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INVESTMENT

Investment Commentary

MARCH 2014

Economic assessment: a cluster of downside risks

In January, we flagged that investors had become too optimistic about the economic outlook.

We illustrated this with a chart of the Citigroup Economic Surprise Index for the US which tracks the deviation of US economic data from market consensus forecasts (positive [negative] readings of the index indicate that economic releases have on balance been stronger [weaker] than consensus forecasts). As we anticipated, since early January, the index has been on a downward trend. The chart to the right presents an update on the index as at March 12th 2014.

Chart 1: Citigroup US Economic Surprise Index

Note: Data to March 12, 2014

Source: Thomson Reuters Datastream

In line with the trend since the turn of the year, economic reports over the last month have been weaker than expected. In the US, real GDP growth rate in the last quarter was revised lower by 0.8 percentage point to 2.4%. The revision was driven by weaker inventory investment, larger decline in federal government spending and slower housing investment. In the US labour market, the pace of improvement has stalled. Payroll gains have been sluggish and the headline level of unemployment ticked up to 6.7% in February following a period of steady decline. More worrying perhaps has been the recent slowdown in the pace of activity in the US services industries. The Institute for Supply Management's (ISM) non-manufacturing index fell to 51.6 in February from a reading of 54 in January. (Note that a reading above [below] 50 in the index signals expansion [contraction]). The latest reading marked the weakest level in the index since February 2010. For comparison, the index averaged a reading of 53.9 over the period between July 2009 (a month after the last recession ended) and January 2014.

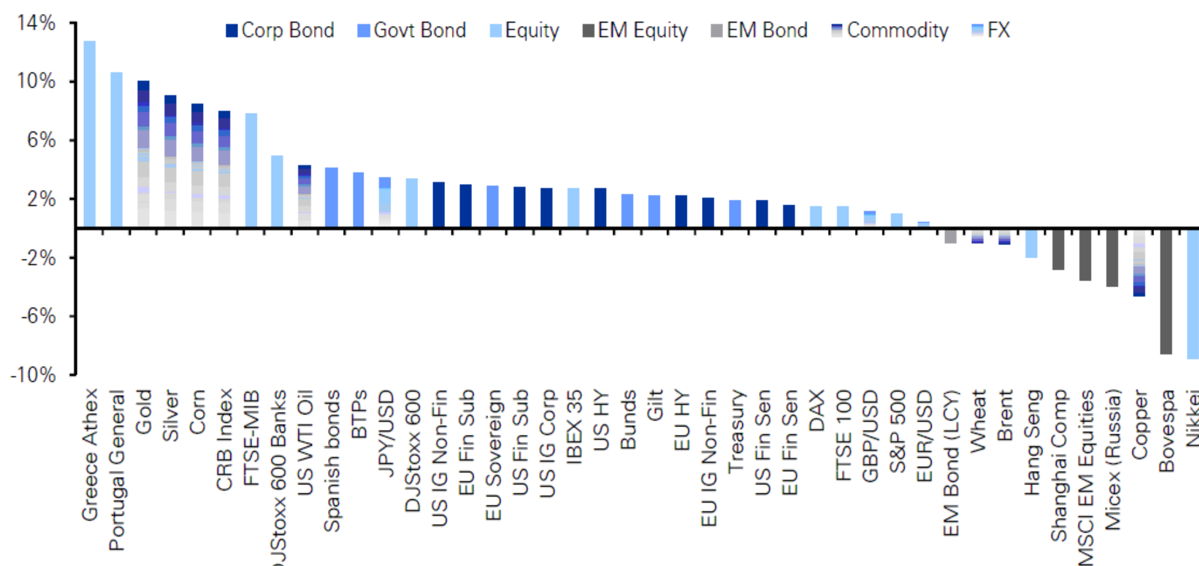
Clearly, at least some of the recent weakness is attributable to severe weather. If weather is the primary driver of the soft patch, then one would expect to see a snapback in the data in the weeks ahead as better weather should result in a release of pent-up economic activity. Data releases for March and the second quarter will therefore be key to determining the extent to which the recent weakness has indeed been down to bad weather.

