Why Deny the Obvious Child?

By Richard Thies

After a year where almost every consensus view was trounced in fairly historic fashion, engaging in yet another round of prognostication feels like it requires an extra level of foolishness (though I'm confident I have enough to complete the task). The main consensus belief heading into 2014, which affects the pricing of nearly every asset directly or indirectly, was the direction of long duration US bond yields. The average forecaster expected the 10-year Treasury to end 2014 at 3.20%, a far cry from the eventual 2.17% that printed on New Year's Eve. With the lessons of 2014 now well appreciated, forecasters have totally changed their stripes and now expect bond yields at the end of the year to be only 3.10%, according to the Bloomberg consensus estimate. Wait, what?! This steadfast consensus leads to the conclusion that either lessons weren't learned about our world in 2014 or that the lesson learned was that everybody was simply just a bit (a year) early.

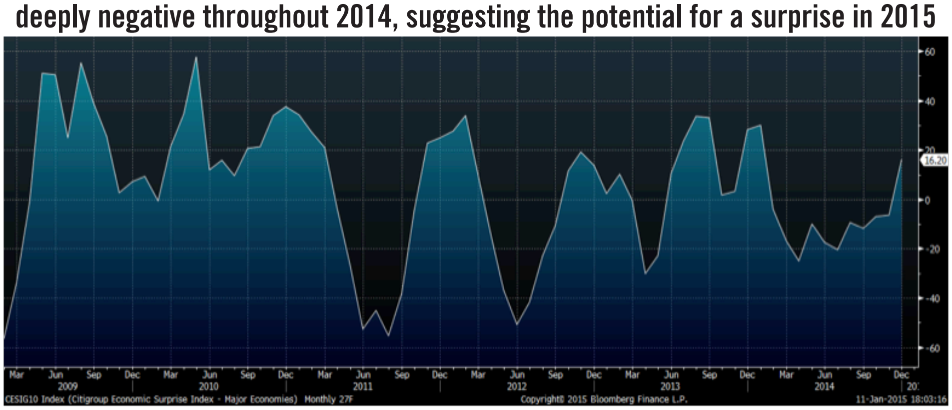
With that said, we'd like to share a few lessons taught during 2014 as they carry great relevance for our forward-looking views and thoughts on asset allocation.

10 Lessons from 2014

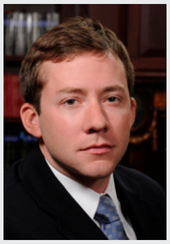
1. **Global growth remains broadly weak, below potential and very uneven.** Further, cycles between the accelerating and decelerating growth remain short, a hallmark of a global economy with pervasive banking sector deleveraging, tame investment and no strong fiscal impulse.

2. **These short cycles continue to provide nimble, active management opportunities** to fade the consensus when it becomes too extreme in either direction. Further, these cycles are getting somewhat prolonged with the fiscal and banking deleveraging easing in Europe. However, going forward, less credit growth in emerging markets will present a new drag on global growth. Currently, expectations for global growth are adequately pessimistic and the bar is low for upside surprises given the behavior of economic data in 2014 (Exhibit 1).

Exhibit 1. Global economic surprises continue to have short cycles and were deeply negative throughout 2014, suggesting the potential for a surprise in 2015



Source: Bloomberg



About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. Also, at the request of portfolio managers and analysts, he provides in-depth analysis of specific events and potential scenarios at the region, country and sector levels.

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3. **The global economy continues to suffer from a supply-side problem in labor markets.** Economies in developed and emerging markets alike report tight labor markets in spite of poor overall growth conditions. The US, Japan, Germany and China are all at or very near full employment, which is a detractor for future potential growth rates and suggests wage increases in the coming years. The bargaining power of labor globally should increase (Exhibit 2).

4. **The global economy continues to suffer from overcapacity in manufacturing.** Opposite to conditions in labor markets, numerous areas of the economy are marked by persistent overcapacity resulting in pervasively low price inflation of goods. In the absence of strong innovation, a lack of producer pricing power will remain and continue to influence global monetary policy.

