capital markets service

Quarterly update Q1 2015

The view through the oil filter

Graeme Johnston

The collapse of oil prices in the second half of 2014 will almost certainly have significant economic effects throughout the world. However, the reaction of financial markets probably reflects a crystallisation of existing concerns rather than any direct impact of lower prices.

Worries about global growth have been a feature for the last year and forecasts for 2015 are still edging lower. However, while the benefits of lower oil prices will be ill-divided, they should be positive for the world as a whole. Global growth was probably a little higher in 2014 than in 2013 and, despite the downgrades, it is expected to accelerate this year.

Headline inflation has already started to fall sharply and there is further to go. Core inflation has been more stable. It has been drifting lower, but that was generally true before the oil prices started to fall. Whether core inflation drops further and stays there for many years remains to be seen, but that seems to be consistent with what bond markets in particular are indicating.

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Government bonds (p3)

Forward gilt yields are now well below 3% p.a. at all maturities. This seems to discount an extreme risk as a given – a generation of nominal GDP growth at levels not seen on a sustained basis for a century. Where discretion allows, we would be as short of duration as possible. Where increasing interest rate hedging is an imperative, we would still prefer to focus on shorter maturities.

Index-linked yields have largely matched the fall in conventional gilt yields, in contrast to other major bond markets. This has limited the fall in the price of inflation hedging relative to global comparisons. We still think the opportunity to hedge on the best terms for two years should not be passed up lightly, although it should be assessed in the context of an overall risk management strategy.

Credit markets (p4)

Despite the widening of yield spreads since the middle of 2014, credit markets still do not look especially cheap, and illiquidity could be a concern for those who may need to sell. But the relative attractions of credit for strategic investors have improved. We would be less inclined to reduce investment-grade exposure below neutral in low-risk portfolios. We would be more inclined to look again at any plans for strategic diversification into higher yielding credit in return-seeking portfolios.

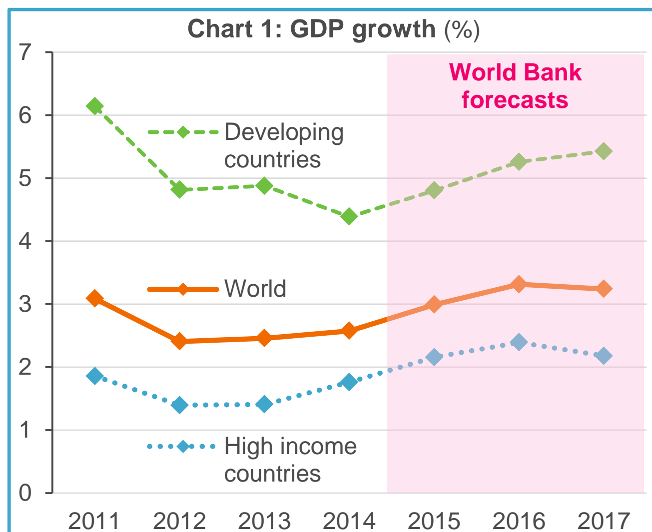
Equities (p5)

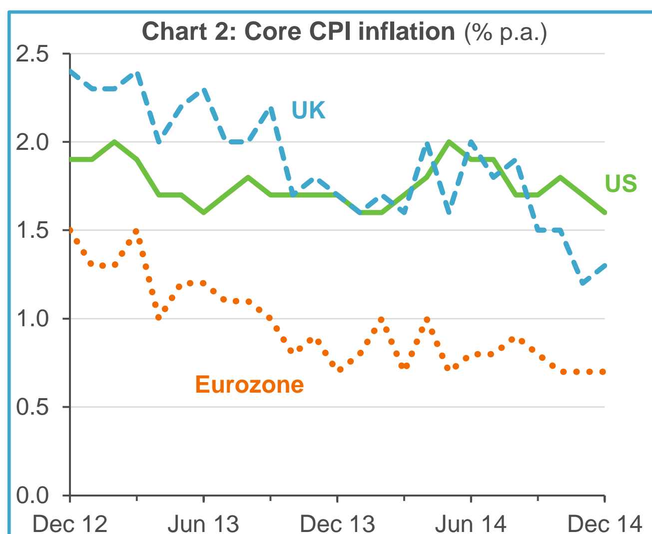
The fall in global bond yields has restored equities' immediate income advantage: de-risking out of equities into government bonds looks much less attractive than it did a year ago. In absolute terms, we are much less sanguine about the outlook. Equities' yield advantage will be required to absorb the rise in bond yields if the latest fall proves temporary. If current bond yields are justified by events, then equities surely have to factor in either or both of a higher risk premium and lower profits growth.

