Fundamentals:

Divergence

The global economy has some engines of growth, but many countries continue to struggle. As this pattern persists in 2015, monetary policy is likely to diverge further.

In this edition of Fundamentals, LGIM's economists and strategists highlight the contrast in performance between the major economies and what this means for the key asset classes in 2015. While some central banks, notably the Fed, are likely to raise interest rates, others will continue to buy assets in an attempt to stimulate growth.

GLOBAL GROWTH IN 2015

The global recovery continued in 2014, but failed to broaden and strengthen as expected. A number of factors continued to keep growth in check. These included tighter fiscal policy in several countries, geopolitical tensions, bank deleveraging in the euro area and more concerted attempts across a number of emerging market economies to either constrain credit growth or meet inflation targets.

As these headwinds fade, the most likely outcome is some gradual strengthening of global growth through 2015 and a major divergence in monetary policy between the US and UK versus the euro area and Japan. US and UK growth should maintain its momentum and the drag from Japan's consumption tax increase should diminish. China's switch to policy loosening should help stabilise growth and while the outlook for the euro area remains uncertain, further policy easing should support the economy.

US

The US economy appears to have entered a sustained period of above trend growth. All parts of the economy are performing well. The drop in mortgage rates has reinvigorated the housing market and solid corporate fundamentals help underpin business investment. The sharp decline in

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UK forecast: The politics of interest rates

Legal & General
INVESTMENT MANAGEMENT

Figure 1. LGIM growth versus consensus (%)

	Actual				LGIM		Consensus		LGIM
	2010	2011	2012	2013	2014	2015	2014	2015	2016-18
GDP, % yoy									
UK	1.7	1.1	0.3	1.7	3.0	2.9		2.7	2.25
US	2.5	1.6	2.3	2.2	2.3	3.6		2.9	1.90
Euro area	1.9	1.6	-0.6	-0.4	0.8	1.2		1.2	1.25
Japan	4.7	-0.4	1.5	1.5	0.5	1.1		1.1	0.75
China	10.4	9.3	7.7	7.7	7.4	7.2		7.0	7.00
BRICs (unweighted)	8.0	5.9	4.3	4.0	3.4	3.3		3.6	4.40
LGIM world	4.1	2.8	2.4	2.5	2.6	3.2		3.0	2.90
CPI, % yoy									
UK	3.3	4.5	2.8	2.6	1.5	1.0		1.6	2.00
US	1.6	3.2	2.1	1.5	1.7	1.3		1.6	3.00
Euro area	1.6	2.7	2.5	1.4	0.4	0.3		0.9	1.20
End year level									
US Fed funds	0.10	0.10	0.10	0.10	0.10	1.00		1.00	3.50
UK base rate	0.50	0.50	0.50	0.50	0.50	0.75		1.15	1.75
ECB base rate	1.00	1.00	0.75	0.25	0.05	0.05		0.05	0.10

Source: LGIM, EcoWin and Macrobond

oil prices towards the end of 2014 will boost household purchasing power, with only a small drag likely from a slowdown in shale oil exploration. Unemployment should continue falling towards 5% through 2015. While wage growth has been elusive in 2014, next year should prove the turning point as the US reaches full employment. We expect the first rate hike around mid-year, but with inflation likely to only slowly edge back up towards target, policy normalisation can proceed gradually.

Euro area

The improvement in euro area credit conditions has not yet translated into stronger economic growth. Weak demand and persistently high unemployment are contributing to low pricing power and a lack of wage pressure, both reducing inflation. More worryingly, inflation expectations have begun to slide below the levels consistent with the European Central Bank (ECB) meeting its inflation mandate in the medium term. This has triggered a fierce debate within the Governing Council about the next steps given interest rates are at their lower bound. The ECB has already committed to expanding its balance sheet by purchasing asset-backed securities and covered bonds. But more is required to demonstrate that the ECB is determined to avoid deflation. In the meantime, growth is likely to improve slightly from its near stagnation, as consumption receives a lift from lower oil prices and the headwind from bank deleveraging fades.

