Headwinds and Tailwinds on the Markets and How to Benefit in the Months Ahead

In recent weeks economic data has come in on the disappointing side, causing us to admit that uncertainty over the cyclical outlook has increased. We find ourselves in an unprecedented period of stagnant economic growth, and the economic recovery we have seen since the third quarter of 2012 may be entering into a consolidation phase. However, offsetting the above, a combination of global cyclical recovery, additional monetary easing and an ongoing flow from zero-return cash holdings into income generating assets is creating a positive underlying tone for the markets. How is this mix of headwinds and tailwinds going to influence the markets in the coming months and how can investors benefit from it?

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Macroeconomic view
It is our belief that the headwinds of late will ultimately blow over and that the tailwinds will prevail. Markets are rational over the long term and market anomalies should find equilibrium over time. Looking at the common denominators of market movements in the past we can identify two different forces. Monetary policy easing has been instrumental in inducing an upturn. Downturns have been mostly the result of a combination of increases in political risk or policy mistakes and idiosyncratic shocks. We seem to be dealing with a set of persistent tailwinds, while the headwinds seem to be short-lived, now that central banks have reduced the systemic risk.

The three biggest central banks, each in their own way, did what had to be done. Their actions are an important tailwind and a major driver for the improvement in global economic growth. Until recently, Japan remained the laggard with no real change in its policy since 1990. However, the determined effort to finally overcome deflation will further boost both Japan and the world. Thus once more, the most important tailwind is a change in monetary policy, in this case in Japan. For Japan it will boost domestic demand, and the weakening yen, caused by the new policy, will also boost exports. The effects of this new policy will remain regional at first, but global liquidity growth, final demand and global economic growth will also benefit from this new stance.

On the other side of the globe, the United States is showing promising data, with both supporting economic data and earnings dynamics. The U.S. housing and labor markets are clearly improving and this data is further amplified by the expected increase in corporate spending. This is already visible in the service sector activity, that is picking up. For now we see no signs of a tightening policy from the Fed to temper the growth in the U.S. market. There is however fiscal tightening, but the effect is small. This is consistent with the view that tailwinds outweigh the headwinds at the moment.

The contrast between the tailwinds of Japan and the U.S. and headwind coming out of Europe is rather large.

The decision of the ECB not to change their policy jogged many investors' memory of the way Japan used to operate before the current leadership. At the same time complacency amongst European policy makers reminded investors of the gridlock in the US. However, evidence of the lack of power of these headwinds is also visible in the European market. The market reaction to the Italian elections, for example, and especially the Cyprus crisis has been remarkably subdued. This can be seen as an indication of the effectiveness of the liquidity mechanisms in substantially reducing the transmission of political uncertainty towards financial markets.

Finally, in the emerging markets, we observe weakening macroeconomic fundamentals and a reduction in competitiveness. However, also here the tailwinds outweigh the headwinds. If markets continue to anticipate more monetary easing globally, flows to higher yielding assets – such as EMD – are likely to strengthen again, despite the deteriorating prospect for economic growth.

It thus seems that attractive allocation opportunities can be found between the regions. The regional differences due to different policy dynamics and economic data are already visible in the market performance and we expect that to continue. Finally, demand growth in the next few months will mainly be driven by the U.S., Japan and the emerging markets such as China, while Europe is lagging. Investors should be aware of these regional divergences when building their portfolios.

What are you looking for?

Depending on your needs and objectives, your portfolio should either focus on safety, income generation or price appreciation.

Relative safety can be found in government bonds, where we advise to look beyond credit ratings, but also take into account liquidity, sustainability of debt, influence of foreign investors and market sentiment. Safety does come at a price: Real yields will likely be negative, causing risk of negative market returns due to rising interest rates. Long-term interest rates however are depending on inflation, growth and also the level of short-term rate rises. All of those are currently low and therefore the probability of a substantial rise in interest rates in the medium term remains limited.

Attractive income generating investment opportunities can still be found, but are becoming more scarce. These lie within the asset classes, not between. In a world where government bond interest rates and cash returns are low and where an aging population prefers income to capital gains, sustainable dividend and fixed income strategies will further gain in importance as sources of income.

In equities we can find income in high dividend. We believe that dividends are relatively safe as well even in a low (earnings) growth environment. The low payout ratio, healthy cash-rich balance sheets and solid cash flow generation contribute to this. Historically, dividends are also less volatile than earnings. Noteworthy is the observation that the traditional high dividend sectors (financials, utilities and telecom) are no longer providing that same dividend certainty. Dividend growth has complemented dividend yield as a factor that delivers the best investment outcome. In this perspective it is important as an investor to constantly re-evaluate one's portfolio and search for shares that can provide both (high) dividend yields and dividend growth.

In fixed income we have traditionally found income in government bonds. However, now that the 30-year bull market in bonds has ended and bond yields are at historic lows, they no longer provide lasting income. Investors looking for durable income thus have to continue to search within the asset class and will likely end their search once coming across high yield bonds. In the current environment, high yield bonds provide much appreciated income with relatively low volatility. Regional differences are also applicable in this case. The outlook for interest rates in combination with the solid corporate credit fundamentals means that the positive environment for high yield bonds will last for the time being. However, the asset class does not provide any meaningful price appreciation potential anymore.

Conclusion

While the global recovery has become somewhat clouded, we believe that the combined longer term tailwinds outweigh the shorter term headwinds. However, there is a chance that the economy may enter a consolidation phase with low nominal growth. To deal with this challenge, investors should take regional differences into account and search within assets classes to find their optimal combination of relative safety, income and capital appreciation potential. Growth and momentum are diverging regionally due to different business cycles and policy stands; investing in the right regions can thus truly make the difference. Low nominal growth invariably spurs the search for income, which can be found within the assets classes, not between. Investing in the right region and within the right asset class can provide investors with the additional income they are searching for. Investors that aim for capital appreciation should allocate to equities, but with that they will have to accept the larger volatility of this asset class.

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To deal with today's challenging environment, investors should take regional differences into account and search within assets classes to find their optimal combination of relative safety, income and capital appreciation potential.