NEWTON
The Power of Ideas

January 2015

Investment comment

Economic and market background

At the European Space Agency in November, scientists waited nervously for confirmation that their Philae lander had successfully completed a ten-year journey to become the first probe to achieve a soft landing on a comet. Critical to the success of the mission was the lander's velocity as it hit its target. After meeting the comet's boulder-strewn surface at 38 centimetres per second, the lander bounced twice (as high as two miles), before coming to rest in the shadows of a cliff. Had it rebounded at 44 centimetres per second, it would have achieved 'escape velocity', broken free from the comet's gravitational pull and made the mission a failure.[1]

Back on Earth, meanwhile, there was much conjecture as to whether the US economy had achieved its own escape velocity – a pace of growth sufficient to lift it out of the shadows of the global financial crisis and into a self-sustaining orbit. To proponents of the theory, the economy's strongest expansion for a decade in the third quarter, and its steady job creation, which has reduced the official unemployment rate to 5.8%, dovetailed well with the end of the Federal Reserve's bond-buying support.

In a number of other economies, however, gravitational forces were evident, and in places there were fears of 'hard landings'. The eurozone was drawn ever closer to both recession and deflation, with Germany, its dynamo hitherto, achieving almost no growth in the third quarter of the year. Japan re-entered recession; China was set for its weakest annual output since 1990; Brazil's growth stalled; and falling emerging-market currencies (notably in Russia, where the rouble plummeted against the US dollar) underscored the difficulties being faced by other parts of the developing world.

1 Wall, Mike (14 November 2014), *European Probe Survived Comet Landing with Luck and Great Design*, Space.com

While US central bankers spoke confidently about their prospects of being able to raise interest rates in 2015 and brought to a close a bond-buying programme which has shaped significantly the fortunes of financial-market participants over the last six years, colleagues in other regions moved in the opposite direction. Sweden's central bank (the world's oldest) cut rates to zero; Switzerland introduced negative rates; the Bank of Japan extended its asset-buying programme; and the European Central Bank (ECB) expanded its array of unconventional policy tools and paved the way for outright purchases of the region's sovereign bonds.

If the threat of deflation appeared largely absent in financial asset prices, which generally built during the final quarter of 2014 on their earlier gains, it was certainly palpable in the plunging price of oil and in the impact of cheaper crude on consumer price indices in the major economic regions. With the Organization of the Petroleum Exporting Countries (OPEC) refusing to reduce production volumes despite softening demand, the price of Brent crude was down 40% in US-dollar terms over the fourth quarter.

