Summer

Market outlook.

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The UK Economy

The conservative party delivered their first budget as a majority government in July, their first in 19 years. They maintained their commitment to austerity and targeted a budget surplus by 2019/20, a year later than previously planned. There were very few surprises in the statement, although the intention to raise the minimum wage by 38% over 5 years, to £9 per hour, has the potential to impact some domestically focused businesses with high labour costs coupled with relatively low profit margins.

The UK economy remains in good shape, unemployment is at its lowest level since 2008, wage growth is positive and with inflation currently non-existent (owing to energy and food prices), consumers should start to benefit. As the economy continues to improve, the case for a rise in interest rate develops, whilst the market is currently expecting a rise towards the middle of next year, the situation is still dependent on data remaining resilient. To reiterate previous commentary, when rates do eventually rise, we expect it to be a slow and gradual process and do not expect that they will return to historical levels, instead peaking at perhaps 2.5% or 3%.

Given the strength in the economy and talk of an interest rate rise, sterling has strengthened versus most major currencies, whilst this improves your holiday spending power it has a negative impact on UK exports and the revenues of UK companies selling their products and services overseas.

The Japanese Economy

Japan's economy has remained largely uncorrelated to other global economies over the past quarter. Lack of further monetary stimulus over the past few months has seen the market fall slightly, but remain relatively flat in terms of volatility when compared to other asset classes.

The head of the Japanese Central Bank, Haruhiko Kuroda, announced that further expansion of their Quantitative Easing programme (the printing of money by buying bonds) is unlikely to be seen over the short term. In addition to the potential lack of further monetary policy expansion, and the continual lack of discussions around reforms to protect the domestic market (the Japanese consumer and smaller companies) from overseas competitors and inflation, it is likely that the market will continue to be flat compared to other asset classes over the short term, even as other markets begin to pick up.

Whilst over the longer term the Japanese Prime Minister Shinzo Abe potentially has the wherewithal to succeed in transitioning the Japanese economy out of its few decades of recession, stumbling blocks of wage growth, inflation targets, and indeed further tax hikes need to be navigated. It is worth noting that whilst Japan is seeing some wage growth, with the current inflationary pressures, the average individual is still getting poorer in relative terms. In addition to this, Abe and his government need to negotiate an Upper House election next year, and with his approval ratings dropping considerably over the past quarter due to his intended policy to change how the military is engaged, it is a potential source of downside volatility in the asset class should the Japanese people lose faith in the current leader.

The Emerging Markets & Asia Economy

The past quarter has been arguably eventful for the Asian and Emerging Market asset classes. The host of volatility that we have seen has been predominantly driven by Chinese government policy and intervention.

Global markets sold off over a couple of weeks in June/July due to negative sentiment around Chinese markets. With investors getting nervous due to the slowing of Chinese manufacturing data, exports volumes, and indeed Gross Domestic Product (GDP), the lack of data and policy given by the Chinese government was spooking investors. Following this slump however, the Chinese government intervened by restricting trading in their domestic markets, with any shareholders owning more than 5% in a company not being allowed to sell, and stemming the level short selling (short selling is essentially betting that a market or stock will go down). This intervention spurred the market which has subsequently picked up.

It must be remembered that China is a communist society which will not actively publicise its policy intentions like the western world governments and central banks do. They will act when they see fit and impose what they feel is required to steady their market. It is this lack of ‘forward guidance’ that scares investors and causes extreme short term volatility, however, China’s long term history shows that they will do whatever is needed to transition their economy into a mass exporter of quality products (we have seen this with not only their recent policies, but with the multiple rate cuts over the past 12 months). They are the only country to have had 5 year plans that have ultimately succeeded. The current plan is due to run to a close at the end of this year with targets of 7% GDP, reduced manufacturing data, increase in service sector data, and increased middle class wage all met. With these targets met and a new 5 year plan to be announced at the end of the year, when coupled with the Renminbi (Chinese currency) potentially being made a reserve currency, and the launch of the Asian Infrastructure Investment Bank (a potential competitor to the International Monetary Fund), both Asian and Emerging Markets look in a stronger position over the longer term. It is again worth emphasising that whilst data from China is largely slowing, it is an intended and controlled slowing, needed to transition the economy to a quality and sustainable growth.

The US Economy

For the past 3 months, and potentially for the remainder of 2015, the U.S. market has and will be focussed on the Federal Reserve Bank (Fed) and its Chair Janet Yellen, awaiting the first increase in the base interest rate which currently sits unchanged at 0.25%. Following the nearing of a resolution to the situation in Greece, confidence has been injected back into the global markets, and has thus given one less reason for the Fed to delay an interest rate increase any further.

