momentum

2014 – A year in review and looking forward to 2015

January 2015

global investment management

2014 in review

Oil's move in the second half of the year is probably the most notable element of 2014. This was crude oil's biggest annual decline since 2008 and inevitably it weighed on the energy sector. Despite this late drag on performance the US's S&P 500 was the best performing major market and while not quite finishing the year at the highs that were regularly tested earlier in the year, it was not far off. Last year was the global market's sixth in a row where it has gained and this is the first time that this has occurred since the 1990s.

Looking back on 2014 it was a bit of a circuitous journey, but the destination was reasonable if unspectacular. Overall, global equity returned 4.9% in US dollar terms thanks, largely, to excellent returns from the US market of 13.0%. Japan also made it into double figures in yen terms, but the fall of the currency against USD was sufficient to result in a negative return in USD. Other majors such as Europe and the UK also made it into positive territory in local currency but the strength of the greenback meant that these returns were negative in US Dollars.

China's Shanghai composite enjoyed a stellar second half of the year to bring its 2014 return to +58.0% in yuan terms. It is interesting to observe these levels of gains against a somewhat shaky economic background, serving to remind us once again the importance of investing for valuations rather than a macro story. We have certainly seen this scenario in reverse a number of times in China as its economy powered ahead but its stock market floundered.

There are still plenty of issues for markets to contend with. A combination of geopolitical risk, energy shocks and underwhelming economic prospects have weighed on emerging markets stocks. In fact the MSCI Emerging Markets (EM) index finished the year in negative territory for the second time in a row; the first time in twelve years. Most notably the Russian index fell 42.1% in US Dollar terms, thanks in large part to the weakness of the Rouble.

Global bond markets enjoyed a strong year. The United States 10 year Treasury started the year at 3% (in fact the close of 31 December 2013 was the highest the bond would yield – it was all downhill from there) and finished at circa 2%. US Treasuries gained 6.1% and UK gilts gained 14.1%. European government bonds performed similarly to the UK's gilts. From these levels the upside is limited and the ability of bonds to provide a meaningful diversification to the equity market is lessened.

US high yield provided modest gains despite being weighed on heavily by the energy sector in the second half of the year. This was sufficient for the US High Yield market to lag the investment grade index (a higher quality index) – in fact the return from high yield was only 1/3 of that of Investment Grade and less than half of that from US Treasuries. In both the UK and Europe, Investment Grade corporate debt was unable to keep pace with the double digit gains from the government component, but they were close. Despite these returns from global government bonds, the performance of their local currencies were such that the returns when translated into USD was modest at 0.8% for the year.

While emerging markets equity suffered, emerging markets bonds performed reasonably well, with a return of 6.2% in US dollars, which is in line with the US Treasury market.

The year was a good one for property securities; with the Global property markets returning 13.6% to keep pace with the US equity market. In fact the best performing region was the US with returns just shy of 30% for the year.

While oil has hit the headlines for the wrong reasons last year it was not the only commodity losing value over the year. In fact, agricultural commodities fell by nearly 7% and gold drifted off by 1.7% over this period.

Oil

In summary Brent crude is now trading at below USD 50 a barrel, not far off a third of the level of 140 it peaked at in 2008 and significantly below the 110 level it has peaked at repeatedly post the global financial crisis. It is now at the lowest level since 2009. There is a lot of speculation over what is driving the oil price moves both with respect to the demand and supply side. If we look at demand first, it is clear that activity is slowing, or at risk of slowing, in a number of key economic areas. The US appears to be doing relatively well whereas Europe appears to be slowing and perhaps on the brink of a recession and Japan's economy also has faltered following the increased sales tax in April. China's economy is also pretty ponderous at the moment and so it is perhaps unsurprising that demand for commodities is unexceptional today.

The supply dynamics are also interesting. For example, oil generated by the US is at meaningful levels now; indeed it is at the highest levels for decades. There is a suggestion that OPEC (Organisation of the Petroleum Exporting Countries) is happy to let the price of oil slide to squeeze high marginal cost of production producers. There is, however, another train of thought that suggests the intransigence of OPEC is a symptom of the waning influence of the cartel and that in fact the cut to production would not necessarily have as predictable impact on the price of oil as it would have had in the past.

Either way, we know that, for now at least, oil is relatively cheaply priced. Cheap oil is unambiguously positive for the global consumer because it reduces one key element of their consumption basket. Conversely, of course, it is bad news for oil exporters. There are a large number of oil producers that still make profit at today's levels – the traditional oil producers in the Middle East for example, but the issue there is that their economies are often run with a higher target in mind – essentially the extra revenues from an elevated oil price to subsidise parts of their economy.