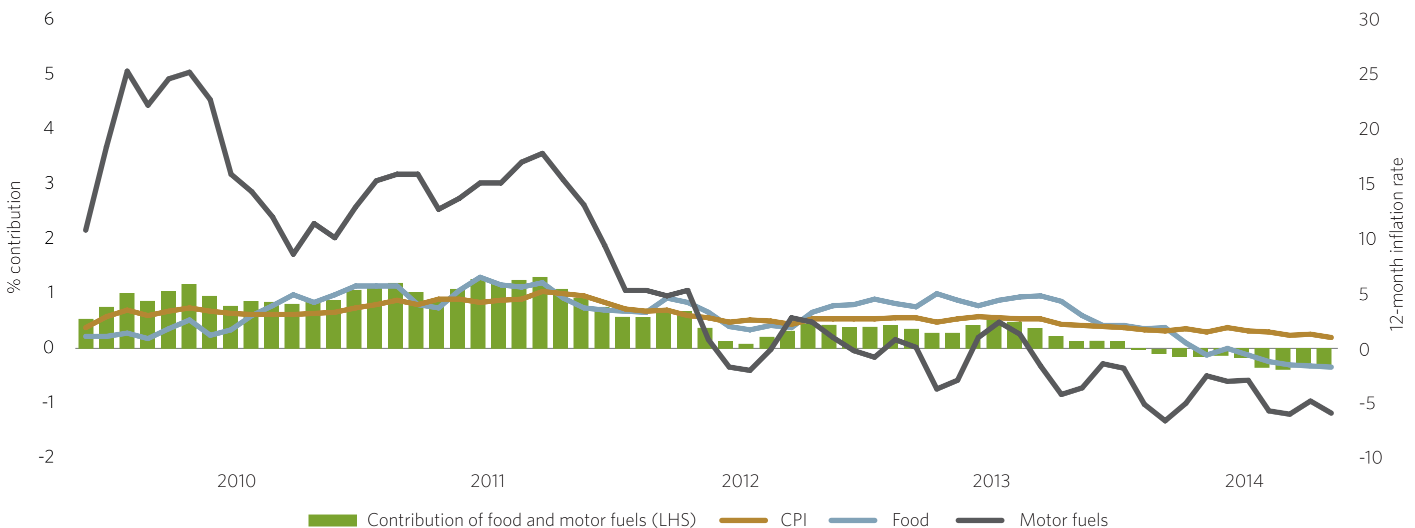
Against this backdrop, returns from equity markets were positive overall to the UK-based investor for the quarter, but in places reflected those gravitational pulls. The North American market powered ahead once again, its imperious (currency-enhanced) sterling return of +8.3% taking its 12-month return to +19.6%. Japan's local-currency return was similarly strong, but sustained yen weakness eroded much of the advantage to the UK investor. In sterling terms Japanese equities delivered a more measured return of +1.6% (+2.7% over 12 months). Elsewhere, investors in Asia-Pacific (ex Japan) stocks garnered a collective quarterly return of +3.2% (+10.1% over 2014 as a whole), and the UK finished the year with subdued quarterly and annual returns of +0.6% and +1.2% respectively. In Continental Europe, equity markets returned -0.5% in sterling terms, to stay just above water for the year (+0.2%), and emerging markets returned an aggregate -0.6% for a 12-month return of +4.3%.[2]

In bond markets, yields (which move inversely to prices) continued to fall. Indeed, US Treasury yields experienced a 'flash crash' in October when fleetingly weak US economic data was followed by the second-largest daily fall in 10-year yields since 1989. The pattern was not as dramatic as 2014 drew to a close but, nonetheless, bond markets generated strikingly positive returns to the UK-based investor over the quarter. The FTA Government All Stocks Index (gilts) returned +6.3%, to extend its return for the year to +13.9%, while the JPM Global Government Bond Index (excluding the UK) delivered a quarterly return of +2.8% to the UK investor (+6.4% over 12 months). Corporate bonds also made further progress, with the BofA ML Sterling Non-Gilts Index returning +4.4% over the quarter (+12.3% over 12 months).[3] The price of gold, meanwhile, fell by 2.2% in US-dollar terms over the quarter, to post a 2014 return of -1.8%.[4]

Source: Thomson Reuters Datastream, Jan 2015

2 Equity market returns sourced from Thomson Reuters Datastream, 31.12.14 (All sterling total returns. Europe, Pacific, UK, US and Japan regional returns are from FTSE World Index; emerging markets return is from MSCI World Index)
3 Bond market returns sourced from Thomson Reuters Datastream, 31.12.14
4 Gold bullion return sourced from Thomson Reuters Datastream, 31.12.14

UK consumer price inflation



Source: Office for National Statistics, Dec 2014

In the **US**, news that the economy had grown in the third quarter at its fastest pace (5% on an annualised basis) in a decade, and reports that job creation was running at its highest level since 1999, appeared to square neatly with the Federal Reserve's evident shift towards raising official interest rates in 2015. Having brought its bond-buying programme to an end, the US central bank signalled its intent to tighten policy this year by tempering its language on keeping interest rates low for a "considerable period".[5] As to inflation, US monetary policymakers expect it "to rise gradually toward 2% as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate".[6]

Those policymakers appear, however, to be caught in a trap from which they can't so readily walk out. While asset-price inflation and economic activity may warrant higher borrowing costs, patterns of consumer price inflation do not: recent price declines have been broad-based, rather than oil-centric, and in any event it is doubtful that lower energy costs are merely 'transitory'. With market pricing (in the form of 'break-even' rates) implying that inflation could soon fall further, the Federal Reserve is reminded of the difficulty of building its dreams on suspicious minds.

