Our Big Picture Outlook

January 2014

ROTHSCHILD

Setting the scene

The scenarios presented here are intended to illustrate our economic outlook over the next few years.

What this is

A series of scenarios for GDP growth and inflation in the main western economies, Japan and China.

A simplification. The global economy is complex and multi-dimensional, and can be represented in many different ways. While narrowing in on just growth and inflation involves some simplification, we believe it is still worthwhile – most other economic variables and policy actions can be covered in relation to their impact on growth and inflation.

A guide to our thinking. The scenarios flow from our investment analysis. They are intended to illustrate the thinking that shapes the way we have built our clients' portfolios. They can also help identify some of the main investment risks and opportunities.

What this isn't

A series of detailed forecasts. In any exercise like this, there is always a danger of giving a false sense of certainty. We have kept our comments at a fairly high level, providing a sketch of what we see as the most likely outcomes.

Something set in stone. Our analysis evolves over time: the scenarios provide a snapshot of our outlook in 2014.

Something prescriptive. The scenarios are mainly a tool for communication. While they are valuable in our investment decision-making, they are not something we use rigidly.

What has changed?

Since we last published this report, the global economy has continued to recover, driven by the US. Although growth remains weak, conditions in the eurozone have also improved. Meanwhile, Japan appears to be making progress with efforts to stimulate its economy and China seems to have avoided a sharp slowdown.

Improving global economic data suggests to us that the world could begin to move away from the current situation of sluggish growth and loose monetary policies. Further monetary "experiments" are becoming less probable. However, significant imbalances and risks persist. This is the reason why we have left the size (probability) of our depression scenario unchanged.

Four main scenarios

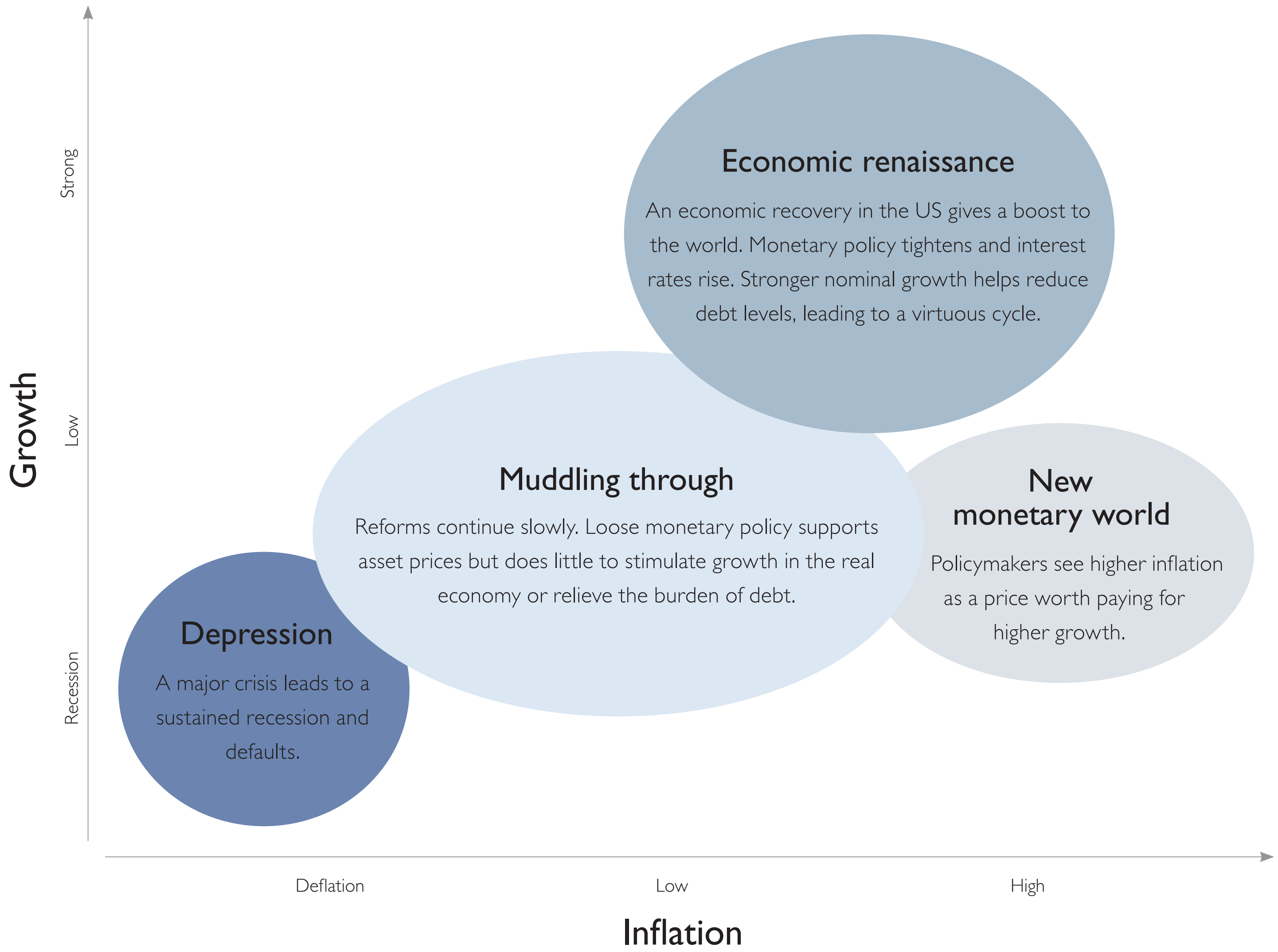
We have identified four different scenarios that, in our view, are the most likely to occur.

