Economic Outlook

- Although Q4 reports have yet to be released, **global** GDP growth is likely to be around 2.6% (nominal GDP weights), in line with the sub-par growth of the past few years and well below early year estimates. This was principally due to the very cold US weather in Q1 and the larger than anticipated negative effects on Japanese GDP from the Q2 sales tax hike. Ironically, GDP growth in the euro area and China are likely to be fairly close to year ago projections.

- Hope springs eternal amongst forecasters and once again a stronger year is predicted for global growth as shown in the following table:

Consensus GDP Forecasts (%)

	14	**15**	**16**
US	2.4	**3.0**	2.8
EU	0.9	**1.1**	1.5
Japan	0.2	**1.2**	1.4
UK	2.6	**2.7**	2.4
China	7.4	**7.0**	6.8
India	5.3	**6.2**	6.9
EM Asia ex Ch. & Ind.	3.6	**4.1**	4.1
Brazil	0.2	**0.5**	1.8
Russia	0.5	**-3.0**	0.8
DM	1.7	**2.3**	2.3
EM	4.2	**4.3**	4.9
World	2.6	**3.0**	3.4

*Bloomberg and Morningstar OBSR

- Despite concerns that the oil price decline could engender a damaging deflationary psychology, and there being obvious casualties among commodity producing nations, most observers agree with the IMF view that it is "a shot in the arm for the global economy" potentially producing "a gain for world GDP between 0.3 and 0.7 percent in 2015". Overall, global GDP is predicted to grow by 3.0% in 2015.

- From a regional perspective, the US economy is expected to be by far the biggest contributor to the global upswing and, should it grow by the generally foreseen 3%, it will account for nearly half of the estimated increased in world output. The bulk of the rest is likely to be provided by other developed markets (DM) with aggregate emerging market (EM) growth undermined by the ongoing slowdown in the Chinese economy.

- While **US** GDP growth is unlikely to sustain the near 5% p.a. pace of the prior two quarters, Q4 is set to deliver growth at around a 3.0% p.a. rate led by another strong outturn from consumer spending. A similar pattern is forecast for 2015 overall, with personal consumption expenditure growth expected to be the key contributor to a 3% or so gain in GDP. Rising wage and salary income, falling unemployment, the boost from the decline in the price of gasoline and growing consumer confidence should all support a faster pace of household spending. In contrast, the contribution from capital spending is set to be diluted by the likelihood of a very sizeable downturn in oil and gas investment.

- With headline inflation having morphed into headline deflation and a sufficiently fragile **euro area** economy, the ECB is likely to introduce its own QE programme later this month. Looking forward, this only adds to a number of growth tailwinds, including a further fading of fiscal austerity, sizeable euro depreciation, collapsing oil prices, lower borrowing costs and easing credit conditions, while business surveys have also turned positive in recent months. Following expectations of near 1% GDP growth in Q4, a faster pace is forecast for 2015, within a 1.2-1.5% range. A number of national elections pose an added layer of political risk this year with the first, in Greece, later this month, perhaps the most problematic.

- Following some recent "official" downward revisions to prior quarterly figures, the **UK** economy is set to grow by around 2.5% in Q4 and 2.6% for the full year. More recent data has shown consumer spending accelerating, a factor that should also support stronger growth in 2015. For much of last year, consumption lagged but, with unemployment continuing to fall, both nominal and real wage growth at last beginning to pick-up and a significant boost from lower oil prices, household spending should be the key contributor to expected near 3% GDP growth for 2015.

- A good deal of uncertainty, however, is being generated by the May General Election as the polls and bookies both forecast a "hung parliament". The prospect of prolonged political gridlock may affect UK business investment, despite revived consumer confidence and some of the lowest borrowing costs on record.

- As widely predicted, **Japan's** Prime Minister, Shinzo Abe, secured a two-thirds majority in parliamentary elections seen as a referendum on his economic policy and he has since outlined a stimulus package and lowered corporate tax rates. Following the mid-year recession, GDP is forecast to rebound towards 4% growth in Q4 and 0.2% for the full year. Looking forward, an acceleration to around 1.5% is predicted for 2015, driven by a turnaround in consumption, stronger global growth and the much weaker oil price.

