CRUDE OIL PRICES TANK

In recent weeks, crude oil prices have tumbled to levels last seen during the financial crisis and global recession more than 5 years ago. While oil prices had been declining since last June, the downward trend intensified markedly after the Organization of Petroleum Exporting Countries (OPEC) decided to maintain its production quotas unchanged, rather than lowering its output target to better align global supply to weaker demand growth.

There are many theories as to why OPEC, and in particular Saudi Arabia, did not cut production despite the prevailing trend of falling prices. The general consensus is that this is primarily an effort to squeeze out the highest-cost producers, in particular some US shale producers. As indicated by Kuwait’s and United Arab Emirates’ oil ministers, OPEC is acting to preserve its market share amid a global supply glut. They very specifically blame surging oil production in the US (+3.5 million barrels/day in the past 3 years) and therefore expect the necessary supply adjustment to be borne by non-OPEC producers.

Other commentators believe geopolitical goals are at play with the US and Saudi Arabia pushing prices lower to inflict additional pain on the Russian economy and pressure Putin to reassess his strategy in Ukraine.

KEY TAKEAWAYS

- On a global basis, lower oil prices mean that wealth is shifting from oil producers to oil consumers. The greatest beneficiaries will be those economies that spend the most on net oil imports as a share of GDP, such as Japan, India, China and the Euro-area. While lower oil prices will boost global growth and are at least partially the result of a positive supply shock, weaker oil demand, particularly out of China is also to blame.

- Recent economic data has been unambiguously positive for the US economy. Despite stronger growth and tighter labor markets, we doubt the Fed will bring forward the timing of its first rate hike as lower commodity prices and a stronger USD drive inflation lower and allow the Fed to lag the economic improvement.

- Although it has become a massive consensus view, growing policy divergence between the US and most other economies will lead to additional USD strength. Exchange rates have become the key transmission mechanism through which monetary policies impact economic trends.

- The Abe government, the Bank of Japan and the main government pension fund all took significant steps to provide an additional dose of stimulus to the Japanese economy.

- Despite our belief that the risk of a deflationary spiral in the Euro-area is limited and that growth is likely to strengthen, the ECB appears increasingly likely to embark on a full-blown QE program next year.

- We expect more monetary easing out of China next year as growth and inflation weaken further. Structural and financial reforms will also remain a major focus.
GOOD NEWS OR BAD OMEN?

On a global basis, lower oil prices basically mean that wealth is shifting from oil producers to oil consumers. The greatest beneficiaries will be those economies that spend the most on net oil imports as a share of GDP, such as Japan, China, India, South Korea and the Euro-area. The US is also expected to benefit from weaker oil prices but the impact will be less pronounced as a result of the ongoing shale boom and the associated sharp decline in net oil imports over the past few years. Additionally, several companies and states which have benefited from the shale boom are expected to suffer from a likely drop in capital spending in this area, as well as lower revenues in the near term. While segments of the high yield market are already exhibiting some signs of stress (shale companies tend to be relatively small and highly levered), the importance of the energy sector for the US economy should not be overstated and the windfall to consumers and other manufacturers from plummeting oil prices will be significantly larger. Indeed, both the IMF and the Federal Reserve have recently commented (and the IMF also raised its growth forecast for the US economy) that this “supply shock” will be a net positive for the US and the global economies.

There is limited doubt that when oil prices decline exclusively because of a positive supply shock, the reflationary impact can be quite significant. On a global basis, the IMF estimates the every 10% decline in oil prices leads to a 0.2% to 0.4% pickup in global output over the following two years. With prices down 40% from their recent highs, the positive impact could be quite significant, although recent US dollar strength means that the fall in oil prices is less pronounced when measured in other currencies.

