How we see the world

We are living in the most extraordinary times in financial markets, conditions which none of us have ever before witnessed. The world economy is struggling to maintain sustainable growth without continuing monetary stimulus on an unprecedented scale. This might not be the ‘new normal’, because eventually cycles will turn, but I think these conditions, characterised by low nominal growth, very loose monetary policy and historically low interest rates will continue for some years to come.

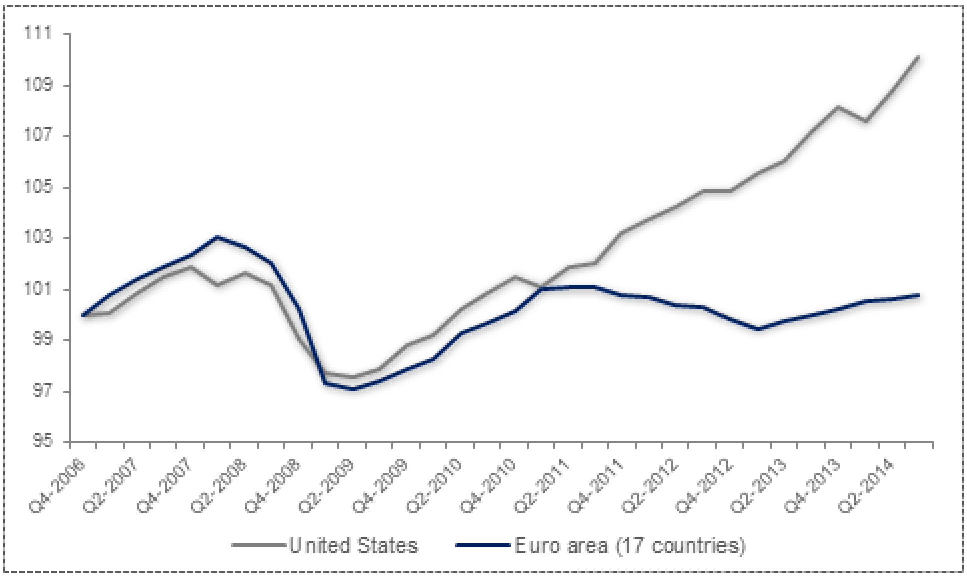
To understand why that might be the case it is worth reflecting on the root causes of the current global malaise. Prior to the financial crisis the world experienced an unprecedented credit boom. The unwinding of that unsustainable level of debt is a slow and painful process. Some debtors defaulted, and that is a straight forward destruction of capital for lenders. Other debt is in course of being gradually repaid, and that means saving more, spending less. Restoring the capital health of the financial system means banks are much more conservative in their lending decisions, so credit is tight and less freely available than before the crisis. Governments became over stretched, particularly in the developed world and especially in Europe. So fiscal spending has been slashed and painful structural reforms implemented. Deflationary forces are dominant, with many goods and materials in excess supply, and real wages falling across much of the world. Finally, the world’s biggest engine of growth in the previous couple of decades, China, is in an inevitable and inexorable slowdown.

This environment has come to be known as secular stagnation, a tendency for demand to remain deficient and long term interest rates to stay low. It is not a normal cycle but one caused by excess debt and a financial collapse which destroyed substantial wealth and productive potential; restoring normal conditions will take much longer than usual. Amidst these economic uncertainties, the unpredictable geopolitical situation is a further deterrent to investment and confidence, vital ingredients for a sustained recovery.

Ultimately conditions will change, real wages will pick up, demand will accelerate and the cycle will turn, as it always does. But already this is proving to be a particularly long economic and market cycle; to put it in perspective the S&P 500, the best index for the US equity market, has tripled since the market bottom three years ago, and this is now the fourth longest bull market in history. But at 1521 days it is still only half the length of the longest bull market, between 1987 and 2000, and the market will have to double again to match that. It is important then to gauge where we are in the cycle as this will have critical importance in asset allocation decisions and structuring of portfolios.

In the developed world demand has been generally weak and growth sluggish. But two large economies, the US and UK, have performed better in the past year and are set for further reasonable growth this year. However the big shift in trend in recent months has been in Europe and Japan, where economies are showing clear signs of coming out of a long period of recessionary conditions. They are benefitting from sharp falls in their currencies, making exports competitive and boosting manufacturing industry. Both regions are among the biggest beneficiaries of the oil price collapse, which is acting like a tax cut and boosting consumer confidence and spending. Furthermore, the aggressive monetary easing policies of the ECB and BoJ are having the desired effect, pushing their currencies down and asset values up, boosting the wealth effect and encouraging spending. There is no question that Europe is recovering quickly, consumer spending is up, leading indicators are pointing in the right direction and growth is being revised up, albeit from a low base, for this year and next. In contrast, the strong dollar is acting as a headwind to growth in the US, where the economic surprises so far this year have been on the downside. Given the momentum in the economy we will see further growth this year, but still at levels well below those normally expected after a deep recession. So although the global recovery in the developed world in aggregate is picking up pace, it remains one of the weakest recoveries on record, particularly in Europe.

