New Year's Data...

Hopefully everyone has enjoyed a festive fortnight but during that time the global economy has continued whirring away. We take this opportunity to review the last couple of weeks' data to see whether it still fits with our view of the world:

- **Although there was plenty of news to feast upon, we find nothing really to challenge our view of an emerging economic recovery in the developed markets, accompanied by low inflationary pressures.**
- **At the same time, early indications are that emerging economies will continue to suffer headwinds in the early months of 2014.**

Japan

Japanese CPI was in line with expectations at a headline level but was firmer at the underlying levels. This is important because Japan is a net importer of food and energy. When the exchange rate falls the price of food and energy rises and this reduces workers' disposable income. There is some significance therefore in the observation that this period of inflation extends beyond the usual periodic fuel price inflation, last seen in 2008.

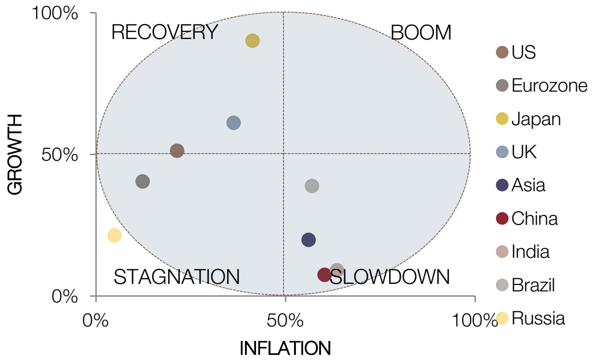
That said, it is also significant that wage growth statistics, released between Christmas and New Year, showed sluggish wage growth which, while providing a modest beat at the headline level, is still lagging price growth significantly. Should we be concerned?

A significant part of our assessment of Abenomics and its impact hinges upon this relationship between prices and wages. It mirrors the situation in the UK over recent years when we have seen incomes falling in real terms creating a significant impediment to recovery. Nevertheless, the fact that companies are following through with nominal wage increases is positive for sentiment as consumers tend to suffer from money illusion – they do not recognise the impact of rising prices when enjoying the increase in wages. Provided consumers and employees remain happy, any gap between nominal price and wage growth reflects a potential increase in profitability.

Fortunately, consumers, despite their real terms impoverishment, have other reasons to smile. Employment in Japan remains robust, and while the latest jobless rate ticked up slightly, the jobs to applicants ratio improved too and these statistics paint a picture of an increasingly tight labour market as economic activity continues to expand.

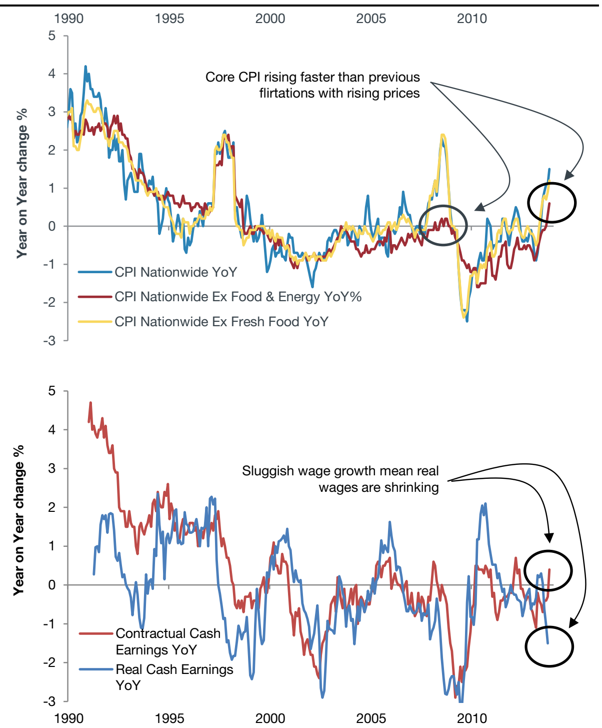
Japanese retail trade was surprisingly strong in November while new housing starts also beat expectations and construction orders increased again. Japanese auto sales released on Monday were very strong. Whilst these aren't the highest year-on-year gains Japanese car sales have recorded, other historic peaks have been associated with recoveries (such as 2011's tsunami and the credit crisis). Beyond these exceptional periods you would have to go back to the glory days of Japan in the 1980s to find such strong car sale growth. The manufacturing PMI and Japanese Small Business Confidence index, both of which are good predictors of GDP, rose in their December readings and are within a whisker of their highs since 1990.

