Winter

Market outlook.

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The UK Economy

The media has remained fixated on the oil price and the Chinese economy over the last quarter and indeed most of 2015. As a result, companies in related industries, such as Oil and Gas, Basic Materials and Financials (which make up over a third of the FTSE 100) saw downward pressure on their share prices. A lower oil price is not that bad; in fact it is hugely beneficial to oil consumers. A lower oil price for example leads to lower raw material costs, lower transport costs and lower heating costs, all of which is positive for businesses looking to control costs in order to improve profitability. Lower oil prices has also forced oil producers to become more efficient and focus on capital expenditure, which implies any pick up in the oil price should have a more profound impact on oil company profits.

UK unemployment is now at its lowest rate for a decade and consumer confidence remained positive for the whole of last year (the first time since records began in 1974). This was helped by improving wages and lower petrol, lower energy and lower food prices all adding to disposable income. UK GDP increased by 2.2% in 2015 as a whole compared with 2014, making it the twelfth straight quarter of expansion. Services were once again the biggest contributor whilst exports and manufacturing remained sluggish.

The EU referendum remains a risk which could lead to volatility in UK markets. The exact date of the referendum is yet to be decided, all we know at the moment is it must take place before the end of 2017; current expectations are for a summer 2016 vote. The UK has been negotiating its position within Europe and EU leaders will debate the proposals at a summit 18/19 February.

Given the uncertainty created by the referendum, forecasts for the first increase in interest rates by the Bank of England since 2007 have been pushed further out. In fact we don't anticipate an increase until at least 2017. As a result sterling has come under pressure versus other major currencies. However, with the majority of the FTSE 100 earnings originating offshore, a weaker sterling could translate into improved company profitability. This contrasts with many smaller and mid-sized domestically focused UK companies. From April 2016, the national living wage for those over 25 will increase to £7.20 an hour, this marks the first step towards the chancellor's commitment to raise the minimum wage 38% by 2020, part of his pledge to make Britain a "higher wage, lower tax, lower welfare" country. Whilst we are sure this will be well received by the 2.7m direct recipients and the further 3.3m expected to benefit, it is likely to begin to put pressure on companies in the unfortunate position of having proportionately high staff costs and low profit margins, for example some consumer services companies.

The Japanese Economy

Given the propensity for the Bank of Japan (BoJ) governor Haruhiko Kuroda in recent years to rely on Quantitative Easing (Q.E. - bond buying programme) to pump money into the economy to devalue the currency (Yen), the past quarter has been a relatively muted in terms of policy implementation. This has arguably been due to Kuroda and Prime Minister Shinzo Abe waiting for the U.S. to make their first increase in interest rates, which we saw in mid-December, and as a result would theoretically strengthen the dollar, thus naturally devaluing the Yen relative to the U.S. Dollar without the need for further Q.E.

With all of this in mind, there remain concerns that the BoJ have little else in their 'tool kit' to try and stimulate GDP (Gross Domestic Product), inflation and indeed wage growth, all of which have been broadly weak throughout 2015. Inflation continues to miss expectations, with the 2% goal still a distant target and wages not growing at a rate that echoes an economy targeting 2% inflation. Whilst accounting for this weak data, it is easy to forget that Japan is still trying to pull itself out of decades of recession, something that was not going to be fixed with a lone Q.E. policy, however large it became. As such at the end of January 2016 we saw the BoJ unexpectedly look towards the European Central Bank (ECB) policy model by introducing negative interest rates of -0.1% in an attempt to stimulate lending, spending, and ultimately inflation and wage growth. However, with inflation goals appearing a long way away, and a lack of significant domestic policy to protect the local economy and smaller companies, in addition to the intended sales tax hike in 2017, there are still many stumbling blocks for Japan to overcome. As such, until the BoJ step significantly away from a solely Q.E. based policy, there appears to be better value in other markets.

The Emerging Markets & Asia Economy

To sound like a broken record, it has been global sentiment towards Chinese policy and growth data that has been prevalent over the past few quarters, especially as there was fear over the impact of a rise in U.S. interest rates negatively impacting the Asian and Emerging Markets. With the first U.S. rate hike now in the past, there still remains negative sentiment towards Chinese growth data, putting downward pressure on the markets as investors seek safety elsewhere. With all of this in mind it is easy to forget that short term sentiment is typically fickle and that the Asian and Emerging Markets represent good value compared to many other asset classes. In addition, with the negativity we saw towards the asset class in 2015, it is also easy to forget that whilst China is indeed slowing with GDP meeting its target of 7% mid 2015, and currently at 6.8%, China is transitioning. With a population of almost 1.4 billion and a targeted plan to move away from manufacturing to a more service driven economy, it is easy to get lost in thinking that China no longer has double digit growth… but growth of 6.8% is still incredibly strong, and with the next 5 year Chinese plan due to be announced in more detail in March it is expected the new targeted growth for the year will be 6.5%. So whilst growth appears to be slowing, in a service driven economy these levels of growth are more sustainable and still attractive from an investment point of view. With all of this in mind, a good measure of managed policy from the Chinese government could be the catalyst to temper fear and reintroduce volumes back into the market and release the value that is apparent.

