Investment Outlook Q2 2015

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- World bond markets continued to strengthen in the first quarter assisted by the ECB announcing the launch of QE, in which they confirmed that their purchases could even include bonds with a negative yield. This move has led to some remarkable prices. For example at the end of March countries whose 30-year debt trades at a yield of less than 2% include Switzerland, Denmark, Japan, Germany, France, Spain and Ireland. At the 10-year level it seems strange that Portugal, where the yield is 1.7%, can borrow more cheaply than the US, where the yield is 1.9%, despite Portuguese debt to GDP being 360%. Even some companies' debt fell into negative yield territory including bonds issued by Nestle and Roche. Estimates put European debt that has a negative yield at $3.6tn, and there is a further $4.6tn of negative debt in Japan. It is a bizarre state of affairs when investors are paying to lend money. Equally remarkably the UK government issued a bond with a maturity date in 2068 with a coupon of just 2.6%; this from a country with a history of inflation and which currently has both a trade deficit and a budget deficit of about 5%. Quite a lot may happen over the next 53 years that may be unfriendly to the holders of this bond. To put these low yields in context it is worth remembering that in the depths of the Great Depression in 1931 no US longer dated bond fell below a yield of 3.13%. This comparison illustrates how great government interference has been, and how far prices have been pushed from the norm. It also raises concern about the effects when policy reverts to normal. A critical turning point will arrive if investors finally start to question the efficacy of central bank policies and their credibility. For example it remains hard to see how the indebted European peripheral countries will be able to repay their debt without either inflation or some form of debt forgiveness. Neither of these two solutions are consistent with the ultra low yields on offer, and this backdrop provides a continuing background anxiety for markets as to what will happen when rates do start rising. The wild surge in the Swiss franc at the start of the year suggests what a shortage of market making capacity there is in a relatively liquid area. A similar shock in the much less liquid credit markets would be much worse.

- Such low bond yields are also inconsistent with the growth rates prevailing round the world, particularly regions with full employment and rising wages. The US is growing steadily at 2-3% and job creation has been running at an average of about 250,000 jobs a month for over a year, so that the unemployment rate has fallen to 5.5%, sparking some wage growth. Wal Mart, for example, raised wages to 24% above the minimum wage for half a million workers. Europe and Japan are growing in euro and yen terms, and the Emerging Markets, while they are slowing as a bloc, are still recording positive growth, and in some cases like India are accelerating. The fall of the price of oil has provided a dramatic stimulus for consumers and industry and so long as energy prices remain at current levels this will underpin continued growth. Equally many countries are gaining export competitiveness from currency devaluations. The US, and China because its currency is quasi pegged to the dollar, are suffering from the strength of the dollar but almost all other currencies have fallen. Dollar strength in combination with rising wages will make earnings growth more challenging for some US companies. However in the last year the market was largely driven by companies that are viewed as bond proxies because of the reliability of their earnings streams. Such companies' valuations are stretched now but many others can now benefit from a stronger consumer and stronger dollar. The emphasis of the market is likely to shift from the multi-national growth stocks towards those companies which focus on US domestic growth. Corporate America has held back from investing in capital equipment for several years and if it finds the confidence to re-tool the factories that would be a new engine for growth. It remains the case that equities appear to look far more attractive than bonds, and as investors are still underweight equities the likelihood is that there will be a steady flow of funds from bond funds where the return outlook is so poor relative to equity funds.

- European markets have enjoyed a strong start to the year. The combination of a devalued euro, much lower oil price and action by the ECB to implement QE has driven most of the major European markets up by about 15% in the first quarter, though the gain is a little less than half that when expressed in US dollars reflecting the weakness of the euro. Commentators have been concerned about the threat of deflation as the inflation numbers have been falling steadily and even accelerating due to the drop in the oil price. However as a significant net importer of oil for Europe the deflationary impact of a falling oil price is almost wholly beneficial; consumers have more cash to spend and producers have lower costs. All these factors have helped Europe shrug off many of the alarms that troubled the markets last year such as the Ukrainian crisis, and the resurgence of a real threat of Greece exiting the euro following the election of Syrizia in January has been largely ignored, except in the Greek stock market itself. Such a robust reaction to bad news gives hope that the European economies are beginning to strengthen, and some areas are showing real strength, for example, in January Sky's bid for the television rights for the UK Premiership games for the next three years was valued at almost £0.5m per player per game.

- The Japanese market continues to rise, and encouragingly this rise has taken place while the yen has been stable. Previously Japanese stocks moved up almost in lockstep with the yen's decline. A further development is that whereas before foreigners were the driving force in the market now domestic buyers have replaced them. Much of this domestic buying has been from the Government Pension Investment Fund which the government has mandated to buy more equities, but their lead is being followed by other pension funds and the Trust banks. The government's expressed policy for companies to pay more attention to shareholder returns is showing tangible results. In particular companies are being encouraged to boost their return on investment ratios (ROE) and evidence of this can be seen in the increase of dividends, and share buybacks which rose 61% in 2014. There is a long way for this to go. Japanese ROE is only 9% compared to 15% in the US. As non-financial companies in the Topix index have 28% of their market cap in cash there is plenty of scope for them to improve returns with further buybacks. Meanwhile the yen is exceptionally competitive which is benefiting exports and leading to a surge in tourism, tourist arrivals grew 29% last year. With unemployment down to 3.6% wage pressure is starting to grow. Japan has had a twenty five year battle with deflation so if wages do rise sustainably then this would finally banish that problem, which might mobilise the vast cash deposits of Japan's savers. Another help is that from 1st April pensions are increasing by 0.9%. An already strong earnings outlook together with the strong impetus from a fallen oil price and a cut in the corporate tax rate mean that Japan is the one country where there should be broad earnings growth this year.

- By contrast China's economic data has abruptly weakened this year. China's problem is vast overcapacity in several sectors of the economy – e.g. according to the US Geological Survey China has used more cement in the last three years than the US did in the whole of the twentieth century. The consequence of this is that China is suffering from a property slowdown which is hurting the banking sector. In addition the wage growth that has been encouraged by the government over the past decade to stimulate the consumer has made Chinese manufacturing less competitive and many companies have been moving factories away from China. On top of all this China pegs its currency to the US dollar so the rise in the dollar has dragged the renminbi up with it making exports less competitive. However as the property market has slowed investors have begun to gravitate towards equities which have been performing strongly. The danger is that to prevent any further slowdown the government may devalue the currency. This would be against their stated desire to build credibility in the renminbi as a store of value, but if the pressure inside the economy rises too much this solution has always been the way that governments have chosen to escape.

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