Chart 1: The developed markets still look close to be in the early stages of recovery, emerging markets still look to be up against it...



Source: Brewin Dolphin

Chart 2: Japanese core prices are rising...but wages lagging meaning real wages are falling



Source: Ministry of Internal Affairs & Communications ,Ministry of Health, Labour & Welfare, Japan

Japan must, of course, face the prospect of rising consumption taxes in April which will boost inflation. No doubt this is encouraging Japanese households to bring forward consumption. The holiday weeks, however, seem to have underlined the positive case supporting the growth of the Japanese economy.

As far as investments are concerned, the yen cleared 105 to the dollar and the Nikkei made a new high since 2007 in thin markets. Both have since receded slightly in 2014 as risk appetite has waned.

China

Still in Asia, a host of PMI data has been the lowlight of the last fortnight. China's official manufacturing PMI sank back to its lowest since August, although at 51 it has remained pretty flat throughout that time. The HSBC iteration fell back to 50.5, the lowest it has reached since September. The service sector was weaker too and the Chinese leading index remains little changed since September. Monday's HSBC service sector PMI was provisionally estimated at just 50.9 – the lowest since August 2011.

Over Christmas, the main story in China was, however, outside the industrial sector. Overnight interbank rates and bond repo rates spiked towards the end of December, prompting the Peoples Bank of China (PBoC) to provide liquidity through its open market operations programme (buying government securities in the market). Rates have since normalised and the PBoC have withdrawn their stimulus. Money market tensions coincided with China's audit of local government financing.

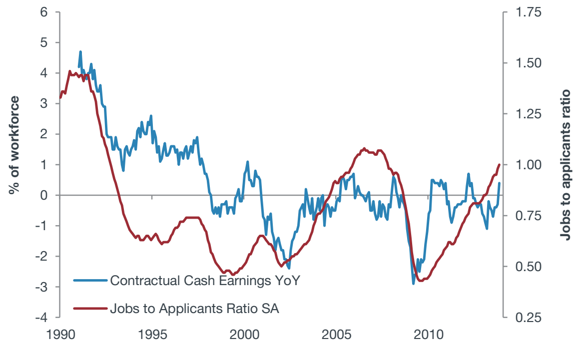
In China local governments are prohibited from incurring debt directly and so employ Local Government Financing Vehicles (LGFV) as conduits to credit. Large spending programmes were financed in 2009 through LGFVs using bank lending that, at the time, was sanctioned by the government. Since then attempts to restrain wasteful and risky lending by tightening bank lending have been thwarted as LGFVs have tapped shadow banking institutions for credit. This is evidenced in bank loans' declining share of total social financing.

Whilst the findings may not have surprised the market, China's recent audit revealed a $3 trillion debt which is increasingly being funded by non-bank sources. The shift of Chinese debt away from the banks is problematic because it means higher rates for borrowers and exposes lenders to potential losses – entrusted loans share features of originate and distribute debt upon which the subprime lending crisis was founded. The yield on Chinese AA rated bonds (those most commonly issued by LGFVs) has risen from 5.4% before June's cash crunch, to 7.6% at the moment. The move is shifting to entrusted loans – where savers offer funds to borrowers through an intermediary (normally a bank) but the bank takes fees and does not accept credit risk. There are signs of China's credit accumulation being tamed – entrusted loans are now the only shadow sector that is still accelerating but, as funding rates rise, the chances of defaults by LGFVs and their guarantors will increase during 2014.

Europe

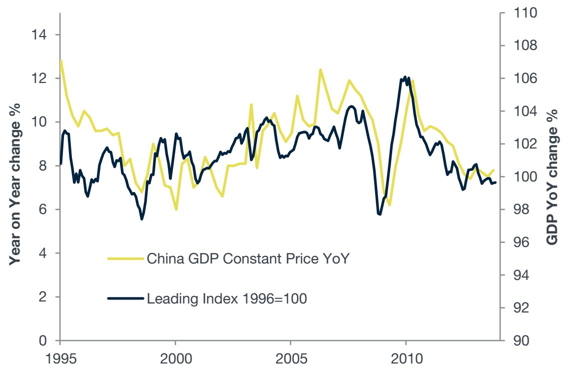
Turning our attention to Europe, yesterday saw French service sector PMIs for December which were revised higher after surprising falls for both services and manufacturing in the provisional estimate. The manufacturing figure was revised down last Friday and, together with rising unemployment, paints

Chart 3: Tighter labour markets should mean wages accelerate soon enough...



