Autumn

Market outlook.

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

The UK Economy

According to the National Institute for Economic and Social Research, the Bank of England will probably raise interest rates in February. We think that this is unlikely and don't expect a move within the next twelve months.

Inflation (and therefore measures such as economic growth, unemployment and wage growth) are what should influence when rates actually lift off. Whilst the UK economy continued to expand over the quarter, the pace of growth slowed. This coupled with lackluster wage growth implies it would take a stronger run of data for an early rise in rates to be on the table.

The Japanese Economy

The past quarter has seen question marks being raised over the effectiveness of the current '3 arrow' policy (quantitative easing, fiscal stimulus and structural reform) implementation. Since the election of Shinzo Abe to power in December 2012 we have seen Quantitative Easing (QE) become common place with now over 80 trillion Yen (annually) being pumped into the Japanese economy to weaken the Yen relative to other currencies, in order to increase overseas competitiveness. In addition, the second arrow of Fiscal Stimulus has been limited, and there is fear that not enough is being done to protect the domestic economy, and even more crucially improve the wider economic growth. At this stage there are yet to be talks over major domestic reform (i.e. the third arrow) to aid and indeed support the domestic market and workforce.

With this in mind, the past quarter has seen GDP (Gross Domestic Product) in Japan contract (-0.3% through September 2015). Hand in hand with this inflation has dropped back into negative territory largely due to the impact of low oil prices, with the target of 2% by 2017 now seeming an age away. This inflation data also raises concern that the only meaningful policy implementation that Japan has put in place (QE) has not inflated the economy the way that it was intended to. We have also seen recent Chinese policy measures cause a drag on the Japanese economy due to their strong trade ties.

As a consequence of the weak data and Chinese policy implementations, the Japanese stock market has lagged most markets over the past couple of months. Whilst many expect the Bank of Japan (BoJ) to react with further stimulus to boost consumption and trade, there are some members of the BoJ that have discussed the potential of not only QE, but also other monetary measures such as further rate cuts. As, given the appearance that current QE measures have not managed to inflate the economy and meaningfully increase absolute wage growth, there is concern that confidence in the BoJ and Prime Minister Abe will dwindle if further QE is the only response to the weakening economic data (despite Abe managing to win a second term in office this September).

The Emerging Markets & Asia Economy

Much like last quarter, the past three months have been all about Chinese policy intervention and investor sentiment dictating not only Chinese markets, but global ones too. The inflection point of intervention came when the Chinese authorities devalued the Renminbi (Chinese currency) relative to the U.S. Dollar (USD) in an attempt to show to the world that they were making strides to allow their currency to operate more freely from its previous USD peg. This move towards a more 'freely' operating economic system is a move to prove to the International Monetary Fund (IMF) that it should include the Renminbi in its basket of reserve currencies (alongside currencies such as the USD).

It is this slight currency devaluation that caused a short term pull back in the Emerging Markets and Asia. However, the currency shift by China proved to be relatively insignificant when compared to the USD's decline over the past decade. Consequently this short term devaluation of Emerging Market and Asian assets made countries such as India and Singapore that have very little trade with China, look good value and have begun to attract investment back. As such, following the short term decline due to the currency move, this asset class has been the best performing over the past couple of months in sterling terms.

Whilst there are concerns around the accuracy of some of the economic data issued by China, the asset class now benefits from more attractive valuations than earlier this year in addition to positive reform policies and monetary measures aiding in gaining positive investor sentiment. As such, China are currently in deliberations over the content of their next 5 year plan with the previous 5 year plan coming to an end going into 2016. With that in mind it is worth noting that the previous 5 year plan had been relatively successful, with the Chinese government attempting to transition their economy they targeted lower growth of 7%, reduced manufacturing levels, and targeted a move to a more service driven economy… all of which they achieved. Further details of the next 5 year plan are likely to be key in the shorter term market direction, in addition to monetary intervention from the Peoples Bank of China (PBoC) by way of rate reductions… we have already seen them reduce interest rates numerous times in 2015, with the latest coming on the 23 October reducing it to 4.35%. For the first time in recent memory the PBoC announced that they would actively use further rate reductions to help stabilise faltering markets if needs be. When compared to Western world economies, China still has plenty of rate reduction capability left in the monetary policy tool kit.

One recent announcement worth noting regarding the Chinese 5 year plan is that they have relaxed the single child family policy to 2 children. Whilst there was call for the policy to be abolished all together, this is a step in the right direction and will aid demographics in its transitioning economy.

