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The investment outlook for 2015

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Divergence – the hallmark of 2014 when it comes to economic and financial market trends – looks likely to be an important feature of 2015 as well, but where will it occur? We ask our Multi Asset Solutions team's chief economist, Joost van Leenders, and the team's chief investment officer, Colin Graham, for their view on the global economy and financial markets for 2015.

To start with you, Joost, are all growth differentials cyclical in nature?

Joost van Leenders (JvL): No, they are not. We foresee some cyclical improvement in the global economy, so the major differences next year will be due to differences in trend growth. Trend growth is the pace at which economies can grow over the longer term as determined by the growth of the labour force and the pace of improvement in productivity. We think this is higher in the US, at around 2.5%, than in the eurozone, where it's about half that pace. In Japan it is probably just below 1%. In emerging markets it is generally higher, especially in China, where the authorities' growth target currently has more weight. This may be cut next year to 7%.

But economies generally do not grow exactly at trend. What could drive any deviations from this long-term growth potential?

JvL: The recent drop in oil prices is positive for the global economy, particularly the major developed countries. Even in the US, which has become a large oil producer recently, we think the impact from lower oil prices is positive. Other positive factors include extremely loose monetary policy, even now the Fed has ended its asset purchases. And in many countries, fiscal policy will be less of a drag on growth in 2015 than it was in 2014. The US will have to cope with a stronger dollar and pent-up demand – usually a big driver of above-trend growth once a recession is largely over. There is room for growth in the housing sector and in business investment, though. This could lift growth somewhat above potential in the US. There is more pent-up demand in the eurozone, so when the economy improves after the loss of momentum in the second half of 2014, growth may exceed potential. However, ending 2014 at a slow pace will inevitably handicap the average rate of growth for the full year 2015. So even if growth slightly exceeds potential in most quarters in 2015, the total for the year could still be around only 1.25%. Japan may struggle to reach potential in view of rising inflation and the 2014 tax hikes, while the Chinese economy may need continuous stimulus measures to reach the authorities' growth target.

"The recent drop in oil prices is positive for the global economy"

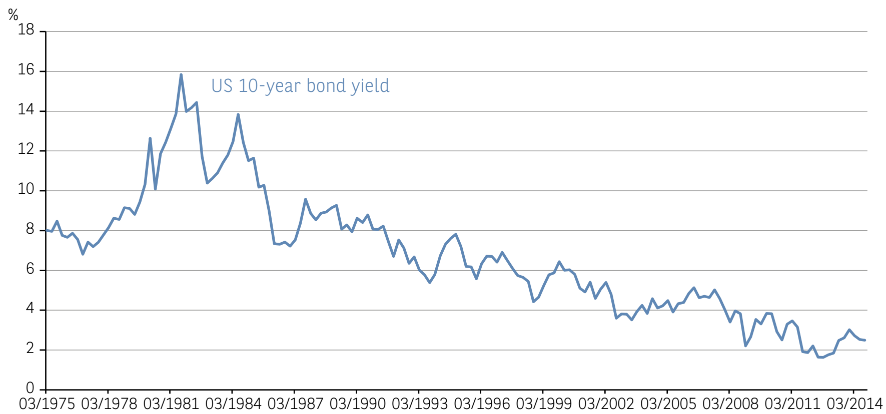
What will be the impact on inflation and monetary policy?
JvL: Inflation has been described as "the dog that did not bark"[1]. This may change cyclically in 2015, in the US in particular. But with growth only somewhat above potential, any return of inflation will be only gradual. The main issue in the eurozone will be whether disinflation becomes deflation. We think the latter will be avoided. We don't see inflationary pressures in emerging economies either, so inflation should stay subdued. In that sense, we think rate hikes by the Fed or the Bank of England should be seen as the next steps in policy normalisation after asset purchase programmes have ended. The Bank of Japan will be on hold for a while after it announced a big increase in its asset purchase programme in October 2014, but the ECB and the People's Bank of China may yet decide to provide more stimulus.

So, Colin, what are the likely consequences of a Fed rate hike in 2015?
Colin Graham (CG): In our view, there is scope for some unintended consequences in the wake of official interest rates lifting off in the US. We envisage volatility rising across most asset classes. Additionally, post the financial crisis, we have seen considerable deleveraging as lenders have restricted access to credit, so the scope for individuals and companies for short-term borrowing to smooth out any kinks in their cash flow has been reduced. We believe this is a change that may lead to more uncertainty around the direction of the economy. The role of the US economy as the locomotive leading the world economy would not, initially, change. However, as the global recovery takes hold over the next 18 months, cheaper assets in other regions where the outlook for growth is improving will start to attract investors. The average US economic cycle lasts for about a decade. We are now six years into an unusually slow recovery. We believe this cycle is already different for many reasons, so we could experience an extended economic cycle in the US this time around.

What about Europe? What is your analysis of the outlook for European financial markets?
CG: With the Asset Quality Review behind us and the ECB embarking on its version of quantitative easing (QE), there should be a freeing-up on bank balance sheets and more of a focus on doing business since uncertainty about the new regulatory environment has been removed. In our view, since European equities are distinctly cheap compared with US equities, we expect investors to rotate into eurozone equities. Valuations of eurozone bonds (both government and corporate) will be supported by the ECB's quantitative easing.