Historically though, sharp drops in oil prices have been associated with recessions due to a collapse in energy demand. The 40% plunge in oil prices could therefore be the consequence of weak global growth and an indication that additional weakness should be expected going forward. However, it is important to note that plunging oil prices have usually been the consequence of a recession and not a warning leading indicator. Indeed, the price declines seen during previous recessions have merely acted as a reversal of previous sharp increases in oil prices prior to the onset of these recessions. Elevated oil prices cause recessions while recessions tend to cause prices to drop, unless supply is growing much faster than demand. Today, there is no denying that several factors have combined to boost oil output at a much faster rate than underlying demand growth. At least part of the decline in oil prices is therefore supply-driven, thanks to technological advances in shale production and increased output in Libya and Iran. Indeed, the IMF attributes 80% of the recent fall in oil prices to supply-side developments and only 20% to weaker cyclical demand.
While we agree that lower oil prices will act as a boost to global economic activity going forward, we also believe that weaker oil demand, particularly from China and other large developing countries is a key factor. If oil prices were declining mostly because of rapidly rising supply, weakness should be constrained to the energy sector. Instead, we are witnessing sharply lower prices across several other commodity markets for which China has historically been the main driver of demand growth (coal, steel, iron ore, rubber, a.o.).

Large price declines in any asset class, and in particular in an economically sensitive market such as oil, always have the potential to become more disruptive than initially estimated due to second-order effects which take time to develop. Although we are confident that the net impact of falling oil prices will be a positive for global growth, the economic and financial problems from the net “losers” (i.e. Russia, Venezuela, higher-cost producers in North America, a.o.) usually emerge a lot faster than the positive effects for the beneficiaries.

**THE NICEST HOUSE IN A NOT SO GREAT NEIGHBORHOOD**

As discussed, plunging oil prices are likely to act as a powerful stimulant for the U.S. economy in coming months. Despite all the bullish headlines surrounding the shale revolution and how much the sector has positively impacted hiring and capital spending in recent years, the reality is that this sector remains relatively small, particularly compared to consumer spending which still accounts for roughly 70% of the GDP. For households, plummeting energy prices are clearly a positive and the same is true for most businesses. Savings on energy bills (similar to a tax cut) are likely to encourage more discretionary spending and, with a lag, provide a further boost to labor markets and capital spending.

Recent economic data has been unambiguously positive for the U.S. economy. During the past 2 quarters, the economy expanded at its fastest pace in more than a decade with a combined 4.25% annualized GDP growth rate. Economic growth has reached 3.5% or more in four of the last 5 quarters. The one exception however was a 2.1% contraction during the first quarter of this year on the back of severe weather conditions. As a result, on a year over year basis, GDP growth stands at 2.4%, not significantly different than the 2.1% growth seen over the past 5 years since the economy emerged from recession (and still the weakest recovery on record since WWII). Another positive is the ongoing strength in labor markets as businesses continue to ramp up hiring across the board. Nonfarm payrolls have now expanded by more than 200,000 for 10 consecutive months and 2014 is on pace to be the best year in terms of job growth since 1999, with the economy adding 2.65 million jobs in the first eleven months.
of the year. A broad gauge of underemployment which includes part-time workers who look for a full-time job and people marginally attached to the labor force remains relatively high at 11.4% and long-term unemployment remains an area of concern too. However, there is no doubt that labor markets are tightening with the official unemployment rate down to 5.8% - not very far from measures of full employment - and it is therefore not surprising to witness the first nascent signs that wage growth is finally accelerating (albeit from very low levels).

GDP growth above potential (although the output gap has yet to be closed), tighter labor markets and the stimulative impact of lower energy prices are factors which could all prompt the Federal Reserve to bring forward the timing of the first rate hike. We think this is unlikely to be the case and agree with what is currently priced in the market, i.e. no tightening before the second half of next year at the earliest. First, strong(er) growth in the US is a stark contrast with recent trends on a global basis where the economic momentum appears to be waning. The jury is still out whether US strength will help lift economic prospects elsewhere or whether weakness overseas will bring down growth prospects for the U.S. economy. We expect the Fed to wait for clearer evidence in one or the other direction before pulling the trigger. Second, better growth and improved prospects are not a justification per se for the Fed to tighten monetary policy. Central banks tighten monetary policy only when growth becomes a problem, and that is when growth causes inflation to rise or at the very least inflation expectations to move higher. As we have said repeatedly, given the large output gap that opened up following the Great Recession, it will require several quarters of above-trend growth to generate an inflation problem in the US. That was true a few months ago, and it is even more the case now as commodity prices have plummeted and the U.S. Dollar has appreciated to its highest level since 2006. Since July, oil prices are down 40% and the USD index is up 12% - that is a very powerful deflationary cocktail, even for an economy showing early signs of finally escaping from years of subpar economic growth.

