UK fared well in 2013** on expectations of strong economic recovery, **but what of Europe and Japan? The prognosis for Europe at the start of the year looked bleak**. France was back in recession, German GDP forecasts were slashed, Cyprus became the fourth European country to require a full bail-out after its own mini banking crisis, in February Italian's voted to elect a comedian as head of state and unemployment in Spain reached 27%, with youth unemployment reaching a miserable 56%. Not the sort of conditions then for a burgeoning economic recovery. So in an effort to inject some impetus, **the European Central Bank (ECB) cut interest rates to 0.25% in November** citing low inflation and economic weakness as reasons for the cut. **This helped to move sentiment** and along with general momentum in the US and UK, **European equities and bonds had a strong 2013**, although with economic recovery far from certain in peripheral Europe **we remain cautious in 2014.**

**One of the biggest success stories over the last 18 months has been Japan**, driven mainly by the announcement of the enormous QE package in mid-2012 that was designed to rid Japan of deflation once and for all. The markets believed the story and **the Nikkei had a rampant end to 2012 which continued into 2013** as the Nikkei finished up over 57%. Whilst we came slightly late to the party, buying Japanese equities in February of 2013 and selling Latin America to make room, this move allowed us to avoid the drop of around 20% in the Brazilian Bovespa and participate in the Nikkei's gain of 45.6% over the same period.

**"Abenomics" (see April 2013 market overview) appears to be working.** The Bank of Japan's asset purchase scheme has helped to weaken the Yen, bolstering Japanese exports and consumer spending is also higher after a series of tax cuts. **As the only major economy still printing money, we continue to remain bullish about Japanese equities going into 2014**.

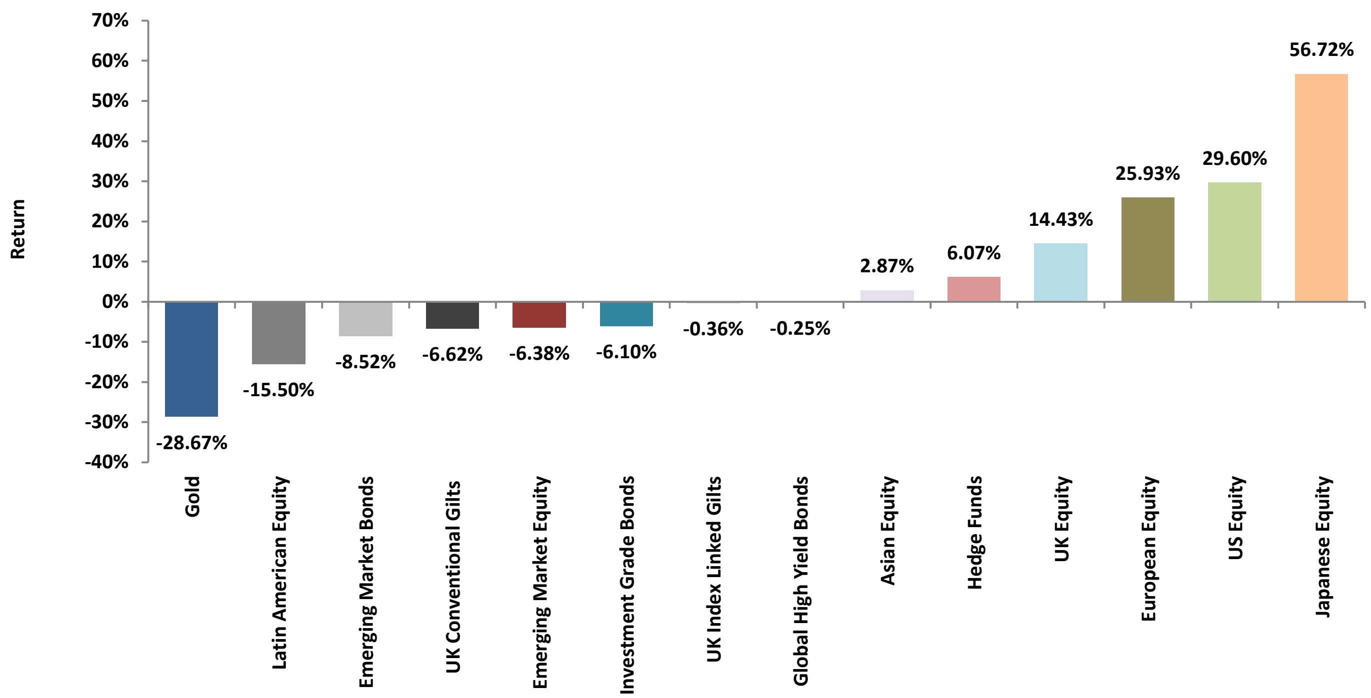
But it hasn't been a bed of roses for all equity markets in 2013 and after many years of strong outperformance, **Emerging Markets (EM) took a beating in 2013.** Mention of QE tapering in May was disastrous for Emerging Market equities and currencies. The Indian Rupee fell to its lowest level in 21 years against the US Dollar in August and despite a rally in September, it's now on the slide once again. As we outlined in September, **tapering is bad news for EM because when the US economy recovers, US interest rates and the US Dollar rise, it is widely expected that increasing flows of capital will pour out of EM into the US** and other developed markets. Institutional investors therefore began a mass exodus from EM in May and we also took part in that capital flight. **Despite a recovery in September when Bernanke announced his policy U-turn**, now that tapering has started in earnest, **we believe that the environment for EM equities and currencies is going to continue to deteriorate.**

