

**momentum**

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Round-up of momentum's international  
think-tank 2014

liquidity,  
bubbles & bull  
markets

**London**

15 - 16 October 2014

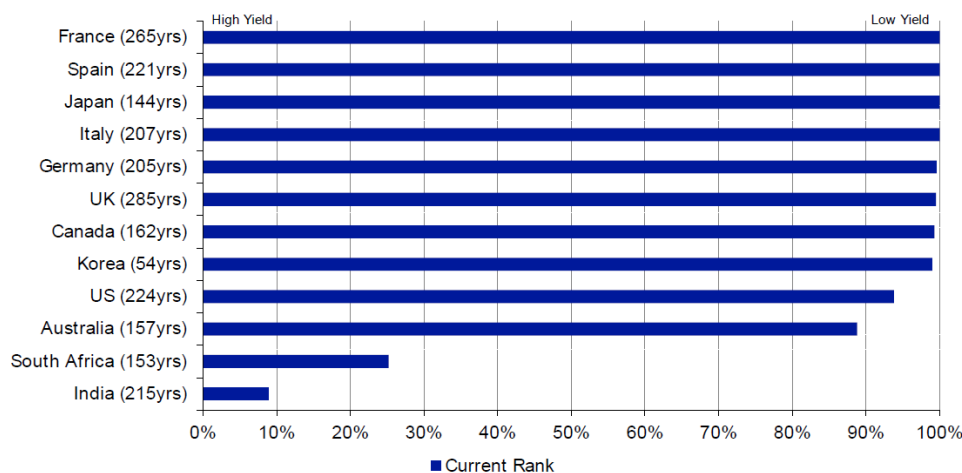


Momentum hosted its annual think-tank in London on 15 and 16 October 2014. The theme this year was “Liquidity, bubbles and bull markets” and once again a host of top quality speakers from a wide range of investment firms shared their expert views with the delegates.

Glyn Owen, Investment Director at Momentum Global Investment Management concluded the conference on 16 October with an overview of the themes which were most prominent during the two day conference. His closing remarks represent an insightful summary of the conference, and are certainly well worth a read:

In my closing remarks at the last couple of think-tank conferences I reflected on the extraordinary conditions which we faced, and how I thought they would continue for many years to come. It is clear that the conditions we face today are no less extraordinary. Central banks have maintained their monetary experiment with ultra-loose monetary policy; in Europe we have the unprecedented situation in which the European Central Bank (ECB) has negative interest rates on deposits; there are negative interest rates on 2-year bonds issued by no less than 10 European countries, including Ireland, which was bailed out only four years ago, and where interest rates at the height of the Euro crisis in mid-2011 reached 23% on the same 2-year bonds; as Jim Reid (Global Head of Fundamental Credit Strategy, Deutsche Bank) pointed out yesterday, most longer-term sovereign bond yields in the eurozone are at all-time multi-century lows and most other government bond yields around the world are close to all-time lows. The following chart illustrates this point.

Chart 1: Current percentile of 10 year nominal yields relative to history.



Source: Deutsche Bank, GFD

Yet despite all the liquidity and near zero interest rates around the developed world, growth remains subdued and inflation is remarkably low; Inflation has not risen as many of us expected after this long and exceptional period of loose monetary policy, but this year it has fallen further to levels in some parts of the world (most notably the eurozone), which are in deflationary territory. At the same time the Federal Reserve (Fed) is trying to manage its exit from ultra-loose policy with minimal disruption. And the world’s great engine of growth over the past decade or more, China, is showing signs of a structural slowdown.

Amidst these economic uncertainties, the geopolitical situation globally is as unstable and unpredictable as at any time since the end of the Cold War. Perhaps no surprise then that equity markets, having been at all-time highs in many cases only a few weeks ago, are now going through a major correction or possibly something much bigger. How do we track a course through these uncharted waters and set our asset allocation strategy for the coming year?