**IMPLICATIONS FOR THE BOND MARKET**

Despite the recent pickup in economic momentum, US treasury yields continue to hover near the lows for the year and significantly lower than at the start of the year, despite nearly unanimous calls for yields to move higher in 2014. Consistent with the recent economic trends of improving growth and the likely impact on inflation trends from a strong dollar and weak commodities, the drivers underpinning low treasury yields have changed over the past few months. Earlier in the year, inflation expectations were relatively stable and real yields came under pressure due to disappointing growth in the first quarter. Since the summer however, real yields have actually moved higher but this was more than offset by implied inflation breakevens coming down quite dramatically.
We think that global developments and trends in the foreign exchange market will shape the outlook for treasury yields as we move into 2015. The overarching theme is one of growing policy divergence between the U.S. (and potentially also the UK) on one side and most other economies on the other side (Japan, the Euro area, China, India, Australia, to name a few). As we will discuss later, there is a lot more policy easing to be expected from these economies next year in various shapes or forms - interest rate cuts, lower reserve requirement ratio, and/or balance sheet expansions. Although it has become a massive consensus view, the direct consequences of this policy divergence will be a further appreciation of the U.S. dollar.

Currency markets tend to go through prolonged cycles and the primary trends usually don't reverse so easily, even when sentiment seems to be so one-sided. With policy rates close to zero in many economies and already depressed bond yields, traditional monetary policy decisions (rate cuts) and unorthodox measures (quantitative easing - large scale purchase of government bonds) will have limited impact on the overall level of borrowing costs. As such, foreign exchange rates will become the main transmission mechanism allowing monetary policies to still have an impact on economic trends. As we have seen since the financial crisis, there has been a direct link between how aggressive a central bank has been expanding its balance sheet and the trend in that country's exchange rate. Recent and anticipated policy moves by foreign central banks mean that the USD will continue to strengthen. While this is a natural consequence of superior growth performance and diverging monetary policies, this will act as a headwind for growth in the US and, as already mentioned, will dampen any building inflationary pressures in the labor market.

Coming back to bond markets, a stronger greenback will most likely limit the upward pressures on bond yields through two main channels. First, bond markets are likely to move in a way to offset the deflationary impact from a stronger dollar. With the Fed funds rate at zero, the only way a stronger USD will not lead to an unwarranted and/or unwanted tightening of monetary conditions is for bond yields to move lower. As the economic recovery gathers more speed, some tightening of monetary conditions might be justified but higher bond yields combined with a strong USD and potentially the initial rate increase by the Fed would likely be too damaging for the US economy. This brings us to the second channel through which the dollar will impact treasury yields. Unless the economy continues to grow above trend (at levels of 3 to 3.5%) and wage growth accelerates in a more pronounced manner, a stronger dollar will most likely encourage the Fed to delay the first rate hike as it will help keep inflation under control for longer. Despite a desire to normalize interest rates, we believe that most FOMC members are also very concerned not to raise rates too soon given that deflation rather inflation remains the most significant threat on a global basis.

DON'T FIGHT THE BANK OF JAPAN

The Japanese government, the central bank and the main government pension fund all took significant steps to provide an additional dose of stimulus to the Japanese economy as new evidence that the campaign (aka “Abenomics”) launched two years ago to end years of deflation was faltering. The main trigger for this renewed policy push was a surprising contraction in the Japanese economy during 3Q2014 – the second quarter in a row, which fits the most common definition of a recession.

