threadneedle investments

# Mid-year market review and outlook – July 2013

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## Tapering is not tightening but valuations continue to favour equities over bonds

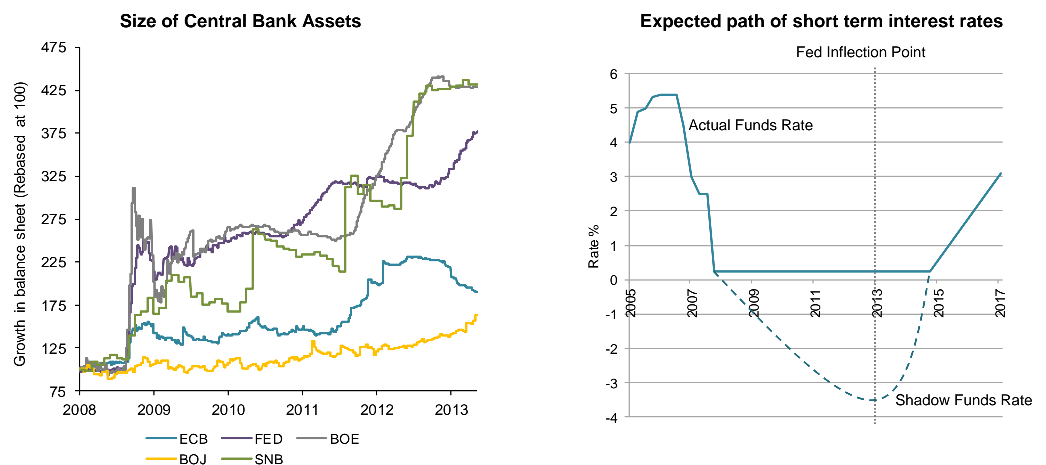
At the start of the year, we forecast a challenging macroeconomic outlook for 2013, continued downside risks, and we expected interest rates to stay lower for longer. In terms of asset allocation, we were positive on equities relative to bonds on valuation grounds, and saw attractions in yielding assets. Within equities, we preferred Asia, emerging markets and the UK to Europe and the US.

In the first half of 2013, developed market equities have outperformed emerging markets, while fixed income has performed poorly, except for high yield bonds, which have benefited from their shorter duration characteristics. After a strong first quarter, risk assets rose through to mid-May before an aggressive bout of profit taking hit most financial markets. The trigger for this was the US Federal Reserve (Fed), which commented that it may 'taper' its bond purchase programme if economic data remains strong.

In this regard, the news is good for the US economy, but not so good for those who had expected quantitative easing (QE) to continue indefinitely. On the data front, US car sales have picked up markedly in the past two years and, importantly, housing starts have also improved – indeed, housebuilding is seeing a material uptick, having been a serious drag on the US economy over the past five years. As a result, US growth should continue to outperform the rest of the developed world. The fiscal cliff has also been less of a drag than feared, while the tax take has been better than expected.

The market now expects a US interest rate rise in 2015, about a year earlier than was forecast a few months ago and prior to the comments on 'tapering'. It is worth emphasising that 'tapering' does not mean tightening (as shown in Figure 1 below), but rather making policy 'less loose'. It is understandable that the Fed wants to begin to unwind QE, given the strength of the US economy compared to the rest of the developed world, and we expect this to happen in $20bn chunks, starting later in 2013. Further support for the 'tapering' argument comes from the fact that US inflation is very subdued, despite the pick up in economic growth.

### Figure 1: Tapering is not tightening




Source: Threadneedle; Bloomberg, as at end June.

Another important trend in the US is that manufacturing and employment are clearly on an improving trend. Unit labour costs are falling and have been for a while. The benefits to manufacturing of cheaper energy from shale gas are huge. Added to that, relatively high inflation in Asia from rising labour costs in that region is creating a shift in US manufacturing and its global competitiveness. As a result, new capacity is opening in the US and companies are repatriating some of their operations back to America.