There are several key themes that are likely to drive asset prices, all with a very substantial impact on markets and which are to some degree inter-related. These are:

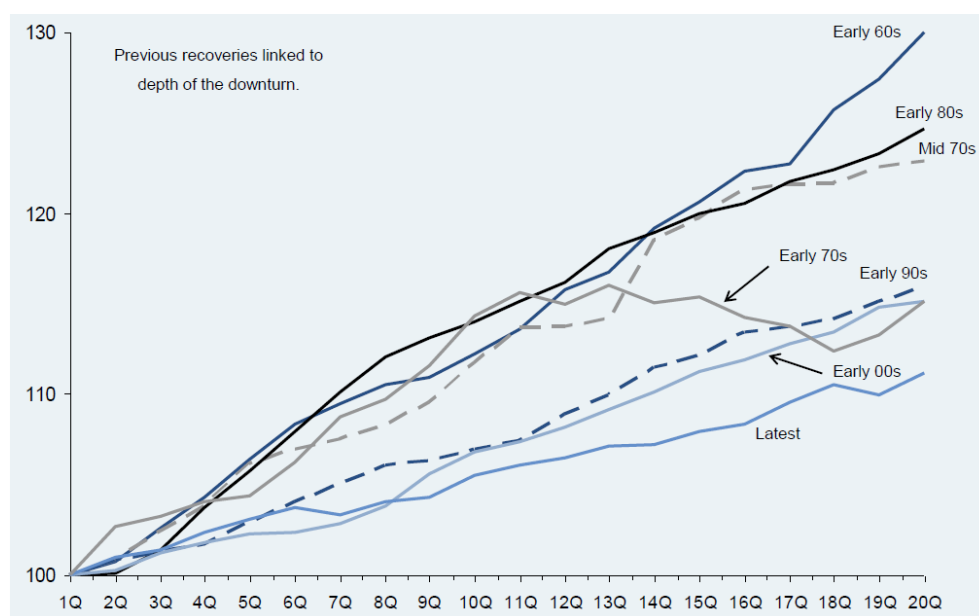
- evidence of slowing global growth;
- divergent performance among economies, especially between the US and other developed economies, notably the euro area and Japan;
- largely as a result of the second, divergent expectations for central bank behaviour;
- a slowdown in emerging market growth; and
- sizeable shifts in relative pricing with a strong US dollar and weak commodity prices.

All of these have far reaching implications for asset prices and I suspect they are of much greater importance to asset allocation policy than all of the geopolitical problems combined.

I am not under-estimating the geopolitical problems we face around the world but it seems to me that there must ultimately be a negotiated diplomatic solution to the Ukraine crisis, where it is increasingly evident that Russia is already the big long-term economic loser of its policy, while the Islamic State (IS) movement in the Middle-East will be halted by the powerful global alliance led by the US. Using President Obama's language I suspect IS will be degraded but regrettably not destroyed; but nevertheless it will be prevented from having any meaningful impact on oil supplies from Iraq and hence on global activity levels. Similarly with Ebola; while it is a human tragedy of potentially considerable scale, it is unlikely that its impact will become economically important on a global scale. Clearly these views might prove to be tragically wrong; they all represent tail risks which by their nature are unpredictable and could have a major impact on economies and markets, but that is not our base case.

Turning then to the key global macro forces driving markets. The world economy is still struggling to reach escape velocity where it can maintain sustainable growth without continuing monetary stimulus; this concept of secular stagnation was explored in depth by David Mackie. Although the US and UK are performing reasonably well, debt levels remain high and continue to provide a headwind to growth. As Jim Reid told us, G7 debt to GDP ratios are at their highest levels in peace time history and, as David Mackie illustrated, the recoveries underway in economies globally are the weakest in history following one of the deepest recessions. This can be demonstrated in the following chart.

Chart 2: Comparison of US recoveries post-recession; 100 = last quarter of recession, sa



Source: BEA, JP Morgan

In the euro area the situation is much worse than the US and UK; excessive debt at government and personal levels, austerity in peripheral countries and structural impediments to growth in key economies such as France and Italy are all combining to keep growth at very subdued levels. And across Europe it is almost certainly the case that, unlike in the US and UK, most banks have yet to price all of their assets at true market values: in other words they still have to absorb writedowns and rebuild capital, meaning that credit remains constrained. We will have the results of the ECB's stress tests in 2 weeks; although Jim Reid was reasonably optimistic about the outcome, the market remains suspicious that Italian banks and the big regional Landesbanks in Germany have still to 'fess up'. Do not be surprised to see bank mergers and recapitalisations in Europe during the course of 2015.