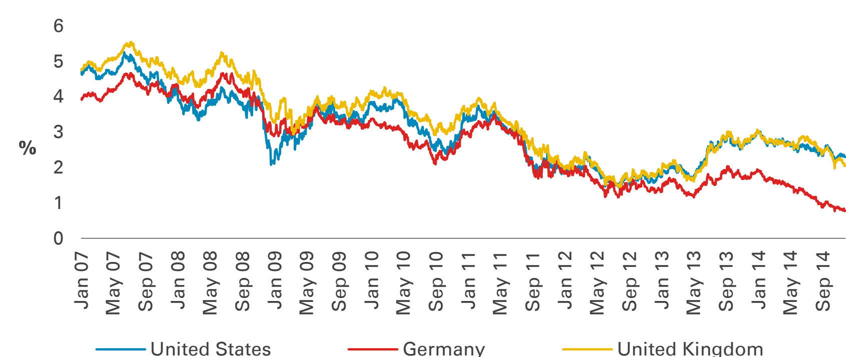
UK

UK activity met our 3% growth target in 2014. Growth is likely to cool only a little in 2015 as macroprudential tightening constrains the housing market, exports are hampered by the lack of euro area growth and uncertainty increases around the general election. However, with inflation likely to remain low, the Bank of England will be able to delay the first rate hike for longer, which along with rising employment and signs of wage growth, provides a positive environment for the UK consumer.

The Emerging World

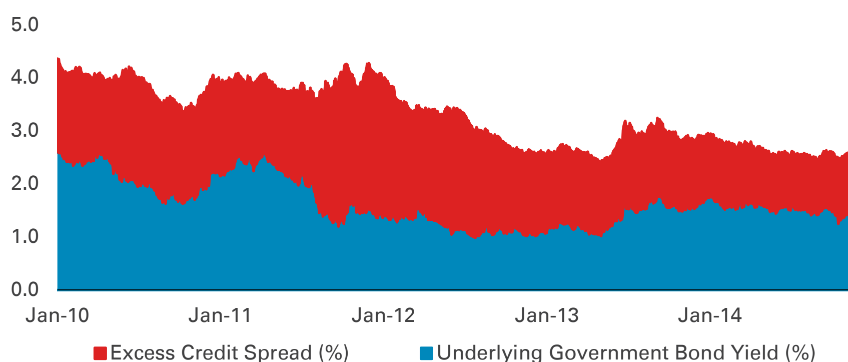
Emerging markets have disappointed for the second consecutive year in 2014. The

Figure 2. Government benchmarks, 10 year yields



Source: Macrobond

Figure 3. Global corporate bond yields



Source: Barclays Global Corporate Bond Index

main culprits were Brazil, Russia and India. The prospects for the first two remain poor with Russia likely to slip into recession in 2015. In contrast, the outlook for India has improved though there is still implementation risk around Modi's reform agenda. The China slowdown has proceeded as expected and the shift towards easier policy suggests the authorities believe credit growth has slowed sufficiently. However, even with some additional stimulus next year, this is unlikely to deliver more than a stabilisation in growth.

RISKS

There are a number of dangers to the outlook. Global debt levels remain a concern and could be constraining growth. Deteriorating demographics and an apparent downshifting in productivity growth compound this problem. Despite some tightening in global labour markets, disinflationary forces dominated in 2014. While we see the decline in commodity prices as supportive for real incomes and global consumption, there is a risk further falls undermine inflation expectations and lead a self-fulfilling drift towards deflation. With inflation uncomfortably low in a number of countries, this leaves the world economy vulnerable as the policy levers available to counter adverse developments are severely constrained. Even if the recovery remains on track, Federal Reserve attempts to normalise policy could prove highly disruptive, particularly in emerging markets. While the Chinese authorities have been successful thus far in engineering a soft landing, the growth slowdown could yet reveal significant problems in the banking system.