In the **UK**, meanwhile, it was a case of some smoke, but no fire, when it came to inflation. In announcing that, thanks to lower food and fuel prices, consumer prices had increased by just 1% in the year to November (the lowest rate for 12 years), the Office for National Statistics (ONS) reported that, of all the major categories for which it provides data, only tobacco had shown a significant price increase.[7] The falling oil price led the Bank of England to anticipate that inflation would fall even further in the months ahead, and not in fact return to the 2% target until the end of 2017.

Meanwhile, the ONS revised down five consecutive quarters of UK economic output, including the third quarter of 2014 which was reported to have seen growth of 2.6% rather than the 3% originally estimated. As in the US, the outlook for future periods depends on whether aggressive monetary policy has fuelled 'escape velocity'. With GDP per head and disposable income remaining well below their pre-financial-crisis levels, only one in seven British adults feeling the benefit of economic recovery,[8] and personal savings actually shrinking, debt burdens appear still to exert a strong gravitational force on the UK economy.

Fears grew during the closing months of 2014 that the **eurozone** was heading for a prolonged phase of stagnation. Amid news that Germany's economy had barely grown over the summer, while the region as a whole eked out growth of 0.6%, the European Commission slashed its forecasts for 2015, predicting that the single-currency bloc would expand by just 1.1% over the year and that inflation would be 0.8% – well adrift of the ECB's 2% target.

5 http://www.federalreserve.gov/newsevents/press/monetary/20141217a.htm
6 http://www.federalreserve.gov/newsevents/press/monetary/20141217a.htm
7 http://www.ons.gov.uk/ons/datasets-and-tables/index.html, 02.01.15
8 http://www.ft.com/cms/s/0/3f40be2a-6434-11e4-8ade-00144feabdc0.html#axzz3NfVJyZea

These milieux were sufficiently disturbing that ECB policymakers began to speak more explicitly about buying sovereign bonds – a practice long resisted by Germany on practical and philosophical grounds. ECB president Mario Draghi reiterated the central bank's commitment to expanding its balance sheet "under all universes" by some €1 trillion,[9] and his deputy, Vítor Constâncio, acknowledged that outright government bond purchases might be the means of achieving it. If existing measures do not work as expected, he said, "we will have to consider buying other assets, including sovereign bonds in the secondary market, the bulkier and more liquid market of securities available".[10]

Hopes of such quantitative easing (QE) grew amid the disappointing take-up of the ECB's discounted four-year loans in December, and following news that German consumer price inflation had fallen to an annual rate of just 0.1% in the same month. They are likely to grow further as banks repay hundreds of billions of euros in previous outstanding loans over the coming months and as the eurozone faces the uncertainty of an election and prospective bond default in Greece. However, it is doubtful whether the ECB will apply the thrusters in time to avoid a bumpy landing for the region's economy.

With the **Japanese economy** reported to have fallen back into recession over the summer, the prime minister, Shinzō Abe, called a snap election in November, which amounted to a referendum on his eponymous economic policy programme. The surprise dip in economic activity was certainly a setback for 'Abenomics', the latest attempt to revive the fortunes of an economy which fell into a torpor two decades ago.