Subdued European recovery



Source: Franklin Templeton and Bloomberg

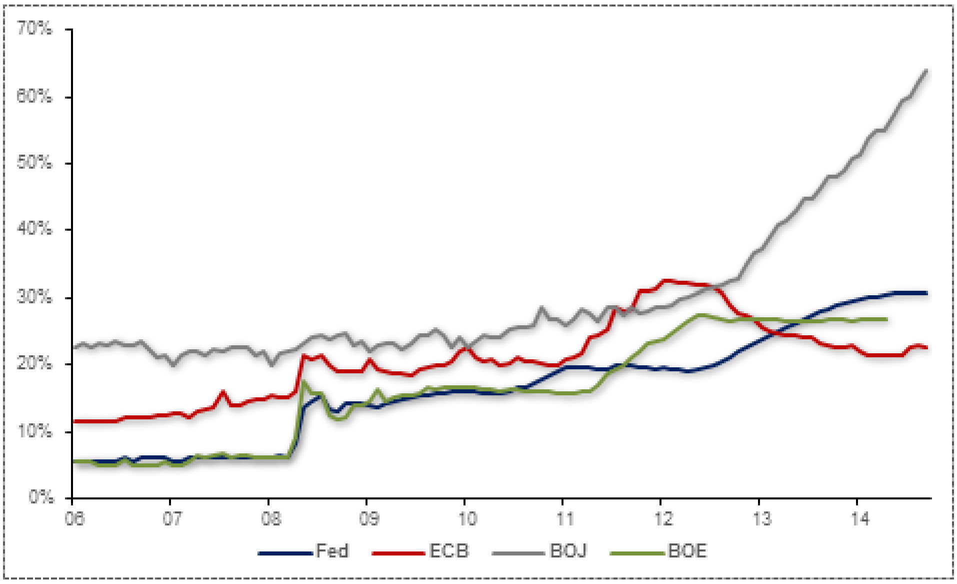
In contrast the emerging world, which had been the engine of global growth for the previous decade, is slowing; this trend is clear in the biggest and most important emerging economy, China, while two of the other BRICs, Brazil and Russia, are in outright recession. Only in India among the large emerging countries is growth accelerating, helped by a new reformist PM and head of the central bank. Emerging countries in general have been hit by weak export markets in the developed world, by the collapse in commodity markets and by the strong dollar, which is especially damaging because many emerging countries and companies borrow heavily in dollars so a strong dollar creates a painful balance sheet problem.

Finally, and most importantly, not just for the emerging world but for the developed world too, the days of double digit real growth year after year in China are over, permanently. Mathematically it becomes increasingly difficult for an economy to continue to grow at 10% plus a year, the sheer scale of the absolute increase required being impossible to maintain. However China has other longer lasting, structural problems which will act as a severe headwind to growth for years ahead. The massive growth over the past two decades was based on capital investment and exports. Capital spending accounts for close to half the economy, a level which is unsustainable and which has given rise to excess capacity across large swathes of the economy. The new administration in China is well aware of this problem and has set about a long term rebalancing of the economy towards consumer spending and away from its dependency on capital spending. The end result will be a more sustainable economy but the transition will be bumpy and result in slower growth. At the same time China is wrestling with the after effects of one of the biggest credit expansions in history over the past seven years as well as a currency which has appreciated almost exactly in line with the dollar in the past 18 months, making China's exports much less competitive. China has the wherewithal to manage this but, as we know, the unwinding of credit bubbles is never straightforward and the risks are on the downside.

None of this is likely to prevent China from becoming an international power of much greater influence, especially in the Asia-Pacific region where it is already flexing its considerable muscle, nor of becoming an important global financial centre with a recognised international reserve currency. But I think that to come near to matching the US in this respect China will have to move in the direction of a less authoritarian, more liberal, transparent, and democratic system, few signs of which are in place today. For investors, China will remain, I suspect, a challenging and volatile place, with returns failing to match the growth of the economy.

The net effect of this sluggish but improving growth in the developed world and a slowdown in the developing world is that global growth will remain well below the rates enjoyed in the years before the financial crisis. Together with inflation rates which were low before the oil price collapse and are now even lower, and into negative territory across sizeable parts of the world, this means that nominal growth globally will remain low, compounding and extending the problem of debt repayment. Little wonder then that central banks have been forced to act in completely unprecedented ways, holding interest rates across the developed world at near zero for over six years and engaging in asset purchases, QE, on a scale completely unimagined before the crisis and never before undertaken. Monetary policy will clearly remain a key determinant of market direction in the year ahead.