- Following near 8% q/q annualised growth through the middle two quarters of 2014 the **Chinese** economy has slowed to around a 7% pace in Q4. This slowdown is due principally to weakness in areas of the economy targeted by the government as part of its strategy to rebalance the economy. To prevent too fast a slowdown, the authorities are aiming to stabilise growth via accelerating infrastructure projects and further monetary easing. Full year 2015 forecasts centre around 7.0% following an estimated 7.4% last year.

- It is no surprise that revisions to GDP forecasts have differed markedly across **EM** as the oil price has collapsed. Russia and Brazil have led EMEA and Latam lower; some estimates now suggest the Russian economy could contract by 5% in 2015 while Brazil may well stall. In contrast, forecasts for Asia Pacific ex China have risen led by an accelerating Indian economy, stronger global growth and the boost from lower oil prices, lower inflation and in some instances declining interest rates.

- The ongoing collapse in oil prices has likely ensured that deflation will predominate over **inflation** in headline figures through much of next year. It must be remembered, however, that the 80% or so of CPI, or other national equivalent, i.e. core inflation, is expected to be little changed. Using the US as an example, the year on year headline CPI rate is projected to be negative over the first three quarter of 2015 and to be 0.2% in Q4 2015. In contrast, the quarterly core inflation rate is generally forecast to remain fairly steady at around 1.8% y/y. For want of a better phrase, this is essentially "good" deflation that is being determined almost entirely by falls in energy prices.

Financial Market Outlook

- Divergent **monetary policy** trends are set to remain a key feature in financial markets. The ECB and BOJ will remain committed to boosting growth and inflation through balance sheet expansion even as the Fed and eventually the BOE begin tightening policy via higher interest rates. While no new initiatives are expected from the BOJ in the first half of 2015, the ECB appears set to introduce its own QE programme at its 22nd January meeting. As ever with the ECB, the devil will be in the detail.

- While there is some uncertainty surrounding the timing of the first rate hike, Fed actions will likely cause periods of financial market instability, especially should it raise rates around mid-year, much earlier than the money markets are currently discounting. As for the UK, the timing of the first hike is now expected in Q4 2015 at the earliest.

- Financial market uncertainty caused by falling oil prices, the substantial decline in headline inflation and inflation expectations and further central bank balance sheet expansion, have contributed to the **government bond** bull market continuing into the early part of January. UK and US markets have led the way and appear to be benefiting from the considerable spreads over similar dated euro and Japanese bonds, alongside the prospect of currency gains.

- US 10-year yields below 1.90%, however, appear incompatible with an expected economic "normalisation" and it would be rare for a new tightening cycle not to be accompanied by a sizeable increase in Treasury yields. UK 10-year gilts, at around 1.50%, also appear far too low with nominal growth likely to exceed 4% by year end. While yields will likely stay lower for longer, the technical factors that have effectively forced government bonds yields to such extraordinary low levels may eventually prove unsustainable in the face of a period of stronger global growth resulting in poor returns over the year.

- UK index linked were amongst the best performing of all assets in 2014 being very long duration. While returns from the sector have essentially been institutionally demand led, yields at -0.9% appear vulnerable and US TIPs certainly appear better value.

- Investment grade **corporate bond** yields have followed government yields lower, but spreads have tended to widen. Issuance has remained high to take advantage of the lower borrowing costs despite a risk-off phase in financial markets as volatility has risen. Should government bonds lose money on a twelve month view, corporates are unlikely to produce much higher returns. Although the outlook for US high yield remains blurred by the high energy content, an increasing number of commentators now believe yields and spreads have backed up sufficiently to compensate for prospective defaults.

- Sentiment towards **EM debt** remains poor and spreads have widened out again. This is despite outperformance from EM equities and even EM currencies against all but the dollar. Given the substantial increase in dollar and local currency EMD issuance in recent years, fears have grown that further dollar strength and rising US yields across the curve could cause a sizeable reversal. Obviously, it will be a much tougher period for many countries and companies in Latam while Russian debt faces a very testing time. Conversely, EM Asia should be a real beneficiary of lower oil prices and with economic imbalances having been addressed in a number of key countries, prior fx weakness, current wide spreads and high yields, this provides the opportunity for up to mid-single digit returns from sovereign debt.

