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Lower oil prices give Goldilocks outlook for deflation

Government and central bank policy actions generally have created a climate for growth and equity earnings, particularly changes to bank supervision and more accommodative fiscal policy.

Last year saw a series of measures taken by policymakers to assess the health of the banking system and set it up for a more stable and active future. European banks were subject to two parallel exercises: the Asset Quality Review conducted by the ECB, which assessed the holdings of individual banks, and the stress tests conducted by the European Banking Authority, which subjected those holdings to a range of adverse scenarios. The results, while not perfect, were encouraging and confirmed the stability of their counterparties and their ability to meet capital requirements that would be enforced upon them. Then, late last year, the ECB took over supervision of the euro area's largest banks, providing further regulatory consistency and clarity. The combination of these efforts has set the ground for banks to lend.

The combination of apparent greater regulatory efficiency and central bank liquidity has given confidence to the markets. Equities in Europe, as many expected, roared away in February as the 'follow-the-money' strategy which has been so successful for those investing in US equities since the financial crisis, moves across the Atlantic.

The German Dax index is up 12% this year, France is up 13%, and the benchmark Eurostoxx 50 is up 13%. The FTSE100 hit a record but it has taken 15 years to do so and in real terms is actually 27% lower than it was in December 1999 when allowing for inflation (in contrast to the US's S&P500 which is 6% higher).

Investors can expect the trend to continue for as long as the bond-buying programme is in place by the ECB, JCB the Reserve Bank of China and other central banks in the Far East and Scandinavia.

The irony is that bond yields are driving lower at the same time as equity valuations are moving higher. In the last week of February, Germany sold five-year bonds at a negative yield for the first time ever when it shifted €3.2bn at -0.076%. France, Finland and the Netherlands have also been able to sell their bonds at negative yields for the first time.

So why would the market be buying bonds if it also feels equities are undervalued? There could be several reasons: a fear that corporate earnings will begin to fall short of expectations; a search for risk free investment even if it means one has to pay for it (German and Swiss bonds currently have to be held for 8 years before you get your money back); or worse, the thought that we are in for a prolonged period of deflation and purchasing power of capital will decrease. The latter reason makes a case for precious metals, and at some point, most probably when more confidence is lost in the value of paper currencies, silver and gold will soar way ahead of the August 2012 records.

Other facts at play for European bond buying include the secure knowledge that the ECB is backstopping the bond market and consequently aiding a situation where there are simply no ready sellers. If bond-buying boosts growth and yields continue to fall, it will mean that the financing of debt becomes cheaper and the carrying of debt more sustainable.

As a net importer of oil, the eurozone economy is a beneficiary of the decline in crude prices, even if it has exacerbated concerns over deflation. Despite some increase in demand, as people change their energy consumption behaviour, the decline in the price of energy should boost spending in other goods and services, fuelling growth and equity earnings away from the energy space. The recent fall in the euro looks set to continue, and the depreciation should boost the value of equity earnings from outside the single currency area. Together with lower energy costs, looser credit standards, improving loan demand and reduced fiscal contraction, the weaker currency creates a supportive backdrop for European risk assets.

Search for yield explains why the dollar index is at an eleven year high. There was a widely held view in 2012 that the dollar could appreciate by up to 45% against an international basket of currencies, as similar circumstances to those of the 1990s began unfolding. Then, as now, credit flowed into Asia with much inefficiency, resulting in declining industrial output. Then, as now, bond yields were falling faster in the international markets than they were in the US.

Additionally, in 2012 interest rate levels and the economic outlook in the US attracted money more readily than elsewhere. So even though QE in Europe, Japan and the Far East will bring capital across to equity investment in those areas, the likelihood is the capital transfer will be measured, and while US capital diversification from the latter's more expensive equity market flows into relatively inexpensive European equities, equally international bond investors are likely to rotate out of European bonds and into US Treasuries. The result is that the dollar bull has further to run. To date, since 2012 the greenback has risen by around 25%, so further appreciation is possible if the pattern of the 1990s continues.

A combination of low oil prices, low inflation, central bank bond buying to aid credit liquidity and last week's encouraging purchasing managers' indices showing increased optimism across the US, Europe and Asia, is all evidence of a world economic 'Goldilocks' environment. If lower commodity prices truly are the harbinger of a widespread decline in inflation, especially in emerging markets, even downtrodden EM equities should receive a boost, at least in the short term.

Favoured investment plays:

Nil risk:	USD & GBP cash (in preference to Euro cash)
Cautious risk:	Structured / AAA Corporate / Government bonds (short duration)
Balanced risk:	Managed funds
Market risk:	**UK, European**, US equity
Adventurous risk:	**US / Asia** / Global Real Estate, **Japan** equity
Speculative risk:	**Timber, China,** India, Africa & Middle East, **European Telecoms,** Emerging Markets

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 21%, US equity 2%, US smaller cos 1%, UK equity 10%, UK smaller cos 6%, Iberia 2%, European equity 6%, European Telecoms 4%, Latin America 2%, Japan 8%, Asia 11%, China 4%, Timber 2%, Precious Metals 1%, Energy 6%, Pharmaceuticals 7%, Cash 7%