Government bonds

The decline in bond yields in 2014 could be an ominous sign, yet there are a couple of explanations for the fall against a backdrop of relatively strong equity markets. First, global inflation has significantly undershot expectations driven by weak wage growth and tumbling commodity prices. Second, global central banks have once again surprised the market in their capacity to ease financial conditions.

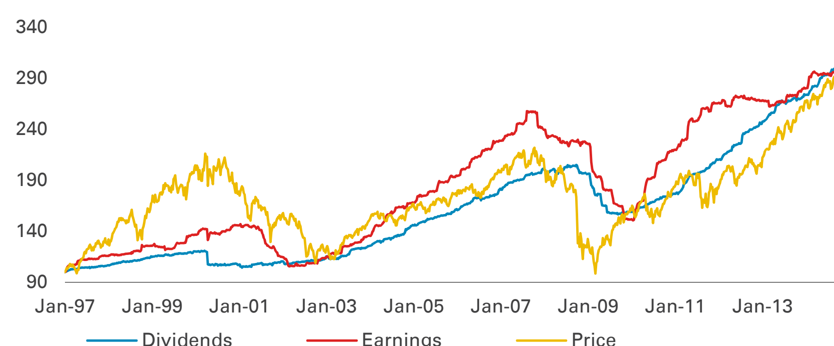
The prospects for bond yields in 2015 therefore hinge on that inflation and policy outlook. Federal Reserve asset purchases are now over and the prospect of wage-driven pressure on consumer prices is likely to keep steady upward pressure on yields. By the end of 2015, we therefore expect yields to drift back to the levels seen roughly 12 months ago. The authorities will try hard to make this a smooth process, but a disorderly few months similar to that seen in the 'taper tantrum' in 2013 is a risk.

However, with the baton of monetary easing passing from the US and UK to the ECB, we should expect fundamental divergence between conditions in major bond markets. Despite the ECB's reluctance, it could be necessary to enhance the asset purchase programme to arrest the slide into deflation, which would keep German and peripheral government bond yields suppressed.

Credit

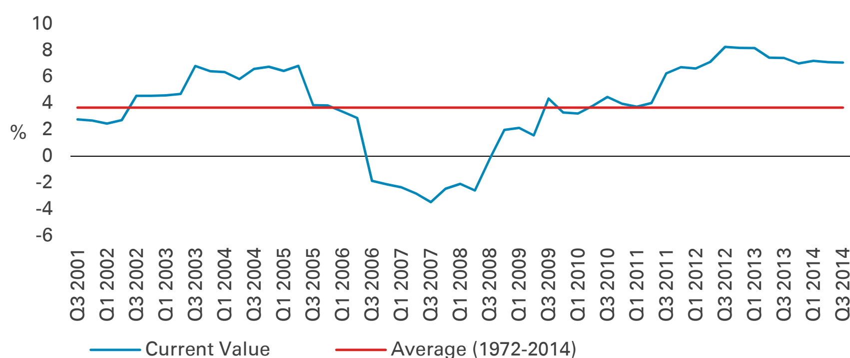
In 2014 there was a modest rise in the excess yield to compensate for credit risk (the spread over government bond yields). However, monetary policy continues to exert a significant influence with the end of US QE leading to an underperformance of US credit, while the ECB's creep towards sovereign QE has helped euro credit outperform, despite the region flirting with

Figure 4. US equities driven by earnings and dividends



Source: LGIM, Datastream

Figure 5. UK commercial property risk premium



Note: Risk premium defined here as current prime property income yield + [subsequent 3 year actual / forecast rental growth] - 10-yr gilt yield

Source: Datastream, CBRE, LGIM calculations

deflation and recession. Falling commodities have also been influential, particularly across emerging market credit and high yield corporates where a number of issuers have been adversely impacted.

If a US economic upswing materialises, rising interest rates would eat into returns, although the fragile nature of the global economic backdrop suggests that yields won't be able to rise very far. Credit spreads are not particularly attractive from a historic perspective, but at least this year's widening has introduced some risk premium (compared to the US equity market). However, capital misallocation and imbalances represented by the global debt overhang remain a major concern, implying that vulnerabilities could rear their heads as US monetary conditions are tightened, notably across emerging markets. This argues for a continuation of caution in credit.

