24th November 2014

The week gone by

Global **equities** (in euro terms) rose for the fifth straight week (this time strongly) reaching a fresh all-time-high on Friday. Euro currency weakness has been a major feature in 2014 (see table below) hiding some poorer local currency returns. Equities continue to be supported by the expectation of reasonably strong corporate earnings' growth and low interest rates. In addition, equities remain better value relative to other asset classes despite the rise in price earnings multiples.

The global index (in euro terms) rose by 1.8% last week giving a total return year-to-date of 18.3%. There was a mixed bag of returns from the major equity **markets** in local currency terms last week ranging from 4.0% in Europe to minus 2.7% in Australia. The bellwether US market was up 1.2%. Markets have reacted positively in recent weeks to a good US Q3 earnings season as well as increased monetary expansion (QE) in Japan. Last week's positive catalysts were dovish comments from ECB President Mario Draghi, in which he strengthened his stimulus pledge, as well as a cut in Chinese interest rates.

Eurozone **bond** prices were up by 0.5% last week and are up an impressive 17.0% year-to-date led by Spain (+21.7%). The German 10-year bond yield fell marginally from 0.78% to 0.77%, a fresh weekly-closing all-time low. Prices have been supported by ongoing deflationary concerns and speculation that the ECB may introduce some form of QE. Equivalent US yields fell marginally from 2.32% to 2.31%. **Commodity** prices in general rose by 0.9% (in dollar terms) last week but they have lost all and more of their strong gains in the first half of the year. Oil prices were up around 1% on the week.

	Index	1 Week Return 14.11.14 to 21.11.14		Year to Date Return 31.12.13 to 21.11.14	
		Local Currency %	Euro %	Local Currency %	Euro %
Global (euro)	FTSE World	1.8	1.8	18.3	18.3
US	S&P 500	1.2	2.3	11.6	24.2
Europe	FT/S&P Europe Ex. U.K.	4.0	4.0	2.5	2.5
Ireland	ISEQ	4.8	4.8	9.5	9.5
UK	FTSE 100	1.5	2.5	0.2	5.2
Japan	Topix	0.0	-0.2	7.5	6.9
Hong Kong	Hang Seng	-2.7	-1.7	0.6	11.8
Australia	S&P/ASX 200	-2.7	-2.6	-0.9	7.1
Bonds	Merrill Lynch Euro over 5 year	0.5	0.5	17.0	17.0

The week ahead

- It is expected that the second estimate of US Q3 GDP (Tuesday) will be at 3.3% quarter-on-quarter seasonally adjusted annual rate (last: 4.6%). It is forecast that the November Conference Board's consumer confidence index (Tuesday) will rise marginally to 94.8 (last: 94.5).
- It is expected that euro area November 'flash' HICP inflation (Friday) to remain unchanged over the month at 0.4% year-on-year. Germany's IFO business climate index (Monday) is expected to improve from its previous reading of 103.2, with 100 representing the long-term average.
- In the UK, it is expected that the second release of Q3 GDP (Wednesday) to confirm growth of 0.7% quarter-on-quarter.

Global Outlook

- We remain overweight equities and underweight bonds and maintain our regional allocations. Equity markets remain attractive relative to Cash and Bonds.

United States

- Fundamentally, the US growth story appears intact and our outlook remains favourable. Company Q3 earnings reports were solid, with earnings surprising to the upside, but revenues only coming in in-line with expectations, with commodity pricing and FX acting as headwinds. Company balance sheets remain in healthy condition, with low debt and high cash levels. Valuations still appear reasonable versus historical standards and on a relative basis (earnings yields on equities still materially exceed 10 year bond yields). Economic data has been positive for the most part. Markets anticipate that the Fed will commence tightening in mid-2015, albeit at a slow pace. The initiation of rate hiking could cause equity market volatility if announced sooner than expected. The outlook on consumer spending for the remainder of 2014 appears favourable, given low gas prices, low unemployment, wage rises in certain states and lapping of fiscal headwinds from year ago. 2015 should see accelerated fiscal expenditure ahead of the elections in 2016. The dollar is expected to remain strong. Further strengthening cannot be ruled out given expansionary monetary policy in other major economic regions.
- Low energy prices have a mixed impact on equity indices. Although earnings for energy companies have taken a hit on lower oil prices, the lower gas price is a tailwind for the consumer and certain subsectors within materials benefit from lower prices.
- Energy prices remain low on the back of multiple supply side and demand side factors, one aspect being “mix” of demand between Emerging and Developed markets. Emerging markets operate at much higher oil intensity versus developed markets, where equipment turnover has allowed for meaningful energy-efficiency. Weaker growth in the more oil intensive emerging markets has partially driven the weakening demand for oil. Pricing has been further impacted by supply-side factors. The OPEC meeting this week should give more clarity on future supply levels.

