5 Key Issues Shaping Current Investment Strategy

1	**Let's get political: Market uncertainty and the general election**
2	**What's in a number? Disinflationary boom or deflationary bust?**
3	**Pick a winner: Selective opportunities in emerging markets**
4	**A world of two halves: Global monetary policies are diverging**
5	**Sliding down: Lower oil prices create winners and losers**

Market Uncertainty And The General Election

- This year's UK general election is set to be one of the most tightly contested and ideologically diverse for decades. The uncertainty leaves UK investors, businesses and sterling exposed to a number of risks.
- Regardless of the winner in May, fiscal tightening is inevitable. With interest rate rises also possible, consumer spending could come under pressure.
- Three sectors appear most exposed to political risk – power utilities, banking and housebuilding.
- Ed Miliband's promise of a freeze in energy prices, if elected, creates uncertainty for power utilities. Over the long term they face falling consumption as technology improves energy efficiency (figure 1).
- Banks are exposed to litigation, tighter regulations and a possible referendum on the UK's membership of the EU ('Brexit') if David Cameron is re-elected.
- Both main parties are serious about tackling the housing shortage (figure 2). Investors who are confident of the stability of the housing market may wish to be overweight in the housebuilding sector.

Figure 1

Electricity consumption continues to fall owing largely to improvements in energy efficiency.

Source: Eurostat, Rathbones

UK electricity consumption (GWh)

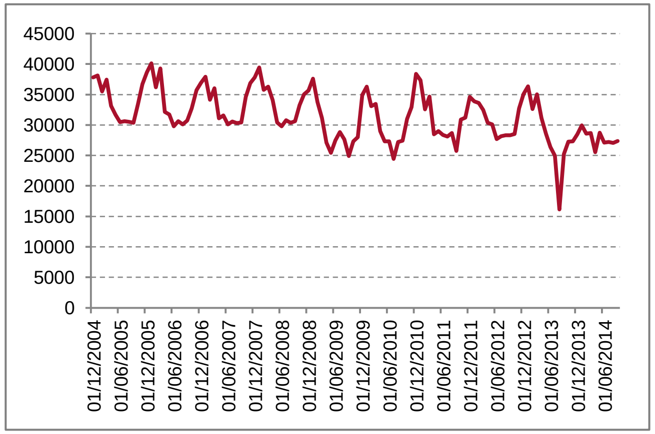
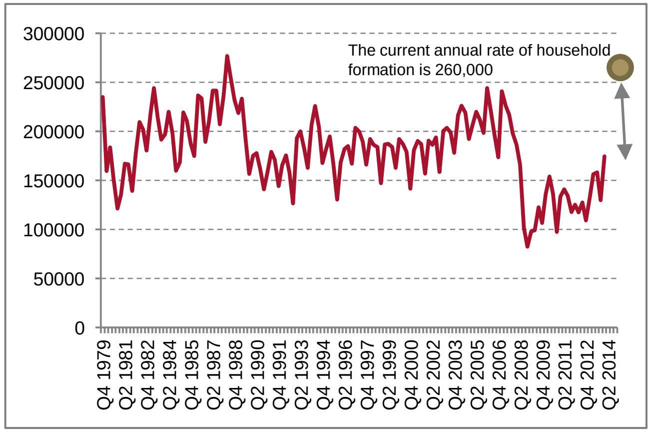


Figure 2

The number of UK housing starts has recovered since the recession but is still some way off its long-term average and the rate of household formation (260,000 homes per annum).

Source: DCLG, Rathbones

UK housing starts (annualised)



Disinflationary Boom Or Deflationary Bust?