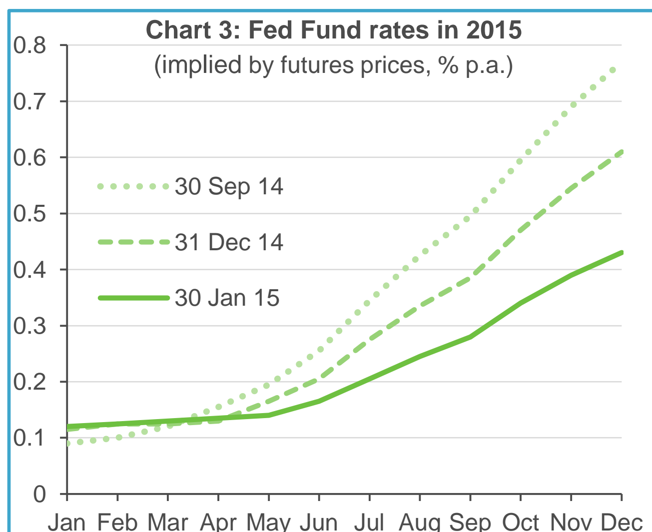
Property (p6)

There is little sign yet of loss of momentum in UK commercial property prices. Rental growth remains steady but much more pedestrian. Yields are now as low as they have been for almost seven years. Further short-term strength is likely – valuation prices are probably still lagging transaction prices – but we would be more comfortable selling into this strength than buying.

MARKET BACKGROUND







Looking on the bright side

2014 was a year in which global economic growth fell short of initial expectations. Nevertheless, in its latest *Global Economic Prospects*, the World Bank estimates that growth rose marginally in 2014 (chart 1). Strength in the US and UK and a (weak) Eurozone recovery from recession helped to offset a slowdown in developing economies. The World Bank expects further improvement in 2015, with both developing and high income countries beating last year's growth. Expectations could be disappointed again in 2015; on balance, investors seem to be taking a fairly gloomy view. Typically, a collapse in oil prices would be seen as positive for growth; this time, any boost to sentiment has been unusually qualified by concerns about the disruptive effect on oil producers. We have often thought that markets have been complacent about economic risks. Now we feel more inclined to emphasise that they are just risks.

