ZURICH

**19th January 2015**

# The week gone by

Global **equities** (in euro terms) rose again for the second full week of 2015. As during most of 2014, euro currency weakness again somewhat flattered returns for eurozone investors. 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 2.4% last week giving a total return year-to-date of 3.2%. There was a mixed bag of returns from the major equity **markets** in local currency terms last week ranging from plus 4.6% in Europe to minus 3.0% in Australia. The bellwether US market was down 1.2%. Markets in the eurozone reacted positively to the imminent start of quantitative easing (QE). Swiss equities, however, fell heavily following the central bank's shock abandonment of its currency cap designed to keep the franc from rising too much against the euro. Switzerland had faced a tsunami of safe-haven inflows, especially from Russia and Greece, in recent weeks.

Eurozone **bond** prices overall were up by 1.4% last week and are up 1.9% year-to-date. Markets reacted positively to the expected announcement of QE this Thursday. The German 10-year bond yield fell from 0.49% to 0.45%, a fresh all-time low. Equivalent US yields fell from 1.94% to 1.84%. **Commodity** prices in general were down by 0.6% (in dollar terms) last week. Oil prices, which had fallen by 60% from their 2014 highs, stabilised somewhat last week.

| | Index | 1 Week Return 09.01.15 to 16.01.15 | | Year to Date Return 31.12.14 to 16.01.15 | |
|---|---|---|---|---|---|
| | | Local Currency % | Euro % | Local Currency % | Euro % |
| Global (euro) | FTSE World (total return) | 2.4 | 2.4 | 3.2 | 3.2 |
| US | S&P 500 | -1.2 | 1.1 | -1.9 | 2.6 |
| Europe | FT/S&P Europe Ex. U.K. | 4.6 | 4.6 | 2.1 | 2.1 |
| Ireland | ISEQ | 3.1 | 3.1 | 1.1 | 1.1 |
| UK | FTSE 100 | 0.8 | 0.8 | -0.2 | 1.5 |
| Japan | Topix | -1.2 | 2.0 | -3.1 | 3.4 |
| Hong Kong | Hang Seng | 0.8 | 3.2 | 2.1 | 6.9 |
| Australia | S&P/ASX 200 | -3.0 | -0.5 | -2.1 | 3.2 |
| Bonds | Merrill Lynch Euro over 5 year | 1.4 | 1.4 | 1.9 | 1.9 |

# The week ahead

- The pace of 4Q earnings is expected to pick up this week with several major industrial companies headlining. It is expected that December housing starts (Wednesday) will increase to 1040k (last: 1028k) and that existing home sales (Friday) will rise to 5.05m units (last: 4.93m).
- At the ECB policy meeting (Thursday), it is expected that rates will remain at 0.05% and that an announcement will be made on QE.
- In the UK, it is projected that the MPC minutes (Wednesday) will reveal unchanged voting of the committee on rates and asset purchases.

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# Global Outlook

We believe that equity markets are fairly valued versus history and they look attractive compared to cash and bonds. Volatility in markets may increase through 2015 as divergent Central Bank policies are implemented in major global regions.

- Volatility levels have been high over the past month, driving risk premia higher. Year to date MSCI World Index has seen approx 2% pull back (price returns, $ denominated). Oil and Copper price declines, mixed US data points, falling bond yields and wider credit spreads are typical during pre-recession stage of the cycle. These factors will likely not persist and better visibility will be welcomed by the market. Oil price stabilisation, clarity on ECB intentions for QE and management of the obstacles faced and more consistent US data points will provide better visibility. However, debate remains over how the Fed will act given the low inflation environment, aggravated by oil price declines and continued USD strength.

### United States

- Fundamentally, the US growth story appears intact and our outlook remains broadly positive. Domestic strength continues to pull against the global weakness and economic growth should continue throughout 2015. The trend in the labour market data suggests slack in the labour force continues to diminish. We see scope for growth to continue for the next year. Company balance sheets remain in healthy condition, with low debt and high cash levels. Profit margins remain high. We view valuations as being reasonable versus historical standards, supported by low interest rates which support a higher than average P/E multiple.
- On relative basis earnings yields on equities still materially exceed 10 year bond yields, despite rally in equities in recent years. The outlook on consumer spending appears favourable given low gas prices, even lower unemployment, wage rises in certain states and lapping of fiscal headwinds from year ago. Lower income consumer's benefit disproportionately from lower gas prices in the US and this demographic is expected to experience the most relative improvement in spending year on year versus other demographics.

