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Q4 Market Recap

2015

Was it hopes disappointed or simply more of the same? Or both? The year 2015 continued to be characterised by what is widely perceived as dull world growth.

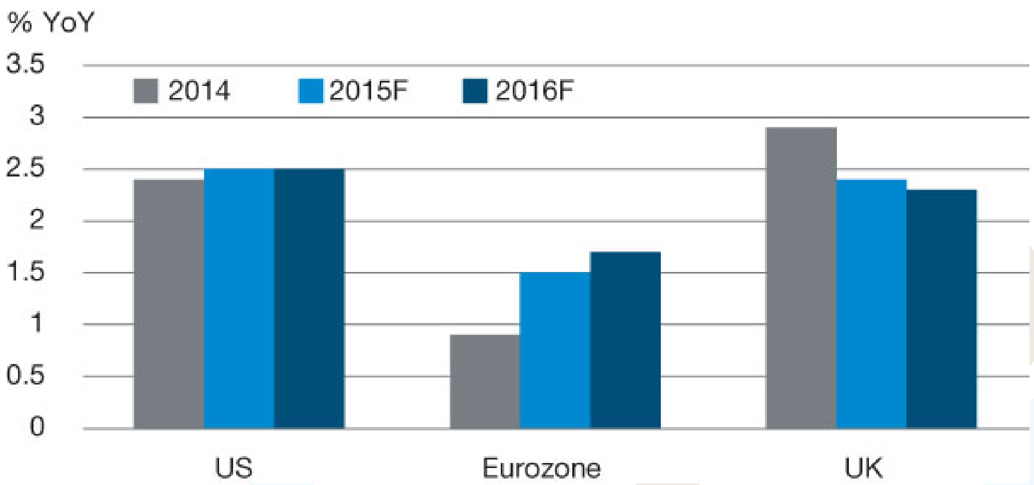
The implications of that dullness became perhaps more obvious during the year, and possibly a little better understood. For Western economies, still in rebalancing mode six years after the great recession, dull growth is much safer, although it is now beginning to demand more active management by central banks.

For emerging manufacturers and commodity producers, dull growth in the West is much more of a challenge. They are structured to supply stronger demand momentum in the mature economies of Europe and the US. The consequence is that there remains significant overcapacity amongst both Asian manufacturers and the suppliers of raw materials and energy. This, in turn, has obvious implications for pricing power – to the benefit of Western consumers, who are enjoying lowerpriced imports of many manufactured goods and appreciably cheaper energy and food.

The US economy is likely to have grown fractionally faster in 2015 than in 2014 (2.5% versus 2.4%), but by less than expected at the start of both years. Although slow-ish by historical standards, 2.5% is consistent with what we believe to be the economy's sustainable growth rate. This contrasts slightly with the eurozone. While its growth rate has improved, and is likely to have been around 1.5% in 2015 compared to 0.9% in 2014, it is still falling short of what should be achievable in the longer term.

For the UK, published numbers imply a deceleration in growth to around 2.5% in 2015 from 2.9% in 2014. However, we expect the 2015 estimates to be revised higher by the Office for National Statistics, probably to around 2.75%.

GDP growth (actual and consensus forecasts)



Source: Bloomberg.

So why, against the relatively subdued backdrop, did the US Federal Reserve (the Fed) decide to raise interest rates in December – the first increase since the relentless and eventually massively debilitating tightening that began in mid-2004 and culminated two years later? The answer to this is twofold. Most obviously, with the US economy growing at more or less its new-normal rate, it was no longer considered appropriate to leave interest rates at crisis levels. What began to put even more pressure on the Fed was the tightening in the US labour market. It has been a feature of the recovery phase on both sides of the Atlantic that relatively unexciting growth rates have translated into very strong job creation – the corollary being only weak gains in productivity.

In the US, the unemployment rate has fallen much faster than the Fed had been anticipating, and is now at a level judged consistent with full employment. Simultaneously, it is evident that job openings remain very high and the rate of increase in labour costs is picking up. Whilst headline inflation measures have been held down by falling food and energy costs, there is evidence that domestically generated inflation is beginning to pick up.

