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# EQUITY MARKETS PULSE

## GLOBAL COMMENTARY AND OUTLOOK

JANUARY 2015

## DECEMBER 2014 - STOCKS GENERATE MIXED RETURNS AS INVESTORS WEIGH STRONG US ECONOMIC DATA AGAINST GLOBAL CONCERNS


- Helen Ford – US
- Dean Tenerelli – Europe
- Archie Ciganer – Japan
- Gonzalo Pangaro – Emerging Markets


Stocks posted mixed results in December. The Dow Jones Industrial Average and Standard & Poor's 500 Index managed to reach new highs before retreating on the last day of the month to end roughly flat. The Nasdaq Composite Index lagged a bit, reflecting the weaker performance of technology shares. Breaking with the pattern for the year as a whole, the smaller-cap benchmarks outperformed for the month, and the small-cap Russell 2000 Index joined the other major indexes back in record territory for the first time since the summer. Along with technology stocks, telecommunication services, health care, and consumer staples shares underperformed the broad S&P 500 index. Utilities stocks performed best, helping cement their position as the top-performing segment for 2014. Financials shares were also strong for the month.

Elsewhere, most international markets recorded losses in December in US dollar terms due to ongoing currency weakness, especially in the euro and the yen. Over the past 12 months, the dollar has rallied more than 12% versus the euro and the Japanese yen, and it has appreciated about 6% versus the British pound sterling.

Within the EAFE index, growth and value stocks generated similar returns, and for the month, small-caps outperformed large-caps. Among Asia's developed markets, the Japanese economy contracted 1.9% in the third quarter and slipped into recession (commonly defined as two successive quarters of economic contraction). Data showed that inflation slowed for a fourth consecutive month—core consumer prices rose 0.7% in November from 0.9% in October, which is well short of the Bank of Japan's (BoJ) 2.0% annual inflation goal. Prime Minister Shinzo Abe and his Liberal Democratic Party won December's snap elections and secured a two-thirds majority in the Parliament's Lower House.

In Europe, weak inflation data caused the euro to fall to a multiyear low versus the US dollar due in part to slow economic growth and low inflation. Deflation remains a serious threat, which is due in part to the plunge in oil prices.

## OUTLOOK

**UNITED STATES:** We maintain our cautious outlook, as the US equity market continued its upward path during the year following strong appreciation in 2013. Global growth is slowing overall, and we are concerned about how long the US can sustain its growth rate if conditions worsen overseas. We believe that the supply driven drop in oil prices should support overall economic growth in the US, but will prove challenging for companies and countries dependent on higher energy prices. We cannot dismiss the potential for geopolitical risk that could emerge if oil and gas prices fall much further. However, US inflation remains contained, and the Federal Reserve is on course to begin monetary tightening sometime this year, which we view as indicative of growing confidence in the economy. The Fed is likely to raise interest rates at a measured pace to assess the potential reverberations throughout the financial markets. Lower growth in the months ahead should warrant lower rate increases than in previous tightening cycles.

Overall, we continue to think US stock prices are more likely to move in line with earnings growth rather than through an expansion in valuations. In addition, with the financial crisis and dramatic policy responses fading into the background, many of the factors that have driven stocks up and down are likely to become less common—even if the markets are periodically volatile. We believe careful fundamental research will be necessary to find opportunities, especially with overall valuations unlikely to expand significantly after the strong run in equities.

The outlook for US corporate earnings is favourable, with anticipated growth in the single-digit range. In what we expect to be a challenging environment in 2015, we will continue to search for investment opportunities in select areas of the market, utilizing our bottom-up stock selection approach.

**EUROPE:** With the ECB now facing real risks to its primary policy objective of price stability (or the avoidance of deflation), quantitative easing is being introduced to buy time and improve sentiment among consumers and corporates who have remained more cautious than their US peers. While the effectiveness of further easing is unknown, the recognition of the need to act among European policy makers is a positive, as is the weakening of the Euro for the corporate sector that will face anaemic domestic demand trends over the medium term.

In the corporate space, earnings have continued to disappoint, where subdued economic activity, weaker demand from emerging markets and prior periods of euro strength has weighed. These negative revisions have slowed and appear to have reached a trough. There is also scope for upside surprises since industry analysts typically underestimate economic improvements due to being accustomed to downgrades during a downturn.

