Straight talk

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From the UBS Asset Management Investment Committee
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Dawn Fitzpatrick, Head of Equities, Multi Asset and O'Connor, highlights the key themes of discussion at the June Asset Management Investment Committee (AMIC).

The AMIC comprises the most senior investors from each investment area, providing a key forum for the sharing of cross asset expertise and debate on the major factors impacting client outcomes.

More than a month since the UK Referendum vote and equity markets globally have rallied strongly buoyed by improving economic data globally, by the expectation of looser monetary policy from central banks and by a broader "lower rates for longer" mantra.

Amidst the broad rally in risk assets, one of the most noticeable developments has been the shift in attitude towards emerging markets with recent mutual fund flows into emerging markets equity and debt among the strongest on record.

The debate among members of the UBS Asset Management Investment Committee (AMIC) members therefore centred on the drivers to this rally and whether the strong flows reflected a temporary rotation and increase in risk appetite - or a more secular change driven by a sustainable improvement in emerging market fundamentals.

We believe that there have been a number of drivers to the rally in emerging markets:

1. Stabilizing economic growth

Over the course of the past few months, we have seen emerging markets fundamentals stabilize, with emerging markets GDP growth forecast to rise as output indicators stabilize on the back of a weaker US dollar and commodity stabilization. This is leading to a divergence between emerging market and developed market growth differentials, the latter of which will remain under pressure given the UK vote to leave the European Union and the spill-over effects to the Eurozone. This is helping to alleviate pressures on capital flows, and balance of payment concerns which plagued emerging markets in 2013-2014. Back in 2013 the term Fragile 5 was coined to describe those countries (Brazil, Russia, India, Indonesia, Turkey and South Africa) that were suffering from weak growth, weak current account deficits, and in many cases twin deficits. While the fiscal deficits across emerging markets have not improved materially, stronger growth and currency adjustments, which have helped repair current account imbalances, have led to an improvement in the imbalances in emerging markets.

While the build-up in private sector leverage still poses a drag on growth as countries deleverage, growth has likely bottomed over the medium term. Additionally, the stabilization in Chinese growth is an important factor for emerging market demand, and it is unlikely that China will do anything to destabilize its economy ahead of the 19th party congress in the Fall of next year.

2. Lower for longer

While moderating developed market growth is not helping markets, central banks are providing a robust liquidity backdrop through continued loose monetary policy, which is helpful to emerging markets. The less robust US dollar and low inflation rates in emerging markets have put interest rate cuts back on the table in emerging markets, and over the next 6 months we expect several countries to take advantage of the market opportunity to reduce benchmark interest rates.

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3. Nominal yield environment is supportive of emerging market inflows

The very low rate environment in the developed market is creating an extremely low nominal yield environment wherein 40% of developed market yields are trading with a negative rate. This is driving a pick-up of inflows into emerging market assets. Last week, combined emerging market bond and equity retail inflows were the second largest on record, at +USD10.2bn, according to the Institute of International Finance, and the largest since January 2013. Emerging market bond funds saw inflows of +USD4.7bn, surpassing the previous record high of USD3.3bn, and emerging market equity inflows accelerated to +USD5.5bn. Year to date, cumulative flows into emerging market bond and emerging market equity total about USD16bn.

The demand for yield is persistent and strong, and this is unlikely to change as central banks globally remain accommodative. Moreover, the Fed is likely to react to its dual mandate much more slowly during this cycle than prior ones. We believe this will keep nominal yields constrained and will sustain the market's demand for carry.

4. Valuation

Emerging market sovereign bond spreads look attractive relative to other spread product like US Investment Grade Corporate Bonds, despite the rally over the past month. Additionally, emerging market equities, which are trading at 15x trailing earnings, are attractive on a relative basis to US equities and global equities.

This presents a number of investment opportunities within emerging markets:

- Emerging Market Bonds: We are bullish on emerging market bonds, particularly in Asia and LATAM. The higher yields of emerging market bonds in both hard and local currency relative to other fixed income asset classes, coupled with more stable fundamentals, are driving strong inflows into emerging market bond funds. We prefer countries with improving balance of payments, real GDP growth and attractive real rates.

- Emerging Market Equities: We are also bullish on emerging market equities, which should continue to benefit as investors move out the risk curve in the search for value.