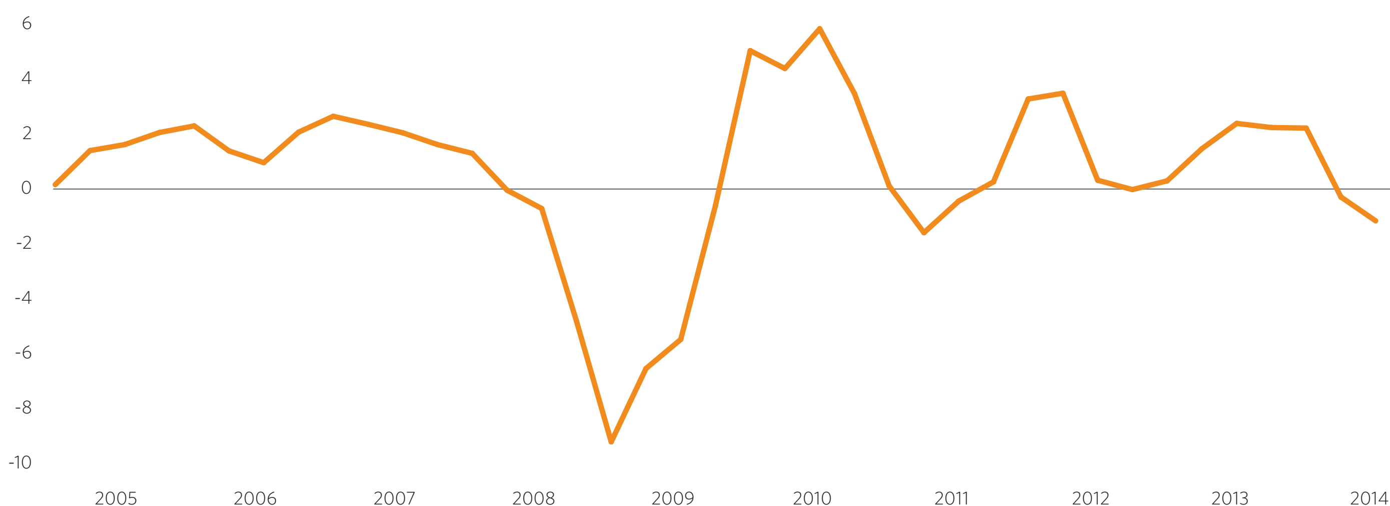
The result of the election was merely a minor change in the make-up of the ruling coalition, but it served to strengthen Mr Abe's mandate and buy him further time to get his policies working. The clock is certainly ticking for Japan's policymakers. The Bank of Japan, for example, having originally staked its credibility on achieving 2% inflation in 2015, will hope that the recent drop in consumer prices to a 14-month low proves short-lived. In seeking to stoke inflation, but with the implicit aim of undermining the value of the yen, the Bank is making annual asset purchases equivalent to roughly 15% of the country's GDP. At their peak, the Federal Reserve's 12-month rate of bond-buying under 'QE3' amounted to just 6.5%.

The BoJ's measures illustrate well the 'beggar-thy-neighbour' nature of policymaking in the major regions, and the acquiescence of authorities in currency devaluation as a cure for their economic ills. In Japan, however, the boon of a depreciated yen has been eclipsed to date by the sluggishness of domestic demand – in no small part attributable to the rising cost of living caused by the yen's decline.

China's economy was on course (for 2014) to post its worst annual performance since 1990, when the country was feeling the force of international sanctions imposed after the Tiananmen Square massacre. Nevertheless, output is likely to have grown by more than 7% in real terms. After three decades of stellar growth, the world's second-largest economy is enduring some significant struggles: industrial overcapacity, rapidly rising debt levels and a slump in commercial and residential property.

Japanese GDP

Annual % change



Source: Thomson Reuters Datastream, Jan 2015

9 http://www.ft.com/cms/s/0/2a6a4896-65aa-11e4-aba7-00144feabdc0.html#axzz3Ng2wXh5l
10 http://www.ft.com/cms/s/0/310b6c24-7555-11e4-b1bf-00144feabdc0.html#axzz3Ng2wXh5l

The last of those challenges, which saw real estate sales falling 10% from a year earlier in the first 10 months of 2014, has encouraged some innovative marketing initiatives. One property company in Guangxi offered prospective customers 1,000 free live chickens at the opening of its development. Another offered discounts proportionate to the amount of weight buyers lost over a set time. In Sichuan province, one developer took a more Kitcheneresque approach in asking a group of short-skirted models to stand outside the opening of its latest project holding placards imploring prospective purchasers to "buy our apartments to benefit the nation and the people".[11]

