HANSON

The Outlook for 2015

January 2015

In assessing the market outlook for 2015 there are several factors to consider. However, the big issue at the moment, in January, is the oil price. The sharp decline in the oil price over the past few months is bad news for oil producers and anybody supplying them. However, it is good news for everyone else as it is the equivalent of a substantial tax cut which means everyone will have more money to spend on other things. Looking at it another way people who produce oil rarely spend the profits, but those who buy it are big spenders and will appreciate a few extra dollars in their pocket. Putting this into numbers, the IMF estimates that a US$25 fall in the oil price should add around 1% to global growth over the following three years and as Brent crude has fallen some US$70 from its US$118 high in 2014 this implies a positive impact on global growth of nearly 3%.

Looking at the bigger picture recent economic data has been mixed and there are clearly major problems in the global economy, but there are as yet few signs the world is slipping into a major recession. Given our top down approach to asset allocation and stock selection we will consider the major markets in turn.

USA

The US economy is experiencing a self-sustaining recovery and growth is likely to reach 3.0% in 2015. With the unemployment rate dipping below 6.0%, it will only be a matter of time before we finally see wage growth stimulating both consumption and the housing market. Circumstances would now suggest it is time for the Fed to start raising interest rates, but whether this first step will be followed by further hikes will depend on how the US recovery progresses. Technically, inflation will remain low after the recent falls in the oil price which will give the Federal Reserve room to be more flexible. Indeed, the reaction of Treasuries has been for yields to fall still further. One year ago the market was confident that US interest rates would begin to rise in 2014 and the same is now being said for 2015. We do expect a rise this year, but equally wouldn't be surprised if it happens towards the end of Q3 or the beginning of Q4. The lower for longer interest rate environment will only help fuel economic growth, but one thing is for sure, when interest rates do start to rise the progress will be gradual, but for now we have to continue to watch Janet Yellon's statements with extreme care!

Commentators see the main risk to the US in 2015 as a spill over from economic weakness in the rest of the world (China, Eurozone & Emerging Markets). We view this pessimism as misplaced: there may be some contradictory economic numbers from the fallout in the oil price, but US consumers will be the beneficiaries and there are many of them. These factors and the underlying growth in the economy will mean the US should have a good year. We continue to favour US equities and for the moment leave the US dollar positions unhedged to benefit from a stronger US dollar. However, after such a strong run we would not be surprised if US equities provided a single digit return rather than the double digit performance that we have seen in recent years. Also, we would not be surprised if the volatility increased this year when compared to 2014 now Quantitative Easing (QE) has come to an end and the market makes the necessary adjustments.

Eurozone

The USA is in stark contrast to the Eurozone where the markets are eagerly anticipating the arrival of QE. Equity markets have already risen and the Euro has weakened in anticipation and an important ongoing theme will be to see the extent of QE and its effectiveness. Further measures perused by

the ECB have included lowering the discount rate to minus twenty basis points and launching a programme to buy covered bonds and asset-backed bonds of approximately EUR 1 trillion.

The economic outlook still shows no sign of a robust recovery, but we are not expecting a severe slowdown in the Eurozone merely a mid-cycle slowdown in growth. We are watching the monetary supply and lending figures to see signs of an improvement and think that several indicators are beginning to improve. European businesses will benefit considerably from the weak Euro, which will make their exports much more competitive, thus benefiting the more industrialised nations of 'old' Europe. European companies remain attractive due to low levels of debt and healthy corporate balance sheets after five plus years of deleveraging. While Eurozone shares are not particularly cheap the currency has significantly devalued and may fall further, so in Sterling or Dollar terms are cheaper, and more importantly, the profit margins of European companies are at their lowest level ever according to Jeffries and it is easy to imagine an earnings recovery, particularly if QE is successful. Currently we hold a neutral position in European stocks and may look to increase this later in the year if the currency weakens further or the outlook begins to improve.

UK

The UK remains a slight enigma with valuations and, particularly, yields attractive on a relative basis even though the price-to-earnings ratio on the FTSE 100 has risen dramatically since the depths of the recession. The current price/earnings multiple is a historic 15x, which is ahead of the long run average (14.7x) but on a cyclically adjusted basis it is only on 12.5x with some (say 6%) earnings growth to come. The dividend yield is 3.4% with dividend increases virtually assured and no real expectation of an interest rate rise until much later this year. Politics will play an important role in the UK in 2015 with the result of the General Election in May likely to have a big influence on the direction of the market; currently the main parties are neck and neck in the polls so the smaller parties are likely to be more important than in the past if there is no clear majority.

Ironically, the UK (along with the USA) is one of the few economies actually growing, but this does not look to have been reflected in equity markets in quite the same way that it has in the US. 3% growth last year and only slightly less this year, is a vast improvement on the rest of Europe. However, it is this lack of growth in Europe that has caused investors concern, as the lack of demand from one of the UK's major trading blocs is bound to have an effect on its own growth and export potential.

