Elgin asset management

M investment commentary monthly

Monthly Commentary 3rd February 2015

January was one of the most exciting months in markets for a long time. It was marked by the unprecedented decision by the ECB for full-blown QE, a completely surprising move by the Swiss National Bank which led to a historic one-off gain for the Swiss Franc, new historic highs for many government bond markets and continuing major turbulence in the energy markets as crude oil continued its slide to multi-year lows.

There were also lots of divergences in equity market performance as US equities, which had led the world in 2014, fell more than 3% whereas European equities were up by 7%.

What is in store of the rest of the year?

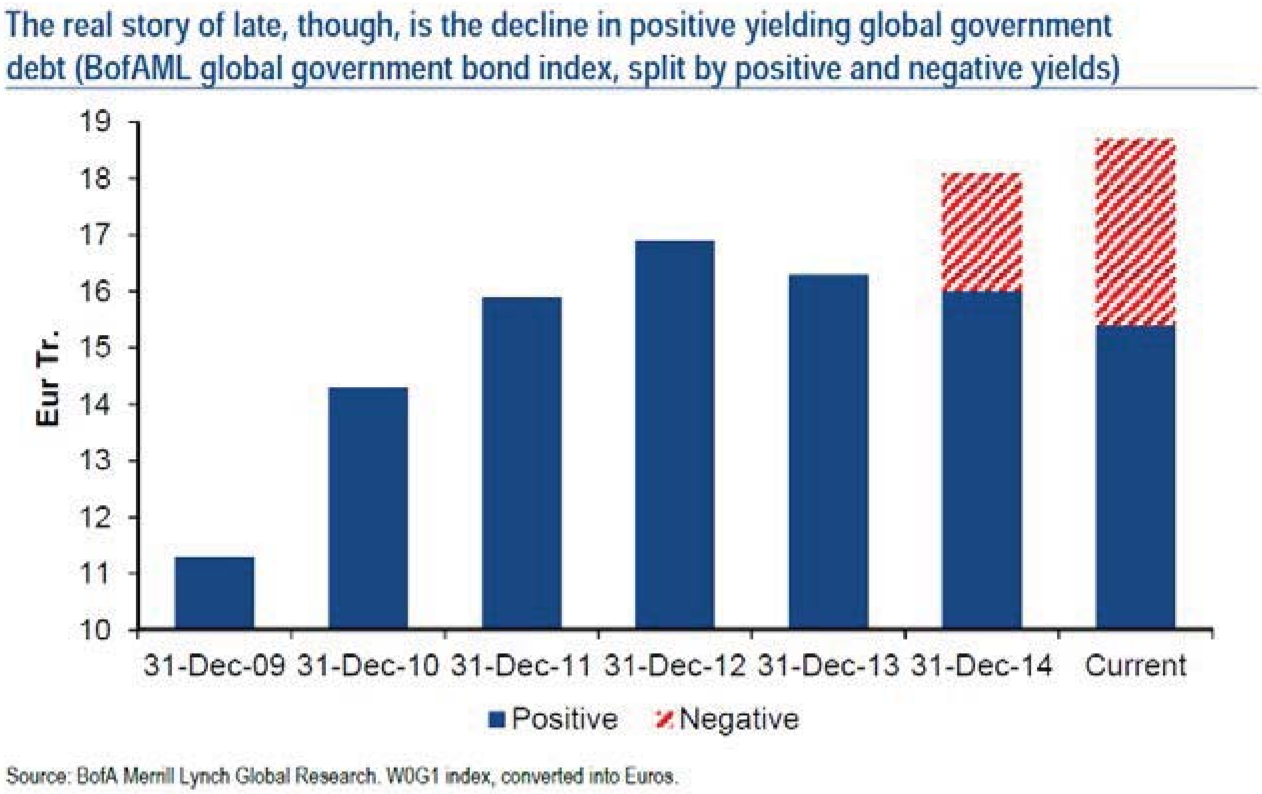
We are being asked all the time about our outlook for financial markets for this year. We'll be happy to provide our opinions but as the events of the first paragraph have proven, most forecasts turned out to be woefully wide of the mark. So wide in fact that basing investment strategy on forecasts alone would have had disastrous consequences.

Let us first ask: What are the markets telling us?

Falling oil prices and falling bond yields have historically been a double signal that global growth is weakening and that a recession is imminent. This explains why the likes of IMF and World Bank have been lowering their global growth forecasts. This, in turn has created a lot of nervousness among equity investors. This is evidenced by the facts that mutual fund cash positions are at the same levels of where they were at the peak of the 2008/09 crisis and pension fund equity weightings are down to where they were 50 years ago.

With regards to falling bond yields, "Negative Yields" are becoming the new buzzwords in the investor lexicon. As we write this, the 2-yr bonds of nine European countries have negative yields, as do six countries' 5-yr bonds! Japan and Europe are the leaders in this negative yield sphere, where almost a quarter of all outstanding government debt has yields of less than zero.

The chart below from Merrill Lynch highlights this.



So where are the positives in all this?

I shall quote from Martin Taylor of Nevsky, who summed it up eloquently below:

"With BoJ and ECB buying, a record global savings rate and near-record equity buybacks, the current wave of inflows into investment institutions will continue to accelerate. This money has to go somewhere so - Ceteris Paribus - ten-year yields in Germany and Japan will soon be at zero. In the US, the Fed, faced with the scary global deflationary message this gives, spillovers into their own bond markets and worried by their current ultra-low wage inflation, will keep US rates at zero far longer than currently forecast; while China, where CPI is heading negative, is likely to cut rates and print money. In stasis this means sovereign cost of capital globally is heading towards zero.

This is obviously madness and collective and unprecedented loss of nerve by the investor community. We have seen such risk aversion in panics and crises but not when in 2015 we see the US economy is cantering at 3%, China at near 7%, India at 6% and even Japan and the Eurozone managing about 1%. No recession here in aggregate or alone."

So our opinion is that the world is not coming to an end. Continuing, and massive stimulus in Japan and Europe, coupled with low oil prices, low inflation and low cost of capital is a strong tail wind for equities. The worries will always be there - and we can list many global worries. But the markets have found a way to climb this wall of worries, and for good reason.
As such, in our portfolios we remain tactically overweight equities even though we expect much higher volatility this year. On the tactical side, we like high-yielding Eurozone equities, transportation and consumer discretionary (which should benefit from low oil prices), Japan, Health Care and Technology. We are also keeping an eye on listed real estate which would be a beneficiary of low rates and QE.

The Elgin Analyst Team