

Great Expectations

A review of 2014 and outlook for 2015.

"Spring is the time of year when it is summer in the sun and winter in the shade." Charles Dickens, Great Expectations.

If you were a stock market strategist harbouring secret desires to be a writer of novels or soap opera storylines, you might have been tempted to write the entire chapter or script for 2014 in advance, for there were plenty of reasons to feel confident that the problems of the global economy in 2013 were at least well understood and, possibly, that markets would be more predictable in the year to come.

Indeed, the consensus view had great expectations that equities would enjoy a year in the sun whilst treasuries and gilts caught a chill. This view was so strong as to make any deviation from the expected plot almost unthinkable. With all the essential characters in their place, the year started with equities and bonds behaving more or less as expected. Equities made a push to new highs while sovereign debt struggled as the market waited for the big bond sell off.

However, in the spring, there was a twist in the plot which threw the two asset classes into a different relationship with bonds rising hand in hand with equities which, despite odd bouts of profit taking, repeatedly tried to recapture the highs. This was driven, in part, by an expectation that the US and UK economies were steaming ahead but reinforced by the slightly unconventional thinking that any bad news would be met by further stimulus from central banks desperate to keep momentum going – i.e. more buying of bonds. This happened despite the one thing that was definitely going to script; the winding up of the Federal Reserve's bond buying program which many believed would be bad for bonds.

If you were overweight equities, the year went rather well if you kept your nerve, avoided obviously bad investments and bought opportunistically on dips. If you didn't hold many treasuries or gilts, your relative performance took a hit but you might be, on balance, content that the absolute gains to be made from them were limited because yields were so low to begin with. A bit like a man with his feet in the oven and his head in the freezer might be described as being, on average, happy.

That's not to say that there weren't plenty of things for markets to worry about and, as we said at the start of the year, there were likely to be periodic setbacks spooking markets as a result of any number of well flagged issues which are as familiar today as they were then, with a handful of new entrants.

Naturally, this list remains relevant for 2015:

- Strong US dollar. Bad for emerging markets.
- Fear over eurozone disinflation/deflation.
- Chinese property bubble.
- Ukraine. Sanctions between US, EU and Russia.
- Falling oil price.
- Ebola
- Brazil. Or rather economic slowdown in 3 of the 4 BRICs.
- End of US Quantitative Easing.
- Fear of rising interest rates in US and UK.
- Middle East: Syria, Iraq, ISIS, Iran.
- ECB inaction/inability to intervene.
- Israel and Gaza.
- German Industrial production slowing.
- UK inflation weaker than expected.
- Low wage growth despite falling unemployment.
- Italian politics.
- French politics.
- Expensive equity valuations.
- Expensive bond valuations.

Things worth being concerned about…

After conducting an audit of this list of dreads, we concluded that the three main culprits worrying the markets in 2014 were the first three above highlighted in bold. Everything else on the list was given high profile coverage in the media but, whilst we don't doubt their sincerity in wanting to deliver newsworthy

stories, we concluded that this is where we saw the greatest threats to the positive outlook for equities that we held here at TAM. There is a fourth, a freshly invigorated character halfway down the list, in the form of the European Central Bank (ECB) who makes an unwelcome return every few months to unnerve skittish markets.

The ECB and lack of action…

Global markets have been waiting for in vain for the ECB to undertake some kind of stimulative QE all year although it's a debate that's been hanging in the air since before 2012. The lack of action in implementing this under the direction of its president, Mario Draghi has been frustrating, but expectations have ratcheted up significantly as eurozone inflation numbers have fallen towards zero, much to the apparent bafflement of the ECB who steadfastly stuck with a 2% target despite all the evidence that it was time to act.

Alas, as we all know, the ECB is not a central bank that enjoys a clear mandate over a fiscal and currency union. And that means that one has to reach for the complicated flow diagram attempting to explain who actually bosses any one of the following: Europe/European, Union/European, Council/European, Commission/Eurozone. Hitherto, the will they/won't they debate has revolved around whether the ECB could implement QE in the face of the objections of the German central bank, the Bundesbank. This time, with the eurozone now in deflation it looks like this time is different. Mario Draghi is all fired up to start up some kind of QE in the hope of kick starting inflation and economic growth.

Markets want full fat QE

We think the ECB will overcome the objections of the German authorities and implement some kind of quantitative easing in the next two months, possibly as early as 22nd January. We say "some kind" because global stock and bond markets will expect it to include the purchases of sovereign bonds. But this is by no means a certainty if the ECB is to be judged on past performance. After all, let's not forget Mario Draghi's famous statement that the ECB "would do whatever it takes" to defend the Euro. This was nothing more than lip service and it has effectively not cost the bank a single cent.

