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EQUITY MARKETS PULSE

GLOBAL COMMENTARY AND OUTLOOK

MARCH 2015

FEBRUARY 2015 - STOCKS REACH RECORD HIGHS ON EARNINGS, EASING GLOBAL CONCERNS

In the US; stocks recorded strong gains in February and easily reversed the losses from January. Stabilizing oil prices, strong fourth-quarter earnings reports, and signs of an easing in the Ukraine crisis boosted investor sentiment. Most of the major benchmarks performed roughly in line with each other and established record highs by the end of the month.

Elsewhere, European equity markets outperformed markets in Asia, although Japan and Australia generated strong gains. Emerging markets stocks underperformed developed markets, but the disparity across regions was significant.

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

OUTLOOK

UNITED STATES: Much of the market moves in the US reflect the sharp recovery in corporate profits from the recessionary lows. Corporates have managed to squeeze business models to deliver record profitability, in spite of what has been somewhat of an anaemic recovery in economic growth.

Today, we believe valuations are best described as 'reasonable' for where we are in the economic cycle, although we would stress that this view is premised on the continued delivery of earnings growth. With US equities trading around 17-times forward earnings, the days of extreme low valuations are firmly behind us. However, compared to an average of 16.2-times and highs of over 25-times, the market is not in extreme over-valuation territory. Equities also remain attractively valued when compared to US treasuries.

An important factor underlying our outlook is that the US economy continues to improve. Average job growth in 2014 was the strongest since 1999, and this strong employment growth has led to the first signs of a pick-up in wage inflation. However, as capacity utilization and unemployment approach 2007 levels, the focus of the debate has now shifted to when we will see a hike in interest rates.

Historically, given the unemployment picture coupled with the bottoming of wage inflation, the US Federal Reserve would have already started increasing interest rates. However, given the severity of the global financial crisis and concerns over the delicate nature of the economic recovery, it was necessary for policymakers to take a different approach. As the US recovery continues, however, we are moving ever closer to the first rate hike. Minutes though from the recent Federal Reserve meeting reflect a division over exactly when to begin raising interest rates. Many officials have said they fear a "premature" rise in rates could dampen the apparently solid economic growth and labour market recovery.

Either way, when the Federal Reserve does raise rates, it is most likely to be at a more measured pace in order to assess the potential reverberations through financial markets and impact on growth. It is important to remember, however, that when interest rates do eventually normalise this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which typically bode well for equities.

Looking forward, the market continues to face some challenges. Questions remain over global growth, and whether the US can sustain its growth rate if conditions worsen overseas. The Federal Reserve is on course to begin monetary tightening at some point this year, and while we view this as indicative of strengthening economic growth, this change in monetary policy may impact investor confidence.

On the positive side, the corporate sector remains in robust shape and the US is home to many industry leading innovative companies. Equity prices are though more likely to move in line with earnings growth rather than through any meaningful expansion in valuations. Importantly, conditions are still supportive for further gains, although the upside is likely more limited due to fair valuations and already high profit margins.

EUROPE: European stock markets have continued to climb higher, with several at their highest levels since the 2008 financial crisis. The current earnings season was generally as we expected, certainly for the companies we are invested in. However, having started off on a strong footing, the overall results season weakened somewhat as downgrades in the energy and materials sectors negatively impacted overall returns.

Elsewhere, it was encouraging that more domestically-orientated companies seem to have met expectations. Although there have been some disappointments from companies more exposed to overseas, especially emerging markets.

The weaker euro should continue to provide a huge boost to the export side of European businesses, and further increase the competitiveness of euro nations. Lower oil prices, more neutral fiscal policy, along with an easing of the deleveraging pressures should also prove beneficial.

Looking forward, sentiment is likely to ebb and flow over the coming months, providing opportunities to invest on bouts of stock-specific volatility. This is certainly likely if disinflation in Europe turns to deflation this year, and there will certainly be data points for market bears to point to in the coming months, but these should be used to add to your highest conviction areas.

JAPAN: Japanese equities have continued to make strong gains as further QE and a weaker yen have boosted corporate earnings in many sectors. For a self-sustaining recovery, however, we believe domestic consumption needs to be the next growth engine. To expect this, we need this 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.

Spring wage inflation will be significant to Japan for the rest of the year, and we are now nearing the end of negotiations. Encouragingly, there has been positive news as the major insurers are looking at raising base wages by 2%, which will be the first hike in the industry in 20 years. Also Toyota has said that it will raise base wages by 3.1% on top of the automatic 2% based upon seniority. While Toyota cannot be classed as representative of Japanese business, it is a flagship of sorts, and this move will likely translate further down the economy.

We could therefore see 3% real wage growth in Japan, which would more than offset last year's decline due to the consumption tax hike. As a result we expect domestic demand names to continue to work well.

Overall, we continue to see scope for further surprises in Japanese corporate earnings, 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 so there remain opportunities for further gains.

EMERGING MARKETS: Economic growth across many developing markets continues to be higher than in the developed world, although the growth premium is narrowing. Performance so far across emerging markets ('EM') in 2015 has followed the same path as last year. Those countries that continue to push forward with reforms have been rewarded, while countries that do not have struggled. Valuations remain attractive overall for the EM world, with Latin America and especially emerging Europe looking especially cheap. Asia by comparison is more fair value, although there are still good opportunities to be had. Importantly, valuations still remain at a discount relative to their history and to their developed-market peers.

There continue to be concerns over the EM world. 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. There are also concerns over another temper tantrum when the US finally begins to raise interest rates. However, 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.

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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