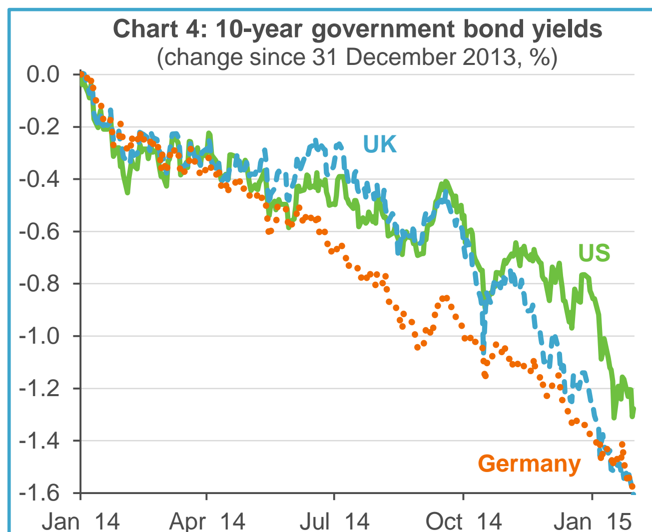
Dramatic headline, but no core meltdown

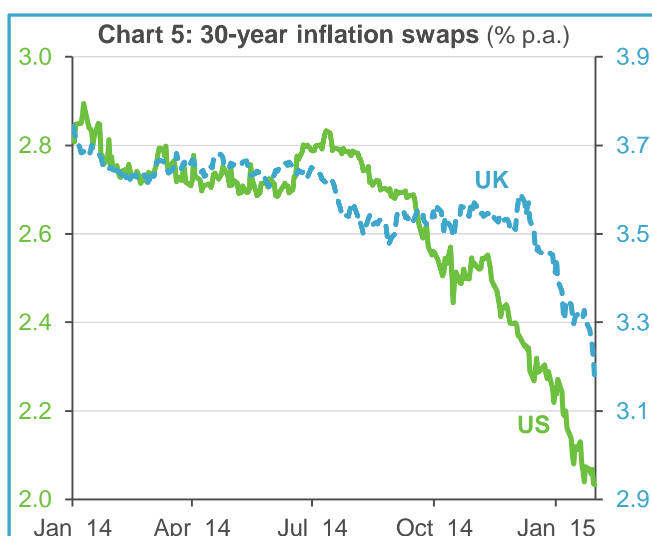
There is less room for confusion as to the impact of falling oil prices on inflation. Headline rates have fallen below 1% p.a. in the UK and US and below zero in the Eurozone. While the last of these readings makes for good headlines, it is probably a little premature to worry about endemic deflation. Core inflation (a more stable measure as it excludes volatile food and energy components) is well above headline rates. However, even core numbers have either been drifting down (chart 2). The prophets of QE-induced hyperinflation will not be vindicated soon … or ever. We have more sympathy with those sceptics who worry instead that the ECB's new QE programme (a long-overdue response to persistently low inflation) will be ineffective. Even so, it provides a reminder that deflationary pressures will not be allowed to prevail without resistance.

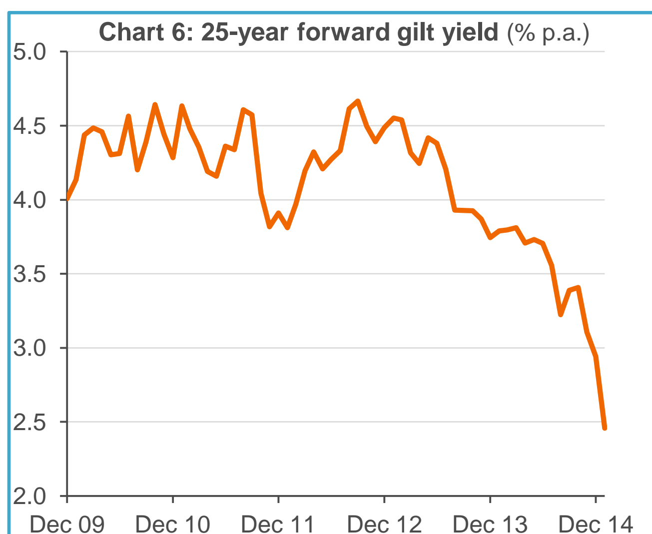
Fighting the Fed

In contrast to the Eurozone, investors still expect monetary policy to tighten in the UK and US, although the date at which they expect the process to begin has been pushed back. Recent comment from the Bank of England suggests they are sympathetic to the market's view that UK interest rates may not rise until 2016. The situation is less clear in the US, where the Federal Reserve has implied that policy rates (currently around 0.1% p.a.) will start to rise at its meeting in June. As chart 3 suggests, markets have been according that a lower and lower probability over the last few months. The latest Fed statement acknowledges the fall in market-based measures of inflation, but notes that survey-based measures have been much more stable. Both the Fed and the BoE maintain that any policy change will respond to what the data tell them. That data will not be restricted to, and will be less fickle than, market prices.

GOVERNMENT BONDS







The pull of the dark side

Some market prices are suggesting that there has been a dramatic change in economic conditions in the last few months. Chart 4 shows the fall in 10-year government bond yields since the start of last year and highlights the extent of the acceleration in the final quarter for the UK in particular. Although the level of yields varies by region (Eurozone rates are much lower), the similarity of the falls is interesting. Of course, in a world of free capital movement, markets are affected by global as well as domestic factors. The view that any effects will be diluted across the world lies behind some of the scepticism about euro QE. It is certainly the case that UK investors will be interested in the impact of the ECB's programme might have on gilt yields. Here, we would note, as we did in **November's issue**, that yields tend to be driven more by economic optimism than whether QE is operating or not.