OPPORTUNITIES

While we must be wary of the risks, there are several asset classes which present opportunities should global growth improve as expected to around 3% next year. Furthermore, even though global growth has disappointed in recent years, there is still a chance that exceptionally loose monetary conditions trigger an even stronger global investment accelerator cycle.

Equities

Consistent with around trend global growth, global equities delivered roughly average returns this year. But the real story lay beneath the surface with great differences among regions and investment styles. The diverging fortunes of the US and European economies was also reflected in equity markets with US equities being the star performers. The continued outperformance of yield-focussed investment styles such as buybacks and dividends tells the second story of 2014: a lack of investor conviction in the global economy's ability to sustainably grow at above-trend rates without central bank support.

In 2015, we expect another positive year for global equities. Given slightly above average valuations in most regions the more likely scenario restricts equity upside to the extent of corporate earnings growth, which we expect at high single digits. Despite impressive share price gains, dividend yields have hardly budged over the past year and remain an attractive boost on top of the likely earnings growth. We expect a total return slightly north of 10% - a touch above the historical average. At the regional level we prefer European, Japanese and emerging market equities over US and UK equities. While the latter may be attractively valued we expect further headwinds from political uncertainty, lack of cyclical global exposure and a relatively strong currency.

Commercial property

There was a sharp acceleration in UK commercial property returns in 2014, driven by increasing confidence in economic growth and a substantial yield arbitrage to cash and bonds. Total returns for All-Property indices are likely to reach 18-20% for 2014, incorporating a 12-14% increase in valuations and a 6% income yield.

Rental growth has broadened out from London and into a more diverse mix of assets. With occupier demand recovering, our expectation is that rents will rise faster than inflation in 2015. Despite the recovery in valuations, the risk premium on property versus government bonds remains above average (**Figure 5**) and recent downward shifts in the yield curve have reinforced this. For 2015, income yield and rental growth together are likely to be in the high single digits, providing a favourable starting point for total returns. These should be led by the office and industrial sectors, which are benefiting from stronger rates of rental growth than retail.

As risk appetite has improved in recent quarters, the compensation for taking quality / leasing risk has been eroded. More than ever, finding value within the market is going to be founded on superior stock picking and asset management.

Market overview:

When doing nothing means tighter policy

Six years after the collapse of Lehman Brothers, government bond yields remain near all-time lows, the European Central Bank is buying bank debt and China, the world's growth engine for much of the last decade, has just cut interest rates. Despite extremely loose global monetary policy, real rates are increasing as inflation is falling across much of the world – with declining commodity prices helping to push inflation lower still. Against this backdrop, equities have managed to regain their poise after last month's wobble. Indeed, US equity markets have climbed to new all-time highs in every single week since our last publication.

UK

No change from the central bank

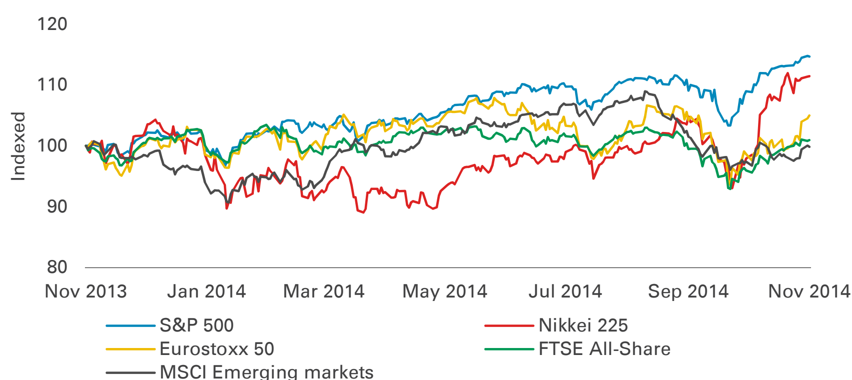
UK equities have recovered much of the losses posted in the previous month, an anticipated gain as the UK economic picture had not deteriorated enough to warrant the fall. The latest benign inflation report relieved any imminent pressure on the Bank of England (BoE) to raise rates and the market has now pushed out its expectations for the first interest rate hike well into next year. For now, the BoE continues to reiterate its awareness that any premature tightening in policy could prove detrimental to the domestic economy. As a result, UK government bond yields have moved lower over the month, across the curve. Indeed, at the long end, 30-year yields are down over 0.70% over the year to date – something that would have been seen as highly unlikely in January.