- The rate of inflation around the world remains low. In the UK disinflationary pressures have been building with the Consumer Prices Index falling to just 1.0%.
- There is a debate around what today's low inflation expectations suggest about the prospects for the global economy, business profits and investment returns (figure 3).
- Bullish investors believe these conditions are just about right – a 'Goldilocks' scenario where the global economy is not so hot that it causes inflation and not so cold that it causes a recession (figure 4).
- Bearish investors believe we could be heading into a dangerous deflationary spiral. They say today's equity valuations are too high as we should apply a higher discount rate because of the risks ahead.
- It is important to be conscious of both sides of the disinflationary boom and deflationary bust argument, and what they might mean for asset prices.
- Yet we also know that central banks fear deflation and will do whatever they can to avoid it – this results from the human cost of the 1930s Great Depression.

Figure 3

Disinflation or deflation? The US interest rate swaps market indicates that even longer-term inflation expectations are drifting lower.

Source: Bloomberg, Rathbones

Even longer term inflation expectations are drifting lower

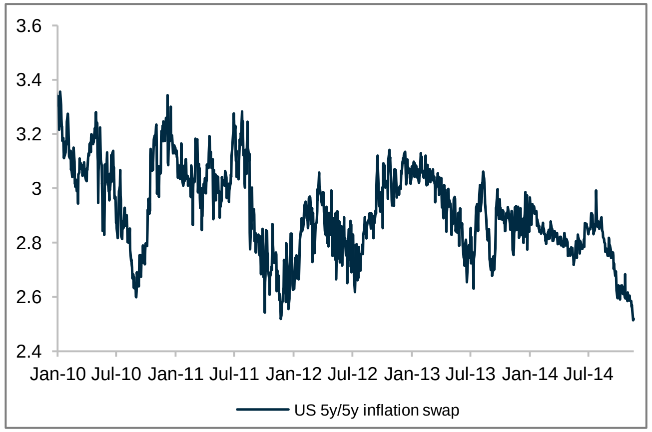
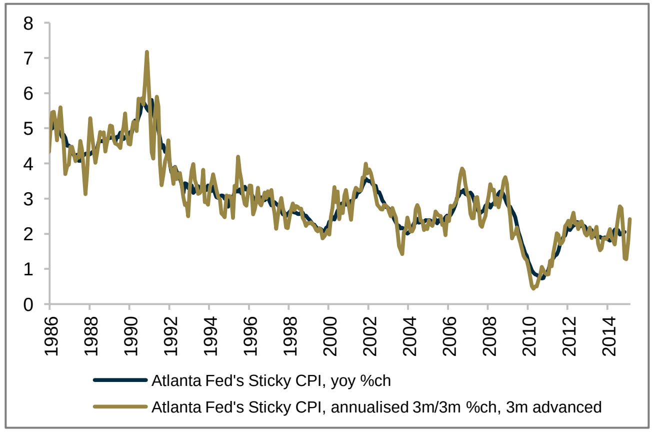


Figure 4

Inflation in goods and services that are less influenced by input prices is still above 2%, suggesting deflation can be avoided.

Source: Datastream, Rathbones

However inflation in 'sticky' goods and services less influenced by input prices is still above 2%



Selective Opportunities In Emerging Markets

- The days of strong economic growth across all of the world's emerging markets (EMs) along with stellar investment returns appear to be a distant memory.
- Asset prices and currency values could fall further owing to a number of trends. They include excessive levels of debt, a strong US dollar and the prospect of US interest rate rises.
- It is important to remember that EMs are not a homogenous group – there are wide and growing differences between the various countries (figure 5).
- Although we do not favour investing in broad EM indices, there are opportunities at a country and security level for active managers.
- The outlook for many of the largest EMs remains gloomy, including Brazil and Russia. China looks vulnerable to credit deceleration (figure 6).
- The best opportunities lie with those countries that are making progress with structural reforms and have the lowest debt levels but which are not vulnerable to low oil prices, such as India and the Philippines.

Figure 5

This table shows the vulnerability to increasing foreign borrowing costs (from least to most vulnerable).