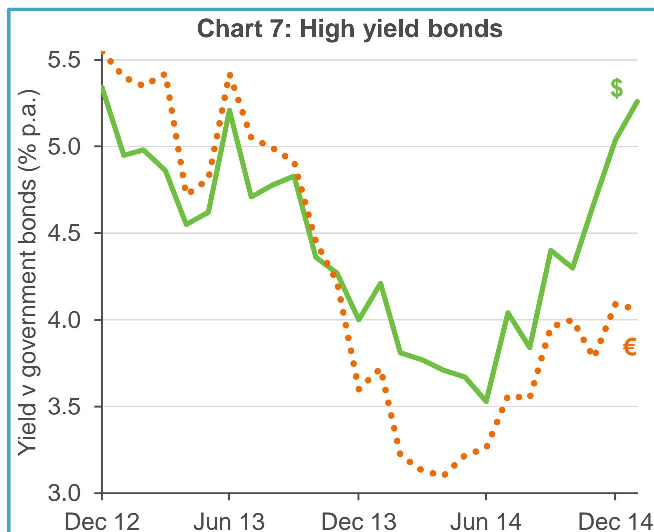
Domestic insurance costs

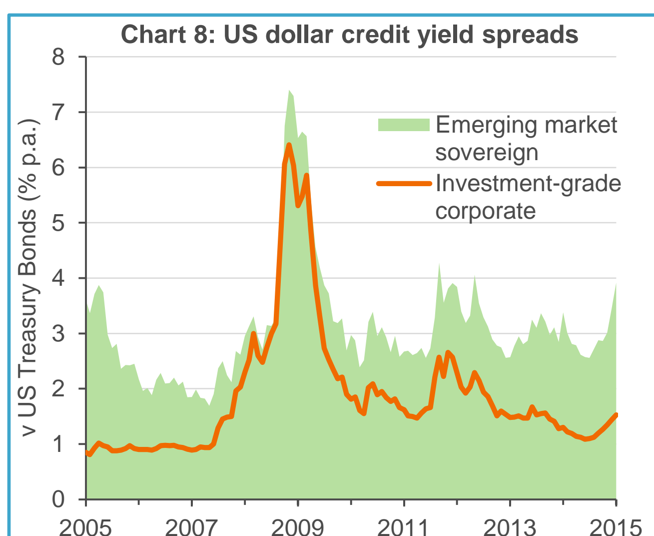
Outside the UK, the latest leg of the bond market rally has been more or less matched by lower inflation expectations. Here, inflation pricing has been stickier – an illustration of how domestic factors can still trump global influences. The price of long-dated UK and US inflation swaps diverged little until the final quarter (chart 5, where the higher UK scale broadly reflects the linkage to RPI rather than CPI). Thereafter, hedging demand kept prices higher than the deflationary tone of markets might have dictated. Even if UK prices are high by global standards, those looking to increase inflation hedging need properly targeted insurance and cannot exploit any anomaly. Where it fits with their overall risk management strategy, they should ignore international comparisons and take advantage of the lowest prices since the RPI review of January 2013.