UK economic reports have held up relatively well despite the weather effects. Recent data showed that the services sector expanded for the 14th consecutive month in February. That run has helped to increase employment levels while boosting business and consumer confidence. Importantly, the strength of the UK economic recovery is not currently feeding into higher inflation or inflation expectations. Indeed, the results of the Bank of England's (BOE) latest quarterly survey of public attitudes to inflation showed that inflation expectations have declined over the past few months. In contrast, interest rate expectations continue to rise. Looking forward one year, 50% of respondents to the BOE's survey expected the Bank rate to be between 0 and 1%; 35% expected between 1-2%; and 8% expected between 2 3%. It is worth noting that interest rate expectations implied by market prices are somewhat less aggressive than they have been in recent months. One-month forward contracts for sterling overnight interbank average (sonia) now price a 25 basis point increase by May 2015. With inflation falling, the BOE has room to maintain the current level of monetary stimulus and refrain from rate hikes for a while longer.

> **"Importantly, the strength of the UK economic recovery is not currently feeding into higher inflation or inflations expectations."**

The Eurozone has now managed three consecutive quarters of growth as region-wide GDP expanded by a revised 0.3% in the final quarter of 2013. However, more recent reports on economic activity in the region have been mixed. For instance, in February, services output expanded by more than expected, driven by strong growth in Germany. In contrast, data on industrial production showed an unexpected contraction in factory output across the region. In all, the risks surrounding the outlook for the Euro-zone economy remain largely to the downside.

Chart 2: Asset performance review: total returns so far in 2014 (Local currency terms)



Source: Deutsche Bank, Bloomberg Finance LLP, Mark-it

Financial markets and asset allocation

Following a sell-off in January, equity markets staged a strong recovery in February. For the month, the S&P 500 index delivered total returns of about 4.6%, more than making up for the 3.5% loss in January. So far this year, the strongest performance has come from the Eurozone periphery, with local currency total returns of about 14.5%, 12.7% and 10.6% from equity markets in Ireland, Greece and Portugal respectively. Although emerging market equities also delivered strong returns in February, they continue to lag over 2014 so far.

The general weakness in global economic activity so far this year has boosted government bonds. As at the end of February, yields on 10-year government bonds were down about 38 basis points in the US and by about 30 and 31 basis points in the UK and Germany respectively. As with equities, the best performing government bond markets have been those of the Eurozone periphery. As investors increasingly buy into the Eurozone recovery story, they have demanded lower premium for holding assets within the periphery economies. Moreover, these assets continue to benefit from the growing expectation among investors that the European Central Bank may eventually have to embark on further monetary stimulus in an attempt to avert deflation. Elsewhere in the fixed income markets, corporate bonds continue to deliver strong returns while high-yield bond spreads have now fallen to multi-year lows.

> **"Looking to the weeks and months ahead, the key downside risks to the global growth outlook relate to uncertainties about the underlying strength of economic activity in the US… "**

The uncertainty surrounding the extent to which the recent softness in economic activity has been down to adverse weather as opposed to any underlying weakness in fundamentals should mean that the pace at which the Federal Reserve withdraws monetary stimulus remains gradual. This should ensure that government bond markets in the major developed economies do not experience sharp sell-offs in the near term. Looking to the weeks and months ahead, the key downside risks to the global growth outlook relate to uncertainties about the underlying strength of economic activity in the US in the context of diminishing monetary policy support; concerns about the cyclical slowdown in the major emerging markets; and unease about the escalating geopolitical crisis in the Crimea region. These risks should mean that financial markets continue to be very volatile in the short term. In particular, equities remain vulnerable to short term setbacks.

On the issue of the Crimea crisis, beyond Russia, the financial market response has been relatively muted. However, there remains lots of scope for the crisis to escalate and undermine investor sentiment. At this point, the most likely outcome seems to be an extended period of diplomatic gridlock. But markets could be hit hard if the crisis develops into a full blown trade war between Russia and the West (potentially alongside a military standoff).

Our asset allocation positioning remains broadly unchanged from last month in that we retain a moderately positive bias on equities in general but remain cautious on emerging market stocks. In the fixed income markets, we continue to favour corporate bonds over government bonds and we have now cut back on exposure to high-yield bonds following their strong run. For now, we retain our neutral positioning on the major currency pairs and await better entry points for positions in favour of the US Dollar.

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