"In our view, European equities are distinctly cheap compared with US equities"

Exhibit 1: Change in the yield of the 10-year US Treasury bond - April 1975 through September 2014



Source: BNP Paribas Investment Partners as at 30/09/2014

How would emerging market equities perform in this environment?
CG: The likelihood of rising rates in the US has weighed heavily on the valuations of emerging market assets. More recently, the US dollar rally and the rise in volatility have pushed valuations even lower. Emerging market bears may warn that such valuations have all the hallmarks of a classic value trap but in the Multi Asset Solutions team, we expect valuations to reach a level at some point in 2015 where these assets are cheap enough to buy. The positive side of such developments in the US and Europe is that it should allow emerging market central banks to pursue accommodative monetary policies.

1 Chapter 3 of the World Economic Outlook, April 2013, www.imf.org or EU should stop worrying about deflation, Andrew Sentance, May 2014, www.ft.com

And what about bonds? Will 2015 see an end to the bull market in bonds?
CG: For the last 30 years, government bond investors have had it all – capital preservation, inflation-busting growth and income (exhibit 1 shows the change in the yield of the 10-year US Treasury bond since 1975). However, with interest rates at emergency lows, yields close to all-time lows and the Federal Reserve poised to hike rates, I would intuitively tend to predict the end of the bond bull market. I recognise that investors have been predicting a turn in bond markets for several years now, so why should 2015 be the year? I'd turn that question on its head and ask "what do we need to see for this bull market to continue?" The answer is a Japanese-style outcome – deflation and lost decades. As already explained, this scenario is not on our macroeconomic road map in 2015, the US not being Japan in so many structural ways. We expect government bond yields to rise, but in an orderly fashion.

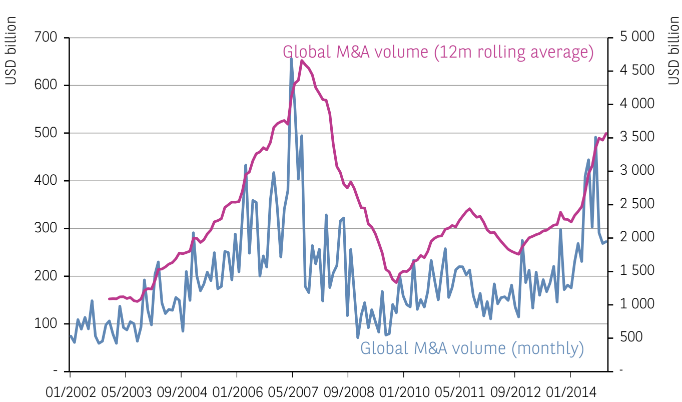
> "We expect government bond yields to rise, but in an orderly fashion"

What other factors should investors take into account?
CG: The commodities, geopolitical and economic growth puzzle continues to confound many investors. Heightened geopolitical risks are here to stay, in my view. The rise in volatility from low levels will cause alarm in short bursts as investors adjust to larger price shocks. There will be times when diversification does not work and times when the successful buy-and-hold strategies are questioned. Dynamically changing portfolios should be able to benefit from the bigger price swings.

Global financial repression has compressed investment yields and income, as highlighted in the government bond market, but investors still have appetite for income-generating assets. This should push yield-hunters further up the risk curve in search of returns to satisfy their liability structures. In our opinion, cheap assets with higher yields stand to receive flows and this cycle will become self-fulfilling as sentiment improves and volatility becomes a secondary concern.

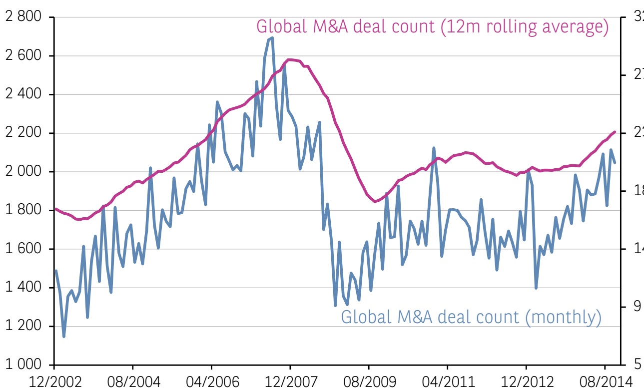
Business leaders are increasingly confident about the future.[2] Accordingly, we saw a significant jump in merger and acquisition activity in 2014 (see exhibits 2 and 3). We expect this to continue and to reach levels last seen in 2006 and 2007. The consequences for investors depend on where you are invested in the capital structure, i.e. in corporate or high-yield bonds or in equity. The growth dividend for equities as managers put their cash balances to work should push equities higher, on average. However, the abundance of cash and access to 'cheap' financing could create conditions for an unfavourable turn in the default cycle in a couple of years and hit the outlook for high-yield returns.

Exhibit 2: Global merger & acquisition monthly volume – January 2002 through October 2014



Source: BNP Paribas Investment Partners as at 31/10/2014

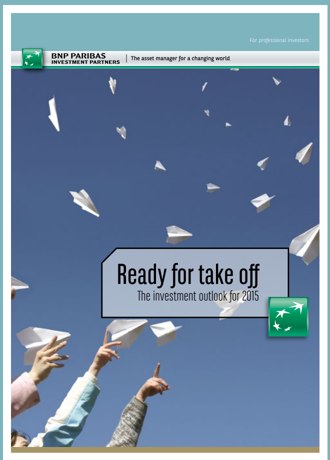
Exhibit 3: Global merger & acquisition monthly deal count – January 2002 through October 2014



Source: BNP Paribas Investment Partners as at 31/10/2014

Written 6 November 2014

2 See the latest Ernst & Young – Global Capital Confidence Barometer



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