5. While the longer-term performance of **U.S. bonds** has been supported by structural factors at home and abroad, **the medium-term asset return remains heavily driven by the global economic cycle**, which makes intuitive sense for the most widely-held global security (Exhibit 3).

6. **The idea that low bond yields will continue to support investments in areas that are broadly conceived of as 'searches for yield,' such as emerging markets, is flawed.** Low bond yields in 2014 did not support emerging markets, high yield or other similar assets, and likely will not going forward. While there are short-term deviations and reactions to spreads, these assets over the medium-term require strong US dollar monetary creation either by the Federal Reserve or US commercial banks (Exhibit 4).

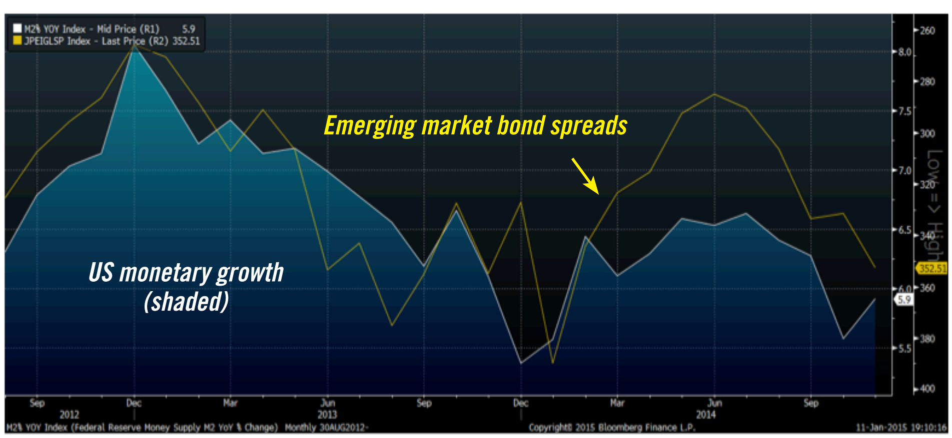
Exhibit 2. Labor markets have tightened globally in spite of poor growth. Little excess labor supply is evident in the US (white), Germany (green), China (purple) or Japan (yellow)

Source: Bloomberg

Exhibit 3. The direction of global leading indicators continues to lead long-term yields: 10-year US Treasury yields in yellow; HSBC global leading indicator in white (shaded)

Source: Bloomberg

Exhibit 4. Widening emerging market bond spreads (yellow, inverted), have moved in line with US monetary growth (white, shaded)



Source: Bloomberg

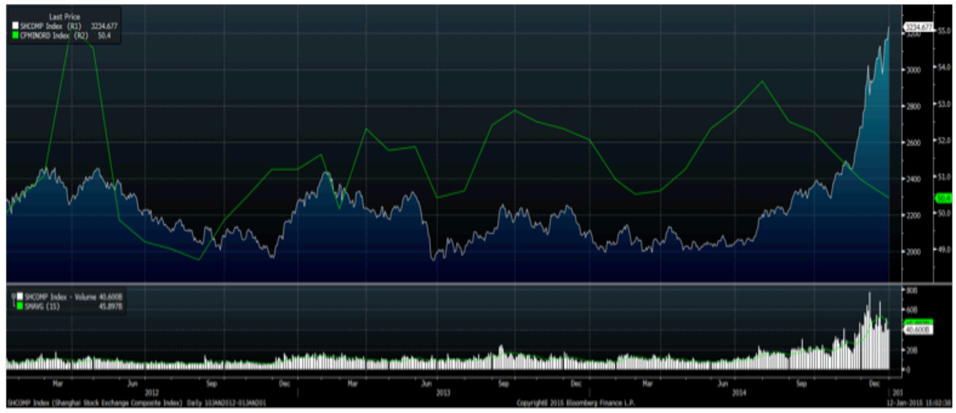
7. **Investors are horrendously bad at predicting oil prices.**

8. As noted in our last quarterly commentary, “A Dollar Saved Is a Quarter Earned,” **we remain convinced that the US dollar is in a secular bull market but are wary of that view tactically,** and the ultimate upside is a function of how high the fed funds rate goes.