For each scenario, the position of the bubble shows the combination of growth and inflation that we expect to see in the next one to three years.

The size of the bubble illustrates our view on the likelihood of this scenario occurring – this is subjective, and is intended just to illustrate our thinking.

Growth is expressed in relation to the potential for each country. For example, a growth rate of 4% would be low for China but very high for Europe. Similarly, inflation relates to a country's individual inflation target.

We have adjusted the size of the bubbles to reflect our view that conditions in the global economy should continue to improve in 2014. We believe the world could begin to move away from our core "muddling through" scenario towards "economic renaissance" and that the "new monetary world" situation has become less likely.



Economic renaissance

Positive economic data suggests this scenario has become more likely.

What happens?

- **The US breaks out of the doldrums.** Loose monetary policy, a recovery in housing, cheap new sources of energy and increased competitiveness of the manufacturing sector boost US economic growth and employment.
- **Policy becomes more normal.** As growth picks up, the US Federal Reserve begins to return to a more normal monetary policy. Even without major structural reforms, debt as a proportion of GDP still falls in the US, driven by higher tax revenues and stronger overall growth.
- **Asia improves.** Abenomics is successful and Japan's recovery is sustained. In China the transformation to a more demand-led economic system proceeds smoothly and imbalances can be addressed. Other Asian economies profit from the economic health of China and Japan.
- **The Eurozone clouds move away.** Strains in the Eurozone diminish. Northern Europe, especially Germany, continues to steam ahead boosted by global trade and solid internal demand. Peripheral countries are affected positively by the buoyant global economic climate and growth reappears.
- **Inflation rises.** The growth in global demand leads to an uptick in inflation. Monetary authorities are slow to respond because they are afraid to nip the recovery in the bud. However, once the recovery has become self-sustained, central banks react vigorously by normalising monetary policy and draining excess liquidity from the system.

Muddling through

This current situation could persist for some time.

What happens?

- **Monetary policy remains very loose.** High debt levels prevent governments from cutting taxes or spending more. As a result, interest rates stay close to zero, but this is not enough to drive sustained and self-supporting growth.
- **Financial repression prevails.** Real interest rates are negative in most Western economies and become negative in Japan. This should help to accommodate, and eventually reduce, the burden of public debt. But the process is slow.
- **Politicians are timid.** Austerity measures are not aggressive enough. Difficult structural reforms are staggered, gradual and sometimes put off entirely. Again, this makes debt reduction a slow process.
- **The Eurozone crisis becomes chronic.** Necessary reforms and institutional changes fail for lack of political support. A divergence in growth and employment within the region adds to the tensions. There are risks of a more acute crisis.
- **Growth is choppy.** A wall of money pushes the price of some risky asset classes above their fair valuations. The authorities are reluctant to tackle any asset-price bubbles for fear of denting confidence. But if they burst there could be big swings in levels of economic activity.
- **Emerging markets are mixed.** Some large economies struggle to rebalance. Notably in China, where the transition to an economy that depends more on domestic consumption is uncertain.

New monetary world

In this scenario, higher inflation dominates the landscape.

What happens?