- Downside risk could arise from various sources. Fears of slow growth in other major economic regions creating a drag on US economic growth, capex within the energy sector could be scaled back materially as project returns fall with falling oil prices, posing risk to capital goods demand. Energy sector capex cuts could drive unemployment levels higher, as it had contributed meaningfully to employment growth in recent years with the oil prices strong from 2010 to mid-2014. Other drivers of volatility include the Fed raising rates ahead of market expectations or fears of deflation.

### Europe & UK

- The macro backdrop still does not appear favourable. The equity market is looking to the ECB meeting on 22nd Jan for some clarity on QE. Given ultra-low growth and inflation levels with the overhang of deflation, ECB policy rates should remain low for an extended period. Ultra low inflation is a drag for equities, with low interest rate environment having very limited benefit given banks unwillingness still to loosen credit standards. Low energy prices should continue to offset the inflation lift the weaker Euro provides in the near term, keeping inflation stagnant. Bond yields should remain low and could drop further on announcement of QE by the ECB. Political risk prevails with the Greek elections looming on Jan 25th and relations with Russia still strained.
- Catalysts to lift European equity markets include credible policy reform in France and Italy or announcement of QE by the ECB and alleviating deflation concerns.

- 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. However, should inflation and wage levels tick up, the UK could see rate rises, standing in stark contrast to the ECB's accommodative policies

- Swiss National Bank (SNB) caused shockwaves in equity markets after removing the cap on the CHF against the EUR and cut the rate on sight deposits by 50bp into further negative territory to -0.75%. The CHF appreciated by c.15% against major currencies and Swiss equities dropped 14%. Over 80% of Swiss companies derive >50% of earnings from exports (mainly healthcare, consumer goods and financial services), driving the strong reaction in equities. The move signalled a strong belief that the ECB will instigate QE on Jan 22nd.

- The move by the ECB increases the likelihood of other central banks in other small, open economies in Europe – primarily the Scandinavian economies - will ease policy as well. Scandinavian currencies appreciated after the SNB announcement.

### Rest of World

- People Bank of China cut deposit and lending rates by 25 and 40 bps respectively in late 2014, 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 late 2014 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.

### Central Bank Watch:

- The general economic backdrop for 2015 still continues to necessitate a reasonably loose monetary policy in several of the major regions but some divergence is evident, with the US leading the change.
  - In the US, the Fed is expected to withdraw some of their policy accommodation with rate rises on the horizon. The low inflation environment is causing the market to push out expectations on timing of rate rises. An ultra-low inflation environment is not favourable for equities; therefore, raising rates ahead of market expectations could drive equity market volatility.
  - BoE are likely on a similar course. In contract, the ECB and BoJ continue with easy policy as they look to stimulate growth and drive inflation up from subdued levels. Wage growth is an important metric watch by the market 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.
  - The market expects announcement of QE in Q1 2015. At the ECB's December Governing Council (GC) meeting, Draghi's speech conveyed a greater sense of urgency around the need to act. However, difficulties remain within the Union. Germany remains a strong opponent to Draghi, political risk persists with elections in Greece, Spain and elsewhere, with the overhang of UK speculation around leaving the EU.

  - In Europe, Draghi's latest speech caused the market to bring forward expectations around the timing of QE, with rumours Jan 2015 will see an announcement. Implementation of QE could prove difficult with speculation of escalating tensions amongst member states. 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 and Draghi reasserted that they may alter the pace, size and composition of the "intended" balance sheet expansion should it be required.

- Wage growth remains a key focus of the MPC in the UK, but is still absent. Wage levels combined with the other economic headwinds have led to expectations around timing of rate rises being 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.

### 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 consumer services. Geographically, the funds are underweight the UK and Europe, neutral Asia Pacific, slightly overweight Ireland and overweight Japan and North America.



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