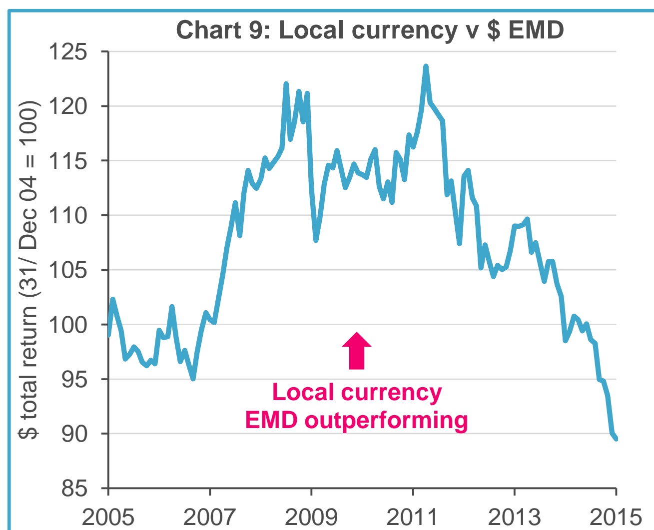
Forward and downward

Hedging inflation certainly looks a more attractive proposition than hedging interest rate risk. At shorter maturities, the interest rate profile implied by gilt yields is lower than it was even before 2013's 'Taper Tantrum'. Nevertheless, we can still see merit in, for example, building a portfolio of bonds to match short-term liability cash flows. That will lock in low absolute returns, but that is what we would expect from most asset classes. But the cost of longer-dated hedging has rocketed. Chart 6 shows 25-year forward gilt yields – the interest rate in 25 years' time implied by gilt prices. For much of the last few years this has been above 4% p.a. – comfortable if unexciting. Even a year ago as it dipped lower, the strong performance of equities made de-risking a plausible strategy. At 2.5% p.a. it will surely attract only those anticipating a Japanese-style 'lost generation' of low growth and very low inflation.

CREDIT MARKETS







High energy workout

Growing uncertainty about the global economic outlook has led to a rise in credit yield spreads from their lows in the middle of 2014. The rise has been particularly marked in US high yield bonds (chart 7), where major index yields are towards the high end of the range they have occupied over the last two-and-a-half years. As we noted in **December's issue**, this is affected by market structure: yields in the energy sector (15% of the market) have risen sharply. The energy sector is much smaller in, for example, European high yield (<1%) and US secured loans (c4%). In wider credit markets, the rise in yield spreads has been less marked and they are still low by the standards of recent years. Nevertheless, as credit markets languish while equities push higher, their strategic appeal as diversifiers grows. The terms for switching from equities to credit are as good as they have been for four years or more.

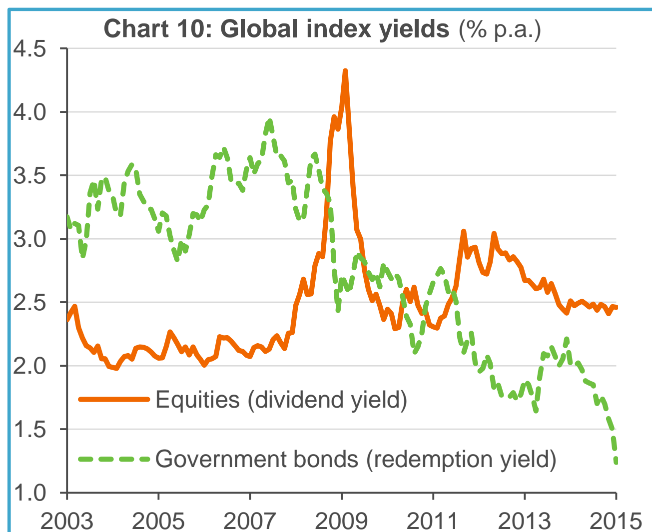
Marked down despite improving grades

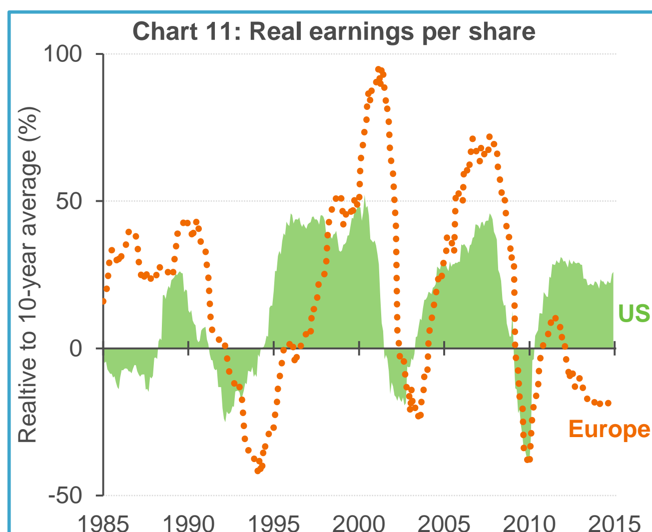
Emerging markets have rather fallen out of favour in the last few years. Hard currency (mostly US dollar plus some euro) emerging market debt (EMD) is no exception. In the period running into the Great Recession, the improving credit quality of the market was a contrast to the deterioration in traditional corporate markets. In 2009, the yield spread on US EMD indices briefly converged with the spread on US investment-grade corporate bond indices (chart 8). Since then, the improvement in credit quality has continued (the proportion of the market rated investment grade has risen from 55% to 65%), but EMD spreads have not fallen as far as corporate spreads. Of course, EMD has its own specific risks – Russia was downgraded to speculative grade in January. But emerging market risk seems well rewarded by the standards of the last decade and EMD certainly merits consideration as part of any broad credit portfolio.

