TIME TO ADVANCE IN ADVANCED ECONOMIES?

UOB INSIGHTS
Making Sense of Investing




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In 2013, we witnessed a shift in global investment interest with an increased confidence towards the advanced economies of the world. On the back of a better economic outlook in the United States (US) market, we saw Federal Open Market Committee (FOMC) Chairman Ben Bernanke announce the slowdown in their asset purchasing programme; which will start in January 2014, and at the same time, a bid to keep interest rates near zero till 2015. We also observed a highly growth-friendly policy adopted by the European Central Bank (ECB) to cut interest rates in November 2013. These policies have introduced an unprecedented amount of liquidity and have injected a renewed confidence in the recovery of the respective US and European economies. Their central banks were determined to, in the words of ECB president Mario Draghi, "do whatever it takes" to get their economies back on track, restore stable employment as well as competitiveness. Today, I speak to the specialist portfolio managers to gain a better understanding on how they view these advanced economies and the markets. For a well-rounded argument, we also explore the relevance of fixed income in the investor's portfolio, in view of highlighting the opportunities that still lay within.

Europe – Franklin Templeton Investment

Eurozone is still facing significant structural problems and we have not really seen any concrete resolution to lead Europe out of the woods. So why should investors be looking towards Europe as an investment option?

The German experience from the years of reform has shown a similar path of recovery, with progress initially being slow. German development during the years of crisis shows that the outcome of a reform process is a much more stable and resilient economy. So, although we hear a lot of criticism about the slow path of recovery in Europe, we think that a thorough but slow structural reform process, with the aim to create a more sustainable economic environment, is the right one for Europe.

There are still risks. France and Italy need to improve their reform efforts and there is still work to be done on fiscal coordination and bank regulation. But we feel that at this point, the potential rewards of a turning Europe trading at low valuations far outweigh the risks.

Because so many major European companies do business in emerging markets, we believe that a pick-up in the global economy will further help to drive an earnings rebound. And with earnings still below 2007 levels and badly lagging earnings in the US, that profit growth can drive additional stock market gains in our view.

There are risks that bear watching, however. We expect China to continue to drive emerging market sentiment. If investors see that recently announced reforms will not work and that lower growth looks set to persist, that could raise negative questions for Europe more so than the US. A stronger euro could also dent exports.

Eurozone's unemployment remains elevated at 12 per cent and the region is facing a potential deflationary situation. Should the markets rationalise that the Eurozone economies are still not on solid footing; is a severe correction on the cards?

2013 was a good year for European equities. As of 15 December 2013, the MSCI Europe was up 13.8 per cent. The Eurozone did even better with the MSCI EMU up 17.7 per cent. While we expect European markets to put in another year of gains supported by a stronger global economy and recovering earnings, we would not be surprised to see markets move at a more pedestrian pace for a while after a strong 2013.

In contrast to the US market, European stocks still have not reached their 2007 peak. That suggests to us that European stocks can rise another 10 to 15 per cent next year, driven by an earnings recovery. Key for that is a slow but well-founded recovery in Southern Europe, where we now see the result of the relentless effort of the past few years to address structural challenges. Strict fiscal austerity combined with reforms in labour markets have improved the situation in many countries that were hit hard by the financial crisis. Lower unit-labour cost, which signals an improvement of competitiveness, is a good indicator of the progress made in a large part of Europe.

In summary, we feel that the seeds for a long-term recovery have been planted, and expect to see the benefits of that in the years to come.

The US – BlackRock

With the US debt ceiling debate returning again early this year, coupled with tapering concerns weighing on investors' minds, how do fund managers see US equities performing in the first quarter of 2014?

We believe that the US debt ceiling issue will continue to resurface as politicians favour a short-term patch over a long-term solution. This will result in continued volatility in financial markets. For some time now, the BlackRock global equity team has pointed to excess global debt as one of the reasons we believe growth will continue to be low and fragile, cycles short and volatile, and markets driven by policy and growth. Policy stimulus withdrawal will prove very hard to do at the right pace without risking renewed recession or an inflation spike. Under these market conditions, it is more important than ever to invest in quality companies with the ability to grow earnings and distribute dividends.