The increase in the sales tax last April (from 5 to 8%) is largely to blame and appears to be undermining the
stimulative effects of aggressive monetary easing. Abe was expected to go ahead with a plan to raise the sales tax once again in October 2015 (to 10%) but this move has since been postponed and Abe called snap parliamentary elections in order to reaffirm the country’s support to his economic policies. The Abe government will soon propose a fresh fiscal stimulus package worth JPY 3 trillion (USD 25bn), a complete U-turn from an earlier pledge to reform/consolidate fiscal policy and deal with the country’s bloated public finances.

Faced with mounting evidence that the aggressive inflation goal was unlikely to be reached, the Bank of Japan announced a significant expansion of its QQE efforts (Quantitative and Qualitative Easing) – the annual target purchase of government bonds will be increased to JPY 80 trillion (from current level of 50-60 trillion) and the maturity of the bonds will be lengthened towards 7-10 years (from 6-8 years). The BOJ will also step up its buying of equities (through exchange traded funds) and real estate investment trusts (J-REIT). This unprecedented and unexpected move was immediately followed by an acceleration of the downtrend in the Japanese Yen and surging stock prices. This suggests that equity prices are still very much dependent on a falling currency and that the negative correlation between the Yen and the Nikkei remains extremely tight.

The one final piece of the Japanese puzzle came from the Government Pension Investment Fund (GPIF), the largest pension fund in the world with approximately JPY 130 trillion (USD 1.1 trillion) assets under management. Just a few hours before the BOJ decision, the GPIF announced revisions to the fund’s target asset allocation with a significant move away from domestic bonds (from 60 to 35%) and a large increase in both domestic and foreign equities (from 12 to 25% each) as well as a higher allocation to overseas bonds (from 11 to 15%).

L’UNION FAIT LA FORCE
(UNITY MAKES STRENGTH – NATIONAL MOTTO OF THE GREAT KINGDOM OF BELGIUM)

The combination of these three policy decisions (sales tax delay/potential fiscal package, a further sharp expansion in the BOJ balance sheet and the large asset allocation shifts to be implemented by the GPIF) should lead to
additional Yen weakness and provide ongoing support to Japanese stocks. Irrespective of whether Abenomics will prove successful in the long-run in not only defeating deflation but also raising the economy's potential growth rate, these measures are likely to boost the economy in the medium term. The power of teamwork is most obvious when it comes to the Japanese Government Bond market (JGB). The GPIF decision to reduce its holdings of JGBs will, over time, result in significant selling pressures in the secondary market (given its size, a 25% reduction equates to JPY 32.5 trillion) and the announcement to delay the second increase in the sales tax will probably lead to a larger fiscal deficit, which will have to be financed by an increase in JGB issuance. These moves are however offset by the BOJ’s additional annual JGB purchase of JPY 30 trillion and, at JPY 80 trillion going forward, the Japanese central bank is expected to buy more than twice the next issuance of JGBs in 2015.

While we remain skeptical that the policies so far implemented in Japan will prove sufficient to once and for all cure the Japanese economy from deflation and depressed growth potential (structural reforms are needed – the third Abenomics’ arrow – to achieve these goals), we continue to recommend a currency-hedged exposure to Japanese equities in the medium term.

CONDITIONAL COMMITMENT

There are increasing indications that the ECB could become the next major central bank to embark on a full-blown quantitative easing program in coming months. While investors have been disappointed by the lack of firm announcement on the heels of the most recent ECB meeting, Mario Draghi has made it clear that the central bank is committed to using additional unconventional instruments within its mandate and he has pledged to reassess the need for QE early next year. The next ECB meeting will be on January 22nd and investors expect Mario Draghi to actively seek a broad consensus, and more specifically German support for a stimulus package that could include the purchase of government bonds.

