threadneedle investments

Equity market review and outlook – August 2013

Leigh Harrison
Head of Equities

Still positive, even with QE tapering

We are still positive on equities. Despite the recent downgrades in the expectations for corporate earnings, we expect profits growth to sustain both dividend yields and dividend growth. Whilst the current valuation of the market is not outstandingly cheap, equities are still attractive on this basis and relative to other assets.

The recent downgrades are, however, a reality check. We have never subscribed to the view that we are likely to see a robust global economic recovery given the headwinds of excessive debt, a challenged banking system in Europe and unsustainably fast growth in China. We believe there are hard yards ahead in the global economy for a number of years from here. The ending of exceptional policy support (QE), whilst inevitable at some point, is going to present a challenge to markets and the economy, and makes the idea of strong corporate profits growth, which some of the more optimistic forecasts had anticipated, pretty unlikely in our view.

Importantly, the weak growth environment means that even if QE is removed, low interest rates are going to be with us for some time. This is supportive for growth and supportive for equities. So, whilst we expect growth to be modest, the combination of low interest rates, attractive valuations and attractive yields make equities compelling at current levels. Regionally, we are still fairly cautious on the outlook for the eurozone. The challenges faced by the area, in combination with the poor growth outlook, make it very difficult to be constructive about eurozone equity markets despite their attractive valuation support. However, within Europe, there are some very strong global businesses that will continue to prosper despite the domestic economic malaise, and these form the cornerstone of our portfolios in this area.

In our multi-asset portfolios, we are neutrally positioned on the US market even though the growth outlook for the US is improving steadily. This is because the valuation of the US market already reflects much of the good news and we think that there is better value to be found elsewhere. The markets we are positive on are: the UK: because it is a truly global stock market with a high percentage of overseas earnings; Japan, because we believe that 'Abenomics' has the potential to produce a seismic shift in the outlook for the economy and corporates (but there are significant risks); and emerging markets (EMs), despite the recent headwinds. A stronger dollar is a massive headwind for EMs but valuations have reached a level where it would wrong to be too bearish about their prospects, particularly as the long-term economic growth fundamentals are still quite attractive.

In terms of the themes that are driving markets, it is evident that QE has been a huge positive for risk assets but it has now been clearly signalled that QE will not last forever. It is therefore important that we consider the implications of this, as markets and economies will eventually have to adjust to a world without QE and, importantly, with normal interest rates. The timescale of the first phase of the 'tapering' of US QE remains subject to the Fed's view of the employment and growth outlook for the US economy. However, even discussing this policy shift has unsettled investors in the short term and increased market volatility.

Persistently slow growth due to ongoing de-leveraging, and the unfavourable demographics in much of the developed world, will make a challenging backdrop for companies in many markets and we think that there will be no easy wins for companies in the world that we now find ourselves in. This should inform and shape the kind of investment strategies that investors employ.

We also expect the search for yield in a low-interest-rate world to continue and to remain a major driver of equities, although one has to be very focused on valuation, as there have been moments in the last six months when the search for yield became something of a scramble. Finally, in a tough world, we think that strong companies will continue to get stronger.

It has been very apparent this year that money printing has undoubtedly inflated asset prices. If we look at the value of the US stock market divided by the size of the Fed's balance sheet, it implies that a lot of the rise in stock markets has been driven by money printing. In effect, QE has gone straight into asset markets, and as such the rise in stocks has had nothing to do with the muted global economic recovery. This is important, because businesses have made considerable progress over the last 3-4 years but this has not really been priced in to equities. On the other hand, there has been a massive ballooning of the Fed's balance sheet, which has clearly got to unwind at some point and will be a significant headwind for equities when it does. Undoubtedly, there is a significant issue in terms of the 'unintended' consequences of QE, and this will not unwind in three months or even six months but will be with us in the investment landscape for years to come. Ultimately, the consequences of the QE policy experiment are going to be very difficult to predict and as an equity investor that has to shape the way that one chooses to invest. It would suggest, however, that a fairly cautious approach is likely to be the most successful.

Moving to China and the EMs, it is clear that the underperformance of the Chinese stock market has been predicting what is happening now, that is downgraded growth expectations. I think there have been plenty of symptoms of asset bubbles in China (for example, the property market, the growth of the shadow banking system and ballooning bank balance sheets), as well as little evidence of a rebalancing of the economy away from a reliance on fixed asset investment to generate growth. We've now reached a point where the authorities are realising that they cannot keep 'pumping up' the economy through massive stimulus programmes and fixed asset investment, and have to let it evolve in its own way, but they do need to focus on financial stability. This means that Chinese growth is likely to continue to trend down, hence we are relatively cautious on stocks connected to China, such as the larger mining companies, and Chinese financials. At the moment, we are also seeing a knock-on effect to other EMs as China was perceived to be the main driver of EM growth. Our own view is that there is an element of truth to this, but the EM economies still have significant internal growth dynamics and are also big exporters to the US and eurozone; so, to some extent, China's importance has been overstated. In short, we think the long-term outlook for EMs is probably much better than recent performance of markets (particularly year to date) would suggest.