While investors are worried about the impact on global liquidity that will result from the tapering of QE, Japanese policymakers are picking up the slack – and more. Policy developments in Japan have been as radical as one could imagine relative to the past 20 years. The anti-deflation programme includes a 2% inflation rate and huge QE programme – for perspective, Japan's QE programme is for an expansion of the monetary base equivalent to 14% of GDP, compared with 7% of GDP in the US. In addition, the government is implementing a large fiscal spending programme, and supply-side reforms are taking place to address the shrinking labour force, such as a review of immigration policy and the encouragement of female participation in the labour market. The impact of these moves has been a significant sell-off in the yen, and growth has already picked up as exports have benefited from a more competitive currency.

Europe is still in recession, but there are tentative signs of life with some better PMIs. There is a lower risk of either a sovereign default or break-up of the euro than was the case a year ago. But deleveraging is still in force and the periphery remains very gloomy in economic terms. There is still some way to go in Europe to address its challenges, and we are in no hurry to remove our underweight in European equities.

Having grown around 10% per annum a few years ago, Chinese GDP growth is now closer to 7.5%. The underperformance of the Chinese stock market has come with worries about a housing bubble and the 'shadow banking' system. The investment boom has reached its limit in our opinion, and China now needs consumption growth to rebalance the economy. The authorities are starting to realise that they cannot 'pump up' the economy indefinitely and eventually will have to let it find its own course. Therefore, we believe growth in China may trend downwards from here. As a consequence, we are cautious on Chinese financials and certain commodities where China is the primary source of demand. Furthermore, as China has been a key driver of growth in other emerging markets, it affects them too. Emerging markets do, however, have good long-term growth prospects, and in some cases their dependence on Chinese growth has been overstated, so there are opportunities for those who are prepared to take a long-term view.

Looking at the big picture over the past three years, the market has consistently overestimated global growth, and this has held back earnings growth. Looking to 2014, we still think growth will generally disappoint, but this is now broadly in line with the consensus, as the market has been downgrading its expectations in recent weeks. We believe the US will grow faster than Europe and the UK, while Japanese growth will remain modest. There is also scope for disappointment in China with regard to its predicted growth in 2014. Inflation remains low, especially in the developed world, as the demand for credit has been weak and growth is slow.

At the asset allocation level, we are still positive on equities. Despite slow economic growth, corporate profits will still grow, sustaining dividend yields of around 3-4% and dividend growth of 5-6%. We think the search for yield will continue, given the low-interest-rate world (though we remain mindful of rich valuations among some income stocks). Corporate deleveraging outside the banking sector is largely complete; this is allowing payout ratios to rise as companies are recognising the need from investors for income. Recent economic downgrades, and profit taking in markets, are a reality check. The market is coming back towards our expectations, with the slowing in QE now being properly reflected in share prices. Continuing low interest rates (because of more deleveraging in some economies) will be supportive for equities too. In terms of valuations, price/earnings ratios of 10-12x earnings for 5-10% earnings growth are reasonable, and fair value in some cases. Japan is more expensive but this can be justified given higher earnings growth and expected upgrades.

In fixed income, our themes from the start of the year remain unchanged, despite recent events. The search for yield continues. 'Tapering' just means a shift from hyper-accommodative policy to highly accommodative policy. A focus on alpha generation is essential and we expect bond markets to remain volatile. The recent sell-off in bond markets has been meaningful and has removed the liquidity premium that had prevailed. Bond markets are reflecting fundamentals more closely than they were, but we do not believe we will see the apocalypse that some investors fear. Credit spreads are still above their long-term averages, despite decent balance sheets, strong cashflow, reasonable growth and low default rates. We also see value in high yield, especially relative to default rates. Government bonds, however, remain poor value though the sell-off means they are now priced for returns ahead of those on cash.

So, in short, our strategy is broadly unchanged from the start of the year: we favour equities over fixed income. Within equities, we prefer the UK, Asia, Japan and emerging markets to Europe and the US. In fixed income, we prefer emerging market debt and high yield to government bonds.

There have been two important changes to our asset allocation model in the past six months. First, we have become more positive on UK property, particularly given its attractive yield of 6%. In addition, the UK banking sector has been recapitalised (at least in part), having been a large forced seller of property in past two to three years, so this removes a major headwind at a time when the UK economy may be picking up. Second, we have become more positive on Japanese equities, thanks to 'Abenomics' and the potential for a significant rerating in the equity market

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