The US Economy

Despite the U.S. being one of the prominent drivers of global markets this year, primarily due to expectation around an interest rate increase being rife, very little has occurred in the U.S. over the past few months on a policy/economic basis. With the Federal Reserve (Fed) chair, Janet Yellen, continuing to put off an initial interest rate rise due to factors such as labour market data and broader global economic growth, it clearly displays that there is no firm method of identifying when the U.S. will raise rates. With this in mind, we have seen elements of volatility in markets this year driven by expectations thus appearing to price in any potential rise. This suggests that markets could go from strength to strength in the U.S. following the first rise, as a rising rate environment is a sign of strengthening fundamentals. There is however a likelihood of volatility in the asset class up until that first rate move is actioned.

At the start of 2015 and even running through to August there was broad concern over the company valuations in the U.S. However, despite a reversion in August following the Chinese currency adjustment that saw the market pull back sharply (it has since reverted back to its previous level in July), the broader market in the U.S has proven to be robust with headline unemployment data running at 5.1%. In addition, even though the S&P/larger companies space is at all-time highs, the smaller companies space looks broadly good value in comparison. This, coupled with a rate rise

environment likely aiding in the strengthening of the USD, in sterling terms there is potential for strong and consistent returns from the U.S. running into 2016. Let's not forget that the U.S. is still the furthest developed nation through its recovery cycle.

The European Economy

For the majority of this quarter the European Central Bank (ECB) has been broadly 'quiet' in its intentions, much like through the second quarter of this year. This could be understood given the external factors such as the potential for a Greek default, Greek political instability, Fed rate expectations, and indeed China's currency control measures. At the beginning of the year we saw the ECB begin a policy of injecting 60 billion Euros a month into the European economy to aid growth. However, with investor sentiment and fear dictating market direction, we have not yet seen the benefits of this Quantitative Easing (QE) policy.

The past few months have seen the Greek uncertainty subside, as following the Greek prime minister agreeing terms of a new bailout programme (avoiding default) earlier in the year, there was concern that his popularity had dipped. After calling a snap election, the incumbent prime minister, Alexis Tsipras, and his party Syriza maintained power. This was a key turning point, as fear of a new ruling party reversing what was agreed was eliminated, vastly reducing the perceived risk of default. In addition to this, markets are beginning to look like they have priced in a Fed rate hike and indeed any major move by the Peoples Bank of China. As such the president of the ECB Mario Draghi has, in October, stated that he will look to reassess the current QE programme in December this year. This was seen by markets as a positive statement of intent and has since seen markets rally off the back of it, as with much of the 'noise' now muted, any policy moves can potentially be more effective, and their impact on fundamentals more apparent.

With all of this in mind, and with valuations in the European asset class looking arguably more attractive as any in the developed world, there is strong potential for European markets to benefit strongly running into 2016, especially with the potential for further QE stimulus from the ECB to 'turbo-charge' the market in December.

Fixed Interest

Interest rate expectations have been key in governing equity market direction and volatility for the majority of this year. With the bond market more correlated to equity markets than it was prior to 2008, there have been few reasons to have a significant exposure to either government debt or corporate bonds in recent years. With correlations still disjointed and little indication of a reversion, in addition to concern of a spike in yield curves driven by a rate rise environment, there is little by way of an argument for being heavily allocated towards the asset class, even with the fears of a Greek default subsiding.

Broadly speaking the vast majority of the western world have been and are currently in a prolonged period of low interest rates. We have seen that the U.S. is arguably the furthest through what is deemed to be a recovery, and with the UK and even Europe making strides in the right direction it is hard to find a case for anything other than a prolonged rate rise environment in the years to come (please do bear in mind that a rate rise environment does not necessarily mean a 'high' rate environment. It is likely rates will remain low for longer with increases at a slow pace). Taking this into account, it is likely that as soon as the Fed makes that first rate increase, bonds that sit at the shorter duration end of the credit spectrum will appear most attractive and liquid as they mitigate any excess volatility, and indeed possess lower default risk. Whilst the case for bonds going into 2016 lies predominantly in the realm of shorter duration credit as and when rates rise, equity markets offer the potential of a far more compelling growth story both from a valuation standpoint and a macroeconomic standpoint. We have seen this over the past few months with the strong recovery in equity markets, and bond markets remaining remarkably flat in comparison.

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