Winter

Market outlook.

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The UK Economy

Most recent data shows that the economy expanded by 0.5% in the three months to the end of December, following growth of 0.7% in the third quarter. During this period there has been a sharp fall in construction output and a marginal fall in industrial production. Manufacturing data has been broadly flat, whilst the services sector has held up well.

UK inflation (CPI) fell to just 0.5% in December 2014 (well below the Bank of England's 2% mandate), owing to lower energy costs and the supermarket price war, while at the same time, the pace of wage growth has continued to improve (albeit slowly) and now exceeds the rate of inflation, relieving the long term squeeze on household incomes. Consequently, over the coming months consumers should continue to feel the benefit.

As household income improves, this feeds through to consumer confidence, which is likely to aid the popularity of the incumbent political party. However, at this stage it is still too close to call, and so the General Election remains a risk.

The Japanese Economy

Japan has been an interesting story over the past couple of years. It is a country that has introduced unprecedented policy measures in an attempt to break out of a 2 decade long recession. As part of this we have seen the Japanese Prime Minister Shinzo Abe stay in power for coming up to 2 ½ years, and having been re-elected as president following an early election at the end of 2014, it is looking likely that this will be the most consistent government and longest serving leader since Koizumi was elected in 2001. Despite a slightly depleting level of domestic support for Abe due to the lack of structural reform, this re-election allows the current government and central bank head to follow through on policy.

Even with this positivity around government support and the attempts of Prime Minister Abe to stimulate inflation and growth, there has been much negativity over the past 6 months around the government's commitment to their '3 arrow' approach to recovery (Quantitative Easing, Fiscal Policy and Structural Reform). With the first 2 arrows arguably effective, the economy awaited the injection of structural reform to aid in protecting the domestic economy from a weaker currency and indeed inflation. Despite Japan only reaching half of its 2% inflation target, in conjunction with the 3% sales tax rise in April 2014 and a potential further sales tax increase over the next few years, the cost of living is rising significantly. As a consequence, the need for structural reform is vital to aid in stimulating wage growth in order to help the domestic consumer maintain their quality of life. Further pressure is being put on wages with policies that are aiding to increase the female workforce which, as a result, is increasing the supply of labour, putting further downward pressure on wage growth.

With all of this in mind, increasing competition from overseas as a result of a weakening currency (Yen) and the up and coming free trade pacts, are both looking to increase pressure on smaller Japanese companies, serving to further increase unemployment and decrease wages. These issues can potentially be resolved with tactical structural reform but with the Japanese Central Bank Governor, Haruhiko Kuroda, stating that they will solve any economic derailing issues by 'printing more money' through the QE mechanism, it looks unlikely that wage pressures will be eased over the shorter term.

The Emerging Markets & Asia Economy

The Asian and Emerging Markets were both dominated by the actions of the Chinese central bank in the last quarter of 2014. China has been somewhat unloved in recent years, certainly during 2014, however it could be thought that much of the rationale behind this stance is unfounded. First and foremost we can't forget the sheer size of China in terms of population, as it runs into the billions. When looking at growth numbers (gross domestic product) slowing from double digit returns to single digit returns, in addition to a slowing of the growth of the middle class tier, this is all in terms of relative percentages. In absolute terms China has a growing middle class tier in the multi millions and growth that still sits above 7%, which is a more sustainable level over the longer term. These are numbers which the West dreams of! However, it is broadly this slowing and the lack of Chinese Central Bank intervention that introduced concern until November 2014, when interest rates were cut from 6% to 5.6% following weaker than expected manufacturing data. This rate cut increased confidence in the market showing that the Central Bank is prepared to support the economy.

Whilst we are not suggesting that the Chinese economy is a harbour for constant strong growth as there are still areas of concern, there are areas and sectors that have the potential for strong returns. The smaller companies segment can potentially grow from increased demand stemming from the growth of the middle class tier and domestic demand. In addition, despite pressures from a weakening Japanese currency, many exporters can stand to benefit from a potentially strengthening dollar in the US, weakening the real value of the local currency. When coupled with returning investment volumes, government/Central Bank intervention and the opening of the domestic stock market to external investors, the prevailing view is that opportunity in the space appears strong even over the shorter term.

There are many areas in the Asia and emerging asset classes that offer strong opportunities. Very few offer the growth potential of India over, not only the short term, but also the medium and long. With the new Prime Minister Narendra Modi taking power last year, many reforms have been proposed in addition to free trade pacts and indeed the broader opening of the economy to global investors. So, whilst the market did perform strongly in 2014 despite few reforms actually taking hold, valuations now look fair value. That being said, as reforms take hold and policy floods the market, there is plenty of potential for strong growth through 2015 and beyond.

Given the above factors and with many major Asian and Emerging Market political events in 2014, it is likely that the next few months stand to be relatively quiet politically with the West dominating on that front, allowing growth to continue as we have seen throughout January. This is of course assuming Russia does not further spark global political frictions and stem gas supplies.

The US Economy

The past 3 or 4 months have been crucial for the US economy, with speculation that it could not support itself after Quantitative Easing (QE) ended. After the tapering of QE ceased in October 2014, this speculation has been somewhat quashed with fundamentals such as GDP, unemployment and manufacturing proving self-sustaining and key markets such as the S&P 500 continuing to strengthen.