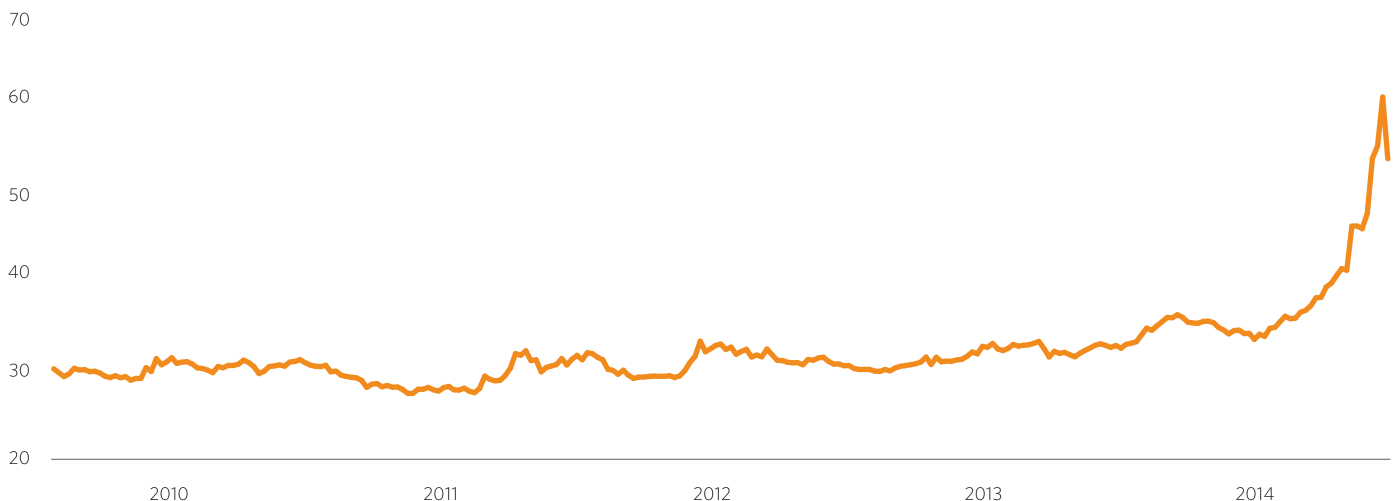
The People's Bank of China initially resisted calls for an easing of policy to arrest the slowdown in the economy, for fear of undermining efforts to reduce the economy's reliance on debt and investment. However, in the face of deflationary pressures in consumer and producer prices, and given the prospect of being a 'beggared neighbour' amid policy easing in Europe and Japan, it cut lending and deposit rates unexpectedly towards the end of November. As pricing pressures persist and economic activity slows, further policy easing appears probable.

Emerging economies should benefit in the years ahead from some notable structural changes, including demographics, infrastructure growth and urbanisation, but during the concluding months of 2014 they faced many adversaries. The ending of US QE, a programme which has done more than anything else to draw the contours of the financial landscape since the global financial crisis, was a seminal moment for emerging markets. Adding to their near-term difficulties were the uncompromising appreciation of the US dollar, falling commodity prices, and weaker exports to China and the eurozone.

Russia had arguably the greatest of challenges – international sanctions and, given that oil and natural gas sales account for about two-thirds of the country's total export revenues,[12] the sinking oil price. The country displayed the most spectacular damage in the form of the rouble's 51.7% depreciation versus the US dollar over the fourth quarter. The situation, according to Sergey Shvetsov, deputy governor of the Russian central bank, was "critical". "I couldn't imagine even a year ago that such a thing would happen – even in my worst nightmares", he said.[13]

Russian rouble v. US dollar

Exchange rate



Source: Thomson Reuters Datastream, Jan 2015

11 http://www.ft.com/cms/s/0/4662e694-449d-11e4-ab0c-00144feabdc0.html#axzz3Ng2wXh5l
12 http://www.eia.gov/todayinenergy/detail.cfm?id=17231
13 https://www.bba.org.uk/news/bba-brief/bba-brief-17-december-2014/#.VKcDeCusUmt

Investment implications

Insofar as there is ever a 'consensus' in financial markets, it was that **bond** yields were likely to rise in 2014. The opposite was the case. The 'flash crash' in US Treasury yields in October, which saw a record $924 billion of US government debt change hands in one day, was certainly extreme, but by no means inconsistent with the downward drift of yields. In Europe, sovereign yields declined further during the final quarter as speculation grew that the ECB would embark on buying government bonds. Yields in the US continued to inch lower in spite of the completion of the Federal Reserve's bond-buying programme and expectations of interest-rate rises in 2015.