With the DJIA breaking all-time highs in 2013, should investors take the above risks into consideration and take some profit off the table?

Some metrics suggest that the US market is fully valued as stocks re-rate ahead of earnings. This is another reason to invest in quality companies with the ability to grow earnings consistently through the cycle, as is the focus for the Global Equity Income Strategy. Our strategy invests in companies with operational strength and financial resilience that are able to provide consistent returns, despite market volatility. These companies provide products that individuals will continue to purchase through periods of uncertainty, such as brake parts (Genuine Parts Company), healthcare (J&J) and telecom services (Verizon).

The US economy has been on the mend for the past two years. What are the drivers that will continue to drive US equities performance in 2014?

US equities are not the US economy, and the performance of one is not determined by improvement in the other. It is important to look past where a company is domiciled and consider where the company derives its revenues. Many US companies have multinational exposure, and as such, can continue to perform even if the domestic economy falters.

The Global Equity Income Strategy invests in multinational companies with global exposure and therefore are less impacted by the movements of any one market. For example, Coca-Cola is a US-listed company that derives over 55 per cent of its revenues from outside of the US. By investing in truly global companies, we are able to diversify geographic risk.

Fixed Income – AllianceBernstein

Will the Fed's taper in asset purchasing programmes lead to an eventual secular bear market in bonds?

We don't think so. In order for a secular bear market in bonds to occur (e.g. the US in the 1970s), we would need to see a spike in systemic inflation in the US. But at the moment, inflation in the US is, if anything, too low. Therefore, we think that the Fed Funds rate probably won't be lifted until 2015.

We think in this environment, the US treasury yields have room to move up further, but probably in a more gradual manner than what we saw in May and June 2013. Given how far yields have already moved up and with still moderate levels of inflation and nominal GDP growth, we think that the scope for another sharp jump in yields is limited. We expect ten-year treasury yields will probably hover around the low to mid 3 per cent range in 2014.

What are the risks or opportunities in the fixed income space?

Treasuries and high-grade corporate bonds will likely continue to be affected by the headwind of higher treasury yields in 2014, though probably to a lesser extent than what we saw in 2013. We should keep in mind that treasury yields today are already meaningfully higher than where they were at the start of 2013, and the yield curve is now very steep, both of which should provide some buffer against potential losses. In addition, while a gradual increase in yields represents our base case scenario, we think treasuries can still play a risk mitigation role in clients' portfolios, in case economic growth turns out to be less robust than consensus expectations.

For clients who can tolerate some risk and are seeking higher income, we believe the global high yield markets can still deliver in 2014. In the US, corporate defaults remain very low and are expected to stay low over the next year or two. The high yield sector benefits from abundant liquidity as well as reasonable corporate fundamentals. These bonds currently have a very favourable maturity schedule that sees very little high yield debt maturing for the next two to three years. In the meantime, credit spreads remain attractive relative to the low default rate environment, and should offer some buffer from rising treasury yields.

But we would caution clients to be prudent on the very low credit quality issues, as valuations among CCC-rated high yield issues are looking quite stretched. By region, the US is still the deepest and most developed high yield market in the world, but we also see quite a few opportunities in the smaller European high yield market as well as select corporate bonds from emerging market countries.

In an environment where the investment gears are turning, we need to be quick to identify and act on the shift in global investment interest. Whilst I believe that 2014 is likely to be a good year for developed economies equities in general; investors need to be aware that not all developed countries are created equal. There are significant structural issues that are still not resolved in the Eurozone; the economic outlook in Germany and the UK is vastly different from that of Greece or Portugal. Likewise, not all industries in the US will be able to achieve "escape velocity" until much later in the future, even with the highly accommodative policies in place. Hence, highlighting the need for very good stock-pickers will be essential for any fund to outperform the benchmark in 2014.

Speak to your UOB Banker today to identify the investment solution and strategy that suits you best.

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