US

Oil boost

US markets have been pulling away from rest of the world in the last month. Better retail sales and labour data helped push US equities to all-time highs. Government bond yields have moved higher, but the 10-year yield is still relatively low at only 2.30%. With US oil imports at a 30-year low and a stronger US dollar, gas prices are languishing at a near-time low. The price of petrol is one of the largest influencers on the US consumer's disposable income – more so than anywhere else in the world – so the boost to incomes provided by the lower gasoline prices should also provide a material boost to the consumer-led economy as it heads into the holiday season.

Figure 1. Global equity markets



Source: Bloomberg L.P. chart shows price index performance in local currency terms

EUROPE

Dovish Draghi yet to deliver

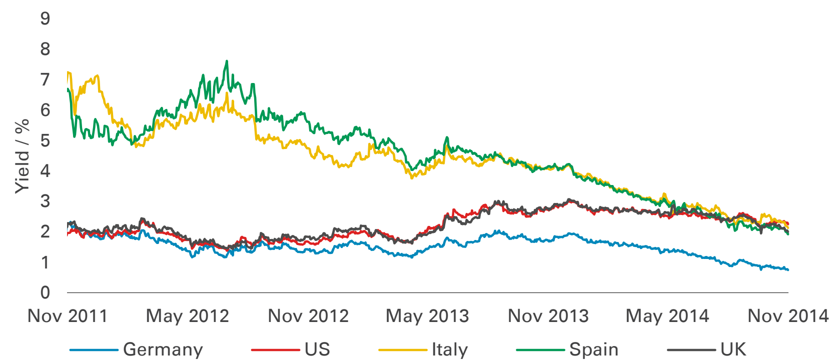
How long will markets continue to take Draghi at his word? On the evidence of the past month, market patience is far from exhausted. The ECB has yet to implement further quantitative easing but Draghi provided his most explicit reasoning yet on the need for further action. Government bond yields have lowered across both peripheral and core European economies, albeit peripheral yields had further to fall. Indeed, Greece can now borrow at a lower rate than the US despite political volatility rearing its head again and Spanish 10-year yields are at the lowest level ever.

JAPAN

Action Abe

The difficulties in the pursuit of a 2% inflation target while avoiding any adverse side effects came into fruition as the Japanese economy slipped into recession. Prime Minister Abe reacted strongly, announcing a snap election, a delay in a proposed sales tax increase and increasing the quantitative easing stimulus package, with ¥80 trillion worth of government bonds now purchased annually. The action certainly provided a boost to Japanese equity markets over the month. The yen has depreciated so much against the US dollar, even compared to its Asian counterparts, that its exports have become much more attractive than the nearby competition.

Figure 2. 10-year government bond yields



Source: Bloomberg L.P.

ASIA PACIFIC/EMEA

China rate cut

The People's Bank of China unexpectedly added to its already easy policy cycle this month despite being roughly on track to meet its 7.5% growth target. The deposit rate was cut by 0.25% to 2.75% and the lending rate was cut 0.40% to 5.60%. The central bank also lifted the ceiling on deposit rates. The rate cut is an effective way for the government to reduce their debt burden and Asian risk assets rallied on the news. Elsewhere in emerging markets, the oil price has been a significant driver of performance. Many Latin American countries such as Brazil, Colombia and Venezuela are under pressure, and markets have been particularly harsh on Russia which was already suffering due to international sanctions related to the Ukraine crisis. On the other hand, countries that import oil – for example Turkey and India – have received a boost.

