Monthly Commentary

January 2015

Review

	Index Level 31 Jan 15	% Change	
		January	1 Year
FTSE All Share £	3622	2.6%	7.1%
FTSE 100 £	6749	2.9%	7.4%
MSCI World $	1678	-1.8%	7.6%
S&P 500 $	1995	-3.0%	14.2%
MSCI Emerging Markets $	962	0.6%	2.7%
	Index Level 31 Jan 15	Index Level 31 Dec 14	Index Level 31 Jan 14
UK 10 Year Gilt Yield %	1.33	1.76	2.71
GBP/USD	1.50	1.56	1.65
GBP/EUR	1.33	1.29	1.22
OIL - WTI $	48.2	53.3	97.5
Gold $	1284	1185	1245
Wheat $	503	590	556

Source: Bloomberg

- Greek election fears and a continued oil slide caused equity markets to lower early in January. However, the initiation of a quantitative easing package by the European Central Bank (ECB) and hopes over extended easy policy in the United States allowed equities to rally. Greece's change in government and possible default, global growth worries and some mixed corporate earnings sapped investor sentiment late in the month. European and Japanese markets ended higher aided by supportive monetary policy environment.
- The ECB confirmed it is to embark on a quantitative easing program worth at least €1.2trillion (€60bn per month until September 2016) to counter deflation and stimulate growth throughout the region. The risks of default will lie with individual European central banks, which will make 80% of the purchases, ensuring responsible management. The program has been initiated despite opposition by German officials, with Austria, Dutch and Estonian governors also cited to have reservations. The ECB confirmed purchases will be limited to 25% of any single bond and 33% of the instruments available from an issuer; allowing markets to price themselves efficiently. This followed intense pressure for the ECB to act following inflation numbers indicating the eurozone had entered a period of deflation. Following the announcement, the Euro hit an eleven-year low versus the US Dollar.
- The Syriza party in Greece won a historic victory in snap elections, as the population vented frustration with austerity. Alexis Tsipras, the leader of Greece's Syriza party, was officially sworn in as the Greek prime minister after successfully forming a coalition government. Markets focused on upcoming policies and Mr Tsipras soon showed intent to stick to the anti-austerity pledges by halting privatisation plans agreed under bailout terms. This sets Greece on a collision course with creditors, with some unwilling to renegotiate. Greek markets endured heavy falls on the news, with investors spooked by the repercussions of a potential default.
- The price of WTI crude fell below the $50per barrel mark for the first time since April 2009, with the price of Brent also falling on concerns over the current supply glut, weak forecast demand growth and OPEC's willingness to withstand a lower oil price.
- The Swiss Franc soared by as much as 30% in frantic trading following the Swiss National Bank's (SNB) shock move to scrap its 1.2 per Euro currency cap. The deposit rate was also reduced from –0.25% to –0.75%. The move by the SNB caused chaos in markets and has pushed several brokers who could not cover losses, such as Alpari in the UK, in to insolvency.
- The World Bank and International Monetary Fund both cut forecasts for global growth for 2015 and 2016. The reduced outlooks came despite the sharp drop in oil prices being a tailwind for many nations, although deflation is still a concern in the eurozone.
- Sovereign bond yields are likely to remain supported by extraordinary measures from central banks. The effectiveness of the negative rates in Switzerland, Sweden and Denmark are being assessed by many others and may allow for other central banks to follow suit.
- The Danish Central Bank cut one of its main interest rates for two consecutive weeks to negative 0.5% in a bid to keep its currency pegged to the Euro. Several other international central banks also acted to reduce interest rates during the month; Canada, India, Peru and Turkey all cut rates. The Reserve bank of India also cut its benchmark interest rate to 7.75% from 8.0%. The move comes after a slowdown in Indian inflation and pushed stocks, bonds and the rupee all higher following the announcement.
- The minutes of the latest Federal Reserve (Fed) meeting showed that policymakers are to remain patient over interest rate hikes, despite upping their assessment of the US economy and jobs market and highlighting the current low inflation environment. The Bank of England's (BoE) Monetary Policy Committee also voted unanimously to keep interest rates on hold for the month at 0.5%. UK unemployment fell to 5.8% although the level of job growth fell to its slowest pace whilst UK construction growth slowed.
- The Shanghai composite index for Chinese shares fell by 7.7%, the largest daily fall since 2008 as regulators tightened controls on margin lending after a strong three month rally. China's benchmark money market rate fell as the People's Bank of China injected liquidity by conducting 60bn Yuan of reverse-repos. This came as Chinese manufacturing contracted for the first time in two years.
- Russia's foreign currency credit rating was downgraded by S&P to junk status for the first time in over a decade as the economy continues to struggle amid falling oil prices and economic sanctions.
- Company earnings releases have been mixed. Apple posted a record quarterly profit by a public company ($18bn), however Caterpillar, the world's largest construction and mining equipment maker, disappointed and cut its outlook for 2015.

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Outlook

- In spite of the outsized returns from government bonds over recent months, consensus continues to view equity and credit markets as offering greater long term value than government bonds. This view is driven by the US & UK edging further along the path to monetary policy normalisation while Europe, Japan and China battle the trepid mix of deflationary and recessionary scenarios. Central bank policy will remain the key determinant of asset class performance going forward.
- US economic growth has remained robust. The Fed is eager to normalise monetary policy going forward, avoiding the formation of Greenspan-era asset class bubbles. That said, we maintain a dovish stance as to the committee's actions 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 (5.8%) and business confidence surveys remain fairly robust. Sterling weakness against the US$, coupled with lower oil prices, is positive for UK corporates. 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 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 lower as investors seek safe haven assets amidst the 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.
- In summary, equities are attractive on a relative basis but are less attractive from an absolute perspective. Despite the fall in the 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 / increasing.	• 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. • Government debt burdens and Global 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. • 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.
UK Index Linked Gilts Neutral/Negative	• The MPC has indicated that a higher inflation rate will be tolerated, assisting the UK's funding rebalance. • Longer term bonds offer a modicum of return in excess of long term inflation. • Continued demand from LDI / Pension schemes.	• 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. • Long dated maturity profile embeds interest rate risk.
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 given, while reduced issuance (excluding Financials) and lofty valuations make Corporate Bonds less attractive. • Longer dated issuance light given cheaper Euro 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. • Central bank dominated markets can be negative for long/short strategies.

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