Central banks

Central banks continued to pursue extraordinarily loose monetary policy.

Last year we experienced Fed tapering and then in October the end of Quantitative Easing (QE). It is fair to say that while the proposition of QE tapering was greeted with dismay in 2013 – remember the taper tantrum – that it had been so well flagged that when it actually came, the tapering and end of QE was something of a whimper. While the US is not actively increasing its QE programme, it continues to reinvest interest and principal and as a result, the Fed's monetary policy is still extraordinarily loose. Indeed most, if not all, major central banks are still poised in the same direction.

So far the divergence between central banks has been one of a large degree with the likes of the ECB and BoJ intensifying their efforts while the US sits on its hands, but the next stage should be a more meaningful divergence. The inevitable strains in the Eurozone will be contained in 2015 and the ECB will engage in full scale QE.

Indeed, we could be on the cusp of a year where we start to see divergent interest rate policies from the major central banks for the first time since the financial crisis. The UK could be close behind while the US appears closest to taking the next step in tightening their policy . We think that the fall in oil price has provided the Fed further breathing space and as a consequence we do not anticipate any interest rate tightening until well into the second half of the year.

While the proposition of increasing interest rates in the US could finally put some pressure on the Treasury market we would expect to see continued support for other government bonds in the coming months in light of further loosening of policy. Even in the US, as and when interest rates rise, a combination of sluggish growth, modest inflation and demand from liability matching investors should keep longer bond yields relatively anchored. As a result we would not expect to see a bloodbath in the long end of the curve. This is because we expect the short end of the curve to drift up rather than the whole curve shifting up.

Multi asset

While equity markets were somewhat less surefooted last year, we expect equity markets to continue to deliver attractive returns over the medium to long term. We have a combination of reasonable (not cheap) valuations, improving growth in some large global economies, supportive monetary policy where this is not the case, reasonable earnings growth and solid balance sheets, coupled to the recent helping hand provided by the fall in oil. We must continue to contain our enthusiasm, however. We expect to see bursts of volatility return to the markets and these are inherently unpredictable and painful if you are on the wrong side of them. As a result, portfolio risk controls will continue to be of the utmost importance. Also, if we see markets dominated by QE style flows once more, it is possible to see bonds and equities moving the same way over periods next year making the traditional diversification benefit from the fixed income market less impactful. Furthermore, given how low yields are today there simply is not much headroom in the fixed income markets and as a result their potential to reward when the equity market sells off is modest.

Europe

The Eurozone is not firing on all cylinders and as a result it seems increasingly likely that the ECB finally delivers the remedy that the market has been waiting for; the outright purchase of sovereign bonds. The case to be made for monetary stimulus in Europe is enhanced by the fall in oil price as it puts pressure on headline inflation rates which were already perilously close to dipping into deflationary territory. The inevitable strains in the Eurozone will be contained in 2015 and the ECB will engage in full scale QE.

Longer term there has to be a Plan B, the euro cannot continue in its current form – this is likely to take the form of enhanced fiscal consolidation across the Union, something akin to federalisation would serve to make a currency union far more sustainable.

As it stands Greece's impending poll – with Syriza looking like a winner – demonstrates the risk of austerity fatigue and even the breakup of the Eurozone – a common topic of discussion in 2012, could yet again return to surprise us. Recently, the German periodical Der Spiegel suggested that German Chancellor, Angela Merkel, is now confident that Greece leaving the euro would no longer be calamitous (although this assertion has now been refuted by the German government). Der Spiegel noted that Ms Merkel and her finance minister, Wolfgang Schaeuble, believe that the reforms put in place following the 2012 euro crisis are sufficient to prevent contagion across the continent, citing German government insiders. With the possibility of Greece leaving the euro area in a so called "Grexit", the currency has fallen to a nine-year low versus the greenback at time of writing.

Geopolitical risks

We expect that these will raise their heads from time to time throughout the coming year and cause further volatility. The largest single geopolitical risk factor is Russia, given their military assets and their apparent appetite for trouble recently. Nevertheless Russia is clearly feeling the pinch and so any international adventures are becoming increasingly difficult to finance, unless the government opts for further populist aggression to deflect attention away from deteriorating conditions at home. North Korea hit headlines recently and this serves as a reminder that geopolitics are inherently unpredictable. Indeed, a year ago most of us had not heard of ISIS (or ISIL). They made quick progress in the first half of last year before becoming bogged down in the second. The ability of ISIS (or ISIL) to finance is made somewhat more difficult by the drop in the price of oil and as a result they may find it more difficult to progress in 2015. Furthermore, oil exporters may also see their public finances come under pressure, which could, in time, lead to civil unrest.