However it is important to note that **most EM economies are much stronger now than in the Asian crisis of 1997** and some economies have aggregate current accounts in surplus, along with modest debt levels. Our decision to exit EM assets in May has helped this year and we are now watching for an opportunity to buy EM assets at attractive levels, although we worry that this may not be in the first half of 2014. **We believe that there are strong enough returns to be obtained in other markets without the need to increase risk by buying Emerging Market equities at the moment.**

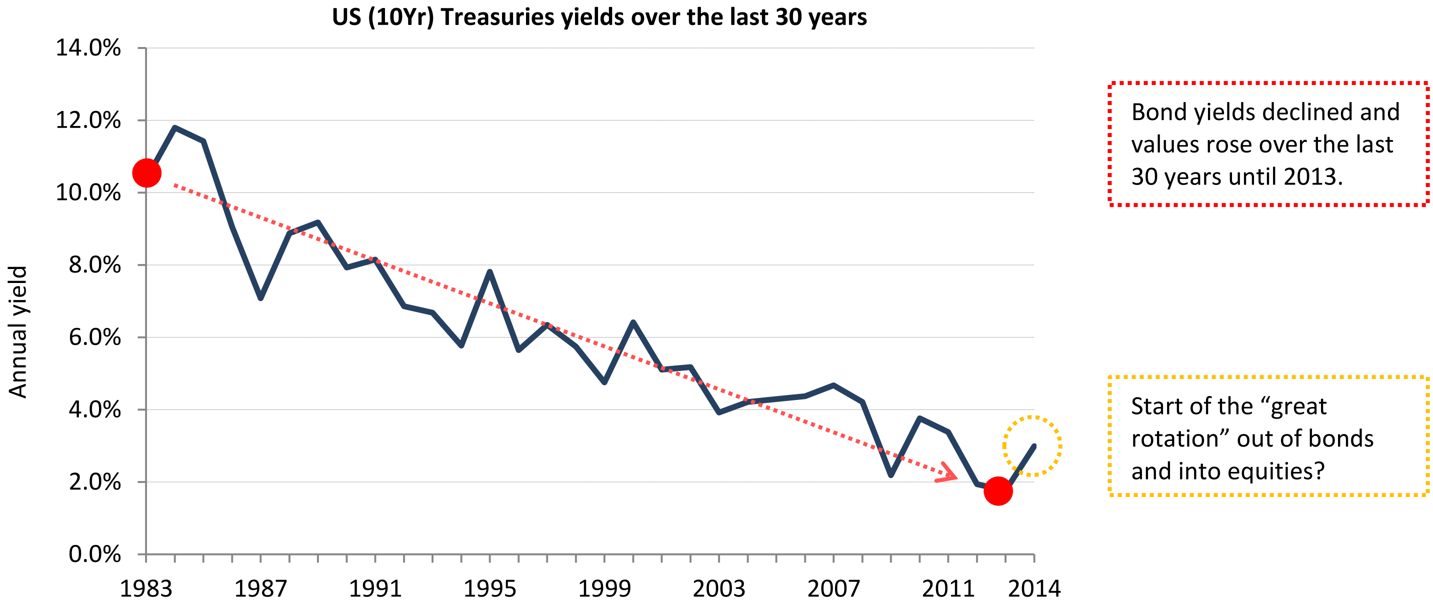
**It was a terrible year for gold** investors as the safe haven yellow metal fell over 28% in 2013, its worst year since 1981. After peaking at over $1900 in August 2011, gold has continued a steady decline in value ever since and whilst holding gold in the past has helped to hedge against inflation and act as a buffer during times of uncertainty (particularly during military conflicts around the world), this perceived natural protection was scuppered in 2013**. Tapering of QE was the primary reason for the loss** because it is widely expected that a slowdown in EM growth will lead to a fall in demand for gold. **Lower forecasted growth in China certainly didn't help** and in 2013 over $8bn was withdrawn from gold index tracking funds. **We've certainly seen the froth blown off the top of the gold price and gold has settled at around $1,200 per ounce but there is risk of further downward pressure in 2014.**

