Monthly Commentary

February 2015

Review

- February proved to be a strong month for global equity markets, as investors became increasingly optimistic over Greek prospects and the global macroeconomic environment. The FTSE 100 rallied to hit a record high at the back end of the month, beating the high last set on 30 December 1999, as Greece was granted extra time by their creditors and the UK economy showed continued signs of strength.
- UK inflation fell to an annual 0.3% price rise during January, a historic low. The falls were driven by significantly lower energy prices as well as lower food prices as a consequence of a supermarket price war. Fourth quarter UK GDP growth of 0.5% confirmed that the UK economy has expanded for eight consecutive quarters. The Pound reached a seven year high against the Euro following the European Central Bank's (ECB) announcement on the initiation of quantitative easing.

	Index Level 28 Feb 15	% Change February	% Change 1 Year
FTSE All Share £	3744	3.7%	5.6%
FTSE 100 £	6947	3.3%	5.6%
MSCI World $	1773	5.9%	8.4%
S&P 500 $	2105	5.7%	15.5%
MSCI Emerging Markets $	990	3.0%	2.5%
	Index Level 28 Feb 15	**Index Level 31 Jan 15**	**Index Level 28 Feb 14**
UK 10 Year Gilt Yield %	1.80	1.33	2.72
GBP/USD	1.54	1.50	1.67
GBP/EURO	1.38	1.33	1.21
Oil - WTI $	49.8	48.2	102.6
Gold $	1213	1284	1326
Wheat $	518	503	599

Source: Bloomberg

- Investors have remained jittery regarding Greek progress and debt proposals. Hopes were boosted when Greece secured a four-month reprieve from its creditors, preventing a default, on the condition that the Greek government delivers a list of reform measures. This came following a week of negotiations with Greece aiming to extend its €240bn rescue package beyond the end of February. The European Central Bank (ECB) called on the Greek government to reach a deal whilst only allowing a small increase in emergency funds for Greek banks and Germany rejected an initial Greek request for a six-month extension. However the extension was agreed upon during a last minute meeting in Brussels.
- The Greek finance minister, Yanis Varoufakis, had his proposed economic reforms approved, thus confirming the four-month extension to the country's bailout. However, the IMF voiced concerns that the proposal did not give 'clear enough assurances' that the government intends to implement the reforms. Yields on Greek bonds fell after the extension was officially granted, and Athens' stock exchange jumped almost 10%. Meanwhile, deflation in the Eurozone deepened with a 0.6% drop in the year to end of January. This is the largest drop since 2009. The move cannot be solely attributed to falling commodity prices, with core inflation, which strips out energy impacts, also falling. The unemployment rate in the Eurozone fell marginally to 11.4%.
- Five-year notes were sold by the German government at a negative yield for the first time in the country's history. €3.28 billion of bonds were sold, just days before the €60 billion per month quantitative easing program began in the eurozone.
- US equities performed well throughout the month with many stock markets hitting new highs. The S&P 500 closed at 2105 after reaching fresh highs earlier in the month following Janet Yellen's comments being taken as a cautious sign as she spoke of the Federal Reserve's (Fed) flexibility in deciding when to raise rates. GDP in the US grew at an annual rate of 2.2% in the fourth quarter of 2014, less than the 2.6% previously estimated, due to a slower rise in inventory investment than expected. Consumer confidence however is on the rise and consumer spending increased at its quickest rate since early 2006. Reductions in oil and gas drilling could slow down the economy's expansion, but the effects of this are yet to be seen. The strong consumer spending is also yet to feed through to inflation, as the US continues to import the low oil price. However, Fed minutes showed officials are increasingly debating the merits of remaining patient over a rate rise following months of strong labour market announcements.
- The People's Bank of China (PBoC) cut interest rates for the second time in just three months in response to slow growth and deflationary pressures. Chinese PMI data remained below the 50-point level at 49.9, indicating a contraction in manufacturing for both months so far in 2015. The 0.25% cut will in part provide a cushion to property prices, following their biggest ever annual fall. The PBoC also lowered its reserve required ratio by 0.5% to 19.5%, freeing 500bn Yuan for banks to lend, in an effort to shore up the economy after data prints for growth were disappointing in January. The Hong Kong-Shanghai Stock Connect permitted the short selling of selected Chinese shares in the month through the exchange, in a further move to open China's markets to international capital.
- The Japanese economy officially came out of recession during the fourth quarter with annualised growth rate of 2.2%. However, this is less than the 3.7% forecast. The Japanese Nikkei 225 reached its highest level in seven-and-a-half years during the month, despite the ongoing uncertainty surrounding Greece. Orders for Japan's core machinery rose, buoyed by the weak Yen.
- The Reserve Bank of Australia unexpectedly reduced its interest rate by 0.25% to a record low of 2.25% and stated their belief that the Australian dollar is overvalued. The move came on the expectation of lower growth, with Australian stocks rallying following the news and bond yields fell to record lows. The Swedish Riksbank also surprised many with a move to a negative interest rate, moving to -0.10% from zero.