FIXED INCOME

Rates anchor

Despite the recovery in risk assets over the month, most government bond markets were also strong. The US has posted two of the best consecutive quarters of GDP growth since the financial crisis, but declining inflation expectations have anchored rates. In the UK, gilt yields moved lower, particularly at the long end of the curve. European and Japanese yields were pulled down by supportive central bank rhetoric. Investment grade credit markets have been more divergent, with European corporate bond credit spreads at the year's tightest levels whereas the excess yields on US credit over US treasuries are at the year's widest.

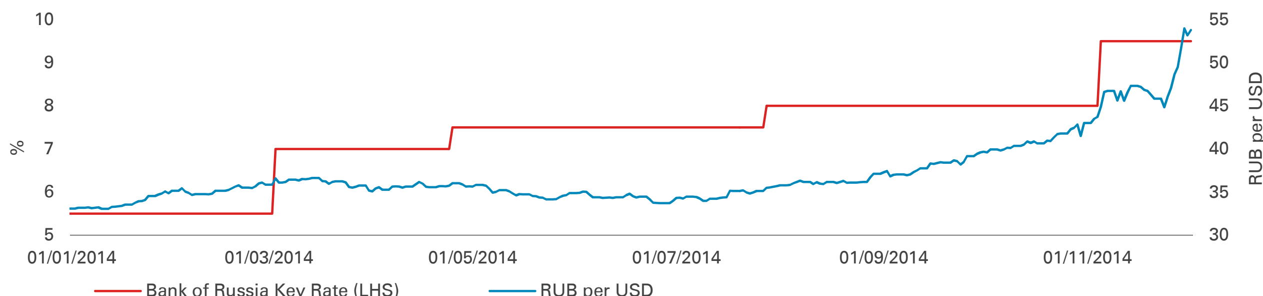
Snapshot:

BRIC breakers - Brazil and Russia shocks damage EM growth

Emerging market growth has disappointed in 2014. For the BRIC countries (Brazil, Russia India and China), growth looks set to average just 3.4% in 2014, down from 4% in 2013 and the lowest rate since the global financial crisis. This is despite China once again defying fears of a 'hard landing' and growing slightly faster than expected. Brazil and Russia explain the downside surprise with both economies expected to record growth of just 0% to 0.5% this year.

In Russia, the political crisis in Ukraine has been the main culprit. A nascent investment recovery at the start of the year was snuffed out by a sharp rise in uncertainty following Russia's intervention in Ukraine in March. The ensuing violence in Eastern Ukraine and the associated sanctions on Russia have harmed the economy. Business confidence has fallen and domestic liquidity has tightened as Russian firms' access to international capital markets has been curtailed. Import restrictions and a sharp weakening of the rouble have pushed up prices and forced the central bank to hike interest rates aggressively. The impact on Russian output is being cushioned somewhat for now by import substitution, but barring a major de-escalation of the geopolitical crisis or a sharp recovery in oil prices, it is hard to see the economy avoiding recession in 2015.

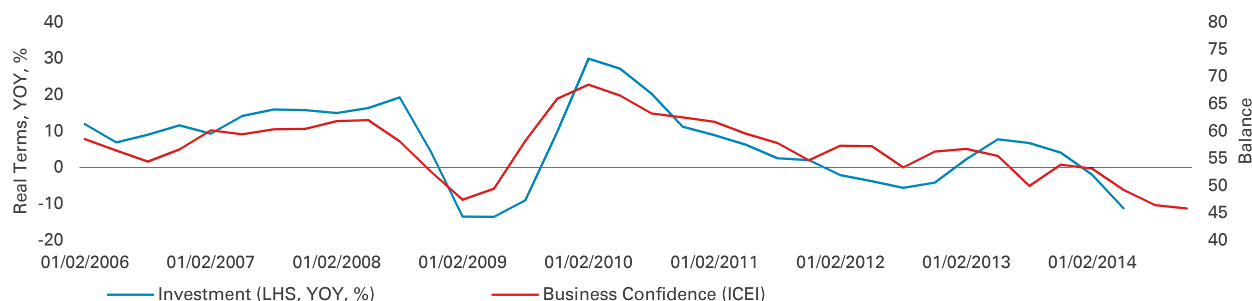
Figure 1. Russia: Interest Rates and the Rouble