9. **Investors no longer believe that inflation could be even a medium-term risk,** as evident in term premia and behavior of long-term breakeven inflation expectations.

10. Finally, seven years after from the early stages of the financial crisis, **central bank policy remains one of, if not the key driver of relative asset returns globally**, with liquidity provision overshadowing the effect of growth in most cases. If this wasn’t already clear, that Chinese equities were the best performing asset in 2014 (Shanghai Composite: +58%) despite the country’s slowing growth rate, should be convincing evidence (Exhibit 5).

Exhibit 5. Chinese equities responded favorably to surprisingly dovish PBOC monetary policy and ignored gathering evidence of a further economic slowdown. China new orders in green; Shanghai composite in white



Source: Bloomberg

Exhibit 6. 10-year US breakeven inflation rate (yellow) and 10-year term premium (white, shaded)

Source: Bloomberg

What are we expecting in 2015?

As fundamental believers in the capital markets, we shy away from saying that markets as a whole are mispriced—but we do see a number of areas that are currently sending mixed signals, many of which we expect to be resolved in the coming year. We have grouped these mixed signals into two main areas: the pricing of inflation risk and policymakers’ potential response to it.

Pricing of inflation risk

Investors are always more heavily conditioned by recent experiences, so it’s not surprising that there’s very little inflation risk premium built into asset markets right now given the absence of inflation in recent years. With energy and other input costs falling rapidly, it’s understandable that there’s no near-term inflation risk priced into markets. However, this is not just a near-term phenomenon; longer-term inflation expectations are falling sharply too. Long-term breakeven inflation rates are falling to levels typically only seen coinciding with recessions. Additionally, term premia (the amount of additional yield investors require to compensate for their duration risk relative to the yield that would be received by rolling over shorter-duration bonds) are again negative and falling quickly (Exhibit 6).

Many have posited that this foretells any number of things, including a potential policy mistake by the Federal Reserve or even that it is incontrovertible evidence that we are in the dreaded 'secular stagnation.' While we won't get into the merits of the Fed policy debate, our current confusion centers on why, if we are entering a period of stagnation such is implied by the inflation pricing, it is not similarly priced into equity markets. Equities continue to rerate higher, especially in the U.S., and are certainly helped by lower discount rates. However, low discount rates support equity valuations only to the extent that they are met with equivalent long-term earnings growth. The last time the S&P 500 enjoyed its current discount rate, it traded at a 20% discount to current valuations. Thus, it's fair to assume current valuations imply some increased confidence about future earnings growth rates, which is hard to imagine in a world that is supposedly in secular stagnation (Exhibit 7). We expect this disconnect to resolve this year.

We also think this is an important point for equity selection as different companies and sectors have differing sensitivities to the low future growth and inflation thesis. For example, the premium or discount that consumer staples companies command relative to the broad market follows almost perfectly the changes in long-term yields and inflation expectations. Consumer staples tend to have 'long-duration earnings'. In general terms, this means the bulk of their value is held in the out-years, and as their stable earnings stream is discounted by lower long-term rates, the stock becomes more valuable than peers in other sectors (Exhibit 8).

Exhibit 7. The S&P 500 is 20% more expensive than the last time discount rates were this low, suggesting some confidence in longer-term earnings growth and a disconnect between the future the bond market is foretelling

Source: Bloomberg

Exhibit 8: Consumer staples sector relative valuation to the broad market (white, shaded) and 10-year US Treasury (green, inverted)

