MARKET EDGE
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Key points

We are neutral on equities and bonds

We prefer equities in Japan and the euro zone but are cautious on emerging markets

US treasuries would be vulnerable if US rates were to rise as the Fed has indicated

The outlook for global real estate remains robust

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Turbulence is inevitable as policy tightening looms in the US and UK, says Stewart Robertson

Equity markets have in recent weeks retreated from record highs set earlier in the year, while commodities have also fallen sharply, as a raft of data suggested the euro zone was falling back into recession and the Chinese and Japanese economies had cooled. Although the US economy has continued to strengthen, any comfort markets may have taken from this has been largely negated by the growing realization that the first hike in US interest rates is drawing ever closer.

Historically, equities have struggled in the six months preceding an initial hike in US rates at the start of monetary tightening cycles. As such recent events have not come as major surprise. But equally, we do not believe they mark the beginning of the end of the current bull market. It's worth remembering that the outlook for the world economy remains fairly bright, notwithstanding the deep problems facing Europe. And besides, monetary policy will remain extremely loose in the US and elsewhere, even if it does seem likely that interest rates have begun to rise by the middle of next year.

The bottom line is that the investment backdrop remains reasonable. Tighter US policy is being offset to some extent by easing in Europe while authorities in Japan and China are expected to loosen policy should economic conditions warrant such a move. In effect the central bank 'put' underpinning equities remains in place.

In terms of the world economic outlook, we envisage robust growth in economic output of between three and four per cent over the next three years, with 'developed' economies expanding by between 2.0 and 2.5 per cent, and 'developing' ones by five. Global inflation will be moderate, which means more 'quantitative easing' seems likely in the euro area and Japan.

Within the developed world, we expect the US economy to lead the way with Gross Domestic Product (GDP) expanding at an annual average of 3.0 per cent. Furthermore, with the US having continued to strengthen over the past quarter, helped by an especially buoyant labour market, the risks to our forecast appear skewed towards the upside. Until recently the opposite had appeared to be the case. Aside from employment gains, greater household wealth stemming from rising equity and house prices, less drag from fiscal policy and reduced political concerns, are all contributing to the recovery.

Against this backdrop more 'hawkish' members of the Federal Reserve (Fed)'s policymaking committee have become more vocal about, and confident of, the case for higher rates. While Fed Chair Janet Yellen is still concerned about pockets of labour market slack, her recent comments have been more balanced.

With the risks to growth now to the upside, and inflation likely to be pushed higher by services prices, it seems likely the Fed will start to raise the federal funds rate in the second quarter of 2015. Its own projections show a rate of between 2.5 and 3.0 per cent by the end of 2016.

Financial markets are discounting less monetary tightening than this but with economic data continually improving, and Yellen's view on the labour market subtly changing, they will have to adjust as time passes unless news of a significant renewed downturn materialises.

By contrast, the euro zone looks to be slipping back into recession again. After GDP growth stalled in the second quarter, leading indicators and recent data have revealed a further clear slowdown. Although it is possible that seasonal oddities could mean a small increase in the third quarter, the underlying picture is bleaker. Further negative readings are quite plausible in the second half of the year and in early 2015. When combined with the obvious deflationary threat, this combination should be enough to lead to policy reactions from the ECB and – perhaps – from national governments.

For now the ECB is insisting its recent initiatives will help ensure both that growth resumes and that deflationary

worries disappear. We doubt both and continue to believe that outright 'quantitative easing' (QE) is necessary and will eventually come. Renewed recession will lead to calls for fiscal stimulus too which has the capacity to rekindle strains between those euro-zone countries which believe austerity is right and those – like us – who think a more flexible approach is required. In our view a sustained recovery is unlikely until QE is started and euro-zone nations take much greater steps towards political and fiscal union.