- **We move deeper into uncharted territory.** High debt levels prevent governments from cutting taxes or spending more, and the emphasis is on central banks to take action. Central bankers press onwards, launching even larger stimulus measures while changing their objectives to target higher inflation rates or nominal GDP.
- **Inflation moves higher.** Inflation rates of 3-5% are accepted in the major economies. But it will prove difficult to keep inflation in this "benign" range, and there is a high risk of much faster price rises. The risk is high in developing economies that continue to peg their currencies to the US dollar.
- **There is a boost to growth, for a while.** Over the short to medium term, economic activity picks up. But the impact on potential growth in the long term is negative – inflation expectations rise, resources are misallocated and uncertainty about when central banks will end their stimulus programmes makes businesses reluctant to invest.
- **Trade may suffer.** Emerging market currencies are likely to rise strongly, which would not be welcomed and may lead to protectionist measures, capital controls and a subsequent decrease of global trade. In turn, this would reduce global growth over the medium term.
- **"Zombies" stagger on.** Fundamentally weak banks and companies are kept on life support. This prevents painful but necessary structural adjustments and stops resources from being allocated more productively.

Depression

A sharp reduction in risk appetite compacts all but the safest assets.

What happens?

- **Confidence collapses.** A failure in the financial system and the renewed flare-up if the strains in the European monetary union is the most likely trigger of a severe depression. In the panic that follows, there could be runs on banks or entire states.
- **A credit crunch in China** followed by strains in the economy and political systems could also trigger a crisis that could spread across the globe, given the still fragile state of the global economy.
- **Official response fails.** Fiscal policy has reached its limits and cannot deliver a further stimulus. Monetary policy is caught in a liquidity trap – more money is printed but this does not restore confidence and, instead, only adds to the instability.
- **Consumption and investment demand plummets**, leading to lower tax revenues and a surge in debt-to-GDP levels. Tensions in the Eurozone rise, making a break-up more likely.
- **Bunker mentality sets in.** Capital controls and protectionist measures are introduced. Developed economies try to devalue their currencies to boost their exports.
- **Emerging markets suffer.** Growth in developing countries falls below trend, asset prices drop, inflation is subdued and there are periods of recession. China eases monetary policy further and props-up its banks. More countries experiment with alternatives to Western capitalism.

Implications for returns from asset classes

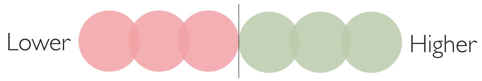
The table summarises the expected returns of the major asset classes under each of our four main scenarios.

The circles in the boxes show the expected return over the next three years, relative to the long-term expected returns*. Light green means higher than long-term expected returns*, while light red means lower.

These figures are an illustration of our thinking. They are based on an informed interpretation of our fundamental valuation models.

Key

Expected return relative to long-term expected returns*:



Notes – 1 Average-quality BBB. **2** Hedged into US dollars. **3** Includes listed (mostly REITs) and private real estate. **4** GSCI index in US dollars. **5** In US dollars.
* Those returns that are expected to be realised on average over several business cycles and economic environments.

Our conclusions

In most scenarios equities are the most attractive asset class. But valuation support is limited, exposing equities to a potentially sharp correction.

1 Continue to favour equities

We continue to favour equities despite their demanding valuations:

- Abundant liquidity and repressed interest rates in our "muddling through" and "new monetary world" scenarios continue to support equities.
- Improved earnings prospects in our "economic renaissance" scenario should also boost equity prices despite the prospect of higher interest rates.
- This pattern applies particularly to the US market. It is the most overvalued region but prices could continue to rise if the "economic renaissance" scenario becomes increasingly likely.

2 Remain cautious on bonds

- We are avoiding long-maturity nominal bonds because they would be negatively affected by a normalisation of monetary policy in our "economic renaissance" scenario.
- Within fixed income we continue to like shorter-maturity corporate bonds. This part of the market has two attractive features. First, there is still a decent yield advantage relative to government bonds. Second, the short maturity would offer some protection against rising interest rates, especially in our "economic renaissance" scenario.

3 Maintain exposure to real assets

- The still sizeable probability of our "new monetary world" scenario lies behind our ongoing exposure to real assets such as gold, real estate and possibly inflation-linked bonds.
- We are also confident that over an economic cycle equities continue to offer protection against inflation.
- Additionally, we are focusing on hedge funds that have the flexibility to adjust to an unexpected increase in inflation.

4 Maintain our portfolio hedges

Although we believe the "depression" scenario is the least likely, its impact would be so disruptive that it must be considered within our investment strategy. Notably, equities are not well supported by current valuations, while monetary policy is limited by high debt levels and interest rates that are already close to zero.

Therefore, we include hedging strategies that can limit the potential losses from our portfolios:

- We have a sizeable allocation to hedge funds that can provide significant protection in a bear market or which are not affected by movements in equity markets and therefore provide true diversification.
- Additionally, we have direct equity hedges usually in the form of out-of-the-money put options on broad equity indices.

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