Source: Rathbones, DataStream

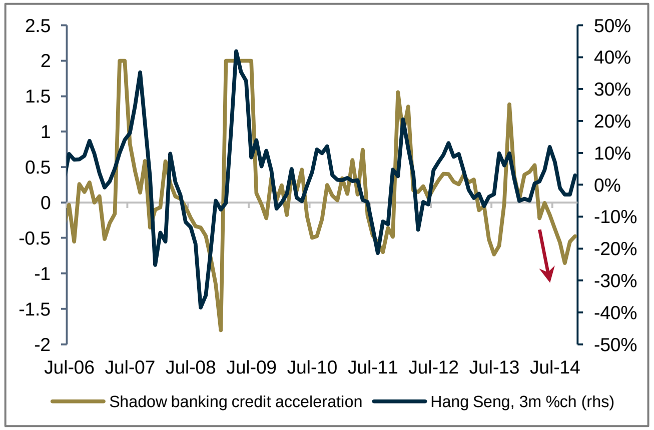
	Overall Rank (Low to High)	Current Account Balance (% GDP)	Foreign-Held Debt (% GDP)	Capital Flow Volatility (Ranked Low to High)
Taiwan	1	13.1	36.4	1
China	2	2.2	9.1	5
Nigeria	3	-0.2	2.3	8
UAE	4	11.2	36.6	10
Philippines	5	4.0	23.1	6
India	6	-1.0	23.6	2
Russia	7	3.0	35.1	3
Brazil	8	-3.8	14.7	7
Venezuela	9	0.8	18.7	14
Indonesia	10	-3.0	33.0	4
Mexico	11	-2.1	29.3	9
Columbia	12	-4.1	26.9	11
Thailand	13	3.8	38.7	18
Peru	14	-5.9	34.3	15
South Africa	15	-4.6	41.4	13
Chile	16	-1.8	42.2	19
Turkey	17	-6.0	49.9	12
Czech Republic	18	-0.8	52.4	17
Malaysia	19	5.5	36.3	20
Poland	20	-1.3	70.0	16

Figure 6

The performance of EM equity markets is sensitive to the credit cycle, particularly in China, where the shadow banking system has fuelled economic growth.

Source: Rathbones, Bloomberg

China-related equities are very sensitive to credit



Global Monetary Policies Are Diverging

- The US economy has enjoyed strong growth this year with unemployment falling steadily. The UK economy has also performed well.
- In contrast, the eurozone has been struggling with weak growth, high unemployment and worryingly low inflation.
- Japan's economy slipped back into recession following a sales tax increase in April. After early signs of success, Abenomics has been less effective in recent months – can Mr Abe use the mandate from December's snap election to regain the initiative?
- With their economies operating at different speeds, the US and UK are set to tighten monetary policy, while the eurozone, Japan and even China are heading in the other direction (figures 7 and 8).
- It is the first time for some years that the major economies have been out of step. In the past, such periods have caused volatility in financial markets.
- Investors believe that action by central banks will lead to better times ahead. But this attitude leaves markets vulnerable to the actions of policymakers.

Figure 7

In 2003/4, the performance of US equities became more unpredictable when the Federal Reserve's policy language changed rather than when interest rates were actually increased.

Source: Datastream, Federal Reserve, Rathbones

US equity volatility likely to increase between first language change and first rate hike

