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Policy divergence in a disinflationary world

A year ago, we said that financial markets would face a long and at times challenging road to normalisation. That certainly proved to be the case this year as volatility returned to equity markets in the latter part of 2014 amid fears that economic growth in 2015 could disappoint. Meanwhile, core sovereign bond yields remained very low despite expectations that the withdrawal of quantitative easing (QE) in the US would send treasury prices lower and yields higher.

The major development this year, and one that could have significant ramifications for 2015, is that inflationary pressure is more or less absent in almost all the major developed economies and headline Consumer Price Inflation (CPI) readings have been declining. This broad disinflationary trend means that policy settings should remain accommodative and should in turn provide support for risk assets. However, it is vital that outright deflation is avoided, given the very high debt-to-GDP ratios that persist throughout much of the developed world.

Policy divergence

Investors will have to get to grips with policy divergence in 2015. While Japan has recently ramped up its QE programme and delayed the implementation of the second hike in the consumption tax, and the ECB has announced the purchase of covered bonds and asset-backed securities, the US Federal Reserve (Fed) has brought QE to an end. In our view, 2015 should be the year when the Fed begins to move away from its near-zero interest rate policy, although any interest rate rises are likely to be modest. Similarly, in the UK, the Bank of England is expected to begin to raise rates at some point in the second half of 2015. In Europe and Japan, interest rates will remain very low, and this should put a cap on any rise in bond yields, particularly in an environment where overall rates of GDP growth are likely to remain sluggish.

Perhaps the biggest challenge facing policymakers in the developed world is to decide what to do if economic growth remains weak. If we ignore the US, there have been few signs of real economic improvement; equity markets have rallied in the past few years in the expectation that an economic recovery would come through, but, by and large, that recovery has proved elusive. The problem for policymakers now is that there is relatively little that they can do to stimulate growth: conventional monetary policy is exhausted and most governments cannot implement looser fiscal policy to support growth because their finances are so parlous. It is therefore important that the upturn that has been seen in the US continues next year and broadens out to other economies; while the US may be able to 'go it alone' in 2015, it is not likely to be able to do so indefinitely.

One of the main tail risks for next year is whether the disinflationary trend that we have seen in recent months turns into outright deflation. The potential 'Japanification' of the developed world is a risk that we have monitored for some time and one that we will continue to monitor in 2015. Europe is at the hub of deflationary concerns and we are not convinced that lower bond yields will help Europe to recover if the ECB does indeed decide to implement some form of sovereign bond QE. Bond yields have been very low over the past few years and yet the growth outlook in Europe has deteriorated. However, if sovereign QE does

arrive in Europe, it could put downward pressure on the euro, which would help Europe's exporters and go some way to allaying the current deflation concerns.

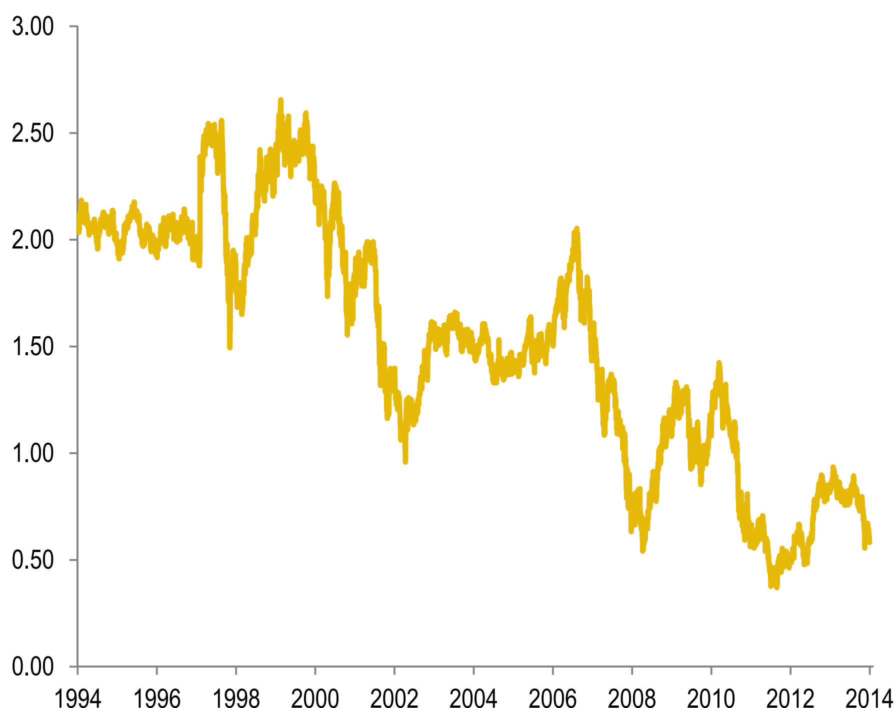
In terms of the major asset classes, we remain constructive on equities versus core government bonds, although we are less positive than we were, given the 'recovery-less recovery' scenario that we have outlined above, as it gives us reason to question whether earnings expectations for next year are reasonable. For us to increase equity exposure at current levels, we would either need to see valuations cheapen a little, or have greater clarity on the earnings outlook for 2015.

Regionally, we believe that Japanese equities should remain attractive as a weaker yen is helping to boost Japanese corporate earnings, particularly for exporters. The size of the QE programme in Japan (relative to GDP) is impressive and underlines the authorities' commitment to put deflation concerns to rest. There are other important developments, such as the commitment from a number of firms to improve return on equity and changes to the huge government pension fund, the GPIF, which is allocating away from JGBs to equities and other investments. These are secular drivers which should help to support Japanese stocks.