With this in mind, the recovery is appearing relatively robust seeing the S&P 500 breaking through all-time highs on numerous occasions through 2014. So, whilst there is a school of thought that valuations in the US are looking 'toppy', the S&P 500 has historically broken through highs in the past (2000 & 2007 as examples) and gone from strength to strength. Alongside the sector specific stories that are yet to play out, one must also be mindful of the currency movements. Whilst it is unlikely that the US markets will see the level of returns in 2015 that they saw in 2014, the current market valuations in conjunction with the stage of the cycle the US is in suggests a period of 'slower growth for longer'. With the ending of QE in the US and the introduction of QE in Europe and elsewhere around the world, the US looks more attractive in sterling terms with a potentially strengthening dollar increasing the relative returns of any sterling based investment.

The unknown element of 2015 is, 'when' will the US Federal Reserve (Fed) raise the headline interest rate from its current 0.25% base? Despite the US market proving self-sustaining, last year we saw the Fed utilise slack in the labour market as the reason for not raising rates. As unemployment had been decreasing, the number of individuals participating in the 'search for a job' had been decreasing also. Consequently, the headline unemployment rate was not reflective of the true level of unemployment. However, this has now altered with participation remaining relatively static (after a slight increase) and unemployment continuing to decrease. After all, despite concern over increased interest rates potentially stalling growth, a slow increase in rates in the current environment is the sign of a recovering economy, which is a good thing for the wider economy and investment growth. The only true question remaining is 'when will rates rise?' and this is something only the Fed and its Chairman Janet Yellen know, as the US economy is technically ready for an increase in the here and now.

The European Economy

Europe has moved on leaps and bounds over 2014, not so much in terms of the consistency of macroeconomic data, but in terms of implementation of policy from the European Central Bank (ECB). Throughout 2013 the ECB maintained that they would 'do whatever it takes' to protect the Eurozone from collapse, but we saw little in the way of action. However, towards the end of 2014 we began to see the ECB act with them moving to a negative deposit rate (currently -0.2%), in addition to a Targeted Long Term Refinancing Operation (TLTRO), and a QE policy.

The negative deposit rate was put in place to stimulate banks to lend money to the economy rather than put it on deposit with the ECB, helping stimulate spending and growth. The TLTRO policy was then developed by the ECB to allow them to lend money to banks with strict conditions that they have to lend it to the real economy (small to medium size businesses). After these two policies had taken hold, the ECB took a phased approach to the introduction of QE (the buying of bonds/assets to inject money into the economy and depreciate the value of the Euro). Unlike the U.S. and Japan, Europe is an amalgamation of multiple countries, central banks and indeed governments, so attempting to introduce a traditional QE policy was always going to be a big ask. Initially the ECB purchased covered bonds and asset backed securities, both untraditional methods of QE, signalling that they are prepared to act, stimulating confidence in the markets.

In January 2015 Mario Draghi, the president of the ECB announced that they would be proceeding with traditional QE measures by purchasing government bonds within the region. Confidence in the markets saw them climb sharply following the announcement, with the prospect for growth in the 19 member state block more prominent. This announcement overshadowed much of the potential negativity around the Greek elections which saw the 'anti austerity' Syriza party claim victory, but not the majority, allowing them the opportunity to form a coalition. However, recent comments from the president elect (Alexis Tsipras) suggest that whilst Greece will look to renegotiate the terms of their bailout programme, they will continue to make payments and are not looking to exit the Eurozone.

So, with economic fundamentals from Europe having remained volatile over the past year and whilst Greece remains a concern, valuations look attractive relative to other asset classes. This, accompanied by active central bank support and returning sentiment is looking to support the European markets over the first half of 2015, as it has done year to date.

Fixed Interest

Going into 2015, the volatility and correlation backdrop for bonds arguably looks similar to that of the majority of 2014, with the market for both corporate debt and government debt heavily influenced by expectation of rate rises in both the US and the UK. With traditional correlations between equities and the wider bond market not yet returning, it is largely the longer duration end of the corporate bond market that is looking the most likely to return to the norm. Duration represents bond price sensitivity to a change in interest rates, so the higher the duration, the greater the sensitivity. Despite speculation from the market in 2014 that the shorter end of the corporate duration spectrum was 'the place to be', it was hurt massively last year with the expectation of a rise in interest rates being pushed further out.

It is safe to say that both the US and UK governments still fear that a rate increase will stall growth and recovery. The US is fearful of slowing GDP and increased unemployment, with the UK too concerned with this and volatility surrounding the midyear general election. As a consequence of these factors, the expectations around increases in rates are being pushed further out, however in reality country fundamentals suggest a rate rise could be earlier than those expectations suggests. Whilst in truth the timings of rate rises in the UK and US are largely unknown, over the shorter term it is likely that we will see the longer duration end of the corporate bond market continue to be strong and have relatively low levels of volatility. Hand in hand with this, the uncertainty around rate rises is continuing to pressurise the government debt arena, particularly with the global markets still in recovery. Low yields and untraditional correlations to equity markets continue to make government bonds unattractive, with default risk rife, safe haven countries offer low or even negative returns on their debt. As such, even countries with higher default risk are not offering strong risk rewards, particularly in the European markets, with many quality corporates far outstripping their risk return characteristics.

Taking the above into consideration, whilst it is likely that 'normal' market conditions will return at some stage in the future, certainly over the short to medium term, geopolitical and policy driven issues are flooding the bond market with uncertainty. It is this, coupled with attractiveness from many areas of the equity market that makes the bond market less compelling, even as a 'risk reducer', over the shorter term.

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