Janet Yellen has historically been a labour market focussed economist, and as such has looked towards labour market data to aid in the timing of an eventual rate rise. With the unemployment rate arguably at broadly full employment level of 5.3%, despite a slight decrease in the participation rate (unemployed individuals taking part in the hunt for a job), the slack in the labour market that the Fed have been so fearful of in recent years seems to be tightening. Hand in hand with this, recent GDP data has been strong with the data for the second quarter coming in at 2.3%. With both the employment and the economic growth data all beginning to stabilise and strengthen, market expectation has reigned in a rate rise in the U.S. to as early as September this year. Whilst this is not certain, in a recent statement Janet Yellen suggested that the Fed, based on recent and continuing data sets, could look to raise rates this year.

It is uncertain at this stage exactly what the U.S. markets have built in to their price, but it is likely that a rate increase could potentially spook investors and market sentiment, causing a sell-off. That being said, an increasing interest rate environment is needed at this stage to support a strengthening U.S. economy, and with the S&P at all-time highs, even with the potential for a short term dip in the market, a rising rate environment is needed for the economy to grow. There are still pockets of value however, as small and mid-cap companies look cheaper on a relative basis than their large and mega-cap peers, and could potentially realise some of this value off the back of a strengthening dollar.

With all of this in mind, despite the U.S. being in better shape than most western world economies, short term weakness in the U.S. market could transpire as investors begin to anticipate the impacts of a rate rise.

The European Economy

The Greek fiasco has undoubtedly been the economic headline of the quarter, being one of the primary causes of most periods of market volatility over the past few months. We have seen the current Greek Prime Minister, Alexis Tsipras (leader of the anti-austerity Syriza party), push back on the Eurozone creditors and IMF on the terms of receiving further bailout, utilising a potential Greek exit from the Eurozone and indeed Greece potentially defaulting on its debts, as leverage. As part of this negotiation the Greeks held a referendum on whether they were prepared except further austerity measures to receive further bailout funds, to which they voted ‘no’. However, despite this ‘no’ vote, facing a potential default and exit from the single currency union, Tsipras capitulated and agreed to terms that were arguably worse than what the Greek people had voted against a week earlier.

Whilst this all seems rather convoluted, the reality is that the outcome could largely be irrelevant. It seems to be the uncertainty of the outcome that introduced the volatility to the markets. Whilst the European markets have settled since the Greeks initially agreed to further austerity measures, it could be argued that even if the Greeks did not come to a resolution and an organised exit from the Eurozone was imposed, this could have been broadly beneficial to the markets also. This would suggest that it is the short term uncertainty that has driven European markets this year, rather than fundamentals and indeed policy implementation.

With all of this in mind, more certainty is likely to inject confidence back into the European markets (we are beginning to see this already), and with value in the asset class looking more compelling than most other regions, it is not only the catalyst of more certainty that can aid in realising this value, but also European Central Bank policy. We could be yet to see the full impact of the ‘€60 billion a month’ Quantitative Easing programme (QE), given all countries involved have participated in the programme to almost a 100% level, in addition to us seeing the resulting boost in manufacturing and industrial production (both of which we expect to see strengthen further as the Greek debacle settles). Whether the current structure of European QE will remain in situ is up for debate, but it can still aid in shaking out value in the market in its current guise going into 2016.

Fixed Interest

The Greek bailout crisis, coupled with volatile ‘rate rise’ expectations has been one of the primary causes of bond market spreads fluctuating dramatically over the course of the past quarter, particularly within Europe. These concerns add a premium to what are deemed safe assets, such as German government bonds, as it is these concerns that reduce the yields on bonds. With this in mind, even in an environment where the Greek situation seems slightly more stable and the market appears more accepting of a rate rise in the U.S than it did earlier in the year, the bond market looks arguably expensive when compared to many equity markets. On a risk adjusted basis bonds are still offering little value when compared to many equity markets, with government debt not considered as safe as it once was.

This being said there are still pockets of value that look more attractive than most in the bond space. Good quality rated corporate bonds, whilst not yielding as much as they have in the past, still offer an element of protection in a volatile market, particularly the longer duration bonds. However, in a rising rate environment it is likely that the shorter duration corporate bonds will begin to offer a stronger risk adjusted return and better protection than that of the longer duration corporates. So, with U.S. rates increasingly likely to rise at some stage in 2015, we are likely to see a market shift in bond duration. In addition, with rate rises a possibility, bond yields stretched, and quality bond market, particularly with many equity asset classes just awaiting a catalyst to release value.

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