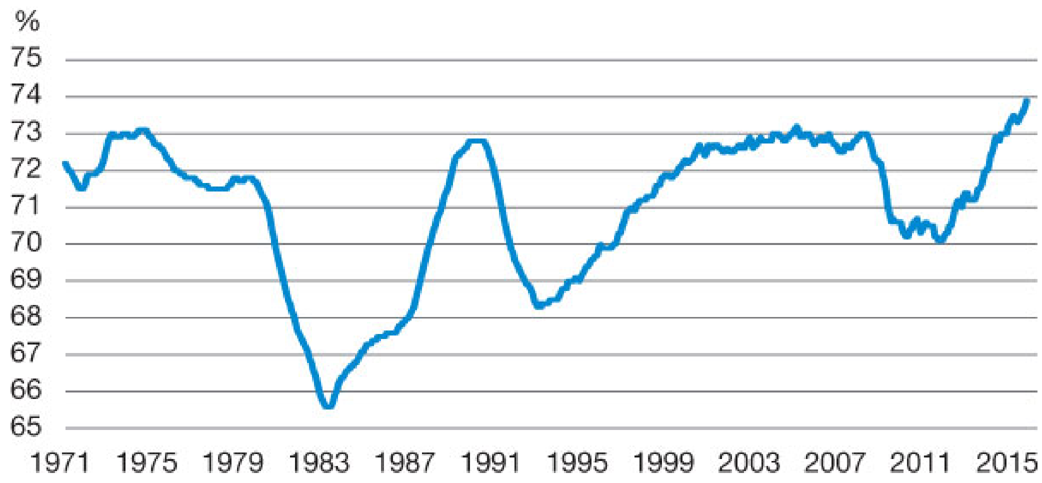
This is a situation which we expect to persist for a while – that the US labour market continues to tighten, despite seemingly modest growth. Eventually, we expect companies to take action to improve productivity by raising investment spending. Until this happens, labour costs are likely to rise faster and the Fed will be under continued pressure to raise rates.

This raises a number of questions with regard to the Fed's reaction function – most obviously, how inflation-tolerant it might prove. This is important since it will determine how quickly interest rates may rise over the period ahead. Our assumption is that the Fed will want to ensure inflation expectations remain well anchored, but will not want to risk undermining growth. It is reasonable to assume that this combination will limit the pace of the tightening to no more than one 0.25% rate increase each quarter.

At the other end of the spectrum, the European Central Bank (ECB) remains under pressure to take further action to stimulate growth. Even so, it was evident that the ECB itself has become more equivocal about the requirement for additional action. While growth in the eurozone may be considered sub-standard by historical standards, it is improving. Hence, at the end of 2015, the ECB disappointed markets by announcing only a marginal further easing. Looking ahead, if the gradual improvement in the economic outlook continues, and if core inflation picks up, it seems probable that the ECB will judge the scope and necessity for further action as being limited.

This leaves the Monetary Policy Committee of the Bank of England (BoE) with contrasting external influences. But the characteristics of the UK economy are most similar to those of the US. While growth was by no means spectacular in 2015, there was a continued tightening in labour market conditions, which has been reflected in an increase in the employment rate for people of working age (that is, aged 16 to 64 years) to its highestever level. More importantly, wage inflation clearly increased during the year. Forward guidance on interest rates from the BoE has been less than helpful (if not highly misleading) over the past few years. Consequently, we place little weight on Governor Mark Carney's seemingly benign comments and the markets' interpretation that rates may not start rising until 2017. Indeed, we would not rule out a first increase in bank rate in mid-2016.

UK employment rate (aged 16-64)



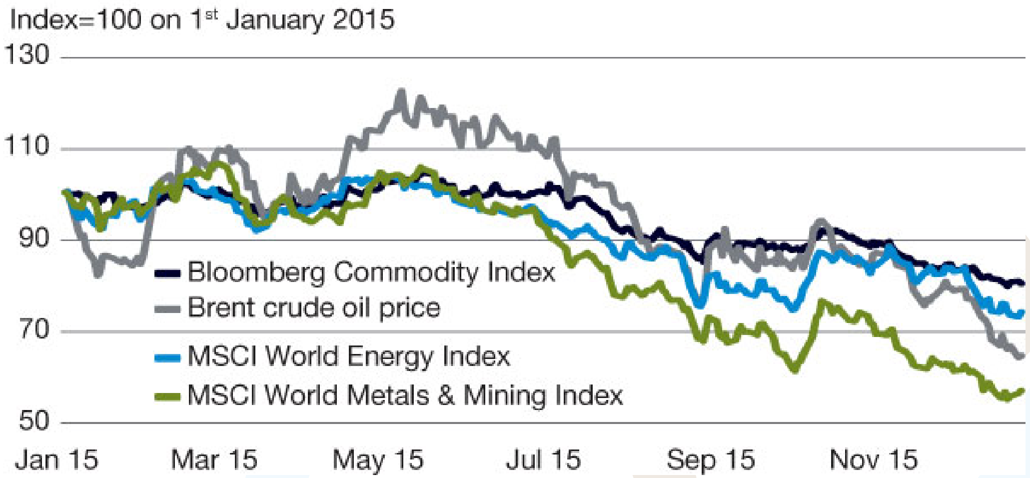
Source: Datastream.