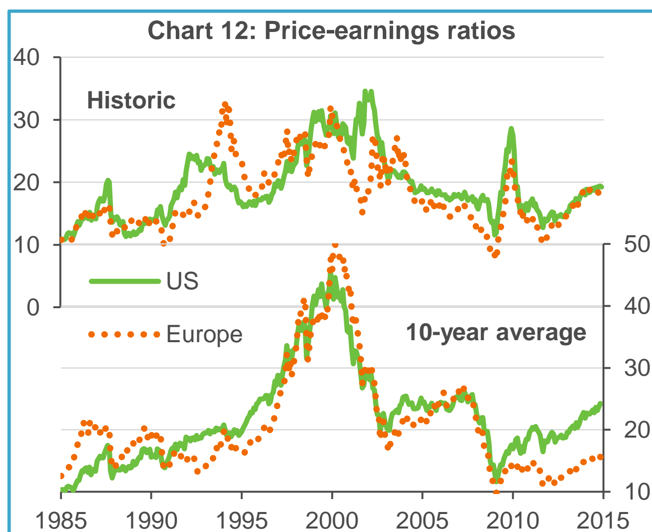
Local opportunities

Those who think that the devaluation of hard currency EMD has gone too far may get more bang for their buck from its younger, local currency sibling. The risks inherent in local currency EMD are different – currency- rather than credit-related – but investors' disenchantment has been even greater. Chart 8 compares the dollar performance of major hard currency and local currency indices and highlights how costly local currency exposure has been since 2009. The difference would have been a little less marked for UK investors who would typically have hedged the dollar exposure of hard currency EMD and thereby lost some part of the return. Strictly speaking, local currency EMD doesn't belong in a credit portfolio, but semantics shouldn't prevent investors exploiting the diversification of risks it can bring to their bond exposure.

EQUITIES







Running risk (reluctantly)

Sterling investors have enjoyed a total return of 70% from global equities since the last serious downturn in summer 2011, mainly from revaluation rather than underlying earnings growth. The last time the historic price-earnings ratio (PE) on the MSCI AC World Index was significantly higher was almost 5 years ago, when earnings were still recovering sharply from recession. That limits the returns we expect over the medium term and raises the risk of a more serious correction than the brief wobbles of 2014. We would still hang on to some of our cash. But valuations on other assets have become more demanding, too; global equities have an income advantage over global government bonds higher than it has been for several decades apart from a brief period in 2009 (chart 10). That provides some protection against a rise in bond yields: de-risking into bonds seems far less attractive than it did a year ago.

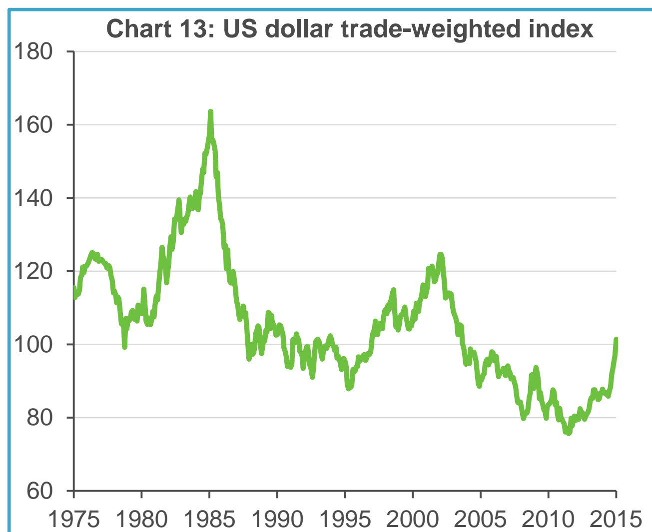
No more boom and bust?