Whilst China has been dominating the headlines, along with a decreasing oil price, one can't forget about the other investment opportunities that lie elsewhere in the asset class. Under the leadership of Narendra Modi, India is becoming a hive of potential with investment in business, infrastructure and indeed the setting up of multiple country specific trade agreements positioning them well for development and growth. With Chinese data weighing on the Asian and Emerging Markets, buying opportunities are rife in the likes of Taiwan, Thailand, India etc. With the latter having as little as 5% exports to China and this sell-off having a disproportional impact on Indian and broader Asian and Emerging Market equities, valuations now look attractive on a relative basis. Coupled with this, the low oil price has allowed governments such as India and Nigeria to remove any oil subsidies, which in turn frees up spending for policy and development. The low oil price too aids growth at the corporate level.

The US Economy

December 16th finally saw the U.S. Federal Reserve Bank (Fed) increase the base interest rates from 0.25% to 0.5%. This is the first interest hike in the U.S. for nearly 10 years. With most of 2015 being shrouded with uncertainty on 'when the Fed would increase rates', it was primarily this uncertainty that drove investor sentiment causing market volatility. However, whilst there will continue to be speculation about when the 'next' Fed rate increase will be, the uncertainty shrouding the first move is no longer present which is positive for equity markets and also allows bond markets to adjust accordingly. As, for the first time in months the Fed rate movement is not 'the only game in town', with sentiment now firmly fixing its sights on Chinese data and policy measures.

With the U.S. now entering a rate rise environment, it is worth noting that the Fed remain data dependant when looking towards increasing rates any further, but this first rate rise is a strong signal that the Fed believe their economy is strong enough to support itself in a higher interest rate, growth environment . With valuations in the large cap space still looking high and GDP data patchy, backed by strong consumer confidence data and strengthening unemployment data, it is anticipated that we are likely to see slow but steady growth in the asset class backed by a strong currency. With that being said, we cannot ignore the potential for volatility in the run up to the elections, and whilst it is unlikely that he will get in, Donald Trump being one of the front runners can only serve to add to any potential volatility, as will a change in political party rule.

The European Economy

In the run up to the first U.S. rate hike in almost a decade, December also saw the ECB make its first significant policy move since the beginning of 2015. It could be thought that the ECB awoke from its majority 2015 slumber as soon as expectation made it clear that the Fed was likely to raise rates in mid-December. The head of the ECB Mario Draghi announced a 0.1% cut to the deposit rate, to -0.3%, on the 3rd December. This move suggests that the ECB believes that the current QE programme is presently sufficient both in terms of its size (€60 billion per month) and availability/liquidity of government bonds to put upward pressure on inflation and help steer growth, when coupled with a low rate environment. That being said, in a press conference Mario Draghi did suggest a review of policy in the ECB's March meeting.

Valuations in many European regions remain strong, and with policy backing of the ECB, Europe looks relatively attractive when compared to many other equity asset classes. The market has seen a drop in the European indices over the past quarter primarily due to Chinese data, and the dropping oil price. However, with the lower oil price beneficial for corporates and the end consumer, and the realisation that Chinese data is going through a controlled transition (being policy backed by the Chinese authorities), whilst not underplaying the fundamental issues in Greece this could be the catalyst to release the pent up valuations, in addition to the ECB further utilising their policy tool kit.

Fixed Interest

With recent volatility in markets centring round the timing of the first U.S. rate rise and the U.S. officially now in a rate rise cycle, it is this environment that is potentially detrimental for the bond market over the longer term. Whilst many central banks such as the Bank of England (BoE) and the

ECB profess to remain independent when it comes to policy implementation, the Fed increasing rates removes a number of global uncertainties when the time comes for rates to be increased elsewhere. As, with neither the U.K. or collective European interest rates looking as if they are going to rise any time soon, a sharp pull back in bond markets and a sudden spike in the yield curve is looking less likely than many expected, with any pull back and yield curve spike looking more likely to be prolonged.

Accounting for this, in addition to equity valuations looking attractive and global central bank policies backing corporate growth, wage growth and indeed inflation, whilst a collapse in bonds is not anticipated, the broader equity markets appear to be offering stronger risk return opportunities. Within the debt market corporate bonds continue to offer more attractive risk return opportunities than Government bonds at present and with rates beginning to increase in the U.S., duration management (the length until a bond matures) is key in order to squeeze out the best risk adjusted returns. It must be stressed that it is likely that global rates, inclusive of the U.S., will remain 'lower for longer', as whilst rate increases are now being forecast, it is likely that we will only ever see small increases over longer spells of time, with the next U.S. rate increase recently being pushed further out.

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