The ECB has already announced a series of measures which have yet to be fully implemented but the consensus view is that these measures will not be enough to boost growth and deal with intensifying deflationary pressures. Mario Draghi has reaffirmed his goal of growing the ECB balance sheet back towards its 2012 level, which would equate to a EUR 1 trillion expansion. The ECB intends to achieve this goal through a series of targeted long-term refinancing operations (TLTROS) and the purchase of covered bonds and asset-backed securities. Most observers doubt that these measures alone will be sufficient to achieve the stated balance sheet expansion goal. First, the size of the market for covered bonds and asset-backed securities is relatively limited and,
at best, these purchases are expected to help the balance sheet rebound by 4 to 5 hundred billions. Second, the first round of TLTRO was very disappointing with limited uptake from the banking sector and commercial banks are still repaying ECB loans obtained through a previous program (at the end of 2011). On the positive side though, this first round of TLTRO took place before the release of the bank stress-tests and results of the asset quality review, which probably led banks to adopt a wait-and-see attitude. Several ECB officials have voiced their concern that introducing QE too soon would be a mistake and that the effectiveness of current measures should be first assessed before taking any additional policy steps.

Putting it all together, we believe that the “Draghi Put” has been reinforced in recent weeks and that the introduction of QE, although more likely than before, remains very much conditional - if current measures are seen to be failing and if the medium term outlook for inflation, inflation expectations and growth were to worsen. Despite a growing consensus view that QE is imminent, two key hurdles still need to be cleared - will Draghi be able to secure enough support for a QE program (the Bundesbank’s view remains that this would undermine the incentive for governments to make structural adjustments and this move will have to clear high legal hurdles) even though Draghi affirmed he does not need unanimity, and - even more importantly - is QE really needed?

THE EUROPEAN ECONOMY AND QE

Despite the overwhelming pessimistic view of the European economy, recent data suggests that the most likely scenario is for growth to continue to gradually recover going forward. While growth remains below potential, GDP growth improved to 0.8% in the third quarter and has now been positive for 6 consecutive quarters. Several factors will support growth in coming quarters, consistent with IMF forecasts of 1.3% and 1.7% growth for 2015 and 2016. Monetary conditions have eased in recent weeks with the rapid decline in the Euro and the stabilization of the ECB balance sheet (after 2 years of contraction). The credit cycle is bottoming out and leading indicators such as the demand for credit and banks’ lending standards point to a further improvement. As mentioned, banks have been reluctant to lend ahead of the release of the ECB stress tests and asset quality review, which are now behind us. The drag from fiscal policy will be significantly less pronounced than in previous years and the potential for some level of fiscal expansion exists in a few countries. The recent
plunge in oil prices is particularly stimulative for the European economy given its position as a major net importer of oil. Finally, better economic data in the US and globally should support a gradual pickup in global trade, a key positive for Europe given its sensitivity to export growth.

While we believe the conditions are in place for a sustainable rebound in growth, market pressures in favor of QE are mostly centered around the growing concern that the Euro area will soon have to deal with moderate deflation and fears that this could morph into a Japanese style deflationary spiral.

Central banks and investors alike are understandably extremely fearful of deflation. Deflation can wreak havoc to an economy through two main mechanisms. First, falling prices cause the real value of debt to rise and this has the potential to trigger a debt deflationary spiral as debtors are forced to sell assets in order to reduce debt levels. Since deflation also raises the real cost of money, it does discourage credit creation and lead to excessive savings, thereby limiting the effectiveness of monetary policy. Second, expectations of falling prices cause households and firms to delay spending and investments in anticipation of lower future prices. This leads to a vicious cycle of falling prices leading to weaker demand leading to falling prices.

The painful adjustments suffered by the Japanese economy mired in deflation for years provide a timely justification for the need to prevent deflation at almost any cost. While some mild deflation is already present in a few European countries, there are many differences with Japan and the likelihood of an out-of-control debt deflationary spiral is relatively unlikely in Europe, in particular since overall debt levels are much less inflated, asset prices have been appreciating in recent years (both equities and real estate), the Euro is already weakening and deflation expectations are not yet widespread (in particular among households). Recent data has actually been consistent with a stabilization of core inflation at levels just below 1% - not high enough but not significantly different than levels seen in the US despite three rounds of quantitative easing. Headline inflation is increasingly likely to turn mildly negative in coming months as it currently stands at only 0.3% and both energy and food prices are deflating on a year/year basis. This is however not the type of deflation which could generate a deflationary mentality and spiral among households as food and energy involve spending that cannot be delayed when prices are expected to fall going forward.