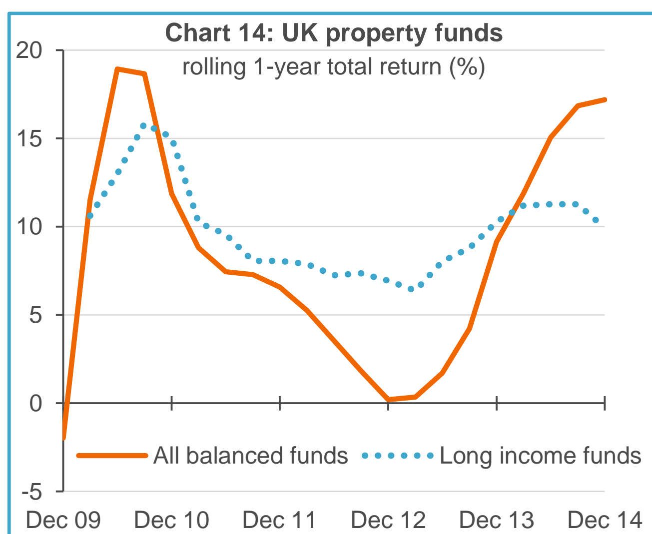
Like any single metric, the historic PE on a global equity index conceals as much as it reveals. It is indifferent to cyclical variations in earnings and differences across markets. Chart 11 does a little unbundling, comparing earnings in the US and Europe with 10-year inflation-adjusted averages. The averages smooth out cyclical fluctuations and can be thought of as a trend level of earnings. There may be respectable arguments that using a trend understates the extent to which power has passed sustainably from labour to capital in the US or overstates the ability of the Eurozone to generate future economic growth. We retain more faith in mean reversion (although our faith threatens to fall short in the Eurozone). Our assessment of the medium-term outlook for these markets therefore reflects a view that earnings growth will be a drag on US returns, but a potential boost for Europe.

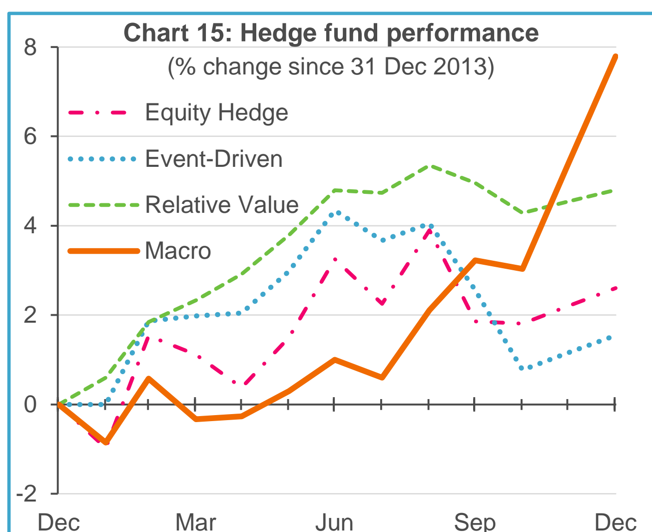
Value judgments

The top half of chart 12 compares the historic PE on US and European markets. For the last couple of years or so, they have tracked each other very closely – neither apparently offering any particular valuation advantage. In the bottom half of the chart, we replace the last 12 months earnings with a 10-year average in the PE calculation. Now, the US looks expensive other than by the standards of the internet bubble, while Europe is well within normal valuation ranges. It suggests that a superior long-term outlook for the US corporate sector is already discounted in prices. If you're sceptical about that, Europe looks relatively cheap. Of course, whatever your view, these assessments will play out over the medium- to long-term. Momentum can be an important factor in short-term performance and, at least until very recently, that has remained with the US.