- Emerging Market FX: We are neutral on emerging market FX, in which performance will likely be country specific given the backdrop for additional rate cuts. We believe that high beta, high yielding currencies with strong idiosyncratic stories will outperform.

Equities drivers

Another key topic for debate during our most recent AMIC meeting was a review of the earnings, rates and valuations support for equities in general and for US equites in particular in the light of the recent rally.

1. Earnings

The most recent quarterly US earnings may have exceeded expectations but we see rising labour costs as a potential headwind to profit growth going forward. According to the Atlanta Federal Reserve Bank's US Wage Growth Tracker median wage growth in the US is running at 3.5%.

We believe revenue growth will be the key to stronger earnings. But overall growth rates globally remain low and fragile. In the US, CEO confidence has been declining for 15 consecutive months according to one magazine survey – albeit overall levels still point to growth.

2. Rates

The relationship between interest rates and equity market performance is not straightforward – and far less correlated than earnings. There is an obvious reason for this: in recessions rates decline but so do earnings.

More importantly we see the general market approach to declining rates as flawed: Using popular discounted cash-flow methodologies it is easy to arrive at a higher "fair value" by lowering the discount rate. But few take the logic of low rates to its natural conclusion and simultaneously adjust down companies' growth rates and cash flow forecasts. One very important caveat to this way of thinking is that rates right now are artificially low relative to growth due to massive central bank intervention. We believe in the US, the supply and demand distortion has likely placed 10–year rates more than 125 basis below where economic conditions would warrant.

However, low absolute rates do support some companies over others. The valuation premium in a low growth environment for those companies able to maintain pricing power due to protected intellectual property and/or sustainably strong franchises or brands is clearly justifiable. In contrast, companies competing in industries with low capital barriers have little earnings protection when rates are so low. We see this manifesting itself in some of the most pronounced valuation spreads in the US market since the Internet Bubble.

Against this backdrop it is perhaps not a co-incidence that the US has outperformed other developed markets so significantly since the financial crisis despite a higher valuation starting point given America's intellectual property dominance in key areas – most notably in technology and healthcare.

3. Valuations
All valuation metrics are poor predictors of short-term returns, most notably the commonly used forward P/E ratio. For longer-term forecasting we believe the Cyclically Adjusted PE (or CAPE) can prove a better yardstick. We believe this currently points to annual average returns in the coming years of 3%-4% for the US, with somewhat more attractive annual returns in other developed markets.

And emerging markets? Most are notably more attractive than their developed market counterparts with Korea and China mid-pack and the valuation of countries such as Brazil and Russia implying returns of around 10% per annum for the next decade, albeit with very heavy sector tilts.

Investor Positioning and the US Elections

The AMIC believes that investor risk positioning was low going into the BREXIT vote, and is still generally below normal levels. Geopolitical uncertainty including, but not limited to, continued turmoil in Turkey, regional elections in Germany and Spain, an Italian referendum that will decide Renzi's fate, and a US presidential election featuring two of the most unpopular candidates of all time are clearly key contributors to market participants opting for an abundance of cash even in a world where we have negative rates on over USD11.7 trillion of sovereign debt. The importance of being cognizant of investors being skewed toward lower volatility portfolios is that it likely dampens the reaction to negative headlines all things being equal.

Focusing on the U.S. Election, it is clear that the market would react well to a Clinton Presidency with a continued Republican led Congress - which we believe is the most likely outcome. That said, a Trump victory is still a distinct possibility. In the scenario where Trump wins the Presidency we believe foreign investors will react more negatively than U.S. domiciled investors and that both will take significant cues from key Cabinet and staff appointments. Given Cabinet appointments cannot be made until after the election, this process will likely prolong uncertainty and market angst.

The Asset Management Investment Committee (AMIC) comprises:

Bruce Amlicke
Chief Investment Officer
UBS Hedge Fund Solutions

John Dugenske
Global Head of Fixed Income

Dawn Fitzpatrick
(AMIC Chair)
Head of Equities, Multi Asset and O'Connor

Bill Ferri
Head of Hedge Fund Solutions and ad interim Head of Product

Barry Gill
Head of Active Equites

Bill Hughes
Global Head of Real Estate Research & Strategy

William Kennedy
Head of Distribution

Ulrich Koerner
President Asset Management; President Europe, Middle East and Africa

Andreas Koester
Head of Multi Asset

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