Spring

Market outlook.

Brought to you by the Investment Management team at my wealth WEALTH at work

The UK Economy

Nothing much has changed since our last update in January; UK inflation as measured by CPI hit 0.00% in February (the lowest since comparable records began). The fall again attributed to lower oil and food prices, which should feed through to the consumer.

Wage growth, whilst positive, (and obviously above the rate of inflation), remains weak and has not been sufficient to stem a decline in the rate of GDP growth, which slowed to 0.3% in the first quarter of 2015, the slowest quarterly growth in 2 years and compares to growth of 0.6% in the fourth quarter of 2014.

The outlook remains uncertain, election polls are still too tight to call and any weakness in the Eurozone (our largest trading partner), likely to be of consequence the UK.

The Japanese Economy

There has been little noise from the Japanese Central Bank year to date, both in terms of policy action and indeed 'forward guidance'. The current stimulus package (quantitative easing) of ¥80tn per annum has been maintained, and noises from the banks head, Haruhiko Kuroda, suggests further expansion of the package is not likely over the shorter term.

With this in mind, performance of the Japanese market year to date has been strong. However, this performance was largely due to a strong 3-4 week period starting at the end of February. Due to a relatively static period for the Dollar/Yen exchange rate, and with the Yen already appearing cheap, when combining this with low expectation of further Japanese stimulus in addition to cheap valuations (relative to the US), for the first time in many years the Japanese market looked better value to US investors than the US market. As a result we saw a wall of money hit the Japanese market from the US and it is this coupled with assets purchasing from the Japanese Central Bank that pushed markets higher over this short period.

Whilst the Japanese market has rallied hard over February/March, the fundamentals remain extremely patchy with wage growth remaining weak, and lack of structural reform alarmingly apparent. This being the case, with current Nikkei valuations high, the weak economic fundamentals and backdrop suggest to us that there is a strong possibility of a correction in the asset class... and this is assuming that the US assets that benefited the Japanese market earlier in the year remain 'sticky', as these assets returning to the US could put further pressure on the Japanese market.

The Emerging Markets & Asia Economy

There has been little in the way of unexpected policy shifts in Asian and Emerging Markets over the past few months, with market direction being largely dependent on the US rate expectation. Chinese data and Chinese central bank policy introduction have had a largely secondary impact, but are slowly coming to the forefront. We can see this in the market movements from both asset classes year to date, with a muted start up until March pricing in a US rate rise in June. However, with US rate rise expectations being pushed back following weaker than expected Job data in the US, and the US Federal Reserve's reluctance to raise rates 'too soon', the markets strongly pulled back easing the rate rise concerns. As, any rate rise in the US potentially stems growth in an economy that is one of the largest trading partner for the Asia and Emerging regions.

With this in mind, and with US rate rise expectations being pushed back, slowing Chinese growth of 7% GDP was swallowed by the market, as it was in line with expectation. This data went hand in hand with stronger than expected manufacturing data which saw the market rally strongly. It is this data coupled with recent Chinese interest rate cuts, and now talk of Quantitative Easing (QE) implementation, that continues to buoy Emerging Market and indeed Asian growth.

In addition to the above, India, under its new leader Narendra Modi, continues to be a longer term growth and value story. The main areas of concern for the Emerging Market space specifically continue to be Latin America and Russia, with both political and economic volatility rife in both.

The US Economy

Following a strong 2014 for both the US economy and stock market, the US, as expected, has had a slow yet positive start to the year. With the US economy being one of the furthest along in the global recovery and the US Federal Reserve Bank (Fed) looking the mostly likely to increase the base interest rates first (amongst the major economies), the markets are looking like they are already pricing in a US rate hike. As markets are currently being driven by sentiment, and with concern that an increase in rates would curb economic growth, it looks likely that the US markets could strengthen off the back of a rate rise once these concerns have been abated. As, let's remember that any rate increase by the Fed is likely to be small leaving the US economy in a 'low rate' environment in which it is likely to remain over the short to medium term.