Although recent investor confidence has lifted valuations from their historic lows, on a cyclically adjusted basis, the P/E ratio for the European market is currently below 15 times versus a longer-term average of closer to 20 times. As this measure utilises the average of the last 10 years' earnings, we believe it is a useful indication to the market's attractiveness assuming a normalised level of earnings. This measure is also attractive relative to other developed markets. On the same measure, Japan and the United States trade at over 24 times. European companies have continued to meaningfully restructure, reduce costs, and improve their market positions, and we believe that many companies will experience significant operating leverage as the gradual recovery in Europe continues.

**JAPAN:** The Shinzo Abe-led Liberal Democratic Party (LDP) has successfully broken the long held tradition of policy inertia via its attempts to jump-start the economy and equity markets with the magnitude of its policy intent. Past central bank and government leaders have made noise about stoking inflation and economic growth, only to see these efforts flounder when their commitment to change and policy implementation was tested. However, monetary policy delivery has continually surpassed expectations; the yen has declined materially and inflation expectations have risen, while Abe has delivered a positive wealth effect on the back of a rising stock market. While participation rates were disappointing, December's election reaffirmed the countries belief and willingness to persist with 'Abenomics' and has cemented Prime Minister Abe and the Liberal Democratic Parties absolute control over parliamentary proceedings – an absolute necessity with respect to implementing a reform agenda.

For a sustained recovery, we believe domestic consumption needs to be the next growth engine. To expect this, we need wage inflation to take hold. Abe has been applying intense pressure on corporations to raise wages in order to support the Japanese consumer and reverse a 20-year cycle of wage and price deflation. Signs of labour market tightening and the healthier corporate profits environment are certainly supportive of wage increases. Indications of economic growth in Japan, together with corporate tax incentives, should also favour an increase in salaries. However, while bonuses and overtime payments are rising, we have yet to see firm evidence of a base wage increase cycle, at least in inflation-adjusted terms. With inflation finally increasing, disposable incomes are being pressured as they fail to keep pace. Part of this squeeze relates to the well flagged and narrated consumption tax hike.

Given the unchartered territory of Abenomics and the likelihood of near term disappointments, there is every chance that sentiment will fluctuate as the efficacy and scope of Abe's reforms are called into question. For those investors able to take a longer term view, we believe there is a fruitful investment opportunity encapsulated within the Japanese journey. Our central scenario is that Abe's political will to make, in his own words, "Japan a great and robust country," is real. Policy efforts should provide further traction in the next 12-24 months – we will continue to look for further signs, beyond this time horizon, that Japan is turning into a durable improvement and self-help story.

While patience is necessary, there are catalysts in the nearer term. We see scope for surprise versus consensus estimates, given forecasts have not fully accounted for yen weakness. Also, with margins and returns starting from a low base, we see ample room for expansion. From a valuation perspective, although the extreme undervaluation of Japanese equities has been rectified; current valuations remain well-below pre-crisis levels.

**EMERGING MARKETS:** Emerging markets equities had another challenging year in 2014, although there was a great dispersion of returns. The end of the global commodities boom and the slowdown in China proved to be stiff headwinds particularly for earnings in emerging markets. Revenues growth slowed and companies suffered from margin pressure, driven in part by rising costs, especially unit labour costs. However, we believe that the bulk of that earnings adjustment has taken place and that expectations for 2015 are reasonable. In fact in countries like India and the Philippines earnings growth is starting to accelerate again.

Economic growth across many developing markets should continue to be higher than in the developed world in 2015, although that gap may continue to narrow. Those countries that push forward with reforms should do well, while countries that do not will struggle. Valuations are as compelling as they were a year ago and remain at a discount relative to their history and to their developed-market peers. However, we are likely to see a much more uneven world going forward, with less correlation and more divergent results. Investors will have to be much more granular in their approach.

Near-term risks include a worse-than-expected slowdown in China or a breakdown in its financial system; a sharp rise in US interest rates; and an unexpected bout of risk aversion due to geopolitical events.

We believe that investor concerns may be overdone. The extent of the Chinese growth slowdown remains a key question but policymakers are now focused on structural reforms that will lead to higher quality and more sustainable growth. In addition, we believe the actual impact of interest rate increases on emerging markets will prove less significant than investors fear. When interest rates do start to rise, markets may suffer a mini sell-off as the hunt for higher yields pulls money out of emerging bonds and currencies. However, if rates move moderately higher because the US economy is doing well, that would be good for the global economy, including emerging markets. Finally, political risk has diminished over the past year, with most elections resulting in new governments that seem willing to adopt more market-oriented reforms.

Overall, the environment will remain complex, but this should provide a good opportunity for active investors to take advantage of valuation anomalies. The emerging consumer remains a powerful force and should continue to drive strong growth in a variety of industries and companies, including retail, banking, technology and the internet.


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