**Global bonds have also had a difficult year**. When the FED hinted in May that it might start to reduce QE, US government bonds immediately fell and yields rose alarmingly. This is to be expected because reducing asset purchases (reducing QE) means buying less bonds and therefore bonds should fall in value to compensate.

**How they fared in 2013**




Source: Financial Analytics. Performance from 01/01/13 to 31/12/13 in local currency terms.




Source: US Federal Reserve.

Of more concern perhaps is that when Bernanke then reversed this earlier guidance in September, US Treasury prices didn't rise anywhere near as much as they had fallen. This tells us that **markets are starting to price in the end of a 30-year bull market for global bonds along with the expectation that interest rates will start to rise.**

Investors should be warned that bond values will continue to underperform equities in the years ahead. **The idea that investors will start to move out of bonds and into riskier higher yielding equities has been dubbed the "Great Rotation**" and whilst the evidence of such a rotation is not yet conclusive, all of the signs point to such a move in the years ahead.

**Investment grade corporate bonds have been a major beneficiary of the QE spending spree**, to such an extent that the annual returns now offered by these bonds has fallen to a level that is not reflective of the risks taken to own them. Unlike government bonds, which are seen as the safe haven asset of choice, (see our November 2013 overview), corporate bonds do not offer the same protection (they are backed by companies, not governments) and **we believe that owning this type of investment will prove risky in an environment where interest rates are rising.**

**Emerging market bond funds have seen large outflows in 2013** for the very same reason that investors have fled from EM equities. Falling EM currencies and concerns about capital flight back to developed markets rocked EM bond markets last year **and we expect that malaise in this asset class will continue in 2014.**

**However if we are wrong about QE and if the Fed suddenly backtracks on plans to reduce it, bond markets might stage a rally this year** (albeit that we think this would be a "stay of execution"). If the Fed does surprise again and inject further QE then for the sake of diversification we believe that it is sensible to own some bonds, provided that the type of bonds owned is chosen very carefully. For instance **high yield bonds still look good value** because returns (yields) are still attractive and in an improving economic environment default rates tend to fall and remain low.

**Another example would be "alternative" bond funds** that have the ability to take "short" positions in the bond market and therefore make money if bonds fall in value. **This type of investment allows us to benefit from rising yields and gives us some protection from the "Great Rotation"** mentioned earlier and we support some of these types of bond funds for our clients.

**However in general, investors would be well advised to remain underinvested in bonds over the coming few years.**

**So how would we summarise our expectations for this year? In 2014 it's still all about the US Federal Reserve** and their programme of reducing Quantitative Easing over time. **We continue to focus on developed market equities, seeing the UK, US and Japan particularly as the major beneficiaries** of continuing capital flight in Emerging Markets **and we will remain on the side lines in EM for the time being** although we think there will be a great opportunity to buy some of these markets selectively, just not now. Also, as a result of these commodity hungry economies displaying weaker growth prospects, we think that this will continue to affect gold and other resources negatively this year.

As already mentioned **we do have some high yield bonds and some alternative bond funds** on our current buy-list as we do believe that our clients will make money this year from these asset classes but generally we remain cautious about bonds as an asset class given the outlook for further reductions in QE.

In closing, **we think that there will be more potholes along the road and some of these won't be signposted, but our shift in stance last year from "neutral" to "positive" is based on the belief that the US recovery will continue to drive developed market equities higher in 2014.**