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Outlook

- Consensus continues to view equity and credit markets as offering greater long term value than government bonds. UK & US government bonds have become vulnerable to yield movements, as witnessed in February, with both the Bank of England and Fed edging further along the path to monetary policy normalisation. Meanwhile Europe, Japan and China battle the trepid mix of deflationary and recessionary scenarios through expansive monetary policies. Central bank policy will remain the key determinant of asset class performance going forward.
- US economic growth has remained robust, and recent strong employment data prints have increased market speculation on the timing of Fed rate hikes. The Fed is eager to normalise monetary policy going forward, avoiding the formation of Greenspan-era asset class bubbles. That said, we maintain the Fed will take a cautious stance with regards to interest rate rises in the coming months. Inflationary pressures remain benign as oil prices continue to languish at multi year lows and the strong US Dollar serves as an efficient drag on inflation. This should provide the Fed with additional time with which to evaluate the US economy. With six years of QE ended in October (now rolling maturing bonds) we are under no illusion as to the dangers of rate rises in 2015 upsetting the applecart.
- UK economic growth looks to have slowed slightly, but remains positive, unemployment continues to improve (5.7%) and business confidence surveys remain fairly robust. The path may have been set for a normalisation in monetary policy, subject to a broadening of the UK recovery. We continue in the vein of thought that an interest rate rise may be slow in coming as the Bank of England (BoE) has adopted a more flexible approach to forward guidance to ensure that economic spare capacity is absorbed. The uncertainty surrounding the outcome of the general election in May is likely to be a headwind to the economy in the near term as investment is curtailed. We do not expect that the BoE will change the direction of policy until after the election.
- Global monetary policy is diverging with the ECB quantitative easing program and the Bank of Japans (BoJ) stimulus justifying a skew to government bonds and risk assets in each region. In contrast the Fed and BoE are both toying with the timing of policy tightening.
- In Japan, Prime Minister Abe and Bank Governor Kuroda's best efforts to encourage inflation continues, despite government bond yields trading at lows as investors take caution amidst the mixed Japanese data prints, oil price weakness and geo-political concerns. The Japanese Yen should weaken further, aiding both export orientated business and inflation and the equity market is seeing the first signs of the increased risk appetite from the government pension scheme. Policies announced under the Third-Arrow banner appear to be changing the actions of corporate Japan and Prime Minister Abe's re-election in December facilitates the implementation of the plan. However, recent commodity weakness places significant headwinds on the BoJ and government to generate the desired inflation. The consequence of significant balance sheet expansion are yet unknown.
- Wider emerging market valuations remain attractive in the context of historic growth and expected forward consumption. However, we expect a wide dispersion in country returns going forward as a strengthening US Dollar and weak commodity prices affect both emerging market currencies and the cost of financing debt. Chinese policy makers, following the success of policy tightening, are now faced with managing monetary policy in order to ensure growth continues given inflation continues to fall sharply.
- Falling energy prices will be generally positive for economic growth and corporate profit margins in near term, however the reduction in exploration and new investment by oil & gas exploration / services companies means that over the medium term supply side dynamics will once again shift pricing power back to the lowest cost producers in OPEC. Non-energy corporates should enjoy the tailwind of lower input costs that oil price falls provide.
- In summary, equities are attractive on a relative basis but are less attractive from an absolute perspective. Despite the low oil price we still view softening profit margins and subdued earnings growth as a corporate risk (impacting equities and bonds). Markets have proved resilient to global geopolitical tensions in the Middle-East. We do not see inflation as a risk in the short term, but the longer term picture is less clear given the unknown consequences of global monetary policy and the reversal of the fall in energy and commodity prices. The key risk to markets remains that of the global central banks. While we do not expect significant a rate rise in the short term, action in US and UK during 2015 remains on the cards. The repercussions of such action are unknown and for this reason we expect the BoE and Fed to proceed with relative caution in raising rates. In contrast, we expect the ECB and BoJ to maintain a loose monetary stance during 2015. In aggregate this will lead to loose global monetary policy and a skew to risk assets such as equities, which should benefit from such an environment. 2015 is likely prove another challenging year from an asset allocation perspective.

