Janet's Jigsaw

Summary

As we gingerly approach 2015 many questions remain unanswered, and the global economic recovery still lacks suitable vigour. The US & UK have finished with quantitative easing (QE), but the increasing desperation of the Eurozone and Japan means they are firing up QE forcefully, whilst China has responded to the slowdown by cutting interest rates on a broad front.

Meanwhile there are minimal signs of inflation in commodities or wages. Only hard assets like property and stocks are rising, buoyed by all this cheap money. Larry Summers has said that the world is heading into a secular stagnation, but the sheer strength of the US recovery suggests this could be wrong. Nevertheless all those knowledgeable about the lost decades in Japan are watching the evolving European train crash unfold with considerable anxiety.

On the other hand, there are grounds for some optimism. Unemployment is falling everywhere and the fall in commodity prices is starting to compensate consumers for the lack of wage growth. Corporates are cash rich and are now finding acquisition and divestment opportunities. We should not forget that many of them are offering sustainable dividend yields which far exceed the yields available from corporate bonds, let alone government bonds and cash!

In the middle of this complex structure sits Mrs Janet Yellen who has now truly inherited Mr Bernanke's mantle. She is the real McCoy; her refusal to be panicked in October/November by extending the QE taper showed she has true grit. So the most relevant question for virtually all of us as the New Year approaches remains; **what does Mrs Yellen think?**

It is quite conceivable that 2015 will turn out much like 2014 with a relatively benign backdrop. This may well be punctuated by fluctuations in bond yields and equities plus further volatility spikes such as those which served to frighten investors in October. If 2016 & 2017 turn into "more of the same" then those experts on Japan will truly have cause for alarm about the situation in Europe.

For now the strength of the US locomotive should help world equity markets. Less volatile growth in Japan alongside a recovery in the Eurozone would also be of enormous help. The former is distinctly possible provided Mr Abe wins a further mandate. Tangible progress in Europe rests on the weak hope that a sense of urgency and realism returns to decision makers both in Brussels and Frankfurt. A final bonus would be that China, for so long the engine of world growth, decides to cut interest rates further to stimulate the domestic and hence the global economy.

In view of this uncertainty about the strength of the economic recovery, plus the possibility of an incipient rise in inflation, the changing perception about the Fed's response and other geopolitical factors we have continued to retain a broad spread of assets.

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Over the last few months we increased our holdings in government bonds, retained our underweight position in commodity stocks, but we were also “sticking to the knitting” by looking for companies with reliable cash flow alongside a sprinkle of what we hope are the growth stocks for tomorrow.

Finally we remain positive on commercial property, this is in spite of the strong run the sector has seen both in the UK and the US, but we do acknowledge that there is now the risk of a considerable bubble. The above views are based on our expectation that money will stay cheap for the foreseeable future and thus the hunt for yield will continue for the time being.

2014 – A bumpy ride

2014 has been a year full of surprises. At the beginning of the year most commentators, including ourselves, were overconfident that stocks would continue to progress and that bond prices would begin their inevitable decline due to the spectre of higher inflation and increased global activity. The net result was that we all had a humbling experience as the year progressed.

Reinhart and Rogoff predicted in their book “This Time is Different” that the train crash we witnessed in 2008 was of such enormous proportions that the world economy would spend far more time than usual in the recovery ward. This prediction has proved to be correct, although once again the genuine inner resilience of the American economy has proved to be a constant and reassuring factor of the recovery.

In the initial stages the world benefitted greatly from an enormous monetary stimulus administered by the Chinese. This action helped to support the natural resource economies in Australia, Canada and Brazil while also providing increased general demand throughout the world. For every action there is a reaction and the property bubble which this stimulus helped to create in China is now winding down rapidly.

The buoyancy in China also provided a useful aid to the European economy since it encouraged the export sector particularly in Germany, Italy, the Netherlands and France. Consequently, after a distinct wobble in 2011 the recovery seemed to be back on track.

Unfortunately the sovereign debt crisis in the European periphery continued to unsettle the global capital markets and this was a major contributory factor to the loss of confidence seen in the second half of 2011. Since that time the US recovery has continued to progress but the European situation has worsened due to a continuing decline of aggregate demand across the continent.

Bond investors love gloomy news. Consequently the run of poor figures on economic growth that we have seen in Europe have provided substantial support for European bond prices. As the situation has deteriorated Mario Draghi, President of the ECB, has reinstated his verbal barrage in support for the euro. He has already started buying commercial European debt as the first step in a major programme of QE in Europe.