Banking union is only the first of many necessary steps in that direction. Recession may also result in unemployment starting to rise again and renewed pressure on policymakers to respond. Such developments are likely to lead to further rises in nationalism and, in the extreme, populist protests. Although the ECB has indicated it will do all it can to save the euro, another crisis of identity or existence should not be entirely ruled out, even if it is a very-low-probablity event.

Along with the US, the UK has the brightest outlook among the developed nations with most indicators arguing for a continuation of recent trends: robust growth and low inflation. Against that backdrop the Bank of England has hinted strongly that interest rates will need to rise. It has not been very clear in communicating exactly when that will be. Two of the nine person rate-setting committee want to act now, but we believe a majority will not be ready to act until next spring. Slow, gradual rate rises are to be expected after that, with the terminal rate dictated by how the economy responds to the first monetary tightening for eight years.

Some cyclical indicators have recently suggested a moderation in the pace of growth in the UK, but not to a worrying extent as yet. However, the UK is far more exposed to developments in Europe than is the US. Britain is a more open economy and the euro zone her most important trading partner. Weakness there will be felt here.

Chinese economic data has continued to disappoint. August industrial production data was particularly disappointing and implied that monetary policy will have to be eased if the government is to hit its economic growth target of 'about 7.5 per cent'. Stimulus measures announced earlier this year failed to fully revive the economy. However, authorities seem reluctant to announce more.

The property sector remains sluggish even though the government eased 'home purchase restrictions'. Beijing is closely watching developments, but as part of its reform agenda would like to see the economy wean itself off this sector. Therefore, a continued slowdown is likely.

As for Japan, optimism about the success of the authorities' efforts to boost activity (so-called Abenomics) has faded. After the sales-tax-related boost to spending in the first quarter, the next three months witnessed an even worse offset meaning the Japanese economy actually shrank marginally in the first six months. Leading indicators are slightly less bleak but as far as enhancing growth is concerned, victory is far from assured. Further stimulus may yet be required. We retain the view that Abenomics will eventually work, but our conviction has been dented a little by recent outcomes.

The impending US rate hiking cycle has dampened our enthusiasm for equities, and credit has to overcome the headwind of rising US bond yields. As a result we are neutral on both asset classes, believing regional selection provides more opportunities at this stage. We especially like equities in Japan and the euro zone given supportive monetary policy. We are simultaneously underweight 'emerging' equity markets given the likelihood higher US rates boost the dollar – something which has historically been negative for this asset class. Within 'emerging' equities we prefer the markets of countries with strong manufacturing bases – China looks very cheap – relative to those of major commodity exporting nations. Commodity price falls have been significant and seem unlikely to reverse course any time soon.

Sovereign bond yields are low everywhere and, with at least some central banks looking to raise interest rates over the next year, are vulnerable to sell-offs. Were treasuries to slide in the event the Fed raised rates in line with its own projections, it will be hard for other bonds not to follow as these markets tend to be highly correlated. However, low inflation everywhere will limit the extent of any rise in yields. The prospect of weak growth and inflation in the euro zone indicates there is greater upside for bonds in this region.

As we move closer to the start of policy tightening in the UK and US, the possibility of credit market turbulence grows – spreads tend to tighten slowly and widen abruptly. We would expect any such shake-outs to be short-lived however as the backdrop, of strong company balance sheets and low interest rates, is fundamentally supportive for credit. Expect returns to be positive but unexciting.

The US dollar is likely to continue its multi-year upswing, as fundamental valuations remain supportive. Faster US growth, improving balance-of-payments fundamentals and quicker monetary-policy normalisation are all supportive of continued dollar strength.

The outlook for global real estate remains robust. Occupier market fundamentals continue to improve with most prime markets seeing continued rental growth and lower vacancy rates. Property continues to offer good value relative to other asset classes and is attracting more equity. Meanwhile debt is becoming both more readily available and cheaper in most markets. Generally the outlook for capital growth is therefore positive. Having said that, while there has been no evidence of momentum easing, the risks of overpaying for prime assets in core markets is increasing.

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