To the continual low rate environment, when coupled with low inflation and indeed a low oil price (currently floating between $50 and $58 per barrel), are typically short term drivers of the market. A strengthening dollar too magnifies returns to investors not based in the US, but it also means that exporting companies become less of a growth story. With this in mind and given that valuations at the large-cap end of the spectrum are beginning to look high, this appears to be a strengthening environment for the small to mid-cap companies. With the respective index (Russell 2000) looking relatively cheap, coupled with a strengthening dollar, this is likely to benefit domestically facing businesses.

All in all, it is likely that the US will continue to grow at a slower pace than in 2014, with UK investors likely to gain from a potentially strengthening dollar. Largely it is rate increase expectations curbing any greater growth potential for the market as a whole, and with recent employment data suggesting that there is again 'slack' in the labour market, expectations of a rate rise have been pushed back to the second half of 2015, perhaps giving the market some breathing space for growth in the right areas.

The European Economy

Year to date it is safe to say that the European asset class has been one of the most active, both in terms of central bank activity and indeed politically. With valuations beginning to look attractive at the back end of 2014, the market needed a catalyst to release this value. This catalyst came in the form of a QE introduced by the European Central Bank (ECB) president Mario Draghi in March. The QE package is a planned €60bln a month that is not only purchasing of government debt in the region, but too includes their current purchasing of Asset Backed Securities (ABS) and indeed Covered Bonds. The initial package is planned to run until September 2016, but QE itself has been left open ended.

Even with the package being structured in a somewhat simplistic manner, with the ECB purchasing relatively more debt from larger contributors to Eurozone GDP (e.g. Germany, France, etc), whilst it is uncertain as to whether over the longer term this will ultimately aid a sustainable recovery, the sheer mention of QE has aided the stabilisation of the European markets and has served to help them be one of the strongest performing asset classes this year.

It is likely that the ECB will continue to try to stabilise markets utilising QE, and whilst this has acted as a catalyst to help release value in European markets, the Greek frictions have remained a concern and have otherwise contravened further gains in the asset class. With the anti-austerity Syriza party getting into power at the beginning of the year, they quickly realised that the European Finance Ministers and indeed the International Monetary Fund (IMF) were not going to ease up on the Greek austerity requirements. As a result, the Greek Prime Minister Alexis Tsipras's approval ratings have fallen, and with him really 'pushing the envelope' on stalling repaying debts to the IMF, the question still remains on whether Greece will default on its next payment. As it stands the IMF will not allow Greece more time to pay its next instalment, as Greece has the assets via another tranche of bailout money that it can only access if it agrees to maintain its current austerity policies. With uncertainty a core driver of volatility and a potential Greek exit from the Eurozone less likely to impact the markets as severely as anticipated 2 years ago, as soon as an agreement is reached over the coming months, all things being equal, the markets can begin to 'normalise' and be guided by fundamentals… assuming the Spanish elections later in the year don't throw the markets a curveball that is!

Fixed Interest

For the majority of this year the story in the bond market has been largely dependent and reactive to expectation around central bank policy, both in terms of QE (primarily European markets) and rate expectations (primarily US markets).

The uncertainty around sentiment, and ongoing policy implementation by central banks, continues to cause traditional correlations between equity markets and bond markets to struggle. European markets have seen a raft of negative yields for example, German bonds with up to 3 years duration posting less than -0.2% yields (the European deposit rate). This means the ECB cannot purchase German short duration bonds as part of its QE programme as it stands. In addition to this, we have also seen Switzerland post the first ever negative 10 year bond. This type of environment makes it extremely difficult to make a value case for broader government bonds, especially with corporate bonds still looking more attractive at the longer end of the duration curve.

However, with the above in mind, and with bond markets highly sensitive to changes in interest rates, as soon as US economic data strengthens further, and as soon as inflation expectation begins to strengthen, expectation of a rise in US (and indeed UK) rates will begin to increase. As such the shorter end of the corporate bond spectrum would inevitably begin to look better value. However, in the current environment the bond markets are as susceptible to policy and sentiment based volatility as the equity market, so equity markets in the current climate have been offering stronger returns on a risk adjusted basis.

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