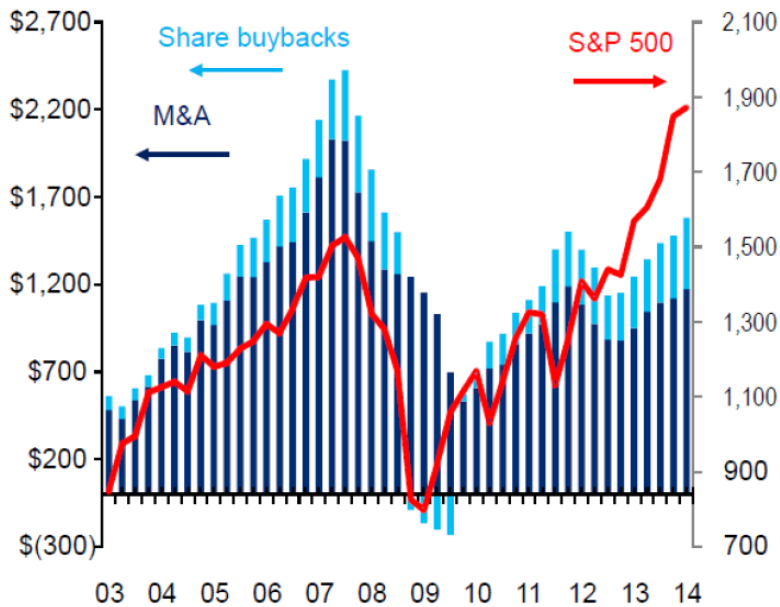
Growth globally has disappointed throughout the years following the financial crisis and this year is proving to be no exception. In particular, in recent months it is evident that growth is stalling in Germany, the powerhouse of the eurozone, France and Italy are in a state of stagnation while peripheral former basket cases are producing generally fragile recoveries from deep recessions. But it is German growth that has most disappointed in recent months. As a huge producer and exporter of capital goods, Germany has been a big beneficiary of the investment and capital spending boom in much of the developing world; but this is not happening in China anymore as the economy rebalances away from its high dependency on capital spending, in Russia, where sanctions are leading to capital outflows, and across much of the emerging world. It will prove difficult for Germany to regain its former growth rate in the next year or two.

Japan's economy has also struggled to pick up, despite the best efforts of Prime Minister Shinzo Abe and the Bank of Japan (BoJ). Clearly the big increase in the sales tax in April distorts the figures this year but it is evident that 'Abenomics' has much to do to push growth and inflation up towards sustainable levels of 2%. But it is arguably the emerging world that is seeing the biggest slowdown in growth. As Devan Kaloo (Head of Global Emerging Markets, Aberdeen Asset Management) showed us, China is in a long-term structural slowdown as its economy rebalances towards the consumer and away from its unsustainable dependency on capital spending. Brazil is teetering on recession and other commodity dependent economies are struggling in the face of commodity price falls. Russia is clearly suffering as sanctions bite, with ramifications for Eastern European economies. Having spent some time in Russia recently, Devan believes that Putin's position is starting to weaken as the Russian people start to feel the effects of a stalling economy.

Jim Reid made a powerful point when he noted emphatically that there is no prospect of any form of fiscal loosening anywhere in the next couple of years - it is firmly off the political agenda. This is despite the very low cost of funding such expenditure currently. Therefore no stimulus can come from this area, meaning that the only policy instrument to influence growth and inflation will be monetary.