However, UK equities still look attractively priced and certain sectors offer good value; telecommunications and consumer services are preferred as consolidation is an ongoing theme and the desire within all the major telecom players to be able to offer, land lines, Cable, TV and mobile remains undiminished. Vodafone look to be in a particularly strong position should things proceed as expected. Clearly, every cloud has a silver lining and whilst oil stocks will continue to suffer with the collapse in the oil price there are many others which will benefit dramatically from lower prices. The leisure sector and travel sectors are obvious candidates. Lower fuel prices and individuals having a little extra to spend, as less is being spent each week on petrol, could mean a foreign holiday is an option. Last year the Mid250 outperformed Large Cap again this time by 3.65% and we would expect further good performance from this sector of the market, probably fuelled by Merger and Acquisition activity. Overall, we believe the UK market should have a good year, especially if there is a positive result in the General Election.

Asia

The Emerging Market economies in Asia face a strong US dollar headwind in 2015, which will impact market returns. In Japan, as expected, the 3% hike in the sales tax has led to a slowdown in the Japanese economy – in fact, a more severe one than was generally predicted – casting doubt on the additional 2% tax hike planned for October 2015. However, in a surprise move the in late 2014, the Japanese central bank voted to substantially increase its program of Quantitative Easing. This led to an immediate further weakening of the Yen. Two weeks later, Prime Minister Abe postponed the tax hike to 2017 and announced an election, effectively asking for a mandate to pursue Abenomics. With a government debt ratio of 240% of GDP, unease about the long-term fiscal sustainability of Japan will increase. We expect the yen to weaken further in 2015 boosting economic growth somewhat and causing slight inflation. These measures will support Japanese equities and we retain a meaningful exposure to Japan.

Growth of the Chinese economy weakened in 2014 and will probably turn out to be slightly lower than the official target of 7.5%. The authorities have resisted the temptation to announce a massive stimulus package, but have quietly increased stimulus measures to ensure that growth will not weaken too much. Chinese policymakers are aware that the economy has to rebalance and that a lower structural growth rate is unavoidable. Their priority is to avoid social instability and thus foster employment growth whilst inflation is expected to remain benign, partly thanks to the decline in the price of oil. The Chinese stock market was a strong performer in 2014 and we would not expect such a strong performance this year.

2014 was the best year for Indian equity markets since 2009 following a rise of around 30% in the benchmark index S&P BSE Sensex. Mid and small-cap indices outperformed their larger peers.

Analysts remain positive on Indian equities as an asset class in 2015 and believe India is heading into a period of growth, with macroeconomic stability. It will be difficult for markets to replicate the gains seen in 2014, but with a Prime Minister riding high in public opinion and deemed to be business-friendly the outlook is brighter than for many years. Furthermore, tighter fiscal and monetary policies and a correct growth mix should gradually correct imbalances, which in turn will produce a steady recovery in economic growth.

Corporate earnings are expected to improve in the second half of 2015 and grow by more than 20% over the next 18-24 months. Markets were helped by the Reserve Bank of India in early January by the cutting of its main policy rates by 25bps, attributed mainly to the fall in the oil price and a softening of inflation data.

Fixed Income

We have been cautious about fixed income as an asset class for a considerable time, but 2014 saw renewed performance from many areas of the bond markets, which exceeded our expectations. While we continue to hold government and investment grade corporate bonds in the UK, Europe and the US, we are cautious on the outlook particularly with the extremely low yields currently on offer. It remains to be seen how effective QE will be in Europe and how it will affect the bond market. One thing to note is, at the time of writing, the Swiss Government 10 year bond has a negative yield, leaving market commentators struggling to find a comparative period in history, but this does provide a precedent and it is difficult to see yields going materially lower. The question for 2015 is will the yield curve become inverted? We expect in the current low inflationary environment that yields will remain unusually

low throughout the year and, therefore, high grade corporate bonds remain attractive, particularly at the longer-dated end of the duration scale.

Currency

We take a positive view on the US dollar, due to the varying growth rates of the US and the Eurozone, the differences in monetary policy between the two, and the reduction in the twin deficits in the US. The Yen is likely to weaken further to reflect the consequences of BoJ balance sheet expansion. Sterling should also strengthen when the uncertainty created by the UK general election in May is resolved.

Tying it all together

We believe that 2015 will prove to be a difficult year and the market will be more volatile than 2014. Sectors will rotate in and out of favour and will need to be traded for optimum results. Global equity returns are likely to be around 5%-6%, below their long term historical average of 8%. Equities remain our favourite asset class for 2015. We expect 2015 to be what US commentators call a zig-zag year, which is much the same as the truncated risk on/risk off conditions that we saw in 2012. This will create opportunities provided investors remember to zig when the market zags! As a result it will be important to be opportunistic and invest cash when markets dip.

This piece represents the views of the Hanson Asset Management Investment Team.

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