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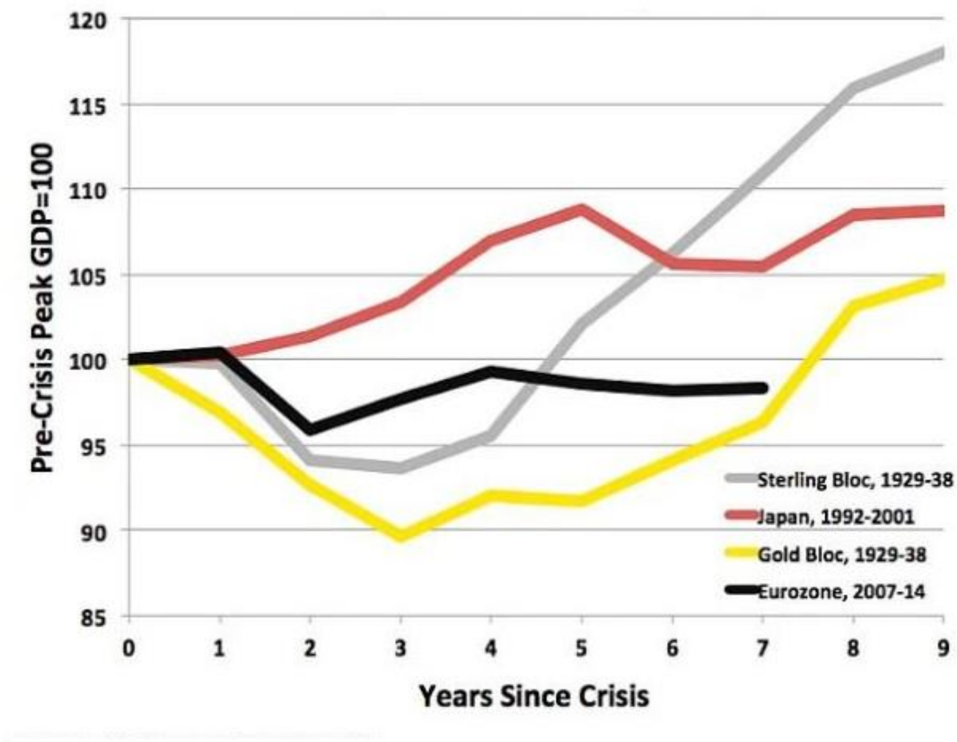
Most of us consider this to be the correct response and also expect the programme to be extended over time with the inclusion of government bonds. It is also clear that the situation is now so serious that monetary policy on its own will be inadequate to turn the tide. Nevertheless it will prove to be necessary to extend the monetary stimulus to include sovereign debt within Europe. The Germans have baulked at such a prospect and once again one is faced with the spectre of continued political haggling whilst the EU inches towards a consensual decision.

Any realistic analysis shows that the drop in aggregate demand within the EU is now so serious that a fiscal stimulus is also required. This flies in the face of current German conservative views as suggested by Hans Weidmann, the German appointee on the ECB governing council, since the budgets of both the EU and its constituent governments remain stretched.



Source: Madison Project, Eurostat

It will require a leap of faith by the Brussels bureaucracy and civil services who are advising the constituent governments to propose and implement a substantial fiscal stimulus programme. It appears Mr Juncker, the new President of the European Commission, has already reached the same conclusion; however the €300bn fiscal injection which he hopes to implement over the next three years looks too small to have a measurable impact.

Meanwhile the slowdown in China and its effect on reducing overall Asian demand means that European exports are not growing at a sufficient rate to help soak up some of the excess capacity within the euro economy.

The Bank of Japan under Mr Kuroda recently announced a further substantial increase in their programme of QE. Unlike the timid response of the ECB, the BOJ envisages a very substantial increase in the central bank's balance sheet due to the purchase of government bonds, REITs, stocks and also commercial debt.
At the same time the Japanese Government Pension Investment Fund announced a massive strategic decision to increase substantially its holdings in Japanese and foreign equities whilst reducing the proportion held in Japanese government bonds. It was no accident that this announcement coincided with the decision from the Bank of Japan that it would be a strong buyer of Japanese government bonds. Recent numbers from Japan have shown a sharp fall in growth following the big rise in the rate of VAT from 5% to 8%.

Both of the above measures have been promulgated as a direct response to this slowdown. Results to date do show that the considerable depreciation of the yen achieved over the last few months has begun to bear fruit as the Japanese trade account has improved with a significant rise in exports and also a modest rise in imports (which shows some improvement in the level of economic activity).

At the present time neither Europe nor Japan are providing a sufficient stimulus to help improve global growth. The main hope for the global economy rests with prospects in the US. The American recovery seems to be progressing across a broad front and this gradually improving scenario has helped to provide continued earnings growth for S&P constituents during Q3, which in turn helped to support current equity valuations.

It is interesting to note that a considerable proportion of this growth now relates to improved sales figures, whereas over the last few years the bulk of the rise in earnings was accounted for by the large increase in corporate margins. Recent numbers have not shown a discernible fall in margins, but do make it clear that the buoyant consumer demand is beginning to effect the whole economy.