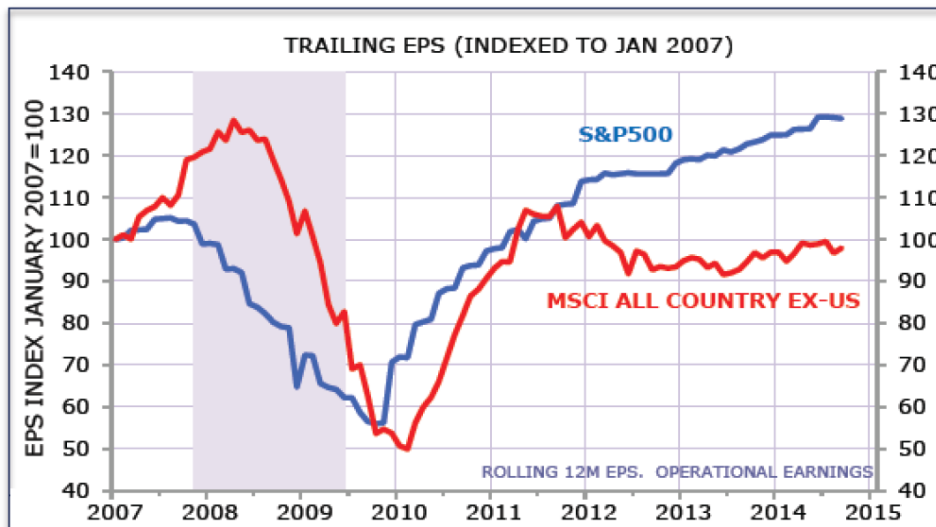
In aggregate, therefore, it seems that the global economy will continue to struggle to reach anything approaching its pre-crisis growth levels. At the same time we are seeing inflation fall as the output gap in most countries remains high and labour is generally in ample supply, particularly if the huge drop in the labour participation rate in the US which David Mackie (Head: Western European Research, JP Morgan) discussed, proves to be transitory. Recent falls in commodity prices will also push inflation lower. A combination of subdued growth and low inflation means that growth of GDP in nominal terms will remain at historically low levels. This is not helpful in the process of reducing debt mountains as a percentage of GDP and it means that top line revenue growth for companies will be a struggle, as Nick Purves (Portfolio Manager, RWC Partners Ltd) showed us. In turn this calls into question the sustainability of what above average operating margins are. At the same time, the big share buy-backs that have been boosting earnings per share are not a sustainable source of growth. Chart 3 shows this relationship while chart 4 demonstrates how corporate earnings outside of the US have not grown for three years.

Chart 3: Buybacks and M&A on the rise



Source: Citibank

Chart 4: ex-US corporate earnings have not grown for 3 years



Source: Minack Advisors

Within this subdued growth environment, we are seeing a clear divergence of performance between the big economic blocs, notably the US and Europe. In turn this means divergence of central bank policy. The Fed is bringing its huge asset purchase programme to an end, whereas the ECB has loosened policy materially this year with a further bank funding programme (the TLTRO), a cut in interest rates into negative territory and purchases of certain private sector securities. No doubt against the better judgement of Germany, the ECB has left open the possibility that further unconventional measures could be taken, and this might well include the use of public Quantitative Easing (QE), whereby the ECB purchases the bonds of euro area governments in the same way as the Fed and the Bank of England (BoE) has utilised its asset purchase programmes. Jim Reid thinks that the ECB will engage in full QE next year and as unprecedented as that would be, I share that view. In Japan the BoJ continues to pump in additional

liquidity of \$60-70bn per month and is committed to do so for as long as it takes to get inflation up to a sustainable 2%. Further loosening cannot be ruled out here either if the economy weakens and inflation remains below target. So, in Jim Reid's words, further liquidity 'pulses' are near certain next year.

A direct consequence of this divergence is US Dollar strength. The US Dollar has risen sharply against all major currencies in recent months, in particular with the euro and yen down by some 10% and 5% respectively over the past 6 months. This is precisely the move that the ECB and BoJ welcome as it provides a stimulus to their economies and will be an important factor in pushing inflation in those countries somewhat higher. This relative currency movement has had a significant impact on returns from markets and while the adjustment process and repricing of the US Dollar continues, which it is likely to do given the divergences I have spoken about, all markets will face a strong headwind; especially those which historically have been heavily dependent on US Dollar flows: here the emerging markets are to the fore. Devan Kaloo explained this link very well during his presentation.

At the same time as we have seen repricing of the US Dollar we have also seen a big adjustment in commodity prices. Sharp falls in industrial metals, notably iron ore down 40% this year, have been in large part due to the slowdown in investment spending and over capacity in China. More recently we have seen soft commodity prices falling sharply followed by a 25% drop in the oil price since June as the oil market faces subdued demand and a supply shock in the form of rapidly rising US production as well as increased supplies from Libya and Iraq. Price falls of this pace and magnitude are initially disruptive, with a big impact on producing economies and companies.

This combination of negative factors has pushed equity markets into the biggest correction since mid-2011, when the euro crisis was near its peak. We need to ask ourselves whether this is the beginning of a more protracted setback, even the beginning of a new bear phase. After all, we have enjoyed one of the longest bull markets of all time, some five and a half years from March 2009, and the uncertainties we face are worrying and deep seated.

