Autumn

Market outlook.

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The UK Economy

The UK economy has shown resilience despite its closest neighbours and trading partners in Europe struggling. UK employment data has continued to improve and gross domestic product [GDP] increased 0.7% in the third quarter, meaning that the economy is now 3.4% above the pre-crisis peak. However, GDP per-capita and disposable income stubbornly remain lower than 2008, as a result of population growth outpacing GDP growth.

With the Scottish independence vote behind us now, policy makers can focus their attention on the economy, although, with the general election just around the corner, any policy decisions may be delayed. Add to this the disinflationary impact of falling oil and commodity prices, suggests to us that interest rates are likely to remain low until well into 2015.

The Japanese Economy

The third quarter of 2014 has been relatively muted for the Japanese economy. Coming off the back of a 3% increase in the sales tax in April 2014, the economy has struggled to regain traction with wage growth failing to keep pace in an environment of rising prices. The Japanese Prime Minister Shinzo Abe has speculated that the Japanese could see a further increase in their sales tax to 10% (from 8%) as early as next year; a move that threatens to derail the Japanese economy despite arguments that it has longer term benefits in helping the economy grow. As we saw in April, with wages remaining relatively static, price increases are putting immense pressure on domestic consumption levels, and affordability for the general population and domestic businesses.

With a weakened currency and rising prices, smaller domestic companies have a difficult environment to survive in, particularly with Prime Minister Abe's third arrow arguably stalling. To date little reform has been put in place to aid the domestic economy, and any that is put in place is likely to take time to prosper. This has not hindered the government's optimism, with the Bank of Japan's governor (Haruhiko Kuroda) recently pledging that he will pump more money into the economy via Quantitative Easing (QE) if their plans look like derailing.

Despite the commitment from the government and central bank, the effects of the reforms utilised to date do not seem to be aiding the domestics, with things not looking likely to change going into 2015. The only wage growth that can be seen is an average increase in bonuses, a fickle element of overall income, and coupled with decreasing 'small business confidence' numbers, it appears Abe and Kuroda may need to readdress their plan of 'more of the same'. After all, whilst the Japanese economy was in recession for over 2 decades and a large policy shock was required to kick start it, an extremely weak currency (due to a continued long term unsupported QE policy) could be detrimental. This year we have seen the longest period of underperformance of 'small business confidence' since 2008/9, suggesting the decreased value of the Yen, new trade agreement pacts, and current reform measures have not yet had a meaningful impact on the domestic economy. So, whilst it is feasible that the Japanese economy can strengthen over the longer term, over the shorter term reform measures need to be more apparent and direct in order for the general population to be able to accommodate both tax hikes and an inflationary environment. It is at this stage that the Japanese economy is likely to continue to recover and grow.

The Emerging Markets & Asia Economy

The Asian and Emerging markets have been relatively muted when compared to their performance in the first two quarters of 2014. The third quarter has largely been driven by two factors in the space, the first being concerns around the slowing of Chinese stimulus and reform, and the second being the elections in Brazil.

Concerns around Chinese growth this year have been focussed on the inherent relationship between employment and Gross Domestic Product (GDP). Until recently, with China transitioning into a lower volume, better quality producer, we have seen GDP levels suffer. As a consequence, the low absolute levels of employment have caused markets to ‘panic’ over the lack of stimulus, despite the overall employment levels continuing on an upward trajectory. So, whilst China did inject approximately £51 billion into the economy in the third quarter, the announcement that the GDP for the third quarter had beaten expectation at 7.3% caused expectation that further stimulus was unlikely. With this in mind, it must be remembered that growth levels of 7.3% dwarf that of the western world, and although China is unlikely to again see the days of double digit returns this level of growth for a transitioning country with the population of China is positive. It is however likely that short term volatility will remain until concerns on stimulus are abated.

The Latin American block has been largely guided by expectation on the Brazilian election in recent months. We saw 3 candidates running, with strong expectation of a change in leader and indeed party in the run up to the polls. It was this expectation of change that buoyed the Brazilian economy. However, come the election in October, the current leader Dilma Rouseff remained in situ with a 52% majority. This pulled back the markets that were beginning to price in change. So, whilst Brazil is potentially subject to ‘more of the same’ from a leader that has seen the Brazilian market decrease by nearly 10% since coming to power in 2011, there are many Latin American countries that now look better value such as Mexico.

Despite some country specific concerns in certain regions within the Asian and Emerging Markets, such as Russian frictions with the West and the potential for the Russians to further restrict the gas supply to the Ukraine, there are plenty of areas of value, in these markets, through reform positivity and indeed new leadership. For an example of this we need look no further than the new Indian leader Narendra Modi; a leader who has had an immediate impact on the Indian economy, further opening India to external investors whilst driving for energy reforms and opening up trade negotiations with Japan and China. With this in mind, the recent lull in the Asian and Emerging Market asset class could see these countries (such as India and Mexico) go from strength to strength going into 2015.

The US Economy

The U.S. economy has had a strong year, even if littered with pockets of volatility and policy inflicted uncertainties. The past quarter has been largely geared into two data and policy sets, the first being the ‘imminent rate rise’ and the second being the ‘true unemployment data’. It would be easier to address these separately, but unfortunately it is a case of cause and effect, as until recently it has largely been the unemployment data sets that have been blamed for the Federal Reserve (Fed) stalling on increasing the headline interest rate.