Source: Bloomberg

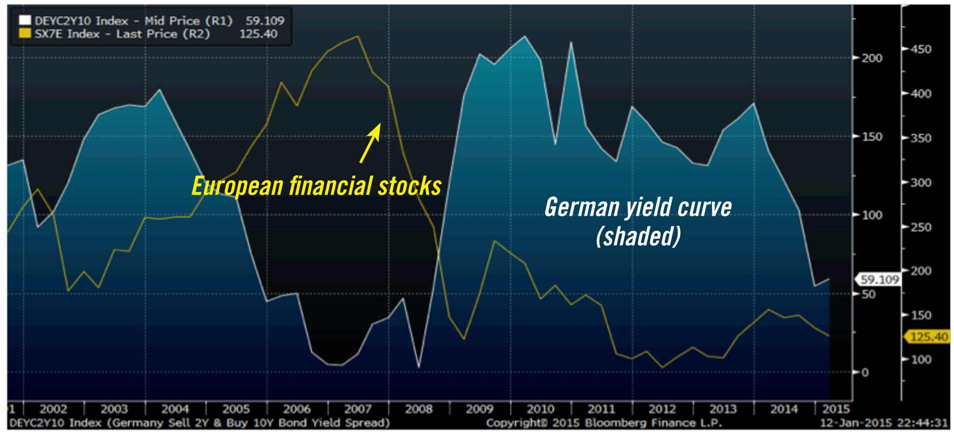
Policy Responses

Another surprising signal we see currently is the limited extent to which markets are pricing in a policy reaction to the aforementioned deflationary impulses. One of our lessons learned in 2014 is that we remain in the age of the central banker and that markets still react primarily to liquidity. If the market is correctly pricing the absence of long-term inflation risk, then it's odd to see so little expectation of a reaction.

The European Central Bank (ECB) has been telegraphing a more aggressive asset buying program focused on sovereign bonds in response to the gathering deflationary forces in Europe for some time now. Interestingly, in every such instance since the financial crisis, markets have responded to such stimulus in similar, reflationary ways. Namely, yield curves have steepened and equities have rallied. Neither of those things is happening now (Exhibit 9).

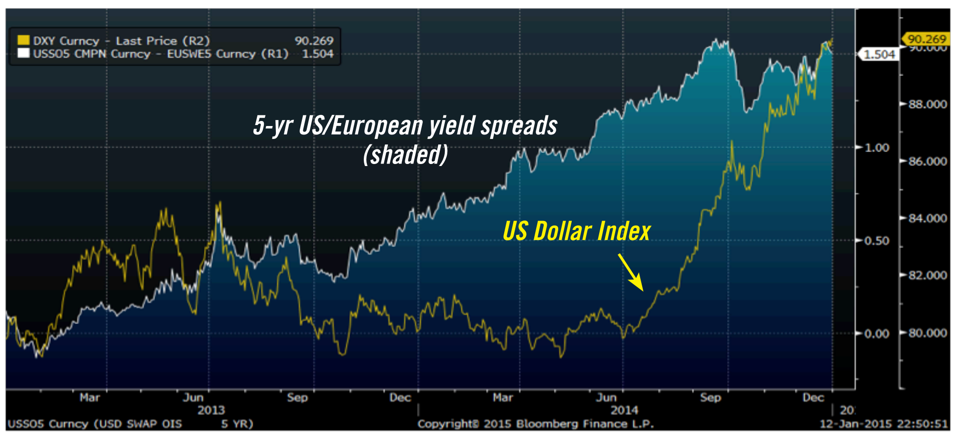
Of perhaps more importance is the unanimity with which investors believe that the US dollar will be strong while also believing in some form of the secular stagnation thesis. Given that the dollar has been moving in line with interest rate differentials, upside in the near-term will be driven by Fed expectations (Exhibit 10). But if the secular stagnation thesis is right, why would the Fed raise rates significantly in such an environment? It's not clear to us that they would. A reconsideration of that policy reaction would have far reaching effects on asset markets, particularly currencies, which would cause today's now main consensus view (a stronger dollar) to be challenged in 2015.

Exhibit 9. Assets in Europe are not pricing in a successful ECB policy response. German yield curve (white, shaded) and European financial stocks (yellow)



Source: Bloomberg

Exhibit 10. The US dollar rally has put itself in line with what is implied by interest rate differentials. US Dollar Index (yellow) and 5-year US/European yield spreads (5y OIS-EONIA spread)



Source: Bloomberg

Moving Forward

We do not strongly disagree with many of the concerns that asset markets began to price in 2014. Growth potential has been falling for years and continues to fall, which is troubling. Inflation is worryingly low and monetary velocity globally remains poor. We merely consider that a lot of issues in the global economy are now so mainstream that they can be considered obvious at this point. The answer to Paul Simon's classic question, "why deny the obvious child?" is that you should deny the obvious when the risk/reward balance shifts or when there's an elevated chance that the narrative behind 'the obvious' has the potential to change.