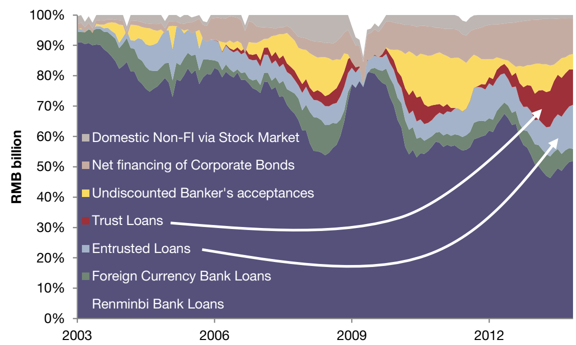
Source: Ministry of Health, Labour & Welfare, Japan

Chart 4: China's leading index suggests a further moderation of growth



Source: National Bureau of Statistics of China

Chart 5: Trust loans and entrusted loans are forming a greater component of China's total social funding



Source: National Bureau of Statistics of China a bleak picture of the outlook for France.

By contrast, Spain's Services PMI recorded a very strong reading with a good contribution from new orders. Before New Year retail sales growth in November showed continued progress. The Manufacturing PMI was a little more understated showing progress in new orders and output. Output running ahead of orders implies a headwind for future months but inventories declined to offset this.

Whilst many of the Spanish unemployed are thought to have moved into informal (black market) employment the PMI continues to tell a story of net job losses. That may be at odds with official statistics which show the number of registered unemployed declining. Upon closer inspection, however, much of this is driven by a falling population and a lower labour force participation rate.

The net impact of these changes was a slight improvement in the PMIs for little change in the headline Eurozone composite PMI which fits with our expectation of very modest, but positive, growth in the Eurozone in 2014. A more bullish, and characteristically volatile, reading came from the Sentix Investor Confidence reading.

UK

Across the channel in the UK much of the economic data released over the past fortnight has simply reinforced the view that UK residential property is enjoying a strong recovery that stands an increasing chance of turning into a problem. Strong mortgage approvals were confirmed by the Bank of England and British Bankers Association.

These are a good indicator of forthcoming house price increases. But as we have observed before, despite this apparent explosion in mortgage business, the UK property market is unlikely to provide the kind of boost to consumption it has in previous cycles. Net mortgage equity withdrawal and net lending secured on dwellings remains extremely low as homeowners use increasing incomes to pay down mortgage debt rather than borrowing against housing market gains as they have in the past. Together these data tell a tale of a strong housing market, which does not drive indebtedness.

Purchasing Managers Indices for the UK were slightly soft in the Manufacturing and Services sectors while Construction spending was in line.

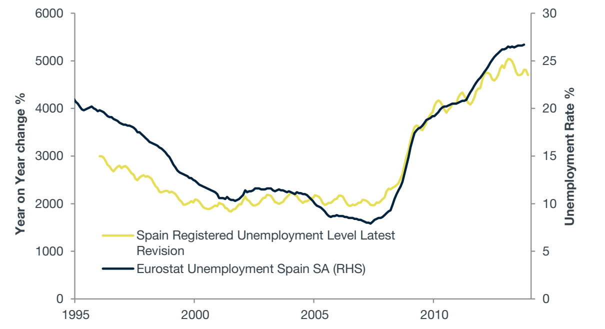
US

In America survey data was generally supportive too. The Institute of Supply Management's Manufacturing Survey beat expectations to remain in robust expansionary mode. The Non-Manufacturing Survey was weaker than expected but remained firmly positive, the most worrying interesting feature being a weak reading for new orders which would be worrying if it persists. The Conference Board's Consumer Confidence Index rose more than expected. The sub-indices of the survey showed "*jobs plentiful*" within a whisker of post crisis highs while the "*jobs hard to find*" moved to a new post 2008 low.

Those readings square with lower than expected Initial Jobless Claims although recent months have seen the downward trend in these numbers distorted by technical problems in October.

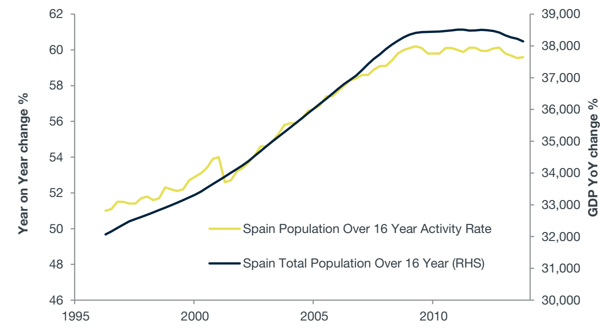
The housing market seems to have recovered its poise after stalling in the face of rising mortgage costs since May. House prices are rising again moving to 13.6% year on year growth.