- The dollar has continued its bull run into the new year and the **currency** is now heavily overbought being accompanied by extreme positioning. The dollar appears due a near term correction, therefore, but over the next several months, fundamentals, newsflow and momentum should remain in its favour, especially against the euro. Yen and euro weakness is part of their central bank's policy prescription while sterling still appears overvalued, especially with the likelihood of political risk building ahead of the elections. While it is unwise to generalise most

EM currencies are unlikely to outperform the dollar but there are many that could generate gains against the other major currencies.

- The dramatic, ongoing oil price collapse remains the lead story in **commodity** markets. With the basic issues being oversupply and OPEC (read Saudi Arabia) intent on maintaining its market share, the price will have to be sustained at levels that lower production, particularly of US shale oil. Crude prices in the $40's will eventually succeed in achieving this and US producers have already begun idling drilling rigs. It is interesting to note that oil traders have charted VLCC's to store crude at sea while net long futures positions are at their highest since last August. A sharp rally is expected later in the year as oil demand should strengthen on weak prices at a time of growing global growth and a peak in seasonal demand in the second half. Year out futures are around 25% above the current spot price.

- Elsewhere the outlook is mixed; gold has rallied on greater financial market volatility while industrial metals have eased led by severe copper weakness that has taken prices well below most commentators' year end forecasts. The supply/demand balance is key and recent data suggests falls may be overdone. As for the main grains, as ever, much will depend on weather trends but a significant shortfall in expected supply will be needed to imbalance a global market where stocks have risen following two consecutive record harvests.

- Having produced a spectacular gain of 19.3% in 2014, the highest for over 20 years, naturally enough the consensus expects a moderation in **UK commercial property** performance this year, although the cycle has further to run. 2014 capital value growth was exceptional for both offices and industrials while retail sorely lagged and, with little sign of any major improvement in this largest sector, office and industrials are unlikely to repeat near 25% total returns. The UK economy enters 2015 in good shape but the May General Election adds to uncertainty. With further yield compression to come, money flows still strong, much easier borrowing conditions, a high starting yield and improving occupational demand, however, another good year is in prospect, although IPD returns maybe somewhat closer to 10%.

- With such a sizeable generally unforeseen event, the oil price collapse has significantly increased volatility in financial markets; Q4 volatility in **equities**, as measured by VIX, was its highest for two years. This has continued into the early part of January as the implications for economies and a possible credit event are discounted. Fed tightening also awaits, valuations in the US, the lead market, are already at high levels while, near term, US earnings are under pressure from oil-related companies. This is expected to be a difficult year for investors to navigate with higher levels of volatility than experienced in recent years. The economic cycle has several years to run, however, and none of the usual imbalances that typically end US expansions and derail bull markets are on the near horizon. Both the euro area and Japan are at much earlier stages of economic recovery and also have stronger prospective earnings growth and much lower valuations. The UK is a difficult call and will have to rely on a rebound in oil prices and commodities to outperform. Also, the General Election provides further uncertainty. As for EM, potential returns are also difficult to quantify but at least EM Asia looks set for further decent gains, although India is unlikely to lead again.

- In what could be a volatile, trading-orientated year, overall global returns of 10-12% could be achieved The EU and Japan have the potential to achieve higher returns and are overweighted, while high single digits gains are forecast for the US and EM which are neutrally weighted. The UK is modestly underweighted for the first half of the year. US mid-caps remain highly priced relative to large caps but there is less differential elsewhere. A better than expected economic recovery would support small caps and a modest pro-cyclical tilt towards IT and consumer discretionary. Other themes include higher yielding stocks with growing dividends in such a low bond yielding world.

- In terms of **asset allocation** positioning, the two core themes from 2014 are retained; equities are forecast to outperform bonds and UK commercial property to outperform cash. Returns from equities and property may be fairly similar and likewise those from bonds and cash.