Strategy & Investment

Outlook for 2015: be prepared for rising volatility

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Global equities are standing today at roughly the same levels as at the beginning of the year, while global bonds are up by around 7 %. While the numbers for fixed-income investments are surprisingly good – the consensus at the beginning of the year, which we at Allianz GI shared, was for rising yields and lower returns – the performance numbers on the equity side are disappointing and low compared to the average returns in the previous five years (15 % p. a. between 2009 and 2013). After tremendous returns following the trough in equity prices in March 2009, however, we should not be surprised that equity returns have begun to falter. We also expect this trend to continue. On the bond side we are also positioning ourselves for lower returns than in 2014 to date.

Growth outlook

This slightly more cautious outlook for asset returns, however, does not imply that our outlook for growth has changed significantly. In the industrialized economies we still expect growth in the coming quarters to be roughly at trend. This is particularly true for the US, where after disappointing growth data early in the year – very much explained by a strong winter – growth data have started to surprise on the upside again. With the labour market improving and wage growth running at around 2 %, private household consumption is expected to be a stable contributor to economic growth. Investment activity, too, is likely to pick up after years of low growth, very much supported by easy financing conditions. Finally, with fiscal policy being less restrictive than in the past, government spending will also make positive contributions to growth. Once again the US is becoming the growth engine of the world economy.

Economic activity in the UK is quite strong too. We also remain moderately constructive for continental Europe, as the labour markets are improving, energy prices are coming down and fiscal policy is becoming less austere, despite the most recent market moves. We expect growth in the region to be at around potential next year. Downside risks are certainly predominating and rising, particularly because of the Ukraine crisis – which, according to weakening sentiment indicators, seems to have already impacted confidence in the industrial sector.

In Japan growth is likely to rebound in the coming months, following a massive contraction (ca. –7 % annualized in Q2) explained by the negative impact of the hike in value added tax (VAT) in April. Still, the medium-term outlook remains unconvincing for the country: "Abenomics" and ultra-easy monetary policy certainly stimulate exports via a weaker yen, but what the economy really needs is higher nominal growth, not just higher imported inflation due to the weak yen. As real disposable income in Japan is declining in line with the weaker yen and rising inflation, the medium-term growth outlook remains moderate despite a sharp recovery in business investments.

Understand. Act.

The growth dynamic has shifted to the developed economies

Gross domestic product (GDP) in the emerging markets continues to outgrow that of the developed economies. However, the growth dynamic has shifted in favour of the latter: the per capita growth differential between the emerging markets and the developed world peaked in 2008. Since then the growth difference has narrowed to a mere 2.6% versus the US; excluding China, according to World Bank data, the difference was just 1.1%. There are various explanations for this: first, over time, emerging markets have matured, which also implies less productivity growth compared to previous years. Second, Japan's weak-yen policy is putting pressure on the international competitiveness of Asian exporters. Third, the sharp increase in private-sector leverage in emerging markets, notably in China, since 2008 is clearly dampening the growth dynamic in real and nominal terms: Chinese nominal growth has roughly halved since the beginning of this decade. The last two factors also have negative repercussions for the growth outlook in Asia, as well as for commodity demand, and consequently for commodity-exporting countries in the emerging world, notably Latin America.

Nevertheless, our economic activity indicators continue to point to a moderate acceleration of the global economy, even though global growth momentum has slowed down recently. Against this backdrop, risky assets should start rising moderately again, in particular after the correction in September and October.

Monetary policy

The second reason why average asset returns are expected to be positive is the monetary-policy situation: the level of central bank rates is important, as well as which way they are heading. Historical experience clearly shows that as long as monetary policy is highly accommodative and rates remain below "neutral" levels, i.e. a level at which the economy is running at around trend growth, high-risk assets tend to do well and outperform bonds.