However, bond yields have fallen further since Christmas, which naturally extends to UK Gilts and US Treasuries, reflecting the heavy expectation that now is the time. For the amount of money being bandied about as what will be necessary to move the needle on growth and inflation, the view is that it will have to be something north of a trillion Euros; an almost incomprehensible number outside the world of central banking. And the only asset class that that could possibly take that amount of money is well beyond the relatively illiquid corporate bonds currently being hovered up from the back books of European banks keen to bolster their balance sheets. Markets will be expecting the ECB to target buying of pan-eurozone Government bonds. Anything less may result in a short term sell off in sovereign debt and is something the TAM investment team will be watching daily.

The big caveat…

Euro QE may do wonders for the values of peripheral bonds yields (Greek 10-year bonds are yielding 14.0%, for example) but, with some short dated bond yields in Germany already in negative territory and their 30-year bond yield now less than 1.0%, and, furthermore, Spanish bonds yielding less than their USA counterparts, one has to ask if the prospect of ECB quantitative easing is already in the price of the core eurozone bonds.

With a twist…

Whilst the potential for corporate and household borrowing may, in theory, be boosted by lower rates, we do not expect this to offset the deflationary pressures of falling oil and food prices, particularly with the high levels of unemployment evident across the eurozone. Low inflation, we believe, is here to stay but the effect of a flood of cheap liquidity on asset prices, by which we mean the stock market, could be very positive for European equities.

There are naysayers on this point but one must consider the way in which money flows. QE may not immediately benefit company profits and the consumer, but it could be very good for asset prices in a "risk on" market looking for a return greater than zero, which you get on cash.

The paradox of low interest rates and low inflation

The TAM investment team have for some time been considering an alternative view of the current relationship between interest rates and inflation. The conventional wisdom is that a growing economy will eventually lead to inflation and that your central bank will stand ready to raise interest rates if inflation rises too quickly.

But what if the Bank of England, for example, is actually causing low inflation by holding rates low? Consider a simplified scenario several years ago when interest on deposit was around 6.0% or 7.0%. You might, if you had some savings, consider treating yourself to a new car. Now the dealership is all ready and waiting with a sticker price on the car out front which is a bit higher than last year. Why? Because they know your average car buyer has earned a bit of interest in the last 12 years and maybe feeling a little bit better off.

This thinking resonates with what's been happening in Japan since the 1990's. A persistent absence of inflation over this time has kept prices virtually unchanged. There now exists an entire generation who have never experienced rising prices. Interestingly, this same generation have, broadly, never sought a pay rise from their employer. Consequently, union membership has fallen because the need for their collective bargaining capacity has been made redundant.

Reasons to be cheerful…

On a positive note, and reflecting the equity portfolio overweights that we have maintained throughout 2014 in UK and US equities, the economy and corporate earnings grew faster than many expected and unemployment fell. It would've been nice to see stronger wage growth but, when it didn't come, it gave the Federal Reserve and the Bank of England the excuse to do what they were going to do anyway, which is nothing.

Rates stayed low and so the prices of Gilts and Treasuries, which move inversely to interest rates, stayed strong throughout the year and went even higher into the final quarter as there emerged renewed concern over eurozone economic growth and deflation worries, compounded by the collapse in oil prices, which ultimately suppresses prices further.

We bought Japanese equities early in 2014 which performed well despite a weakening Yen limiting the

gains for Sterling and Dollar based investors. However, this is a familiar scenario as foreign investors typically buy the well known exporters that may benefit from a weaker Yen, such as Toyota, Canon and Sony. However, we believe that we are now best positioned to benefit from the reflationary policies being implemented and are invested more towards financials and real estate, for example, which should benefit in an improving domestic economy.

Throughout the year, we have maintained a good mix of investments in large multinational companies in addition to well researched small and mid-sized companies. As interest rates stayed low, we also stayed invested in income generating funds that we have held since 2008 for their superior yield.

Steady performance despite a volatile 2014

As we reflect on our outlook for 2014 and what we thought would happen last year, the TAM investment team made the right calls on all the asset classes either wholly or in part. UK Equities took their lead from the economic fortunes of the USA which led global stock markets despite an initial fear that all the good news was already baked into valuations.

Considering the UK stock market for example, starting from a December 2013 FTSE 100 Index level of 6,749.09, and factoring in 7.0% earnings growth and about 2.3% of dividends, it was conceivable that our expectation would come good that the FTSE would break up decisively above 7,000. For a majority of companies within the index, this is pretty much what happened unless you were a mining or oil exploration company, two sectors that make up a quarter of the FTSE All Share index and dragged the FTSE average down.