Global central bank assets increasing significantly



Source: Franklin Templeton, Federal Reserve, European Central Bank, and Bank of Japan

It is important to bear in mind, then, that monetary policy is loose almost everywhere, with just one or two emerging countries, notably Brazil, forced into tightening policy, whereas over twenty central banks have loosened policy this year already and two, the ECB and BoJ, are committed to massive asset purchases, running at around $60bn per month each, for at least the next 18 months.

So it seems that the world will remain awash with liquidity for the next year or two, underpinning asset values everywhere. Why then is everyone so worried about monetary policy? The simple answer at the moment is that the US Federal Reserve, by far the most important central bank in the world and the steward of the world's only true international reserve currency today, is anxious to begin the process of policy normalisation by raising short term interest rates. Since it has not done so for a decade, and during that time the world has become heavily dependent on ultra-loose policy, the timing and impact of rate rises in the US are high among investors' concerns.

Predicting the timing of central banks' policy moves is never easy. However just last week the Fed flagged a more dovish tone, reducing its growth and inflation forecasts for the economy and at the same time cutting its predictions of where interest rates will be over the next two years by around 0.5%, a meaningful number when rates are already expected to be low. The market interpreted this as a first rate rise most likely in September. However given the lack of inflation and the headwinds still to growth I would not be surprised to see the first rise deferred into next year; we have been firmly in the 'looser for longer' camp throughout the post Lehmans period and we remain of this view. It seems to us that the Fed, along with nearly all other central banks, will prefer to take risks on inflation than deflation: after all, they have ample room to tighten policy if the need arises whereas unintended and unwanted consequences of loose policy such as asset bubbles, which would store up longer term inflationary risks, are not yet in meaningful evidence. Whenever the first rise comes, we think that further rises will be gradual and data dependent and it seems highly likely that rates will peak in the next cycle at levels well below those in previous tightening periods, perhaps no more than 2-3%.

‘Most assets are no longer intrinsically cheap and some are simply expensive’.

While there are few signs of bubbles developing, care needs to be taken as the cycle unfolds. In a low growth, low interest rate environment with valuations well away from rock bottom levels we should expect returns from here to be more modest than those enjoyed in the past few years. However we believe that positive real returns are available from these levels; the key will be diversification and a disciplined focus on valuation.

In equities there is much concern that markets have moved up substantially in the past six years. However we need to put those moves into an historical context. In the preceding couple of years most markets had virtually halved and some are only now getting back to all-time highs reached in the very early part of this century. Critically, earnings growth through this period has been generally strong, so valuations, while clearly higher than at the depths of the bear market, are not stretched by historical standards. Furthermore, corporations are mostly in excellent shape financially and with growth picking up in the developed world earnings will expand further through this cycle. There will undoubtedly be periods of volatility ahead but we expect further progress in markets over the next couple of years, based on earnings expansion rather than a further rerating of stocks.

Within equities there are some markets and sectors which offer particular opportunities: we expect the recovery underway in Europe and Japan together with central bank asset purchases to result in above average gains. At the value end of the spectrum, energy stocks are now interesting following the sharp falls in prices over the past nine months, and there are opportunities opening up in emerging markets, where the poor performance of the past few years is giving rise to an attractive entry point for what still remains a good long term growth investment.

It is clear that the world’s financial markets are not without risk. Of course they never are, but I am conscious that when the usual safest haven investments, government bonds of triple A countries like the US, UK and Germany are offering extremely low yields, there is a danger that many investors will be tempted into taking unintended risks with unfortunate longer term consequences. Surveying the world today I can see several risks which while unlikely to occur would have a high impact should they do so. Greece might yet be forced to exit the euro, China might suffer a hard landing, emerging markets could suffer a crisis if the dollar continues to rise and interest rates rise more sharply than anticipated, Fed tightening could result in a disorderly sell off, Putin is completely unpredictable and could continue his aggressive expansionary policies beyond Ukraine.

However, there are strong reasons to expect the upward cycle we are in to continue for an extended period ahead, albeit with bumps along the way. The usual conditions which trigger a downturn, excess demand, capacity shortages, high inflation followed by sharp monetary tightening and recession, are all absent in today’s world and indeed are a distant prospect. We are therefore intending to use periods of volatility in markets, perhaps caused by heightened concerns about the evident risks around the world, to add to equity holdings in our portfolios.

As ever, however, there will be two key over-riding guiding principles. First we will focus rigorously on valuations and maintain strict longer term parameters to ensure we do not over pay. Secondly we will always diversify our portfolios across uncorrelated assets; diversification by asset class, by country, by currency, by manager and style, blending complementary and distinct approaches such as value with growth and quality, to protect capital as far as possible during the market’s downturns while capturing the upside which we believe is still to come in this extraordinary cycle.

Kind regards,

Glyn Owen