The important aspect from an investment perspective is that the economies and markets involved – even Russia – are relatively small and as a result their impact on the global financial system is moderate in their present state. Were any of these conflicts to escalate materially, however, then things may be different.

China

China must continue to try to balance their need to move towards a consumption rather than investment driven economy whilst ensuring that a population that is accustomed to rapid growth and wealth creation, both benefits and perceives to benefit from any such rebalancing. It is a difficult situation to engineer and it is being done against a backdrop of growing credit and patchy economic performance.

China's GDP is still 46% driven by fixed capital investment and only 36% by household consumption, whereas the likes of the US will have approximately double the amount of domestic consumption as a percentage. So China does still have work to do and does not yet show the necessary momentum to let the reforms work themselves out. What China does still have, however, is money and they will continue to drive the economy when it flags through investment. For example the FT recently reported that there were 300 infrastructure projects with a value of USD 1.1tn that have been accelerated this year to generate activity. China is an oil importer, however, which is positive, but nevertheless, it appears that the world cannot rely on it to be the engine of growth on an on-going basis – other economies must step in to pick up the slack.

Japan

Prime Minister Abe is on a high stakes bet that his monetary and fiscal reforms will stimulate the economy. This suffered some knocks last year as the result of the consumption tax increase had a first positive and then severely negative impact on activity and led to a shelving of a second proposed increase.

The Bank of Japan's (BoJ) balance sheet has swollen to 60% of Japanese GDP and the BoJ is even buying equity. Furthermore the $1.2 tn Japanese Government pension fund is doubling its exposure to equity.

Beneath the surface Japan is an interesting investment proposition; dividends are beginning to grow and buybacks too and Goldman Sachs believe that these will continue to rise from what is their highest level in 6 years.

Japanese equity also remains cheap and as long as the Yen can remain weak on the face of some stiff competition elsewhere (e.g. falling Euro); this should be good for exporters.

US

The US economy appears to be in a cyclical upswing and is one of the few major economies expected to grow faster in 2015. Steady growth in employment, a stable or lightly improving housing market and rising consumer spending power thanks to the oil price all bode well for a growing economy.

BlackRock data suggests that ultra-loose monetary policy flowing into house prices and stocks has boosted the net wealth of households in the US by $23tn.

Unemployment rate continues to grind down and is now below 6%. Companies are hiring, suggesting a positive outlook from corporations and again is likely to help consumer spending. Risks to this include weak global demand and a strong dollar hurting exports.

Corporate earnings are also a risk - if growth disappoints, valuations could come under pressure. Companies have picked the low hanging fruit by slashing costs following the global financial crisis – it is difficult to envisage scenarios where companies get double digit growth if GDP is only 4%, it relies on a lot of highly skilled managers or clever use of leverage.

Implications for funds

Equity is a bit on the expensive side, but still not too bad compared to both its own history and to the other available options (for example, high quality sovereign debt). The cheaper regions include Global EM, UK, Europe and Japan. All of these areas have their own risks – UK election for example we have not considered in this document, but we think the rewards are worth the risk especially in this environment.

Within Fixed Income, government debt looks expensive – but there is a little health warning here because we thought the same last year. Nevertheless, from here it is difficult to make the case for holding duration – interest rate risk – for anything other than diversification tool. Nevertheless it is possible for government yields to go lower from here and so to be too aggressive on duration is a big risk for a multi asset fund to take today. Having said that the upside from fixed income is limited and the risks do appear asymmetric. There will be poor real returns if there is a sniff of inflation.

Credit is still interesting in part but some of the trades here are crowded so it is important to bear in mind the liquidity of an asset class as you do not want to be caught out by a rush from an asset class. US High Yield is cheaper now as long as you do not mind buying some energy names. Investment grade is a useful substitute to government debt. Convertibles are interesting because volatility is low, meaning that the equity option is cheap and long-term equity market participation with a bond floor is attractive.

Emerging market debt is attractively priced but investors must accept the assumption of credit risk and also be confident that sentiment regarding Global Emerging Markets does not sour meaningfully. The strong USD is not good news for EM, especially those with frail and over extended economies as we saw to an extent in the taper tantrum.

Cash remains a reasonable store of value for investors and we look to hold a reasonable amount in a portfolio to put to work in the markets as and when valuation opportunities present themselves.

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