Chart 6: Spain's jobless numbers are declining...will the unemployment rate follow?



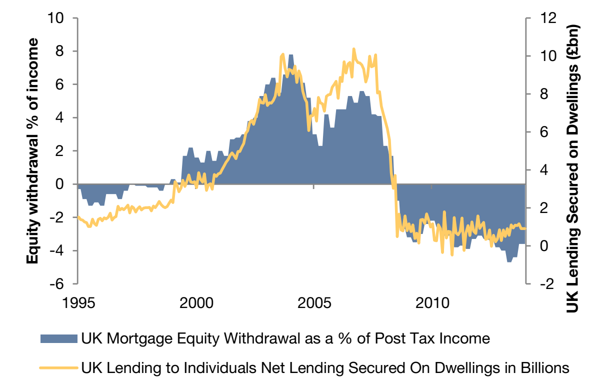
Source: Spanish Labour Ministry, Eurostat

Chart 7: ...probably not as it has been driven largely by workers leaving the country or leaving the workforce...



Source: INE,

Chart 8: Despite strong mortgage approvals and low interest rates households are chasing ever lower levels of mortgage debt...



Source: Bank of England

	Asset Class	Short Term Outlook (<12m)	Short term rationale	Long Term Outlook (>12m)	Long term rationale
Debt	Cash	Negative	Opporuntiies for invested assets remain attractive	Negative	Low inflation should keep UK rates on hold
Debt	Conventional gilts	Negative	We still see further modest dowside for quality bonds as policy normalises	Negative	Gilts offer poor value which is offset to a limited extent by low cash rates and equity correlations
Debt	Index Linked Gilts	Neutral	Break-even inflation rates have fallen but the outlook for inflation is tepid.	Neutral	Inflation protection is unlikely to provide much protection relative to generally rising yields
Debt	Corporate bonds	Negative	Spreads have tightened in high yied and investment grade providing limited abiulity to ciushion rising government yields	Neutral	Yields remain modest in absolute terms but are supported by structural demand for bonds
Debt	Emerging market debt	Negative	Pressure looks set to remin in the early months of 2014	Neutral	Valuations are not yet truly outstanding
Equity	UK Equities	Neutral	Markets look set for a pause	Positive	Dividend yields and strong capital discipline suggest markets remain good value
Equity	US Equities	Positive	Policy worries have been a headwind but the worst is now behind the equity market	Positive	Improvements in wealth and income support smaller risk premia and higher equity prices
Equity	Europe ex UK Equities	Positive	The expected cyclical upturn is continuing in parts of Europe	Positive	Growth remains elusive but companies are operationally geared into modest improvements
Equity	Japan Equities	Positive	Abenomics seems destined to succeed in achieving a lasting depreciation in the yen	Positive	The return of inflation will create new opportunities for Japan to structurally reform its economy
Equity	Asia ex Japan Equities	Negative	Many Asian markets remain in a tightening phase of their cycle.	Negative	Chinese growth is slowing and Asia is losing competitiveness relative to western markets
Equity	Emerging Markets	Negative	Defending currencies against capital withdrawals will come at the expense of growth and shareholder value	Negative	Labour and commodities are assets of diminishing importance to economic activity. Governance remains weak
Alternatives	Absolute Return	Neutral	Low cash carry and a shortage of trending markets are weighing on absolute return strategies	Neutral	Trending strategies could see their time come again as risk on/risk off is left behind
Alternatives	UK Property	Positive	Rents are improving and vacancies are declining reflecting the improved prospects for the UK economy	Positive	Underbuilding will lead to a shortage of quality commercial property in the UK in the long term
Alternatives	Oil	Neutral	Prices look to have reached an equilibrium	Positive	A modest increase in the supply/demand balance should cap further gains
Alternatives	Precious metals	Negative	The case for precious metals weakens as economic prospects improve and inflate recedes	Negative	The bull case for commodities is intensely threatened by the modest change in monetary stance
Alternatives	Industrial minerals	Neutral	Industrial metals will likely continue to trade close to their marginal cost of production	Neutral	Growth will support further industrial metal prices although the pace of industrialisation will slow

Important Notes:

Main source of information: Company Report and Accounts, Bloomberg

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