We continue to like UK equities, and believe that the FTSE's 3.3% dividend yield should remain an attractive characteristic in a world where 10-year German government bonds yield just 0.7%. One potential headwind for the UK is the current weakness in oil and commodity prices, given the market's tilt towards areas such as energy and resources. However, we think that, over time, investors who reinvest their dividend income (to benefit from the compounding effect) should be able to achieve reasonable returns compared to those available on other assets. Importantly, we are positive on US equities as the US has stood out for its good earnings growth, and it is that (rather than a valuation re-rating) which has driven the market forward this year.

The outlook for fixed income markets for 2015 is much more difficult to judge. On paper, sovereign bond yields are poor value; consider for example the chart below, which compares the redemption yield of the 10-year gilt versus the dividend yield of the FTSE All-Share index over the last 20 years:

Figure 1: Benchmark 10-year UK government bond redemption yield versus FTSE All-Share dividend yield (times)



Source: Thomson Reuters Datastream. Data to 30 November 2014.

Charts such as the one above have been used to characterise government bonds as 'return-less risk assets' rather than 'risk-free' assets. However, while government bond yields are very low by historic standards, and still unappealing on a total return basis when compared to other assets, we do not expect to see a bond market rout next year. In part, this is because inflation expectations are very subdued (some parts of Europe are in outright deflation) and it is

extremely unlikely that any of the major developed world central banks will tighten policy aggressively in 2015. More broadly, demand for high-quality sources of income remains strong, which is perhaps unsurprising in a zero-interest-rate world. This trend is unlikely to change given that there are aging populations in much of the developed world, and even in the developing world the increase in incomes in countries such as China is pushing savings rates higher. In bond markets such as the UK, there is always a strong technical bid from institutional investors at the long end whenever yields do rise, as they look to hedge their long-term liabilities. There is a further, more fundamental constraint for sovereign yields in that many governments now have so much debt that they simply would not be able to tolerate a big increase in their cost of borrowing.

In credit markets, the outturn for 2015 will to some extent be governed by what happens in sovereign markets; after all, corporate credit is priced using the sovereign yield curve as a reference point, with investors compensated for taking credit risk through the additional yield or 'spread' over good-quality government bonds of equivalent maturity. In general, though, we think that 2015 could be a year in which investment grade credit does reasonably well, as it an asset class that is suited to a low-growth, low-return environment. Moreover, corporate balance sheets remain healthy relative to those of many governments, and the lack of any meaningful economic recovery (outside of the US) has meant that many companies have remained cautious with regard to their spending and investment behaviour, which is credit friendly. What we would say is that the period of very strong excess returns from credit markets is over. The starting level of yields today and the current spread levels over government bonds mean that credit simply cannot continue to deliver the stellar returns that we have seen in recent years.

One thing that hopefully is clear from what we have said above is that the 'search for income theme' that we have mentioned in previous years will continue unabated in 2015. In this environment, assets with high real yields will remain in demand and for that reason we remain positive on the outlook for direct commercial property in 2015. Property also has the benefit of being a tangible asset, which is important to many investors in the post-financial-crisis world, and can also provide important diversification benefits as returns generally do not move in lockstep with those of the mainstream bond and equity markets.

Investment themes for 2015

- **Can the US 'go it alone' in 2015?** In many ways, this is the most important question for next year, because without the US the global growth picture for 2015 is not particularly inspiring. If the US does continue to go it alone, we should expect US assets – US equities, US credit and the dollar – to perform well.
- **Will the Fed raise rates in a disinflationary world?** We believe that the Fed will begin to normalise policy next year, but it will do so slowly. The overall policy environment should remain very accommodative. There is a qualitative difference between the disinflation seen in the US (driven by lower energy and food prices, which helps the consumer) compared to the generalised price weakness that is being seen elsewhere in the world (which largely reflects the absence of any meaningful economic recovery and correspondingly weak demand).
- **At what point do government bond yields become attractive again?** Many market participants have been (and continue to be) short duration in government bonds. However, as inflation profiles deteriorate, governments bonds could become more attractive given the global thirst for income. A 2.5% nominal yield could look a much more compelling proposition when inflation is 0-1% and interest rates are still close to zero.
- **In a low-inflation, low-growth, low-interest-rate world, assets with high real yields should remain attractive.** Commercial property is one of the most obvious beneficiaries of this theme. Institutional demand for income is likely to remain strong, which should support credit markets globally. But the period of very high excess returns from credit is over. That is not a matter of opinion but a matter of mathematics. (In other words, the starting level of yields and credit spreads today will not permit a repeat of the outsized returns seen in the past.)
- **The compounding effect of reinvested dividend income (especially from higher-yield/total return strategies) should win out over bonds in the longer term, given where valuations are today**. In a low-return world, investors need the power of compounding on their side. Good-quality companies will grow their dividends over time and investors can reinvest that growing income to boost their returns. We have long been advocates of reinvested income as the primary driver of total returns in markets such as the UK and we see no reason why long-term investors would steer away from reinvesting their income in 2015, particularly in a world where growth is likely to remain elusive.
- **There are likely to be selective opportunities in global emerging markets (GEMs)**. Country differentiation is likely to be very important; 2014 has served once again as a reminder (if one was needed) that GEMs should not be treated as a homogenous bloc. On a country-by-country basis there will be good opportunities as some nations work to reform their economies while others attempt to persevere with broken growth models. A move to slower, more sustainable growth in China should be a long-term positive, and valuations in GEMs are attractive versus

developed equity markets. However, we note that a strong dollar has historically been a headwind for the asset class.

Tail risks

These include deflation – which we believe would be very damaging given the magnitude of government debt in the developed world. Currency volatility is another risk to watch for as Japan continues with QE and the ECB adopts a more dovish stance, with full sovereign QE still an option for 2015 on top of the recently announced stimulus measures.

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