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Market Environment VOLATILITY, POLITICAL RISK AND VALUATIONS – THE PERFECT STORM?



Arif Husain
*Head of International
Fixed Income*

Amid tightening monetary policy in the US, increasing threats to global trade and ongoing political uncertainty, Regional Head of Portfolio Specialists, Helen Ford, recently asked three of our leading investors to share their views on how heightened volatility could impact their markets. Their answers are below.

WHAT WILL BE THE MAIN IMPACT OF THE WITHDRAWAL OF QUANTITATIVE EASING?

Arif Husain: The situation with QE is nuanced: while the Fed is tightening and the European Central Bank (ECB) remains on course to do so, it's still not clear when the Bank of Japan will begin tightening and the Bank of China has turned the money printing presses on again. So it's a mixed picture overall, but I think the bottom line is that there is going to be less money in circulation – and since most of the money created by QE flowed into financial assets, that's where it will come out again. This will not only have a profound impact on equity and bond returns, but also on volatility and correlations.



Chris Alderson
*Co-Head of Global Equity
and Head of International
Equity*

Chris Alderson: We're heading into the hardest part of the cycle. It's 10 years since the collapse of Lehman Brothers and the punch bowl is finally being taken away. This year was probably as good as it's going to get for US earnings growth. Next year will probably remain a reasonable environment for risk assets, but not as good as it has been for the past few years.

WHAT EFFECT WILL HIGHER RATES HAVE ON THE EARNINGS POTENTIAL OF US COMPANIES?

Eric Veiel: The debt-to-EBITDA leverage ratio for the S&P 500 is currently above 2008 levels, so a simple analysis would tell you that higher rates will have a negative impact on earnings. I'd point out, however, that index-wide averages can be deceiving, and that if you look across the various sectors of the S&P it becomes clear that it's the more conservative and stable areas that have taken on more debt – i.e., healthcare and utilities. The more cyclical sectors, such as materials and energy, are closer to their historic averages, while debt levels of the industrials and technology sectors have actually declined.



Eric L. Veiel
*Co-Head of Global Equity
and Head of US Equity*

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The biggest impact so far has been on small cap companies. Around 30% of companies listed on the small cap Russell 2000 index are not making profits, and many of those firms were heavily funded by QE (the flow of money into biotechs has also been a factor here). However, if the Fed's hikes are modest and controlled, there will be some negative impact on earnings, but it's unlikely to be excessive

WILL INFLATION LEAD TO A SPIKE IN VOLATILITY?

Chris Alderson: I'm not concerned about a pick-up in inflation. We've had ultra-low interest rates and extraordinary monetary policy for 10 years, and we're only just beginning to close output gaps – it's not as if we've got pent-up inflation that's about to pop out like a genie from a bottle. In fact, I think modest inflation could be good for equity markets – it would signal stronger economies around the world. I think emerging markets would do well in that environment as they tend to be procyclical and heavily weighted in commodities, which perform better when there is inflation.

Arif Husain: We need to be careful what we wish for, though. One of the reasons for the low inflation of the past decade or so has been the fact that companies have lacked pricing power because of globalisation – if they raised prices, people would just buy their products from China for less. But it looks like tariffs are making a comeback, which will lead to less substitution and a return of pricing power. This in turn could lead to higher inflation around the world.

IS NOW A GOOD TIME TO INVEST IN EMERGING MARKETS?

Chris Alderson: While the US is clearly at a late stage in its cycle, emerging markets (EMs) are arguably very early, which has led to some mouth-wateringly cheap valuations in some markets and currencies. Some EM equity markets are down to 2008 levels, while Argentina and Turkey have recently hiked their interest rates to 60% and 24% respectively to support plunging currencies. The key question is: will everything move together, or will there be some differentiation across EM? There are definitely some weak EM countries, but there are also strong economies with large current account surpluses that have posted positive real yields – and I think this differentiation is only going to increase. China is the wildcard – if it were to fold, a domino effect would ensue. But we don't think that's likely.

Arif Husain: EM beta tends to move in the same direction whether you're in debt, equity or currencies. For there to be an EM rally, three things need to happen: first, there needs to be a sentiment change towards emerging markets, which has already occurred to a large extent; second, China needs to demonstrate that it can maintain a stable economy in the face of potential tariffs from the US; and third, the US dollar needs to be weaker. The third of these is crucial – if the dollar remains strong, it will be difficult for EM currencies to perform, and therefore difficult for EM equities and debt to perform.

WHICH COUNTRIES WOULD BE LEAST HARMED BY A STRONG US DOLLAR ENVIRONMENT?

Chris Alderson: It's very difficult to predict the path of the US dollar, but if it strengthens further it would obviously be bad for emerging markets. I think Europe would probably muddle through, and the US market itself would do very nicely, particularly small cap companies.

Arif Husain: I'm actually short the US dollar at present as I think it faces some major headwinds, although some colleagues take a different view. Right now, we're probably at peak US growth relative to the rest of the world, and that gap is going to narrow. And while the mid-term elections probably won't have much immediate impact, they could provide a window to the presidential election in two years' time – and any sense that the 'Trump

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premium’ may disappear will be negative for the dollar. Finally, the US has a huge budget deficit, and that is going to get bigger - which will also be bad for the dollar.

IS POLITICAL RISK UNDERMINING THE PROSPECTS FOR US EQUITIES?

Eric Veiel: The political situation in the US is currently creating a lot of fodder for television, but it’s not the primary driver of the US economy. The main driver is the US consumer, who is doing pretty well given recent wage growth and tax cuts. It’s true that valuations are high, but while valuations tend to be accurate indicators of long-term returns, they are poor at predicting returns over one or two years. Overall, I think the US economy is in relatively good shape and there is a decent chance that it will continue to deliver solid returns over the next few years. Even if Donald Trump fares badly in November’s mid-term elections, I don’t think it will have much impact – he’ll continue to govern through executive order.

FINALLY, WHICH CURRENTLY OFFERS THE STRONGER INVESTMENT OPPORTUNITIES – JAPAN OR EUROPE?

Chris Alderson: If I had to choose between the two, I would invest in Europe because it has stronger fundamentals and attractive valuations. A number of sectors there are doing very well. The healthcare sector, for example, currently includes companies trading at earnings multiples in the mid-teens, with healthy dividend yields and positive earnings growth – the valuations are nowhere near as stretched as they are in the US.

I also think Japan is a good long-term prospect. There are lots of small reforms taking place that are improving corporate governance in a way that should improve returns on equity. However, our Asset Allocation Committee has taken down their allocation to Japan recently, for no other reason than Japan is a global cyclical economy and it is likely that the global economy is going to slow from here. Japan has lots of very cyclical areas within its stock market, which are all likely to suffer in the event of a global slowdown – hence my preference for Europe over Japan.

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