Despite our belief that the risk of a deflationary spiral in Europe is limited and that growth will strengthen going forward, we see one major factor that will eventually convince the ECB to implement QE at some point in 2015, and that is the likely boost it will give to investor and business confidence. Higher investor and business confidence will in turn lead to rising asset prices,
declining risk premiums and eventually a pickup in capital spending and hiring. Related to this, QE is increasingly becoming necessary because of market expectations - indeed, a failure to implement QE could result in higher bond yields, lower equity prices and a rebounding Euro. Contrary to the U.S. precedent where QE had a material impact in driving down bond yields, this is unlikely to be the case in Europe given the starting point of extremely low bond yields, both at the core and the periphery. To the extent QE is successful in driving a rebound in inflation expectations (highly debatable given the experience in the US), real bond yields have some room to move lower, thereby providing some support to the economy.

We continue to recommend an overweight position in European equities on a currency-hedged basis. The likelihood that QE will be implemented next year has moved up significantly, even if not entirely justified by the outlook for growth and inflation, and even if its effects on the real economy are unlikely to be material. With the ECB balance sheet set to expand in coming months (with or without QE) and interest rates stuck at depressed levels for quite some time, we look for the Euro to weaken further. European equities are attractively valued, particularly when using metrics not solely dependent on near-term depressed earnings - such as price-to-book and cyclically adjusted price-earnings ratios. Easier monetary conditions, a pickup in global trade and improved domestic demand should support the consensus view of a strong rebound in corporate profits.

REFORMING AND EASING

After a series of piecemeal easing measures (mostly through the injection of short-term liquidity into the banking sector), the People’s Bank of China (PBoC) finally succumbed to political and market pressures and cut interest rates for the first time since 2012. The PBoC announced a 0.4% cut in the lending rate (to 5.6%) and a smaller cut to the deposit rate (to 2.75%). As part of a move towards interest rate liberalization, the central bank allowed banks more flexibility in setting actual deposit rates up to 20% above the deposit benchmark rate.

Despite the weakest growth in more than 5 years, the central bank had resisted intensifying
calls to ease monetary policy in order to avoid a broad based pickup in credit growth as authorities try to steer liquidity away from sectors already suffering from excess capacity.

The rate cuts point to a shift in the central bank's approach and a realization that weak private demand and rising deflation risks cannot be dealt with effectively through targeted easing measures. At the same time, the asymmetric nature of the cuts (lending rate cut larger than deposit rate cut) sends a clear signal that monetary easing and interest rate liberalization can be compatible.

The PBoC policy of deregulating bank deposit rates by introducing more competition for customer deposits will likely result in actual deposit rates not moving lower. A deposit insurance scheme is also expected to be implemented in the near term and this will further exacerbate the competition for deposits (and hence put upward pressure on the cost of funding) as smaller lenders have historically offered better rates.

Chinese banks have warned that the recent cuts will not lead to a rebound in bank lending as interest rate margins have eroded, primarily due to rising funding costs. Indeed, deposits - the main source of cheap funding for the banking sector - have declined (as Chinese households look for higher-yielding investment products) and this has forced banks to rely on other and more expensive sources of funding.

The Chinese authorities have to deal with two conflicting objectives. On one hand, the main objective remains the implementation of structural and financial reforms and the necessity to make the economy less dependent on credit, particularly in the context of rising non-performing loans, inadequate allocation of resources to state owned enterprises and overall credit-to-GDP ratio already above 200%. On the other hand, weak growth dynamics and tight liquidity conditions for the corporate sector (specifically small and medium companies) signal the need for policy easing. Indeed, overall monetary conditions appear too tight due to banks' reluctance to lend to small businesses, the official crackdown on the shadow banking sector, rising real rates due to intensifying disinflation and a strong currency on a trade-weighted basis.

