Investment outlook – 2014

December 2013

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We believe that 2014 will be characterised by the move towards financial markets standing on their own feet, as the global policy support that has provided abundant liquidity to markets starts to be withdrawn. This will mark an important change in the drivers of investment returns:

- Instead of liquidity, corporate earnings will move into the spotlight and drive equity performance
- The gap between equity and fixed income valuations will continue to normalise as bond yields rise
- Corporate credit is likely to outperform sovereign debt but we do not anticipate a 'great rotation' out of bonds
- Emerging markets are a 'wildcard' and likely to remain volatile

Following many years of liquidity provision from the world's central banks which supported the performance of risk assets, 2014 will see the global economic recovery put to the test. Financial markets will have to re-engage with reality against a backdrop of significant macro and policy challenges and investors need to be alive to the consequences of this changing environment and subsequent volatility. What happens if quantitative easing (QE) is withdrawn too quickly? What risks lie ahead if companies do not deliver earnings growth?

Equities

While we remain bullish on equities overall, regional and sector performance is likely to vary. Investors are increasingly shifting their focus away from market liquidity to company fundamentals following the US Federal Reserve's announcement in September that it is preparing to taper QE. Companies will have to step up their game and earnings will have to pick up if equities are to come close to matching the rally seen in developed markets during 2013.

US company earnings have been robust, having recovered and surpassed their previous peak. We do not think this year's equity market returns of close to 30% will be repeated in 2014, but our global equity team believes that US equities remain attractive. The banking sector is well capitalised and has started lending again, providing a boost to the economy. While the debt ceiling remains a risk, a combination of low energy and labour costs should support company margins into 2014. We believe the best performers will be companies in the technology and consumer discretionary sectors.

In contrast, only half of European companies have beaten earnings expectations so far this year. The region remains beset by relatively poor growth dynamics compared with the rest of the developed world. The stock market recovery seen in 2013 could easily herald a false dawn. The banking sector still has a long way to travel to address its capital shortage, although the fundamentals are much improved. While Europe is likely to return to positive GDP growth in 2014 (the first time we have anticipated such an outcome in three years), earnings growth is likely to be steady rather than dramatic. Stock pickers, however, could be handsomely rewarded when concentrating on companies with strong business models, robust finances, experienced managements and, ideally, dominant market positions.

While the UK economy is still smaller than it was pre-crisis, we have seen some very encouraging data in 2013 and GDP growth could be in the region of 2% next year. Unemployment has been falling and there is a likelihood that the Bank of England's 7% threshold could be reached in late 2014. The problem is that the positive data has not necessarily translated into domestic profits thus far. On the upside, we have seen a pickup in IPO activity and expect the improved economic backdrop to further drive corporate confidence and activity in 2014. We think the best returns are likely to come from industrials and the consumer discretionary sector, with consumption (and housing) having driven the economic recovery to date. However, relatively little economic rebalancing has taken place (something that has been exacerbated by the success of the 'Help to Buy' scheme) and raises questions over the sustainability of the recovery.

Japan has embarked on a clear and credible path, and 'Abenomics' has been transformative. Low interest rates support credit growth and some surveys suggest that 80% of companies are set to raise base salaries.[1] More challenges lie ahead but we expect further gains in equities and are overweight in financials and beneficiaries of policy action.

Fixed income
2014 is likely to be a year of transition for bonds. The expectation of QE tapering has already led to the end of the bond market rally, although we see no evidence for a rotation out of the asset class as demand from pension funds and banks remains.

In sovereign markets, we expect yields to move gradually upwards, with the 10-year US treasury yield at around 3.5% by the end of 2014. While we may not witness a return to the historic norms just yet, the gap between equity and bond yields should slowly start to normalise, so the ‘risk-on’ stance that has worked well for investors during the last few years should become less glaring in 2014. In fact, corporate credit is an asset built for a slow growth environment and we continue to prefer it over sovereign debt. High yield in particular has had a good year and European high yield has benefited from its non-dollar and short duration characteristics. Company balance sheets are robust and we see defaults as very unlikely.

Emerging markets
Emerging markets are a mixed bag and a potential wildcard in 2014. The announcement of QE tapering has caused significant headwinds in fixed income assets and concerns over currency volatility and current account deficits remain. Emerging market equity valuations are attractive, but history shows that rising US treasury yields and a stronger US dollar can have a negative impact on returns. In addition, GDP growth in countries such as Brazil is unlikely to look spectacular compared to the developed world. On the upside, Mexico should benefit from solid growth linked to the US economic recovery and the country’s lower manufacturing cost base compared to China. While the latter has impressed us with its recent policy announcements, stock picking is going to be of particular importance over the next few years. Equally, domestic markets in Latin America and those emerging market companies that are geared to an economic recovery in the developed world should not be dismissed.

Commercial property
We expect the UK commercial property market to make further headway in 2014 as the economic recovery continues to have a positive impact on occupational demand. The main beneficiaries should be the South East, as well as logistics and warehousing markets across the country. Top provincial office markets are also showing some signs of recovery. We believe investors will continue to be attracted to commercial property next year and competition for stock should place upward pressure on capital values.

[1] Japanese Ministry of Labour and Welfare survey