We leave you with what are, in our opinion, the two most important variables to follow in 2015 as they have the potential to challenge the consensus views previously discussed. First, the longer the U.S. wage recovery takes to arrive, the more the pressure will build for a pause in the U.S. dollar rally. Second, the global economic leading indicators will pick up again and already the downward momentum in growth looks to be easing. When that happens, many investors will be caught flat-footed as it becomes apparent that the world's two major economies (US and EU) are on much sounder footing than they have been in recent years.

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Fourth Quarter Market Review

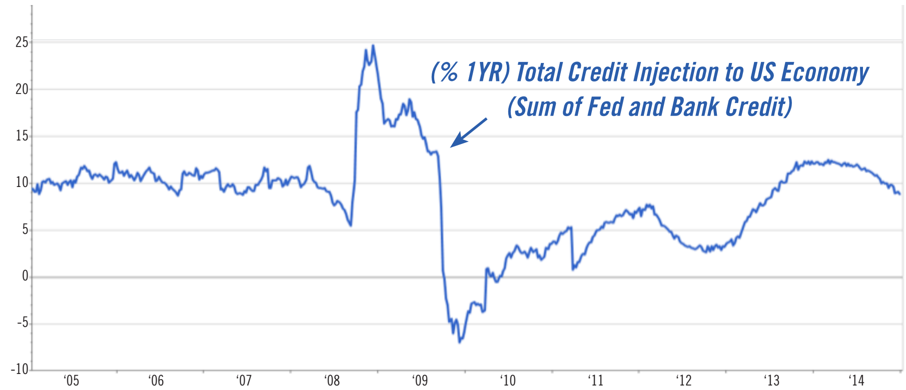
By Richard Thies

United States

US equities posted another strong quarter to cap another year of significant outperformance. Throughout the year, investors continued to reward the U.S. for its sounder near- and medium-term growth outlook relative to most peers. The U.S. gained 4.81% in the final quarter of the year, beating all developed markets despite a notable pickup in realized volatility during the period. Chaotic energy markets and confusion over the 2015 outlook for Fed policy led to a few quick selloffs that were immediately bought. Investors favored microcap growth equities above all else, which dominated for the fourth quarter with a 12.91% rise. In all segments except for large caps, growth again outperformed value. On a sector basis, investors favored sectors positioned to benefit from falling discount rates, falling energy prices and high-growth technology companies. Unsurprisingly, energy stocks were the worst performer, weighed on by the collapsing commodity price.

Going forward, we are reasonably positive about the near-term economic outlook for the U.S. We share the conventional wisdom that the sharp fall in oil is a positive for the U.S. consumer and will continue to support real purchasing power, whether or not nominal wage growth accelerates. On the downside, we are mindful that this is not a free lunch for the whole economy with capex spending, bank lending to the energy sector, and employment in the energy industry likely to suffer significantly. Declining oil prices should act to redistribute spending power with a net negative long-term overall effect.

Exhibit 11: Total credit injection into the US economy, which tends to lead activity by a year and suggests the economy will slow in the second half of 2015



Source: Bloomberg

Without the Federal Reserve purchasing significant assets, the onus of liquidity provision is on the banks. As such, we continue to focus on the total credit provision to the U.S. economy as an early indicator of turning points (Exhibit 11). Currently, extrapolating this data suggests a likelihood that the U.S. economy starts 2015 with a bang and slows in the second half, coincident with when the Fed will supposedly begin its tightening policy.

