



An Inconsistent World

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- **Equities discount more growth than the world can deliver at present**
- **Bonds have remained the star asset class, in keeping with our cautious view on markets**
- **Central banks remain challenged, as economic agents fail to take on more risk**
- **We are more confident on China**
- **Current crude prices may have already discounted much of the good news**

What an inconsistent world of investment. Both equity and bond markets generally stand close to their recent highs. Global equities have risen 11% from their February lows whilst bonds have rallied, with the US 10-year bond yield at 1.71%, close to its recent lows. Think of it this way, the last time that the 10 year bond yield was at these kind of levels equities were 11% lower down. We continue to believe that the valuation of bonds is more right than equities. Equities to our mind discount far more growth than the world can deliver at present.

Developed market equities have ducked and dived since the start of the year, but underlying fundamentals remain poor. Many of the valuations are high by historical standards and highly dependent on policymakers doing a good job of convincing the markets they are going to achieve something with their low interest rates and quantitative easing. Meanwhile investors have to deal with the ongoing fundamental negatives. Corporate earnings of the US equity market S&P 500 are forecast to have fallen 7.6% year-on-year in the first quarter, according to data compiled by S&P Global Market Intelligence.

Bonds have remained the star asset class in keeping with our cautious view on markets. US 10 year-yields have dropped to low 1.70% in keeping with a perspective of limited global economic growth. Note though that the previous recent yield lows were around the 1.68% mark hence there may be very limited capital upside on conventional treasuries from here. For other bonds to perform will need further spread narrowing and little support we believe from the performance of US Treasuries.

With US Treasury 10-year yields probably at the low end of the likely trading range, it is important that investors are discerning buyers of credit. We have had a preference for euro high yield over US high yield and this continues to be the case. The ECB's actions in the bond markets support higher yielding Eurozone corporate credit. Mutual fund flows into European high yield have remained positive in recent months, at a time when supply has been limited and indeed with the natural maturing of bonds net supply has been negative. With a number of Eurozone government bond markets giving negative yields investors are being forced to take more risk by investing in more volatile bonds such as high-yielding debt.

Central banks remain challenged. The Bank of Japan believed that setting negative interest rates would help the Yen depreciate. Instead they have overseen a sharp appreciation of the Yen against the dollar up to a 17-month high. The ECB's policies to date have yet to create momentum in the economy, recent economic data has remained mixed. The minutes of the latest Fed policymaking committee showed members to be concerned about global events and fearful that both growth and inflation had a downside bias. The market is now discounting that the Fed has no chance of increasing interest rates at their next meeting in April. Indeed it is only by the December meeting that the market is currently discounting a 50-50 call of whether the Fed raises rates.



Japanese equities have had a torrid time of late provided with little help from policymakers. The economy is going through a significant soft patch with consumer and industrial confidence both falling sharply in recent months. Household confidence fell from 50.0 in the first quarter to 40.1 in March. Industrial confidence fell from 50.3 to 43.9 over the same time period. The aggregate level of confidence is back to where it was through much of 2015, i.e. there is no improvement from the struggles of previous years. The policy makers will be under intense pressure to respond to the ongoing weakness of the economy. Many commentators however do not expect a policy move from the Bank of Japan at their April meeting, although the pressure must be building for something to change.

We are holding our positions on Japanese equities despite the poor flow of news. We believe that the authorities will have to move at some time to prop up the economy and the equity market. There are a number of episodes in recent history where policy action can easily put 15% on the index in a matter of days. Note though that the poor performance of the equity market is mitigated in dollar terms by the strength of the Yen. So a year-to-date performance of -16.9% translates into a 7.7% fall in dollar terms, about in line with the Eurozone.

We have gained more confidence in our positive tactical view of China. The positive surprise in the Chinese industrial confidence means that some of the government's actions to stimulate the economy are bearing fruit. The equity market represented by the Shanghai composite is up 12% from its lows in mid-January. Other data for March is expected to show an acceleration of economic activity, in further support of the equity market's recent outperformance. Industrial production is expected to be up 0.5% month-on-month in March, a sharp acceleration of the level of activity in the first few months of the year.

Our conviction in the Chinese equity market helps support our overall positive view of emerging market equities. The emerging market index has paused for breath after rising nearly 19% from its lows.

Could it be that all of the good news is already in the oil price? As we approach the Doha meeting on April 17th of OPEC and non-OPEC countries on a possible deal to freeze production, the omens are not looking that good for a deal that underpins the oil price significantly above \$40. At the end of last week the oil price spiked on news that US inventories of crude oil had dropped and US production had fallen back for the tenth week in eleven. The Brent oil price has spiked from a recent low of \$37.40 to end last week at \$41.90. Looked at a slightly longer time perspective, the price has risen over a third from its February lows on the hope of a deal to freeze production. We suspect that much of the good news is in the price.

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