In both the US and Europe interest rates are close to 0%, and significantly lower than our estimate of "neutral". What is the neutral level today? It can't be measured, so it has to be estimated, e.g. by referring to the long-term trend in nominal GDP growth. For the US, the nominal growth trend is currently just below 4%, in EMU just below 2%, which implies that the "neutral" central bank rate is currently somewhere around 3¼ to 3½% in the US and around 1¼ to 1½% in EMU. This contrasts with Japan, which – despite having had interest rates close to zero for many years – has had a negative trend in GDP growth for most of the last 15 years. In other words, Japan would have needed interest rates to be negative, not just zero!

But the two arguments advanced above in favour of risky assets do not preclude setbacks in their prices, as we have just experienced true once central bank policy, in the US particularly, starts to change direction – even if monetary policy remains highly accommodative in terms of rate levels. At least this is the lesson of previous occasions when the Federal Reserve started raising rates. We think the current macro backdrop warrants a degree of caution: given the Fed's communication of its forward guidance, it is reasonable to assume that it will start its rate-hike cycle in June 2015, and will keep interest rates below "neutral" until at least mid 2017. Money markets, in contrast, are currently factoring even less rate hikes Given that economic data in the US have been quite solid since spring, and that inflation data approached the Fed's target level of 2%, we think the market is very likely to have to bring its rate expectations closer to what the Fed has so far communicated. The implications for sovereign bonds are straightforward: as the long end of the yield curve is priced off the short end of the curve, yields at the longer end of the US curve are likely to go up, especially after the drop in yields in October. Would German Bunds be able to de-couple from this trend, given that the ECB (European Central Bank) will continue to maintain its current 5 bp[1] interest rate (main refinancing repo) and may even consider more non-standard

[1] BP = basispoints

policy measures further down the road? Bond yields in Germany would certainly react much less than US Treasuries. Still, we doubt whether historically strong correlations between both markets would collapse totally, and we consequently also expect some moderate rise in German yields in response to higher central bank rates in the US.

What about equities and risky assets in general? A rise in sovereign bond yields per se need not be a problem for high-risk assets, as long as yields rise smoothly to levels that are still moderate (around 5 to 6% for 10-year US Treasuries has historically been the hurdle rate) and are well communicated by the Fed. Nevertheless, on most of the occasions when the Fed embarked on a rate-hike cycle in the past, equity markets entered a stagnant period or corrected by up to ten percent.

High valuations of several risky asset classes are adding to the risk of setbacks. This is true for corporate bonds, especially high-yield bonds, which could be hit not only by a general rise in the level of sovereign-bond yields, but also by a widening of spreads from their current very low levels on a historical comparison. Also various equity markets are highly priced, notably the S&P 500, which is trading at a Shiller PE of around 24. All the aforementioned asset classes could continue to perform well against the backdrop of ultra-relaxed monetary policies as long as the monetary policy stance is ultra-loose, and we do not think any of them is in "bubble territory" (we provide a more detailed analysis of asset valuations in our separate note on asset valuations.) However, the higher the valuation of an asset class, the bigger the risk of re-pricing in the event of sudden risk-aversion among investors.

With monetary policy remaining highly accommodative and our growth outlook still moderately optimistic, we expect prices of risky assets to rise again after the set-back in autumn, despite existing uncertainties for the global macro outlook.

The low level of volatility until summer in the equity, bond and currency markets, potentially reflecting complacency, indicated a need for extra caution. More than once in the past, low volatility has been a precursor of price corrections. What is more, low volatility has not only been confined to market prices: investors' expectations for growth, inflation and earnings are also in a very narrow range. Any change in the direction of monetary policy – typically a trigger for higher volatility – as well as any other negative shock, be it a negative growth surprise or a political developments as this time around, could trigger higher volatility in investors' expectations as well as in market prices, especially as market liquidity in some segments is low by historical standards. Nevertheless, with monetary policy remaining highly accommodative and our growth outlook still moderately optimistic, we expect prices of risky assets to rise again after the set-back in autumn. We also reiterate our expectation that the new long-term trend in the yields of high-quality sovereign bonds will be upwards. However, investors should continue to be prepared for rising market volatility. As the outlook for directional positions of asset markets becomes more difficult, active returns within asset classes become ever more important.

Stefan Hofrichter

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