The other major factor now impacting capital markets is the substantial fall in both the producer price and consumer price inflation indices. The general level of inflation has not only ceased to become a concern but many policy makers are now extremely anxious that the inflation level in continental Europe is so low that the euro area is very close to a deflationary spiral.

Falling Oil Prices

As mentioned above, these forecasts which expect a very slow rate of inflation coupled with the fact that real wages have been stagnant in most major economies over the last few years are a cause for major concern. The massive, almost indiscriminate, rise in government bond prices across continental Europe, together with a similar increase in prices in the States and the UK should be a clear, confident assertion that global economic conditions are pretty dire.

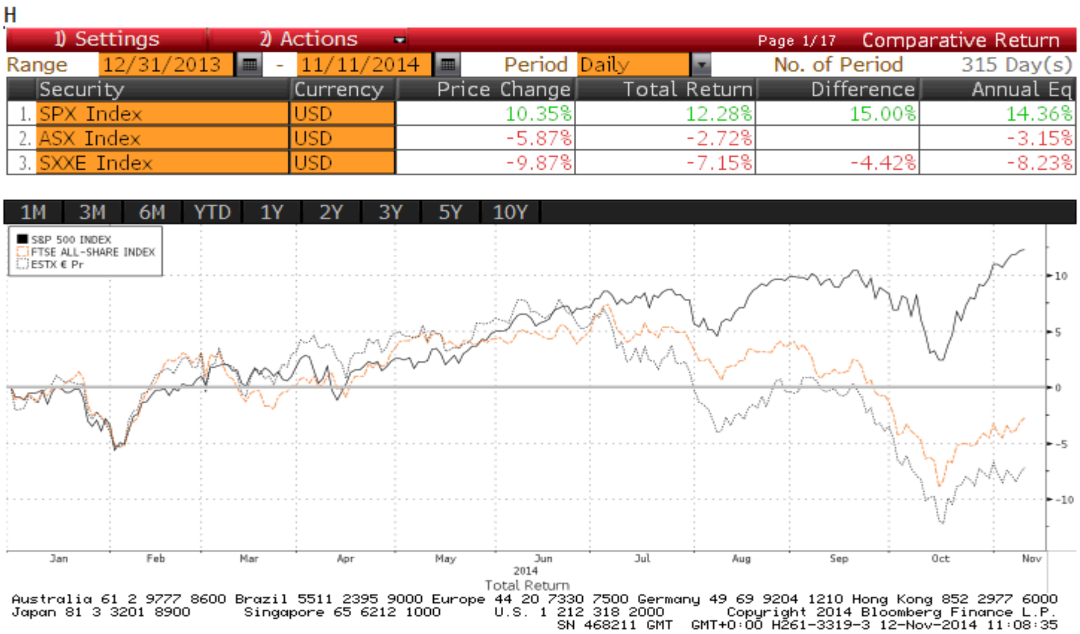
Whilst it is clear that global growth could easily be modest next year; the pessimistic conclusion of the bond markets has not been accepted by Wall Street since the American stock market has continued to improve across a broad front. This could be confirmation that markets consider the US recovery does not need assistance from the world economy because domestic factors such as improved housing demand, gasoline prices below $3 a gallon and the large improvement in the balance of payments due to impressive growth in fracking and exports generally all serve to underpin the continuing American recovery.

We expect that this conclusion is correct and that the US economy has attained modest escape velocity. Whilst this recovery is not as impressive as some previous ones it does suggest that US inflation should rise over time as the labour market continues to tighten which should promote higher inflation.

Such a course of events should mean that we finally see the shape of Janet Yellen's jigsaw with the pieces identifying her response to this two speed world. At that time we will gain some further understanding of her view about the fragility of the American economic recovery and hence the strength of her determination to raise interest rates rapidly if necessary.

Currently the massive stimulus from QE has impacted the capital markets with a big rise in asset prices, but the rate of velocity of money in circulation in the general economy has not increased much. So this wall of money has not yet discernibly affected the general price level for producers or consumers.

US Stocks have outperformed



Last month was the first time we saw an appreciable rise in the US CPI to 1.8%, if the number moves well above 2% the chips will be down. Janet Yellen and her colleagues will have to decide whether they still need to protect the recovery or whether they can resume their roles as central bankers by raising interest rates modestly as a signal of their intent to try and keep inflation at low levels, rather than letting it rise too far too fast due to their fears about the durability of the recovery.

We think the Federal Open Market Committee will err on the side of caution. This will help to support equity prices, but might also prove difficult for the US treasury market to stomach. Such a result would then hit equity prices as they would worry about the potential size of the Fed’s response. Comment to date has sought to calm the markets, but the FOMC is no longer as homogeneous as in the past, so any decision not to raise rates might provoke a strong dissenting vote and this will also worry the markets.