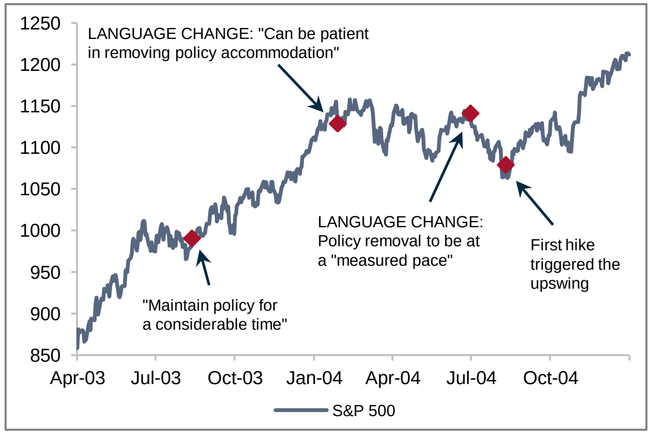
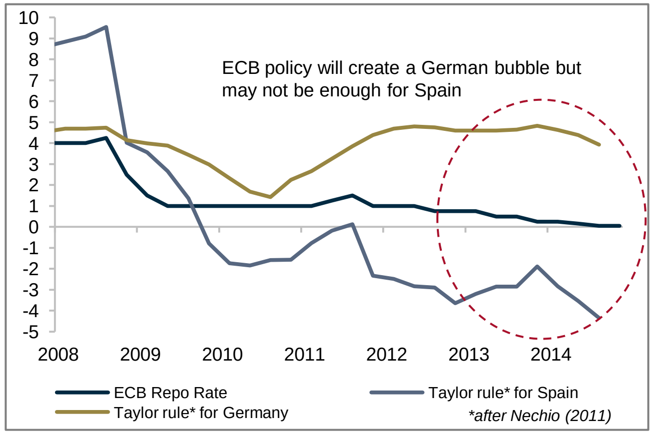


Figure 8

The needs of the divergent eurozone countries mean that the ECB repo rate is far too low for the German economy and far too high for Spain.

Source: Rathbones, DataStream

Setting the right policy rate in the eurozone is almost impossible



Lower Oil Prices Create Winners And Losers

- Oil prices have fallen dramatically over the past few months with Brent crude sliding below $60 a barrel by the end of 2014 from its previous range of $100-115.
- The causes are a combination of lower global demand and plentiful supply. Saudi Arabia has resisted calls from OPEC members to reduce output (figure 9).
- A lower oil price is good news for the global economy by transferring spending power from producers to consumers. But there will be winners and losers.
- US retail sales are likely to pick up significantly over the next two quarters and consumer discretionary companies should benefit (figure 10).
- Yet firms that derive a substantial portion of their revenues from emerging markets could suffer – slowing growth across these regions has triggered lower oil prices.
- Countries that require a high oil price to balance their budgets are the most vulnerable to lower prices. They include Ecuador, Iran, Nigeria and Venezuela.
- The US corporate bond market may also be vulnerable were shale oil and gas companies to default.

Figure 9

The fall in the oil price may result from tensions in OPEC - Saudi Arabia can tolerate low oil prices for far longer than most of its peers, especially Iran.

Source: IMF, Reuters, Russian treasury, Datastream, Rathbones

Saudi Arabia can tolerate low oil prices for far longer than Iran

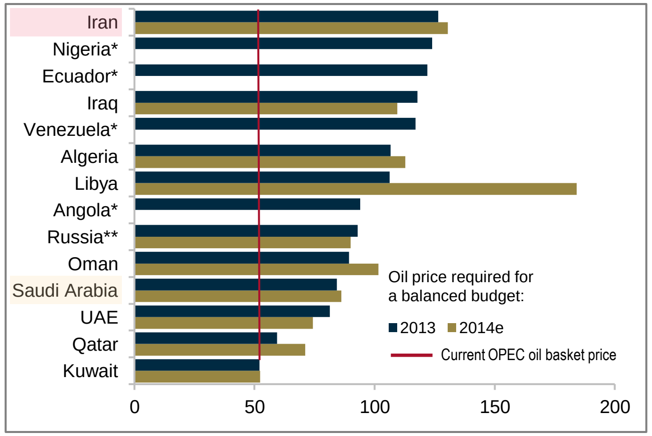


Figure 10

Lower oil prices should boost consumer spending and US retail sales could grow substantially over the first half of 2015.

Source: Rathbones, DataStream

Retail sales will likely grow above the pre-crisis average in 2015