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Asset Allocation

View	Positive Points	Negative Points
UK Equity Neutral/Positive	• Global monetary policy remains supportive of equities. • Equity yields are attractive relative to gilts & credit. • Companies have strong balance sheets, resilient corporate margins and strong cash generation. • Potential for further capital flows from cash / fixed income markets. • Merger & acquisition activity continues.	• Negative earnings revisions and the potential for revenue growth to stagnate. • Valuations look expensive relative to earnings and relative to history. • Central banks tightening ahead of expectations. This could be negative given the FTSE's skew to cyclical stocks. • IPO activity reducing.
Global Equity Neutral/Positive	• Global monetary policy remains supportive of equities. • Equities are attractive on a yield basis relative to investment grade credit and G7 government bonds. • Companies have strong balance sheets. • Earnings growth has been stable and corporate margins resilient (despite elevated levels through QE). • Merger & acquisition activity continues.	• Many companies have continued to downgrade guidance on earnings. • Developed market valuations are looking expensive, notably in the US. $ strength will act as headwind to overseas earnings for US companies • Government debt burdens and US tightening in rates remain a risk.
Emerging Market Equity Neutral/Positive	• Attractive valuations vs. global developed market equities. • Favourable demographics provide long term structural support with a consumption backbone. • Long term growth expectations greater than those of developed markets.	• Investors are factoring in a lower long run sustainable growth rate in China. • Soft commodity prices continue to weigh on companies and countries with a resource bias. While this is partially offset by a strong US Dollar, the US Dollar strength poses funding pressures and exacerbates local currency volatility. • Emerging markets remain susceptible to the whim of foreign investors with investment flows driving short term volatility in both equity bond and currency markets.
UK Fixed Interest Gilts Neutral/Negative	• Continue to be viewed as a safe haven investment. • The long end (of the curve) is expected to remain relatively stable compared to the front end, as the BoE edges towards rate normalisation. • The deflationary pressures in Europe & associated ECB action are spilling over in to the UK gilt market, leading to lower rates for the UK government. • Any further increases in political risks or a softening in global economic data would see a further fall in yields.	• Positive and trending economic growth with falling unemployment may result in an earlier than expected rate increases. • Short dated yields remain unattractive given the expected path to monetary policy normalisation in the UK and yields should move higher in the medium term. • UK government borrowing continues to exceed forecasts. • The uncertainty of the UK election will weigh in on investor sentiment.
UK Index Linked Gilts Neutral/Negative	• Longer term bonds offer a modicum of return in excess of long term inflation. • Continued demand from LDI / Pension schemes. • Supply remains constrained.	• Real yields remain unattractive across the curve. • Inflation has been persistently below the MPC's target, though expectations are anchored to being marginally above target over the next 10 years.
UK Corporate Bonds Neutral	• Yields are reasonably attractive relative to gilts. • Recent weakness makes lower rated issues more attractive. • Demand remains elevated in this yield hungry environment.	• Spreads are tight relative to history. • Interest rate risk is a concern, while reduced issuance (excluding Financials) and lofty valuations make Corporate Bonds less attractive. • Longer dated issuance has dried up light given cheaper Euro financing costs.
UK Property Neutral/Positive	• Attractive yields relative to credit and gilts. • Property provides a degree of inflation protection with inflation-linked contracts. • Demand for prime property remains high and positive economic growth is pushing up occupancy levels.	• Valuations for prime properties are expensive. • Construction activity is increasing, with an increase in construction costs. • Central banks tightening ahead of expectations.
UK Cash Negative	• Short-term safe haven.	• The real value of cash continues to be eroded as interest rates trail inflation.
Absolute Return Positive	• With valuations on equities relatively expensive and bonds potentially reversing course on the 30 year bull market, risks in traditional asset classes are increasing. • Dispersion in market returns suits long/short, managed futures and multi asset strategies.	• Short-term reversals as a result of political risks and central bank actions can be negative for trend following strategies.

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