In the second and third quarters of 2014 we saw strong manufacturing data from the U.S. backed by healthy GDP data, which has conversely not been backed by the employment data. Whilst unemployment has been relatively low and decreasing, the participation rate (individuals taking part in the ‘job race’) has too been decreasing. As a consequence, the head of the Fed, Janet Yellen, has blamed this slack in the labour market as the reason for the Fed not increasing interest rates from their 0.25% low. However, at the very back of the third quarter the Fed announced that unemployment had further decreased, but continued to push back expectation of a rise in interest rates highlighting slowing global growth as the rationale.

Whilst the Fed has, and is, being extremely cautious in increasing rates; not wanting to stall the recovery, and even though we have seen the S&P500 break through its all-time high, there are still many growth and value opportunities in the thematics (e.g. healthcare/energy). In addition to this, earnings growth is still looking strong, all of which supports the slow and steady recovery story. So whilst it is unlikely the U.S. economy will continue to grow at the rate it has done year to date, it is arguably in much better shape than many other regions; even though many economists (including those at the International Monetary Fund) believe that we are looking at a period of slower growth… but growth none the less! For those who are fearful of a rate rise and its impact on the economy, a rise in rates from their current levels is a sign of a stronger economy and a recovering economy, which is surely a good thing. In addition, any initial rate rise is likely to be in 2015 with any increases being in slow and steady increments.

The European Economy

In a year where we have seen the German index (the DAX) hit all-time valuation highs, the third quarter of 2014 has seen investor and consumer confidence dissipate in respect of Europe. It was this confidence coupled with lower valuations last year that attracted investors to Europe and helped bolster the European markets this year. However, continuing uncertainty around fluctuating growth, unemployment, and production statistics in the Eurozone has dwindled confidences. It is this, coupled with geopolitical tensions surrounding Russia that has introduced an air of caution to the valuations in the asset class, seeing the European markets pull back sharply in the third quarter of 2014.

The political frictions with Russia has been one of the drivers of volatility this year. In the longer term it is thought unlikely that Russia would cut off the gas supply to Europe and stretch tensions further. As Europe is one of Russia’s largest clients, the withdrawal or cut off of which is enough to cripple the Russian economy. Although Russian leader Vladimir Putin is seemingly pushing the envelope and broadly brushing off the sanctions imposed by the West, he is not likely to want to cause Russia a severe economic frailty and see Europe source its gas supply elsewhere triggering a Russian fiscal crisis.

Whilst impacted by many external influences, the European markets remain largely fixated on the European Central Bank (ECB) and its president Mario Draghi. The recent introduction of the Target Long Term Refinancing Operation (TLTRO) was intended to stimulate banks to lend to the real economy (broadly small to medium sized businesses) in order to aid growth in the region. However in the initial allotment banks loaned just over half of what the ECB had anticipated leaving the question mark of ‘what to do next’ blissfully apparent. The ECB too have been considering methods of further injecting money into the economy, and with possibilities of a traditional QE policy still uncertain, they have released limited details of an ‘Asset Backed Securities’ programme (private sector asset purchases) in an attempt to revive lending and stave off deflationary risks. However, with little detail of these plans apparent and with strong German opposition to the legalities of whether the ECB can legally undertake a QE policy, this uncertainty has caused the European markets to suffer, certainly in recent months. So, whilst valuations are now beginning to look attractive in certain countries and sectors, Europe is likely to remain a volatile proposition until the ECB injects more certainty into policy direction and detail, and also outlines how it would proceed with any such QE plans without German support.

Fixed Interest

2014 has been tough for the bond markets largely due to geopolitical issues, central bank pressures, and general expectations driving returns. In a world that has been relatively cautious in its investment approach this year and extremely reactive to macroeconomic climate, with traditional correlations still strained between equities and bonds, the wider market has been seeking out yield/income wherever it could find it. Consequently it is the high yield market and even bonds with shorter duration that have been over bought and are looking stretched.

With the hunt for income becoming ever more cumbersome, quality is driving a premium with meaningful yields only really available further down the credit quality spectrum. It is this hunt for yield coupled with the pressure of longer term low rates that continues to tighten spreads and indeed liquidity. There are still widespread concerns around the risk reward dynamics of many government debt issuances in Europe (such as Spain, Italy and Greece), even with yields increasing slightly over the third quarter. With this in mind, and with the concern over the lack of austerity dedication within Italy and Greece attempting to exit the bailout programme, it appears the government debt market still has some way to adjust.

With that said, whilst there are multiple external factors that are reducing absolute returns in the bond market and weakening the risk return attributes of the asset class, there are still specific areas of value. So, although the high yield market, government debt arena, and short dated issues are coming under pressure; the longer end of the quality corporate bond market in certain sectors represents a strong risk adjusted exposure with good yields. This end of the market still offers a more traditional correlation to equities whilst arguably offering arguably more secure risk adjusted returns than government debt…… however over the longer term this too is likely to be impacted by any movement in rates, whether that be from the UK or the U.S.

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