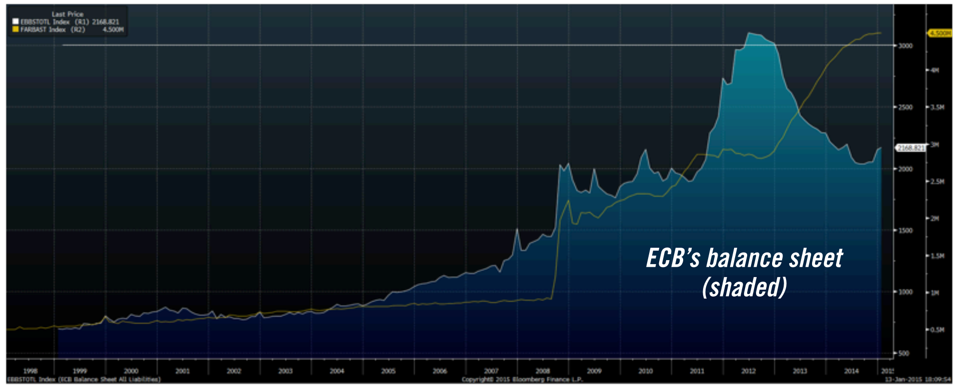
Developed Markets ex-US

International markets were less kind to investors, particularly those with dollar-based investments, as the strong dollar rally sapped returns from every large international developed market. The overriding theme for the quarter remained disappointing growth in most developed economies, particularly in Europe, while commodity-producing economies suffered a profound terms-of-trade shock that will have adverse growth effects going forward.

The poor performance of developed global ex-US countries was most acute in commodity-producing nations where falling equities were compounded with foreign exchange depreciation. Norway (-24.91%) was the notable laggard for the quarter. The peripheral European nations generally performed poorly in spite of well-behaved fixed income markets. The poor performance of European banks and several capital raisings weighed on indices. Portugal (-23.01%), Italy (-10.9%) and Spain (-8.19%) were the other bottom-performing countries. Equities in Hong Kong (+3.10%) were the best performers in the group, following the bullishness in China during the quarter.

The near-term outlook for developed markets is rife with event risk. This is mostly focused on Europe and the much anticipated late-January ECB meeting where an aggressive policy response may or may not occur. We are cautiously optimistic with the ECB's ability to surprise positively with an aggressive sovereign bond buying program. The scale of its challenge is well known and we believe the bank will be able to get the balance sheet back up to 3 trillion euros. While we are sympathetic to the prevailing narrative of deflation in Europe, we are not as negative as the consensus. The ECB's balance sheet has contracted by roughly a third since 2013, so the lack of monetary growth or inflation is not a surprise. To our knowledge, this was the biggest contraction of a major central bank balance sheet in history and reversing it will reverse many of its adverse effects. While the initial target will be about 3 trillion euros, we believe the balance sheet will be even larger in the coming years (Exhibit 12).

Exhibit 12: The ECB's balance sheet (white, shaded) has just gone through an unprecedented contraction and will likely return to 3 trillion euros by the end of 2015. (Fed's balance sheet in yellow for perspective)



Source: Bloomberg

Emerging Markets

The fourth quarter did not bring any relief to another poor year for emerging markets with stocks falling 4.44%. Emerging market currencies were not spared from the dollar rally either with a challenging environment being exacerbated by the sharp commodity weakness and the extreme movements of the Russian ruble. On the whole, emerging market currencies fell 6.14% during the quarter and 11.76% during the year. Equities, however, saw a wide dispersion as commodity-producing nations fell sharply but oil importers like Turkey (+11.60%) reacted well. The biggest surprise for the quarter was definitely the strong rally in Chinese equities, led by monetary policy easing aggressively. Chinese stocks were up 7.17% for the quarter as a result, shrugging off mounting evidence of a further growth slowdown.

This coming year is likely to see continued volatility within emerging markets and high levels of dispersion at the country and sector levels. We anticipate a primary component of EM equities' overall return will again be foreign exchange. With most currencies having already corrected significantly, we are less bearish on the outlook than a year ago in part due to high yields and many reforms likely to bear fruit. However, the top-line growth outlook is not exciting but we see significant room for profitability improvements at the company level given how poor profit discipline has been in recent years for many large companies.