Europe & UK

- The dovish tone of Draghi’s speech in Frankfurt on Friday lifted equity markets. Announcement of QE is now more likely to happen sooner than previously thought, given Draghi’s tone with much speculation that it could happen as soon as December. PMI data remains soft. Low energy prices offset the inflation lift the weaker Euro provides. Fiscal budgets for 2015 have yet to be finalised. Corporate earnings remain lacklustre. Catalysts to lift equity markets include credible policy reform in France and Italy or news of QE by the ECB, which is edging closer.
- The UK government is approx. half way through the required fiscal cuts creating a headwind for the UK economy. Strong business and consumer confidence levels indicate some momentum is left in pockets of the economy. However, overall consumer debt levels remain high. Wage growth remains a key focus of the MPC but is still absent, pushing out expectations around timing of rate rises. Headline inflation is decelerating, weakened by low energy and food prices.

Rest of World

- People Bank of China this week cut deposit and lending rates by 25 and 40 bps respectively, the first cut since 2012. Equity markets reacted favourably and further rate cuts throughout 2015 are expected as the PBOC look to stimulate the economy.
- The additional monetary expansionary measures announced by the BoJ in recent weeks will involve annual purchases of a size equivalent to 15% of the Japanese economy. The Yen should remain weak as the BOJ implements its monetary easing, a positive for inflation and exports in Japan. Japanese exports should benefit as other major economic regions grow. The recovery trend remains intact in Japan, broadly, and is supported by the continued expansion of the monetary base. Valuations in the region look attractive, relatively, and earnings revisions have turned positive. In figures released over the weekend, Japan’s real GDP contracted 1.6% q/q saar in Q3 in contrast to expectations of a +2.2%. The downside surprise was mainly due to inventory investment which has been a volatile component of GDP since the beginning of this year and also due to private imports. Excluding these two components, final demand added 1.5pp to real annualized growth, broadly in line with expectations.
- Export led Emerging markets may see some benefit from an accelerating US economy and easy monetary policy in Europe; however, this will be overshadowed by the headwinds facing Emerging markets, including rising US interest rates, a stronger US$, and negative sentiment and uncertainty around China. This may keep investors sceptical on emerging market in the near term.

Central Bank Watch:

- Whilst the general economic backdrop for 2014 still continues to necessitate a reasonably loose monetary policy in several of the major regions, the Fed and BoE will withdraw some of their policy accommodation with rate rises on the horizon, whilst the ECB and BoJ continue with easy policy as they look to stimulate growth and inflation.
- The level of slack in the U.S. labour force participation rate remains a key focus of the Fed, particularly the debate over secular vs cyclical drivers, and expectations around the timing of rate rises feed off this. The tone of their latest meeting minutes was incrementally more hawkish. Rate rises are expected in mid-2015 with the magnitude of the initial hike expected to be small.
- In Europe, Draghi’s latest speech was very dovish and caused the market to bring forward expectations around the timing of QE, which could happen before year end. Implementation of QE could prove difficult with speculation of escalating tensions and Draghi facing a number of opponents including Germany, Luxembourg and Holland, despite Draghi’s tone. Previously Draghi had announced the targeting of balance sheet asset levels of $3tn, from current balance sheet levels of $2tn. The balance sheet expansion was unanimously supported by the Governing Council.
- The strength of UK economy has exceeded market expectations and unemployment has fallen faster then expected, however, headwinds remain and expectations for rate rises have been pushed out.
- Japanese monetary policy is expected to remain loose for some time to come given the latest announcement of further QE. Abe’s efforts have broken the two-decade cycle of deflation, although, inflation is still far from the 2% target level and this was cited as one of the reasons for the additional measures.

Positioning

- Zurich Life funds are overweight in equities and underweight in bonds versus the manager average. The funds are underweight utilities and energy and overweight consumer goods and industrials. Geographically, the funds are underweight the UK and Europe, neutral Asia Pacific, slightly overweight Ireland and overweight Japan and North America.

Zurich Life Assurance plc
Zurich House, Frascati Road, Blackrock, Co. Dublin, Ireland.
Telephone: 01 283 1301 Fax: 01 283 1578 Website: www.zurichlife.ie

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