We would argue that a significant correction in equity markets was overdue. Valuations had been pushed to very high levels in many asset classes including equities. In general, valuations are being restored to more reasonable levels and given the sharp underperformance of certain sectors there are some real opportunities emerging. Importantly, although we recognise the likelihood that global growth will remain relatively subdued, we do not see signs of the big economies returning to recession. Austerity programmes are having a reducing impact; as David Mackie pointed out, some of the factors that have been weighing on demand are transitory - credit transmission mechanisms are steadily being restored, employment growth has been remarkably strong in the US and UK in particular and falling commodity price, especially that of oil, will prove to be unambiguously good news as they keep inflation low and act as a tax cut to consumers. Furthermore, low inflation will enable central banks to continue to pursue a policy of looser and lower for longer, as they face no inflationary threat for the next couple of years at least. Like Jim Reid, we would not be surprised if neither the Fed nor the BoE, the two central banks currently expected to increase interest rates in the first half of next year, will need to do so and may not raise rates until well into 2016 at the earliest. We have the certainty of continuing injections of huge amounts of liquidity from the ECB and BoJ (and we should not rule out the possibility of QE4 in the US), so we can be confident that liquidity will remain in ample supply next year.

We have all rightly been concerned that these massive amounts of liquidity on a global scale will lead to asset bubbles. I mentioned last year that we saw no signs of bubbles at that stage, other than in certain parts of the residential real estate market, notably in London, Hong Kong and Singapore. I think it is encouraging that we have seen signs of a modest deflation of these bubbles in recent months, with macro prudential measures and qualitative lending controls having the desired impact. This perhaps increases confidence in the ability of central banks to lean against the dangers of asset bubbles, particularly in the area that has always been the most damaging - real estate.

The other, much bigger, area that we have been concerned about is in fixed income markets. We have seen how government bonds across the developed world offer near all-time low nominal if not real yields. There is no room for any disappointment on inflation. Until very recently, credit showed bubble-like characteristics; in the great search for yield, bond issuance has soared, and it has increasingly been covenant light, with spreads ever tighter. Complacency was back with a vengeance.



The sharp correction we are now experiencing is healthy in our view. Using the terminology introduced by Rama Krishna (ARGA Investment Management, LP), we had been seeing an overvaluation of certainty and now anxiety is creating value. It has shaken the investor complacency that had crept in and has brought back a greater sense of realism to valuations. Credit spreads have widened very considerably and some parts of the equity market, particularly outside the mega cap stocks, have fallen very sharply. As Steve Wilson (Lapides Asset Management, LLC) and Nick Purves mentioned, there are plenty of smaller and mid-sized stocks that have fallen by 30 or 40% and opportunities are emerging that they have not seen for some time. The same applies across most markets today.

We therefore see this as a good opportunity to increase our weighting in equities and some other risk assets in this period of correction. Having sold out of high yield bonds earlier this year as Andrew Smith pointed out, we are using the very significant spread widening since then to rebuild positions. Parts of the emerging market debt world also look attractive; Warren Hyland (Portfolio Manager, Muzinich & Co) illustrated this point with corporate emerging market debt. In emerging markets we subscribe to Devan Kaloo's view that we are seeing a cyclical rather than structural shift as well as increasingly positive policy developments. There are also pockets of particularly good valuation opportunities in Japan, as Rama Krishna discussed. But government bonds across the developed world appear to be far too expensive and have become materially more so in the latest bout of investor nervousness, which has led to safe haven buying at yields which surely offer asymmetric and deeply unattractive risks.

To end on a broadly optimistic note in this period of considerable gloom, we have a healthy correction underway, not the beginning of a new bear market. Economies are sluggish but will continue to grow next year, albeit at relatively subdued rates: this is a pattern we can expect for some time ahead. But in turn that will mean looser monetary policy for longer, a further extended period of interest rates at the zero bound (especially in Japan and Europe) as well as ample liquidity to underpin markets. Valuations are returning to more attractive levels, from which we can expect reasonable albeit modest returns in the year ahead. In an era of low nominal growth and low interest rates we should all be conditioning our clients to expect modest single digit returns, but positive they will be as this long credit and market cycle continues.

We recognise the risks to our base case and the tail risks introduced by a worrisome geopolitical background. The extraordinary policy era we are in might well be storing up problems for the longer term, including eventually inflation. So a degree of caution and broad diversification within portfolios remains vital. As Nick Purves mentioned, it is still important to pay up for resilience and stability. But markets are presenting us with the best opportunity for two, possibly three, years to take on some additional risk and take advantage of this remarkable environment in which we find ourselves.

Glyn Owen  
16 October 2014