OTHER INVESTMENTS







The greenback is back

Momentum is usually an even more important factor in currency markets and here it rests even more firmly with the US. In trade-weighted terms, the dollar has already risen one-third since its low of summer 2011, but major currency trends tend to very long and very large (chart 13). Nor do valuation measures suggest to us that the dollar looks expensive. We would not fight the consensus that expects dollar strength to persist and we certainly see no reason to hedge dollar exposure on a discretionary basis. Dollar strength might provide some offset to the relative weakness we expect from US equities, although it would represent a headwind for earnings growth. It is already taking its toll. At the end of September, earnings on the S&P 500 for the final quarter of 2014 were forecast to be 8% ahead of the previous quarter; they are now expected to be 7% lower.

Supermarket price cuts

UK property funds had a strong end to a strong year. The core All Balanced sector returned over 17% in 2014 (chart 14). There is probably more to come – valuation prices have still to catch up with transactions prices. Rental growth remains modest and yields are lower than they have been for 6 years. We would not be looking to buy property, but see no urgency to sell. Returns from the few specialist Long Income funds have been more modest. These focus on properties with long-dated leases and rents linked to inflation. This is a defensive strategy likely to lag a strong rise in the market, but it has also been hit by high allocations to supermarkets, where perceived covenant strength has been undermined by a changing industry background. We have been wary of the sector in the recent past on valuation grounds, but recent underperformance and superior income growth have gone a long way to allay our concerns.

Trending now

Hedge funds and other absolute return funds have theoretical attractions in a period when prospective returns from traditional assets look unexciting. The gap between theory and practice can be large: manager skill is often more important than the underlying strategy, charges are high and the diversification achieved may disappoint. When the other issues can be overcome, the last leads us to prefer macro strategies – consistently the least sensitive to equities – to other major hedge fund strategies. We noted in the last quarterly that macro funds had weathered the wobbles in equity markets rather well and their performance recovery, after several disappointing years, has continued. Timing of purchase shouldn't matter for a genuine absolute return approach, but macro funds typically benefit from sustained trends. Recent performance may have been boosted by dollar strength and falling bond yields.

MARKET RETURNS (%)				Local currency		Sterling	
UK	Jan 15*	Q4 14	OVERSEAS	Jan 15*	Q4 14	Jan 15*	Q4 14
EQUITIES	3.4	0.6	**EQUITIES**				
BONDS			North America	-1.5	4.4	1.4	8.3
Conventional gilts	3.8	6.3	Europe ex UK	4.8	0.2	4.7	-0.5
Index-linked gilts	3.7	8.4	Japan	0.4	6.8	5.5	1.6
Credit	4.1	4.3	Developed Asia ex Japan	2.9	0.8	4.1	0.5
PROPERTY		4.4	Emerging Markets	1.9	-0.3	5.6	0.4
STERLING			**GOVERNMENT BONDS**	1.9	2.8	3.5	3.0
v US dollar	-3.3	-3.8	**HEDGE FUNDS** **		0.7		
v Euro	3.2	0.4	**COMMODITIES** **	-8.0	-14.2		
v Japanese yen	-4.8	5.1	** Returns to 29 January.*			*** Local currency = $*	

SOURCES

CHARTS

Babson Capital, Bank of England, Bloomberg, Datastream, Hedge Fund Research, Hymans Robertson, IPD, MSCI, World Bank

TABLE OF MARKET RETURNS

Datastream – indices as shown below

Equities	
UK	FTSE All-Share
Overseas (developed)	FTSE World
Emerging Markets	FTSE All-World
Bonds	
Conventional gilts	FTSE-A UK Gilts All Stocks
Index-linked gilts	FTSE-A UK Index Linked Gilts All Stocks
UK credit	iBoxx Non Gilts All Maturities
Government	JP Morgan Global
Property	IPD Monthly
Hedge Funds	Dow Jones Credit Suisse Hedge Fund
Commodities	S&P GSCI Light Energy

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