Central banks have clearly been worried about two risks: deflation and the wider impact of a slowdown in China. In our view, the risks of outright deflation (characterised not just by falling prices but also an implosion in demand) in the West have been hugely overstated. Indeed, falling food and energy prices have resulted in a demand stimulus in Europe and the US. That Japan is still struggling to raise its growth is more to do with having a rapidly ageing population than a lack of policy stimulus. Similarly, while slower growth in China undoubtedly represents a problem for commodity-producing countries, it is unlikely to have a significantly negative impact on growth in the West, since most Western industrial countries (including Germany) export relatively little to China.

For the UK, stronger growth in the eurozone is potentially much more significant than weakness in China. Unsurprisingly, the Chinese authorities themselves are worried about growth prospects and are likely to take further action to stimulate their economy. Undoubtedly, this would be welcomed in South America and by other commodity producers. Even so, we doubt that we will see a major rebound in commodity prices over the year ahead. This means the costs of oil, industrial raw materials and food products will remain subdued.

So, looking ahead, what are likely to be the key characteristics of the world economy in 2016? Overall, we expect world growth to be modestly stronger than in 2015. However, this improvement is unlikely to be sufficient to instigate a significant turnaround in emerging economies. While Asian manufacturers are likely to find the environment remains very price-competitive, demand for raw materials and energy is expected to remain sluggish. If pressure builds up on policy makers in the West, this is expected to be the result of rising domestic inflationary pressure coming through as a result of tightening labour markets and the consequences for wage inflation. It may also be that monetary authorities in the UK and US begin to worry more about the pace of credit creation. One thing will very definitely remain the same in 2016: all eyes will remain firmly focused on the Fed.

Selected commodity-related indices



Source: Datastream

From an asset class perspective, capital market behaviour reflected investors' concerns regarding the themes outlined above and their slow acclimatisation to the return to normal growth (trend-like rates).

Risk assets have been supported by very accommodative policy measures over the last few years, thus higher valuations were likely to be challenging (particularly for the US), with investors also showing greater focus and differentiation between sectors – energy and industrial commodities unsurprisingly suffering the most. As initial hopes of stabilisation and rebounds in commodity prices faded, investor concerns moved from temporary cashflow impact and corporate adaptation to structural challenges and survival of the fittest.

The UK equity market was most adversely impacted, having the greatest sectoral weighting of major developed markets to these areas. Stock markets that did well over the year were generally those where monetary policy was still being eased, such as Europe and Japan, while emerging market companies were still struggling to adapt to lower external demand, excess capacity amongst competitors and low commodity prices. China has continued to march to its own beat, such that while we have seen incredible highs, collapses and mass stock suspensions, domestic stock markets have still shown double-digit gains for the year. Within main equity markets dispersion was significant, with the aforementioned sectors lagging while investors were paying an increasing premium for companies evidencing growth.

Corporate concerns also impacted the credit markets, with spreads* continuing to widen – led by, but not isolated to, energy companies in the high yield sector. Reduced liquidity in bond markets ensured increased volatility, but overall government bond yields were more stable through the last quarter. While we saw significant volatility in the early part of the year, the reduced impact of falling energy prices on core inflation has been picking up in the UK and US, leading to yields being increasingly underpinned.

Volatility is likely to be something that remains with us into 2016 across a number of markets. The ongoing divergence in monetary policy between the global currency of the US dollar, and almost everyone else who isn't pegged to it, is likely to lead to currency and earnings volatility. Lower for longer commodity prices may cause meaningful changes across the geopolitical spectrum, causing challenges for commodity producers and exporters, as well as a significant boost for many consumers around the world, boosting disposable income and expenditure. While volatility should be welcomed from an investor's perspective (as it can offer greater opportunities), we should also positively acknowledge that this is partly due to less synchronised global economies as some have largely recovered from the great financial crisis with normalising monetary policy; technological advances have also played a part (for example fracking) in bringing about lower goods prices around the world.

1 The difference in yield between that offered by a corporate bond and a comparable government bond.

Commentary by Richard Jeffrey, Chief Investment Officer, and Kieron Launder, Head of Investment Strategy, Cazenove Capital Management.

Market Commentary from Parmenion Investment Management

The wait is over! In December the United States raised interest rates by 0.25% to 0.50%, the first rise since 2006. Emboldened by an economy that is creating more than 200,000 jobs per month, the Federal Reserve obviously felt the recovery could withstand a rate rise.

Economists now expect rates to rise by a further 0.5% to 1.0% during 2016. But how are other regions faring and what are their prospects for 2016?

Rising US rates and their effects on emerging markets is one particular source of concern, particularly as these fast growing regions account for 35% of global GDP (Source: FT). One concern has been the high level of low cost dollar borrowing by emerging market companies, reported at $1.7 trillion in the five years to March 2010.

