CityFinancial

On the Mark – Multi Asset Allocation

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Backdrop

- We continue to believe that the overarching long term environment incorporates a number of disinflationary threats. These conditions are the direct result of the ongoing debt overhang and ambition to delever from both developed and emerging countries.
- The global economy is desynchronised and countries appear to be caught in mini cycles of growth improvements which fail to sustain due to deep and unexplained structural impediments e.g. almost universal low wage growth and low productivity.
- We are now past the point of central bank policy divergence, with the US raising rates while the UK is on hold and Europe and Japan look certain to continue with accommodative policies. In the US, the Fed are raising rates, even though their favoured Core PCE measure of inflation is still a long way below its 2% target. They are raising rates with high yield market credit spreads much wider and GDP growth much weaker than at the start of previous hiking cycles. It should be noted that seven major economies who have raised rates since 2009 have all had to reverse and cut rates. As a result, this is an acid test of the Fed's policy credibility and with it we are highly likely to witness a period of heightened volatility in most asset markets.
- This occurs on a backdrop of the IMF forecasting the slowest pace in global growth since the global financial crisis. They went on to state that weakness reflected common longer-term forces slowing the potential for growth in many countries, including lower productivity growth, high public and private debt levels, ageing populations and a hangover from post-crisis investment booms in many emerging economies. The risks of policy error are extremely elevated.
- Investors are still wrestling with a slew of new complex issues with a wide range of outcomes that are truly confounding and extremely difficult to price. High conviction *a priori* positioning leaves markets open to violent rotational moves and we expect to see a continuation of this environment, where markets are treacherous to navigate.
- As if to prove the preceding point, we can see from a range of investor surveys that investors are extremely crowded into the long US dollar trade, and all of its variations, i.e. long US banks, US technology stocks, short Euro, commodities and emerging markets. This positioning is predicated on the primary belief that the Fed will follow its "dot plot" of tightening. However, we feel the risks are now asymmetric with two alternative paths possible, the latter being priced in the interest rate futures markets.
    1. The Fed tighten more aggressively than markets currently expect and the US dollar continues to strengthen. US financial conditions would tighten, growth would markedly slow and this could provoke a crisis, led most plausibly by emerging markets and commodity producers.
    2. The Fed relent after a couple of rate rises and the US dollar significantly weakens. This would ease deflationary pressures and a violent rally in the under owned and depressed areas of markets, such as emerging market equities and commodities, would likely follow.
- Consequently, there is a tension in the markets as the movement of investor expectations from one path of rate tightening to another will be a critical driver for the USD and everything that naturally follows.

Review

- At the start of 2015 we offered a number of forecasts on markets and we thought it would be worthwhile spending a moment to review them:
    - Headline inflation would be under sustained downwards pressure and we would see some downside surprises.
    - The Fed would take a long time to raise rates if they did at all in 2015.

- The US dollar would remain strong, as the best from a number of poor choices.
- The ECB, Bank of Japan and Bank of China would embark on many more rounds of stimulus, support their bond markets and leave their currencies vulnerable.
- Conditions were in place for violent rotations between bonds and equities to ensue.
- Continued weakness in most commodities and Australia, Canada, South Africa, Russia, Brazil and much of the Middle East would struggle.
- Many emerging markets would see dramatic currency moves in combination with big bond market selloffs.
- We favoured US equities, particularly consumer and technology sectors, Japanese and Chinese equities, the US dollar, ten-year UK Gilts and 30-year US Treasuries, for the first half of the year.
- Consensus expected a hard landing and continuing debt problems in China, with the increase in equities likely to fizzle out. We believed that credit issues will be contained and further easing would be forthcoming along with other stimulus measures.
- Chinese companies were on cheap valuations and were a buy on any setbacks (likely to offer significantly rewards in H1 2015).
- Most markets would continue to positively surprise the majority.

* Whilst many of these were correct, we underestimated the slowdown in China and market falls, did not foresee the Greek crisis and were subsequently too optimistic on risk assets in the middle of 2015.

Outlook

* We continue to believe that we are in a highly elevated risk environment as the point of divergence in monetary policy has been reached. The risk of policy error is very high and it is likely to result in extremely elevated bond, equity and currency volatility. This period will be an "acid" test of the Fed's policy credibility and their assessment that low growth and inflation can be attributed to cyclical rather than structural factors. As such, it is likely to create a number of unintended tensions within markets.
* Recent activity in markets has opened up a range of interesting opportunities and we look forward to taking advantage of these. There appear to be a number of disconnects priced into different asset markets that will have to be resolved at some stage. The obvious downside risk is that a marked slowdown or recession unfolds in the US.
* In the meantime we see that most central banks are likely to extend stimulus and usually this has positively impacted asset prices. European equities look likely to benefit most as they still offer some value and should be supported by few inflationary pressures and a supportive central bank.
* We believe that China should stabilise after the stimulus measures enacted and this will lend some support to global growth and commodities. However, there is an obvious danger that the currency is further devalued and this unleashes greater deflationary forces into the global economy.
* A range of investor surveys show investors heavily crowded into the long US dollar trade and all of its variations. It naturally follows that the expectations for US monetary policy will be key to the US dollar and areas of reward in 2016.
* We feel that the Fed will waver in 2016 and this will cause a lot of rotational activity. We believe that they will move from a short-term softening of tone to a more hawkish bias around the end of Q1, only to relent on rate rises in the second half of the year as US growth momentum fails to sustain. As a result there will be elevated levels of volatility. These thoughts lead us to the below expectations for asset markets:
* In the short term, the US dollar weakens, then strengthens around the end of Q1 only to weaken late in the year.
* US long bonds remain under pressure in Q1, but yields fall back to previous lows later in the year.

- Favour developed market equities, especially Europe, but gains will be relatively muted, with the chance for significant losses in areas where growth disappoints.
- Dividend growth will be a very rewarding equity style for 2016 in most equity markets.
- Emerging markets remain in a structurally poor position, leaving their bonds and currencies especially vulnerable as they continue to try to delever but face growing economic pressures. The continuation of a weaker than stronger oil price will be particularly difficult for the oil exporters and Saudi Arabia will face increasingly difficult choices, with a currency devaluation highly likely in our opinion.
- A violent rotation into the laggard and depressed areas of the markets is likely to occur in Q1 as investors rush from their crowded trades. Commodities, emerging market equities, the Yen and Euro will all rally but then unwind their gains as US dollar reasserts its dominance. As a result, the range of returns will be very wide but over 2016 returns will generally be weak in these asset classes.
- High Yield markets offer excellent opportunities following their spread widening over 2015 but may face threats in the second half of the year if US growth slows.
- We continue to see many opportunities that should reward investors in 2016, but remain very conscious of the risks posed by a policy error, primarily in the US but also in many developed and emerging countries that face an ongoing challenge to reduce debt levels in a demand-deficient world.