Happily, not only were TAM equity portfolios overweight the US, where these sectors make up proportionately less of their stock market, the UK equity investments in TAM portfolios were very underweight mining and oil which were naturally exposed to the economic slowdown in China initially, but also to the remarkable collapse in the price of oil where the price of Brent crude halved and has now dipped below $50 per barrel. Avoiding these sectors made the difference between following the FTSE to a 2.7% loss and making a +4.0% to 5.0% achieved by the TAM equity portfolios.

TAM clients are not exposed directly to the weakening of the Russian Rouble. Our emerging market investments have long excluded Russia from the “BRIC” (Brazil, Russia, India, China) investment area. Without the rule of law, valuations are meaningless, and whilst Vladimir Putin may attempt to turn the currency collapse to his advantage, Russia remains uninvestible, in our opinion.
With Russia already out of the BRIC trade, we have a very cautious view of emerging markets. Whilst the bull case focuses in improving corporate governance and the ability of managements to self finance along western-style agreements, we are concerned that any progress could be offset by the strengthening of the US dollar in which a lot of emerging market debt is issued thus raising the difficulty of emerging market companies to fund interest payments.

We continue to be underweight sovereign debt in the US and UK

We remain underweight Gilts and Treasuries because regardless of whether the UK or US raise rates first, we believe they will go up. Unemployment continues to fall and whilst we accept that wage growth could be better, both central banks know that running interest rates at close to zero is not consistent

with economies growing at between 3.0% and 3.5%. We are conscious that UK bond yields are also inextricably linked to their eurozone cousins, such as German bonds, but with these yields practically zero or even negative, we cannot justify a bullish outlook for Gilts unless the economic outlook turns particularly dire, which we do not envisage.

As 2015 is a UK election year, it's tempting to wade into the political debate and the ramifications of a resurgent SNP, an unstoppable UKIP and the possibility of a grand coalition government post the election. But, broadly speaking, the TAM investment team are more interested in the actions of central banks. With the ECB about to start QE (in our opinion), the Bank of Japan implementing an almost unbelievable amount of QE, the Bank of England knee deep in QE and the Federal reserve winding up QE, we may as well talk about them collectively rather than apart.

Let us be clear, QE is not the great panacea for the ills of any economy and without a combined contribution from Government policy combined with genuine reform, no central bank can fix everything on its own because high level printing of free money is a world away from the pocket of the consumer who represents ultimate demand.

However, the money that it provides must ultimately end up being invested in asset classes that are liquid enough to absorb it. At the highest level, this mean bonds, equities and, to a lesser extent, property.

Overweight property in bricks and mortar…

We have added property to client portfolios generally and to "bricks and mortar" investments in particular. These are investments in physical property assets and the revenues that they generate. Whilst we are fully aware of the sky high prices commanded by London and, to a meaningful extent, the South East of England, we believe there are a great many opportunities in the secondary non-prime market in the rest of the UK. Our investments will also stretch to certain properties in Europe on a highly selective basis, conscious of the problems facing the eurozone as a whole.

Staying overweight equities in 2015

We have, over the last few years, noticed that market sentiment and commentary appears to have adopted a calendar year mentality. It's an interesting perspective and not without merit for there is a certain seasonality to geopolitics which commands greater attention from stock and bond markets that inevitably take their guidance from policy by governments and central banks.

Furthermore, with investors fixated on signs of genuine economic growth, bullish expectations are heavily reliant on third quarter company earnings results in October for they throw light on economic activity through the summer months but give guidance as to the state of the consumer in the all-important run up to Christmas and the retailing bonanza.

This year may have a slightly different feel because of the collapse in oil prices. Shares in the oil majors have obviously suffered as a result but, broadly speaking, the 20% fall in the value of the sector does not fully factor in a halving of the price of oil itself. Taking both this and analyst forecasts into account, it appears that oil prices are expected to stabilise and even rise before the end of the year. It is early days but we note that one or two developments in the sector such as the bankruptcy of the first of the high

cost producers in Canadian shale gas.

Nearly all TAM clients have exposure to some equities whatever their level of risk. We have maintained a positive view on equities for a few years now and have don't anticipate changing tack now. The equity investments themselves have broadly outperformed their benchmarks. Where they have matched the broader equity market, they have done so with less risk and avoided the worst sell offs that have hit stock markets in the face of any number of geopolitical shocks.

We believe that the time of reckoning is upon the eurozone but anticipated action by the ECB may well be positive after months of speculation and fear of the worst. In addition to retaining a positive outlook for UK and US equities, we will also stay poised to buy into sharp market sell-offs if we believe the opportunities outweigh the risks.

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