This may be a particular problem in commodity dependent countries faced with higher interest bills and declining commodity revenues, for example Brazil and Russia. To make matters worse for emerging markets, the rise in US interest rates may strengthen the US dollar further, causing problems for companies that have local currency revenues but pay dollar interest.

After years of export and investment led growth giving year on year rises in GDP of 7%, China in 2015 was more volatile as witnessed by gyrations in the local stock market, falling imports and exports, a devaluation of its currency and even a relaxation of its "one child" policy. Its problems stem from overinvestment in manufacturing capacity and property after the financial crisis in 2008, from which the country emerged relatively unscathed. Such largesse will take time to unwind and it is prudent to expect lower growth (more like 4% per year) over the next few years. This may impact other countries that have done well from Chinese growth, particularly the commodity exporters like Russia and Brazil.

Continuing on the commodity theme, 2015 witnessed a collapse in the oil price, as Saudi Arabia pumped oil, forcing down its price. The strategy is thought to be aimed at making other producers uneconomic such as US shale oil producers and hence maintain Saudi market share.

However this appears to be coming at a price to the Saudis. Government finances are suffering as oil revenues fall, and they are facing a deficit of 15% of GDP. The global oversupply will also not be helped by the resumption of Iranian exports in 2016 as sanctions are lifted.

Whilst low oil prices mean more money in the pockets of consumers, it can present dilemmas to central bank policymakers. The European Central Bank (ECB) has a target inflation rate of 2%. Low oil prices do not help the ECB to reach this target. Many countries in the Eurozone are barely recording any signs of inflation and may even be slipping into deflation.

The latter can lead to a deadly spiral of falling demand as consumers hold off spending, lowering demand and investment as companies cut back. With already high unemployment in many of the Mediterranean countries, the ECB will likely continue to keep interest rates low. However the accommodative monetary policy enabled European stock markets (like Japan which was up 16% in sterling terms) to climb nearly 4% during the year.

Closer to home, now the US has lifted rates there is an expectation that the Bank of England will do the same in late 2016 or even early 2017, albeit it is not clear what the trigger will be. Inflation remains low as does wage growth. However the stock market may well come to focus more on the once in a generation Brexit vote in 2016, rather than when interest rates rise.

Looking ahead for 2016 the world is tending to split between those regions now in the process of raising rates (the United States and the UK) and those still "printing" money to engineer a recovery (Europe and Japan). It will be interesting to see which policy leads to a better performance in the year ahead.

Commentary by Simon Brett, Director & Chief Investment Officer, Parmenion Investment Management

Turbulence in China

As you will have seen from the headlines, financial markets have had a miserable start to the year. There has been a coalescence of uncertainty in the opening days of 2016 - most dramatically reflected in the recent turbulence in China (and elsewhere) as investors focus on a range of issues.

These issues include:

- The wider impact on emerging/ developing economies of continuing dull growth in industrialised economies. In effect, this has resulted in a persistent over-supply of oil and other commodities, and of manufactured goods (the latter is also a consequence of the longer-term trend of globalisation).
- The short- to medium-term outlook for the Chinese economy – on this, we have long been of the view that China's growth has been slowing.
- The negative consequences for the Chinese stock market of previous margin-financed flows into equities, with much of that investment being undertaken by very unsophisticated private investors.
- The policy response of the Chinese authorities to slowing growth and financial market problems. With regard to the former, it would seem that China may be happy to allow the renminbi to depreciate in order to stimulate exports – a policy that could trigger similar action by other central banks. The authorities would appear now to be re-thinking the use of circuit breakers to manage selling pressures within the Chinese stock market.
- The exposure of UK and other western banks to problems in China and other emerging economies.
- Oil being used as a political tool in the Middle East – alongside wider concerns about political instability in the region.
- The deflationary impact on the West of falling import prices. Our view remains that falling prices of energy, food and some manufactured goods are not deflationary, and actually give rise to a real income/demand boost to western consumers.
- The short-term implications of rising US interest rates – on this subject, we do not think the extent of tightening likely in the US will have a meaningful impact on domestic demand.

While a loss of confidence could damage growth in economies such as the UK, we do not believe that industrial economies will grow significantly less quickly in 2016 than in 2015. Indeed, we could see slightly stronger growth in the eurozone and Japan, accompanied by maintained momentum in the US and UK. The present rates of growth may be dull when set against the more 'exciting' (but eventually self-destructing) rates that were 'enjoyed' prior to the great recession. The financial system, while not fully healed, is a good deal more resilient than it was five years ago.

First published on 8th January 2016 by Richard Jeffrey, Chief Investment Officer, Cazenove Capital Management.

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