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Slow and low that is the tempo

10-year US Treasury yields have now fallen 0.50% over the year, reaching 2.50%, a near 1-year low. Similarly, Australian Commonwealth 10-year bond yields fell 0.70% over the same period, reaching 3.70%, also a near 1-year low. The story is the same in Europe, where 10-year German bund yields fell 0.65% over the year, reaching 1.30%. Yet markets remain stubbornly consistent in their expectations for rising bond yields. At the beginning of 2014 virtually no one predicted lower bond yields, even in the face of moderate growth and little inflationary risks. Almost everyone predicted higher bond yields by year-end and they remain consistent in their expectations. The story is the same on the currency front. We can't think of anyone who expected a stronger Australian dollar in 2014. Our views on the eventual direction of rates and currencies are laid out further on in this document.

A critical tenet of our investment philosophy remains that you don't get paid to take large positions in interest rate or currency moves, and that those will only deliver more volatility to your portfolios. Over the past few years this point couldn't have been proven to be more true. The problem in taking large interest rate and currency positions is that markets can and will move against your economic fundamentals for very long periods of time. You might eventually be right, but it will be a painful ride. John Maynard Keynes' famous warning[1], "The markets can remain irrational longer than you can remain solvent" serves as a useful reminder and remains a guiding principle behind our investment philosophy.

In structuring our portfolios in today's environment we take a more agnostic approach to current yield levels. Yes, rates are near record lows, but with good reason. Inflation isn't a problem for the world, rather deflation remains a bigger risk, in our view. And while the balance of economic data does point to eventual economic recovery, it's more consistent with a far longer, slower recovery than markets appear to anticipate. We may be right, we may be wrong, but the key for our portfolio strategy is to ensure that our interest-rate and currency calls don't drive overall portfolio returns.

Therefore, we feel it's important to maintain our overall interest-rate (duration) exposures very short, in the ¾ to 1 year range. And it's important to keep our active currency exposures very small, so we remain close to 100% hedged to the Australian dollar.

So whilst we believe in the ongoing global recovery story, it looks to be taking shape at a moderate pace. In the US, we expect continuing slow improvement in economic data, particularly after the exceptionally cold

[1] While commonly attributed to Keynes, there is no primary source proving Keynes used this term.

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weather season ends. We remain biased toward an eventual rise in bond yields as:

- Growth continues to recover in the US (housing, jobs, and consumer confidence);
- The likelihood of a hard landing or debt spiral in China dissipates;
- The market prices in a monetary policy 'exit';
- Real yields normalise from alarmingly low levels.

However, significant rate rises may be months or even years away as low global inflation, slow jobs growth and continuing political turmoil create a cap on bond yields. We believe bonds are fairly priced in today's environment and expect rates near today's levels over the coming months. Additionally, central bank rate hikes remain years away, in our view. 10-year US Treasury yields in the 2½ to 3% range and Australian Commonwealth government yields in the 3½ to 4% range appear fairly priced, balancing moderate growth and minimal inflation risks versus the imminent end of Federal Reserve support for the Treasury market, amidst a more stable jobs environment.

While US growth is improving, the pace will remain fairly muted and well below the 3.4% average pace for the period following WWII through 2007. Despite an improving consumer, private sector deleveraging will continue and put pressure on the recovery in 2014. And business spending will only improve marginally - business sentiment has fallen in recent months. Nonetheless, the private sector will continue with moderate gains over 2014. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite increases in mortgage rates which will slow the housing recovery. Despite occasional hiccups, employment gains will continue in the 190,000/month range, which could bring the unemployment rate down toward the 6% range by year-end 2014. We expect to re-gain the net remaining 1.3 million lost jobs over the 2008 – 2009 period by the third quarter of 2014. We foresee potentially larger job gains in the coming months as the effects of past cold weather pass, and more unemployed find jobs. However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market replacing higher paid roles with lower paid and temporary jobs.

Globally, other global deflationary risks still remain, particularly in Europe. The ECB will continue to pay lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues. The European Central Bank (ECB) will eventually reach their limit, but we believe they have ample political support to continue current policies through the remainder of 2014. European quantitative easing may take longer than currently expected, but we eventually expect the announcement of a €1 trillion programme closer to year end. However, the rationale the ECB has used to continue supporting peripheral countries, i.e. promises of fiscal austerity, has deteriorated over the past 12 months. Despite marginal improvements, peripheral European economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term, but we view this as a 2015 and beyond problem, given the ECB's continuing support.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold although the currency isn't doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower Australian dollar. The economy is still functioning at below trend in terms of jobs and sentiment. Tighter fiscal policy may also drag on the growth story, although not significantly. We forecast annual 2014 growth around 2.7%, well below the 4.5% long-term average of the past 25 years. Continuing Australian dollar strength will limit growth in the manufacturing and servicing sectors, which are unlikely to fill the gap created by the fall in mining investment. The RBA will maintain low rates as limited wage growth will stem inflationary pressures and allow continuing support for the housing market. While equity markets continue to approach new record highs, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures, putting more pressure on the labour market and non-mining domestic growth.

We expect the Australian dollar to remain strong, supported by both continuing financial flows into Australia as a result of its appeal as an attractive investment destination and relatively high real yields, particularly compared to other developed markets. However, the Australian dollar is likely to be driven more by US Federal Reserve (Fed) action and US economic data rather than by anything in Australia. We expect US QE3 will conclude as planned toward the 4th quarter of 2014 and provide some eventual relief for the Australian dollar, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world. We expect US dollar weakness to continue its reversal in 2014 as the ending of the Fed's quantitative easing programme, combined with stabilising growth, supports the US dollar over the year.

While 2014 news headlines will remain focused on a hard landing in China and risks in the 'shadow banking' sector (a red herring in our view), we foresee further liquidity, improving reforms and a continuation of growth in the 7.5% range. The burgeoning debt of Chinese municipal localities, used to finance infrastructure projects, is unlikely to bring about a major debt crisis in 2014. While this growing debt may represent China's largest economic problem, material defaults are unlikely and ultimately the central government will allow more tax revenues to flow to localities to pay construction debts. A recent report showed this debt increasing significantly over the past 2½ years, reaching $3 trillion, however China's overall total debt at 56% of GDP still compares favourably to most developed countries. We expect Chinese growth to remain in the 7½% range over 2014, allowing China to continue to support the global growth story. Reforms will continue, and we expect eventual liberalisation of deposits rates combined with necessary deposit insurance, although this may take considerable time.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, less global liquidity will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e. those with deteriorating budgets, current accounts and reserves.

India will remain a top Asian story as weaker fundamentals provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as South Korea, China, Hong Kong and Singapore. We expect to hold 10-15% of the portfolio in this region over the course of 2014.

Overall, the theme of extremely low global central bank rates and more liquidity will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the equity and risk market gains of 2013 amidst a steady but moderate growth environment. While we expect continued volatility in the coming months, we believe risk markets will continue delivering solid returns, particularly investment-grade credit, which we expect will also have lower volatility.

You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals remain attractive, the technicals surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets which will outperform in an eventual secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated global banks, conglomerates and quasi-sovereigns) which are held in more solid hands and less sensitive to moves in interest-rates. We have again implemented small positions in Spanish and Italian sovereign bonds with expectations for further ECB liquidity, providing both support for peripheral economies and a back-stop against major yield rises.