It is a mathematical truism that falls in yields on higher-quality bonds to date have sapped those bonds of some of their future potential gains. Lower yields also increase a bond's duration (interest-rate sensitivity), thereby increasing investment risk; but neither of these truths prohibits further gains for fixed-income investors.

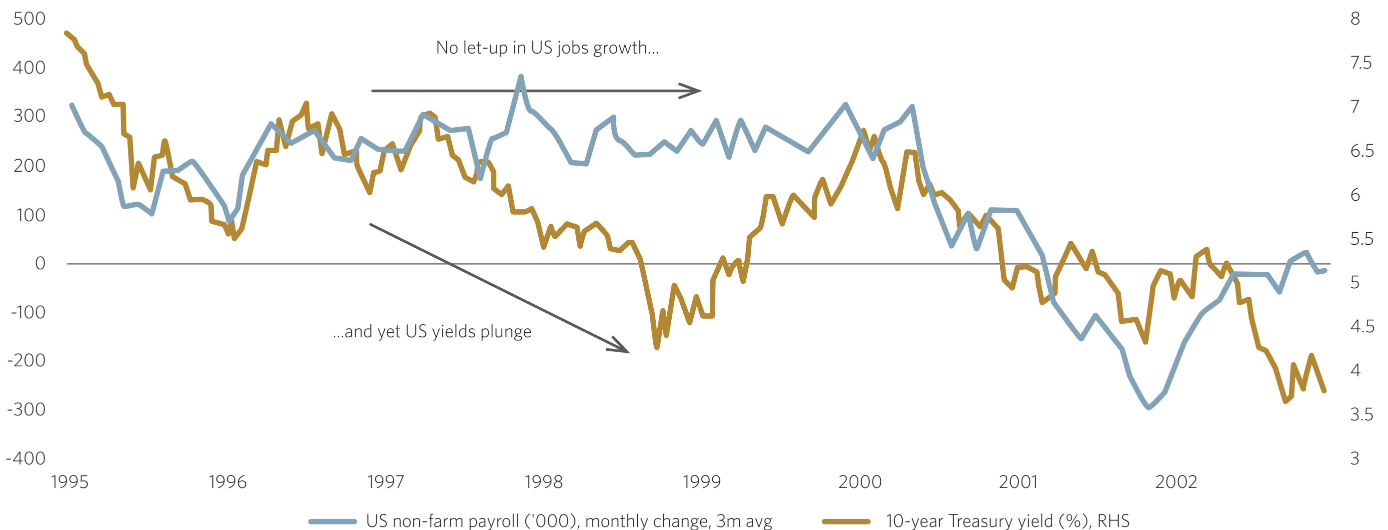
If the US economy were to continue to display strength, US Treasury yields could rise, particularly at the 'front' end if investors focus more intently on the prospect of gradual US rate increases. However, as the late 1990s showed, strong job gains do not necessarily foretell a weaker bond market. It is just as feasible that yields could continue to make fresh lows as the disinflationary (or deflationary) consequences of post-financial-crisis policymaking continue to unfold. Amid lacklustre global growth, subdued inflation and persistent political risks (including in Ukraine and the Middle East), long-dated 'safe-haven' assets may retain particular support.