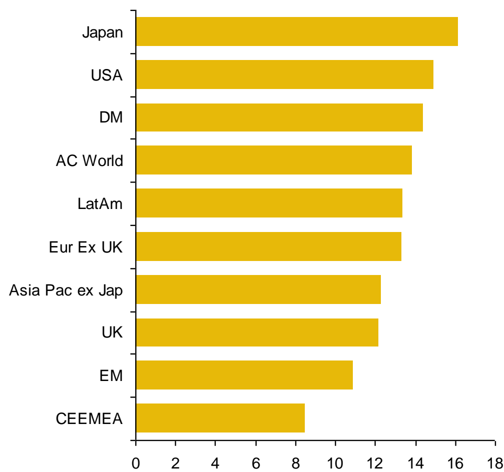
Turning to the US, there is an industrial renaissance of sorts underway. I don't want to overplay this, but given the backdrop of pretty grim news everywhere else, it is good to see the US economy emerging from what has been a tough period. US manufacturing and employment have clearly been on an improving trend; one of the reasons for this is unit labour costs, which have been falling steadily for some time. If you consider the benefits to US manufacturing from shale gas, the huge wage inflation that's been seen in the cheaper labour economies, plus the extended supply lines that are needed to service the US from a manufacturing base in the emerging economies, it's very easy to see why there has been a change in how US manufacturing thinks it needs to be positioned. Indeed, manufacturing capacity in the US is opening up again, and this will be a big driver of the US renaissance, and is encouraging for US companies generally.

Looking at valuations (see Figure 1 overleaf), we can see that valuations are not really extended. Whilst equities are not as cheap as they were 3-4 years ago, the PEs (10-12x for earnings growth of 5-10%) are reasonable, and might even be on the right side of fair value. To me, if you are buying equities, most markets are attractive and while Japan does look relatively expensive, this can be justified by the fact that Japan is the only market that has seen earnings upgrades over the last six months; it therefore deserves a higher valuation.

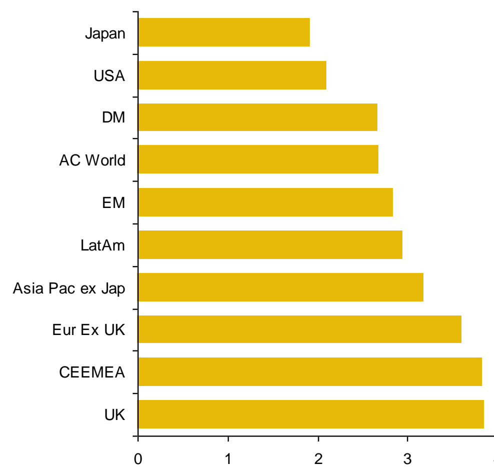
Turning to dividends, given where interest rates and bond yields are, equity yields of 3-4% are great value and, in addition, offer dividend growth of 5% plus. Crucially, this means that the yield has the scope to grow ahead of, or at least in line with, inflation, something that traditional bonds simply cannot offer.

Figure 1: Valuations are attractive

P/E 2013e



Dividend yield 2013e



Source: IBES, MSCI, FactSet, Citi Research (May 2013).

In summary, the case for equities from here is attractive. Looking at equity free cash flow yields versus corporate bond yields, we see equity yields growing, earnings growing and valuations that are inexpensive, whilst corporate bond yields are, you could argue, artificially low because of very low government bond yields. Bonds have to revalue and I think that equities can cope with this move. My own view is that the turbulence we saw in bond markets in late May and June was a sign of bonds starting to return to fair value. While equities will get caught in the initial turbulence, the underlying healthy fundamentals for equities will drive the market forward over the next 2-3 years.

For income investors, it is important to note that the flat yield you can get from equities and the yield growth you can expect are better than the return from government bonds, investment-grade corporate bonds and EM debt. Equities are undoubtedly more risky than bonds, but the risk/return trade off, as far as we are concerned, is attractive.

One of things that people have lost sight of with the passage of time is that well-managed companies are still generating profits, good cash flows and re-paying debt, and as a result they are getting stronger every day. Even though the economic outlook is challenging, the businesses that have survived the downturn are moving into a better and better place. One consequence of this is that because capex requirements are relatively modest in a low-growth world, companies are increasingly looking at how they can reward shareholders by pushing up dividends and are recognising (for the first time in a long time) that the dividend is a key part of the return to shareholders and it is a way of not only demonstrating the success of the business but also its financial strength. The uptrend in payout ratios is therefore a fantastic sign of confidence amongst company managements.

So, looking forward, what does this all mean for the rest of the year? It's still a tough economic environment but equities look reasonably attractive in valuation terms, particularly for investors who are interested in income and are able to tolerate the volatility that is associated with equity investments. Low GDP growth, as a consequence of de-leveraging, will be a feature for years to come. We also think that markets will continue to oscillate between optimism and despair, depending on what the Fed says about QE, the data releases in Europe and what China says it is doing about its banking system, amongst other things. But, if you are confident on the long-term prospects for equities, as we are, the periods of despair are likely to offer good opportunities to increase exposure. However, we would caution against getting carried away when optimism is in the ascendant, as was the case earlier this year.

Moreover, while valuations are attractive, a focus on beta alone is unlikely to be enough and we believe portfolios that own the right stocks will be able to outperform significantly given that the headwinds from slow growth and the winding down of QE are not going to go away. In short, in the next few years, finding the winners will be very important, and it will be just as important not to run from volatility but to use it as an opportunity to increase positions in the strong franchises that are best placed to prosper in what will still be a low-growth (and eventually, post QE) world.

Important information

For Investment Professionals use only, not to be relied upon by private investors. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Asset Management Limited. Registered in England and Wales, No. 573204. Registered Office: 60 St Mary Axe, London EC3A 8JQ. Authorised and regulated in the UK by the Financial Conduct Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: Unit 3004, Two Exchange Square, 8 Connaught Place, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.

This material includes forward looking statements, including projections of future economic and financial conditions. None of Threadneedle, its directors, officers or employees make any representation, warranty, guaranty, or other assurance that any of these forward looking statements will prove to be accurate.

Issued in the US by Threadneedle International Limited ("TINTL"), a UK.-based investment management firm provides financial services to individual and institutional investors. TINTL is registered as an investment adviser with the U.S. Securities and Exchange Commission and is authorised and regulated in the conduct of its investment business in the UK by the UK Financial Conduct Authority.