Summer

Market outlook.

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The UK Economy

The UK economy finally recovered to pre-crisis levels in the second quarter of 2014, with UK Gross Domestic Product [GDP] passing the previous March 2008 peak by 0.2%. Additional economic data showed employment improving, rising house prices, and inflation remaining low, which all helped consumer confidence reach a nine year high in June, although this was somewhat restrained due to negative real wage growth. In addition, the recent "Mortgage Market Review" has forced lenders to impose tighter mortgage lending criteria, which is likely to slow the rate of house price inflation in the coming months.

UK exports have struggled to keep pace with the domestic economy principally due to the strength of sterling and weak export markets, especially Europe.

There is a lot facing domestic politics over the next twelve months with the Scottish Independence Referendum in September 2014, the General Election in May 2015 and the potential for a European Referendum, all of which have the ability to change the course of the UK economy.

As a result we do not expect to see an interest rate rise in 2014, as we anticipate the rate of UK GDP growth to ease in the second half as the housing market cools and the strong pound weights on British exports. When interest rates do rise, we expect it to be a slow and gradual process peaking at 3%.

The Japanese Economy

Given the strides that have been taken in the Japanese economy over the past 18 months, the recent quarter has been relatively muted by comparison. With the Japanese stock markets being negatively impacted in the first quarter of 2014 by the looming 3% sales tax rise that was to come in April, we have seen the market perform strongly in May through to July. Sentiment is now once again focused on the 3 stage approach to economic recovery imposed by the Prime-minister Shinzo Abe and central bank governor Haruhiko Kuroda. With the first 2 stages of currency devaluation (Quantitative Easing) and tax controls (Fiscal Policy) arguably successful to date, the third stage is less apparent.

Expectation is/was that Abe and Kuroda will/would impose an immediate set of reforms to help growth in the domestic economy. With a large targeted increase in inflation, following years of deflation, required in order for Japan to break out of this 2 decade recession, reform is needed to support wage growth. As, with prices increasing and demographics showing that approximately a quarter of the population are over retirement age, there is increasing pressure on the Japanese population to earn more. Consequently reform is required to aid businesses to stimulate wage growth, which is difficult to do over the short term. So, whilst we have not seen and are unlikely to see a single set of reforms to stimulate the domestic economy, we are seeing several small policies and reforms such as a recent decrease in the corporate tax rate, and a separate trade agreement put in place with Australia. These types of policies look to increase external demand for Japanese produce, increase employment, whilst freeing up corporate cash to stimulate wage growth. We are yet to see an increase in basic wages, but there has been a noticeable increase in average staff bonuses which is a positive sign things are improving.

It is always worth noting that whilst strength in the domestic economy is the key to Japan's resurgence, trade relations with China, the U.S. and indeed Europe remain equally important. Whilst we are unlikely to see the currency (Yen) weaken to the extent that we saw last year, the potential strengthening of currencies such as the U.S. dollar, making Japanese goods in the U.S. relatively cheaper, could aid Japanese output over the next quarter. This, in conjunction with policy support gives the Japanese economy every opportunity to close 2014 out strongly.

The Emerging Markets & Asia Economy

Despite a slow start to the year, the Asian and Emerging Market regions have been some of the strongest performing and least volatile markets throughout 2014. Still out of favour with many investors, the strength of the current recovery following a poor 2013 has been in the absence of support from investment volumes. Many large concerns that were apparent in 2013, such as a market collapse in China and stemmed growth in India have been all but abated. Of all of the geographic regions, it is the Asian and Emerging Markets that have been the most reform driven of all.

In the past quarter we have seen India elect a new Prime Minister, Narendra Modi. This election was considered by many to be a large step in the right direction for India's continual economic development. Modi's policies include the further opening up of India to external investment and indeed external companies. In addition to India, China has shaken many concerns economists had over it having a hard landing (a period where an economy slows down sharply following rapid growth) with GDP (gross domestic product) data this quarter beating expectations. Concerns of China's 'shadow banking system' (a collection of non-bank financial intermediaries that provide services similar to traditional commercial banks) have partially abated following the realisation that relative to the western world the shadow banking system in China represents a much smaller percentage of its overall GDP than the U.S., Japan, or indeed the UK. In addition, unlike most large economies in the west, China has approximately $4 trillion in reserves.

There have also been many other factors that have driven the Emerging Markets and Asia, including Mexican energy reforms and Indonesian elections. However, despite an air of positivity, growth and indeed low volatility, the looming political pressures surrounding Russia have the potential to introduce some friction in global stock markets. In the past quarter we have seen Russia strike an energy accord with China to supply the Chinese with gas. Despite this being potentially lucrative, the sanctions imposed on Russia by the western world following the frictions with Ukraine have the potential to dislodge, not just Russian and Emerging Market stock markets, but global ones also should an agreement not be reached. That being said, it is widely believed that the Russian president Vladimir Putin is pushing the boundaries of the western governments and an agreement will eventually be struck.