In Europe, the threat of deflation and the spread of economic stagnation to Germany have heightened anticipation of further ECB balance sheet expansion, which has represented a supportive backdrop for the region's debt markets. Nonetheless, it may prove better to travel than to arrive when it comes to the effect of QE on bond yields. The anticipation of QE tends to drive yields lower, but its fruition usually does not. With the yield on German five-year bonds having reached zero at the turn of the year, for example, it is clear that value has been eroded. If investors are to be willing to pay (via negative yields) for the privilege of lending their money to the German government, they must surely be persuaded that the eurozone is heading further down the road to deflationary contraction, not simply that the ECB will carry out QE as expected.

Investment-grade credit remains highly correlated with movements in underlying sovereign bond yields, and tight spreads (low additional yield premia) afford only modest potential for gains over and above those reaped in government markets. Higher-quality corporate bond investors must be mindful also of the potential for continued (debt-holder unfriendly) merger and acquisition activity.

In **high-yield** markets, the limited refinancing requirements of issuers may provide attractive medium-term opportunities, but a cautious approach is merited for the time being. The vulnerability of US shale oil companies (which now comprise a notable part of the US high-yield index) to falling crude

US employment gains v. Treasury yields – late 1990s



Source: Thomson Reuters Datastream, Jan 2015

prices threatens to increase default rates. This could lead to contagion, which may spread not only from the US energy sector into other sectors in the US, but eventually to lower-grade European issuers, because US high-yield funds own a significant amount of European debt. In high-yield bonds, and in emerging markets, too, given the analogous exposure of some governments to lower energy prices, these risks make a discriminating approach favourable.

In **equity markets**, selectiveness also looks essential. While QE continues in Japan and is thought likely to be unleashed in Europe, there can be no mistaking the watershed represented by the end (for now at least) of QE in the US, whose liquidity has helped drive a remarkable rise in stock markets, particularly in the US itself. Between 13 September 2012, when the Federal Reserve unveiled its third QE programme, and 29 October 2014, when it confirmed the end of that programme, the S&P 500 index of leading US stocks returned +42.0% in US-dollar terms, with most of this gain reflective of increased valuation rather than higher earnings.

Whether post-crisis policymaking can continue to lift share prices and suppress equity-market volatility as it advances without the engine of US central-bank bond-buying is debateable. This is particularly so as the investment backdrop is now complicated by sharp movements in commodity and currency markets, and by the broad disinflationary trends which appear to be developing.

In the meantime, we believe it is critical to recognise that policy measures to date have caused distortions in asset prices, which render equity investors vulnerable to being inadequately compensated for the risks they take. The slower rate of growth in corporate earnings than in share prices has left valuations stretched in places. In the US, most notably, the cyclically adjusted ten-year price-to-earnings ratio continued to nudge well above its long-term average during the final quarter of 2014. In turn, those earnings have been flattered by (mostly unrepeatable) cost-cutting activity, falls in interest rates and share buy-backs. With QE enabling large-scale financial engineering, it is telling that US companies have been, by far, the biggest buyers of US equities.[14]

In an environment of diminishing policy support, divergent economic fortunes and pervasive pricing pressures, we believe it becomes increasingly important to focus upon stock specifics. There will inevitably be companies that struggle in the face of such headwinds, but there will be those that can weather them too. Thematically attractive businesses with cost bases flexible enough to manage challenging pricing trends, and with balance sheets sound enough to resist adverse changes in funding conditions, should continue to offer appealing investment opportunities.

14 http://www.ft.com/cms/s/2/721b67f4-73bc-11e4-82a6-00144feabdc0.html

Conclusion

The US central bank has begun to look forward to a time when it can 'normalise' policy, following the abnormal aftermath of the global financial crisis. More than six years after that crisis, the policymaking environment looks anything but normal: in all the major economies headline interest rates are moored at close to 0%.

In the meantime, global debt as a proportion of GDP has continued to increase since the crisis. Even in the US, heralded as having made more progress than most to deleverage, debt reduction has been patchy, and in aggregate it pales in comparison with the scale of pre-crisis debt accumulation.[15] This makes it doubtful how well-equipped even the US economy is to weather higher borrowing costs. Should it, or any other economy, fall prey to falling output growth or deflation, or should global geopolitical tensions escalate, the prognosis would be all the warier.