As a result, we expect additional rate cuts next year as well as one or several cuts to the required reserve ratio (RRR) which currently stands at 20%, which means that banks have to keep 20% of their deposits as reserves with the central bank. A cut in the RRR will be significantly more efficient in generating the type of easing which will eventually help channel funding towards the private sector. Given the reluctance to unleash a massive credit boom similar to what happened in 2008, some level of currency depreciation is also likely in order to generate a more pronounced rebound in money supply. The Chinese renminbi has appreciated sharply in recent years and the economy (exports) would benefit from a weaker currency particularly in light of recent USD strength (key Chinese trading partners have benefited from significant currency weakness). Given the Chinese trade surplus, allowing the currency to depreciate would have to be achieved through currency intervention (USD buying) without sterilization - the resulting increase in FX reserves will directly flow into M1.

In light of these developments - and despite the wild moves already seen in Chinese equities - we maintain our bullish outlook for Chinese stocks given still very attractive valuations and our expectation that reforms and monetary easing will coexist in 2015.
INVESTMENT STRATEGY

• Despite stellar gains since 2009, we believe the equity bull market is not over yet. Several factors will help equities outperform bonds for a fourth consecutive year in 2015:
  
  • Global liquidity will remain abundant: despite the likely start of a Fed-tightening cycle (the first in a decade), additional easing is expected in the Euro-area, Japan, China and several other economies. US credit growth is running at 6% on a year-on-year basis and the Eurozone credit cycle is bottoming out.
  
  • Global growth is expected to accelerate in 2015 with the US economy growing above potential and growth picking up in Japan and Europe. Despite better growth, inflation is expected to stay low.
  
  • While valuation ratios have moved higher, relative valuations remain attractive in an environment of depressed bond yields. Global bond yields are unlikely to move significantly higher towards levels which would either lead to an economic slowdown or pose a threat to equity valuations.
  
  • Positioning and sentiment among investors point to a lack of excessive optimism.

• From a regional perspective, we believe international markets are likely to outperform US stocks in 2015. Japanese and European markets should benefit from more aggressive monetary easing as well as ongoing currency weakness. Both markets trade at attractive valuation levels, particularly when factoring in the potential for a more significant rebound in corporate profits. We are also positive on Asian markets due to a combination of structural reforms (India, Indonesia and China), a gradual shift from tight to looser monetary conditions and the upcoming rebound in global trade. In general terms, we are overweight commodity importers and markets where overall monetary conditions will turn more accommodative.

• Our portfolios remain positioned for further USD strength driven by the growing policy divergence between the US and the rest of the world. We continue to recommend hedging equity and fixed income investments in Europe and Japan. Commodity currencies (AUD, CAD, BRL, a.o.) need to adjust more in order to offset the negative terms-of-trade shock from plummeting commodity prices.

• We remain underweight fixed income but caution against being too short duration (interest rate sensitivity). We recommend a barbell strategy in the US as we look for the yield curve to continue to flatten. Bond yields are unlikely to move significantly higher at the long end of the curve due to the gravitational pull from depressed global bond yields, ongoing support from foreign fund flows and the disinflationary impact from weak commodity prices and a strong US dollar. We see more upward pressures on bond yields at the front and belly of the curve once the Fed starts hiking rates, most likely in the second half of the year.

• We maintain our overweight position in high yield bonds despite recent underperformance. While yields are historically low, high-yield spreads have widened to levels which we consider attractive based on where we are in the business and credit cycle. Corporate balance sheets are very healthy (low debt/equity ratio, strong free cash-flows), credit conditions are still accommodative (bank lending standards, demand for credit) and default rates are expected to remain low.

• We remain negative on gold due to a combination of low inflation, strong US dollar and our expectation that real rates will resume their uptrend later in 2015. While markets have a tendency to move from one extreme to another, the natural floor price for crude oil is unlikely to be significantly below current levels, given current production costs and/or levels needed to balance public finances in several key producing countries.