Source: Bloomberg, LGIM

Growth underperformance in Brazil reflects rigidities on the supply side of the economy, exacerbated by sluggish external demand and a terms-of-trade shock. Wage growth has outstripped productivity growth, forcing the central bank into faster-than-expected monetary tightening and squeezing corporate profitability. Alongside concerns about excessively interventionist industrial sector policies, this saw business confidence and investment fall sharply in the first half of the year, driving Brazil into technical recession. With the central bank continuing to tighten and the need for fiscal adjustment increasingly clear, prospects for 2015 growth remain weak.

Figure 2. Brazil: Investment and Business Confidence



Source: Datastream, CNI, IBGE, LGIM

UK forecast:
Confidence vs. uncertainty

UK economy	Price inflation (CPI)		GDP (growth)		10-year gilt yields		Base rates		$/£		£/€	
Market participants' forecasts	2014 %	2015 %	2014 %	2015 %	2014 %	2015* %	2014 %	2015* %	2014	2015*	2014	2015*
High	2.10	2.20	3.20	3.20	3.00	4.25	0.50	1.75	1.66	1.68	0.81	0.82
Low	1.40	1.10	1.70	2.00	2.20	2.10	0.50	0.75	1.53	1.37	0.75	0.72
Median	1.50	1.60	3.00	2.60	2.50	3.20	0.50	1.25	1.60	1.58	0.78	0.75
Last month median	1.70	1.80	3.00	2.60	2.80	3.35	0.50	1.50	1.62	1.60	0.78	0.75
Legal & General Investment Management	**1.50**	**1.00**	**3.00**	**2.90**	**3.30**	**3.30**	**0.50**	**0.75**	**n/a**	**n/a**	**n/a**	**n/a**

Source: Bloomberg L.P. and LGIM estimates
***Consensus forecasts are for end of 2015**

The future of UK monetary policy remains certain yet unspecific. No-one expects more quantitative easing. Everyone is looking for a rate hike. But nobody knows when it will come. During the summer, the 'Carney moment' – where the Governor of the Bank of England warned that rates could rise "sooner than people think" helped bring consensus forecasts for that first rate increase forward into 2014. But subsequent data – notably a stalling housing market, very poor euro zone growth, falling commodity prices, lower inflation and weak wage growth combined to push the expected date back into 2015. But when?

The conviction behind rate forecasts has been materially affected by the oil price weakness over the past six months. The 30%-plus falls in Brent mean that inflation, which was already very low, is likely to dip under 1% in the next few months. As this is a deviation of more than 1% from its 2% mandated target, the Bank of England will need to write a letter to the Chancellor. This is unprecedented territory: there have been some 14 letters written since the Bank took over, but this would be the first explaining an undershoot.

Ordinarily, we would expect tightening labour market, some nascent signs of wage increases and reasonable GDP growth to lead to rate increases. However, with inflation so near to zero – even if this is due to temporary effects – we think that the Bank will have to err on the side of caution in case inflation expectations fall leading to second-round effects through lower wages and price setting. it hasn't been in this situation before and hence we believe that, at present, the most accurate statement we can make on interest rates is that we think the bank will wait for longer than previously thought.

However, this rate rise uncertainty creates certainty elsewhere, specifically on economic growth. As we said earlier, while not yet an established trend, wage growth is showing positive signs. Employment growth remains robust and survey data suggests that this will continue, leading to further wage growth. At the same time, although oil prices do not affect the UK consumer as much as these do in the US, that 30% decrease effectively is a small tax cut.

The fall in inflation makes forecasting interest rates much more uncertain. But more jobs, the potential for higher wages and falling inflation is a terrific backdrop for the UK consumer. This in turn gives us much greater confidence in our expectation that UK growth will be above trend next year.

The forecasts above are taken from Bloomberg L.P. and represent the views of between 20–40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

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