Just before leaving his post as chairman of the Federal Reserve, Ben Bernanke joked that "the problem with QE is it works in practice, but it doesn't work in theory".[16] QE may have kept deflation at bay since the financial crisis, but, however well-intentioned, we believe it is likely actually to have exacerbated longer-run pricing pressures by encouraging over-expansion and over-production, which can undermine pricing and profitability. Central bankers see falling energy prices as ephemeral, but such lower prices are, we think, characteristic of the challenges facing economies.

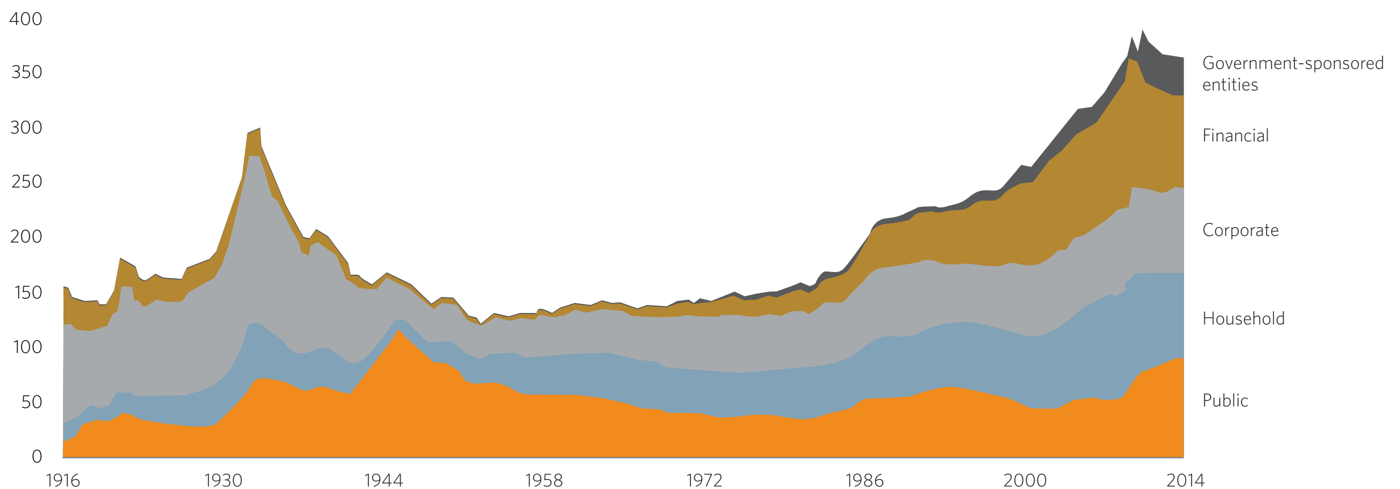
Meanwhile, investors must contend with the paradox that, however abundant the liquidity provided by monetary authorities, changes in regulation and trading behaviour have led financial markets at times to look ominously parched. Even in the gargantuan US Treasury market, a sudden change in sentiment in October brought about an abrupt and seemingly outsized fall in yields. The portents for greater damage in less liquid markets are clear.

In the midst of these challenges, there are patent dangers in seeking to dodge waves. Instead, we believe investors should pursue an active and discriminating approach, which seeks both to harness stock-specific opportunities and to manage risks.

> "Nae man can tether time or tide."
>
> **Robert Burns,** *Tam o' Shanter (1791)*

US total debt by sector

% of GDP



Source: ICMB Geneva Report 16, Deleveraging? What Deleveraging?, Luigi Buttiglione, Philip R. Lane, Lucrezia Reichlin and Vincent Reinhart, September 2014

15 *Deleveraging, What Deleveraging? The 16th Geneva Report on the World Economy*, CEPR, September 2014
16 http://www.brookings.edu/~/media/events/2014/1/16%20central%20banking%20great%20recession/20140116_bernanke_remarks_transcript.pdf

All data is sourced from Thomson Reuters Datastream unless otherwise stated.

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