The US Economy

Over the past quarter we have seen a U.S. stock market that has been arguably more timid than that which we have seen over the past few years. The economy has been extremely reliant and indeed focused on each meeting of the U.S. Federal Reserve bank (Fed). The head of the Fed Janet Yellen, despite eliminating their 'forward guidance' policy (forward guidance pertains to specific numerical guidance on data such as interest rates and unemployment), has been extremely vocal in the Fed's non numerical policy guidance.

With U.S. interest rates currently at a low of 0.25%, the majority of the current market volatility is as a result of fear that an increase in rates would impact the housing markets, make lending more expensive, and indeed reduce overall demand in the economy. However, that being said, the speculation is seemingly pricing this concern into the stock market valuations, and with Janet Yellen continually stating that rates would remain low for the foreseeable future, it is likely that any future increase in the headline interest rate would be marginal. It must be remembered that an increase in headline rate is a sign of a recovering economy, and once the fear that shrouds the current speculation disseminates, the economy can begin to normalise.

In addition to investor sentiment hanging on every shred of information provided by Janet Yellen on the interest rate, the information that drives the rate decision must not be forgotten. The Fed still have some concerns over the number of individuals that are participating in the workforce, as the individuals that do not, are not included in the headline unemployment number. So, whilst the unemployment numbers look strong the Fed believes that there is still work to be done. On top of this, Yellen has recently stated that the Fed believed that they have some way to go before they meet the targeted inflation rate of 2%. So, whilst the U.S. stock markets are currently at all-time highs, with the economy only being part the way through a recovery and the Fed suggesting interest rates won't rise in the short term, there are many sector specific growth opportunities.

The European Economy

The second quarter of 2014 has remained one of uncertainty for European stock markets, with outlook for the rest of the year unlikely to change. Year to date we have seen positive investor sentiment with investor flows helping prop up the stock market valuations at the beginning of the year. However, despite the continual positive inflows throughout the second quarter, the continuing frictions with Russia and the vague set of sanctions the Europeans have placed on them, in conjunction with the volatile data coming out of core European countries, has caused a large pull back in the European stock markets. We have seen countries such as France and Italy fall considerably below expectations on numerous occasions in terms of their GDP results (Gross Domestic Product), unemployment levels, inflation targets, and indeed the overall industrial production levels. This resulted in the Eurozone as a whole producing poor sets of results, with consumer confidence for the area considerably missing expectations in both June and July (2014).

The weakening data has caused the European Central Bank (ECB) and its Head, Mario Draghi, to consider multiple measures to alleviate the weakening economic backdrop. We saw the ECB reduce its deposit rate to -0.1%. This token negative rate is intended to stimulate banks to lend out money rather than deposit it at the central bank, in order to increase spending and growth in the economy. This is the first time that a major global central bank has utilised a negative rate facility.

A further mechanism that is being considered by the ECB is one that is being utilised by other major economies such as the U.S. and Japan, and that is Quantitative Easing (QE). The idea of QE is to pump money into the system, devalue the currency and in turn increase demand. This increase in demand is intended to increase production, employment, wage growth and inflation. However, Mario Draghi has postponed a QE policy, and has seemed relatively reluctant to engage in one due to the complexities involved. As, with the Eurozone consisting of multiple economies and central banks, creating a QE policy that will be 'fair' and 'effective' is arguably much more difficult than generating one for a single country such as the U.S. or Japan.

With the continuing uncertainty and inconsistent data shrouding Europe, 2014 is expected to be continually volatile for the region. Although nobody is certain what the ECB will do to stimulate growth, there is certainty that they will need to do something, whether that be further rate reductions or Quantitative Easing in some guise.

Fixed Interest

It is fair to say that over the past few months the bond market has been a bit of a 'mixed bag' when it has come to returns. In the corporate bond market (bonds issued by companies) we have seen a relatively static period when compared to the past 12 months as a whole. This is partly due to western world Central Banks indecisiveness on their respective headline interest rates. So, whilst the strength in investor sentiment is aiding drive the equity markets, and indeed the corporate bond markets, expectation and nervousness around interest rate movements has penalised the asset class.

Last year's fear of a 'great rotation' (investors moving out of bonds and into equities) now seems an age away, with many parts of the bond markets appearing robust. That being said, many economists are still concerned with two core factors in the bond market:

- Central Bank interest rate movements
- Risk rewards from government bonds

The first concern, as explained above is keeping bond returns low. As, with the headline rate low a bond only has to issue returns in excess of the headline interest rate to start becoming increasingly attractive. The second of the two points is arguably more of a concern, as the market is beginning to see more and more governments of troubled countries issue bonds with low yields. We have recently seen Greece and Spain issue 5 year bonds with yields below 5% and 4% respectively. Many economists now believe that with countries such as Greece and Spain issuing such low returns on debt, that the wider market for government bonds is not currently offering consistent rewards for the risks being taken, when compared to corporate debt and especially when compared to many of the equity markets.

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