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SE Market Wrap

HD **Globally speaking, where to from here**

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International outlook In these volatile times, **equity** experts see bargains beckoning.

With tensions in Crimea mounting and concerns about **China**'s growth outlook getting stronger, it is easy to understand why Australian investors might be hesitant to follow the usual advice to get more diversification by investing in global equities.

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If the problems in Ukraine and **China** aren't enough, then months of worries about the health of emerging markets have only added to jitters on global markets. Those economies with the largest current account deficits – Brazil, India, Indonesia, South Africa and Turkey – are particularly vulnerable to foreign capital outflows in the year ahead as the United States Federal Reserve withdraws unprecedented levels of monetary stimulus.

But a group of international **equity** experts assembled by The Australian Financial Review have urged Australian investors to look through the gloom.

Not only are fears of the fallout from Crimea overblown, but if **equity** markets in the "Fragile Five" are oversold there could be bargains to be had.

Jason Nogueira, T. Rowe Price global equities associate portfolio manager : It is a common mistake to group all emerging market risks together when they are very different. I can't remember a time when sentiment towards emerging markets was more negative than now. That means there are lots of opportunities. Against the MSCI world benchmark we are underweight the US and Europe and overweight emerging markets.

Matthew Beesley, Henderson Global Investors head of global equities: Right now, I am not sure investors should move into emerging markets, given the numerous challenges. But for those investors who do want EM exposure, there are select opportunities. Henderson is not invested in Korea but we have recently undertaken detailed analysis on a number of companies that might fit our bottom-up criteria. Some of the financial services stocks in the Middle East could be interesting investments on a two-to-three-year view.

Alex Torrance, CQS European equities portfolio manager: Recent relative underperformance alongside stabilisation in some of the macro data suggests that later this year could see emerging market equities return to the fore. But EM is not a homogeneous region or asset class. Some countries have restructured their economies effectively, while others have not.

Alan McFarlane, Apostle Dundas Global **Equity** Fund portfolio manager: The long-term case for economic growth in emerging economies is intact, but clearly their **equity** markets have taken a beating. Our strategy adopts a 'one world' view, investing regardless of a country's developed or emerging market classification.

Torrance: It creates more risks, especially for the utilities and **energy** sectors in Europe given Ukraine's role as conduit to Europe for Russian gas.

McFarlane: Economic integration means it is very unlikely Western Europe will respond by doing anything more than saying unpleasant things in a diplomatic way. The only significant thing the US government could possibly do if it wanted to put pressure on Russia would be to allow unrestricted exports of its **oil** and gas. But the American public probably wouldn't support that because cheaper **energy** has been a major driver of the US economic recovery. If Russia takes control of Crimea, Ukraine will probably need to be bailed out by the EU and that could see a number of European banks in trouble.

Nogueira: The tension with Ukraine is a reminder of the risks the Putin administration poses to companies within Russia. We have a small position in Sberbank, the largest bank in Russia, and an active watchlist of other quality Russian-listed stocks. But even when the market dropped 10 per cent we found the discount still wasn't enough.

Stephen Anness, Invesco Global Opportunities Fund fund manager: Over the past couple of months the fund has built a big position in British American Tobacco after the stock sold off on fears of emerging market currency volatility and the impact of electronic cigarettes, two factors we believe have been overestimated by the market. BAT is headquartered in London but no longer has a British business; its biggest markets are Brazil and Russia. In the nadir of the Spanish crisis we purchased holdings in Spanish TV broadcaster Mediaset España, and Spanish airline International Consolidated Airlines Group; both have performed well since. If things get worse in Russia we will be looking for opportunities to buy.

Beesley: As long as these challenges remain isolated and contained, the prospects for global **equity** markets in 2014 remain good.

McFarlane: Five years on from hitting bottom after the GFC in March 2009, global equities have risen by more than 140 per cent in US dollar terms. The twin policies of super-low interest rates and boundless liquidity via quantitative easing have been the major factors supporting a five-year bull market. So interest rate increases and withdrawal of liquidity will be challenges for **equity** markets, although the implications for **bonds** may be worse.

Beesley: The so-called "Fragile Five" (Brazil, India, Indonesia, South Africa and Turkey) are vulnerable. Expect the fragility of each of their economies to be on full view over the next 12 to 18 months, with local market credit seasoning and all the consequences that go with a decline in credit availability within each of these individual economies.

Torrance: The lesson from last year was that markets are sensitive to it. There are still many issues that will emerge, especially those economies with large current account deficits – notably the "Fragile Five". But importantly, we have seen a shift in the Fed's playbook from forward guidance to qualitative guidance. As the Fed (and other major central banks such as the Bank of England) attempt a smooth and orderly exit from quantitative easing the key question for their sharemarkets is whether **company** earnings can rise faster than share prices decline.

Nogueira: The consensus view is that emerging market stocks can't succeed while the US is tapering, but that view is too simplistic. The Fragile Five with their large current account deficits are going to see negative impacts, but a lot of that is already priced in. Indonesia is the poster child for the Fragile Five but its stockmarket is pushing higher.

Anness: Everyone is talking about the impact of a reduction in QE as a negative on businesses outside the US. So we are investing in Citigroup and JPMorgan, two US-listed banks with high deposit rates for which the longer-term rise in interest rates will be hugely beneficial. We topped up on Citigroup after it sold off on simplistic fears about volatility in emerging markets and it is now the biggest holding in the portfolio. Citi's two biggest emerging market exposures are Mexico and South Korea, economies we are quite positive on.

Beesely: We have a healthy allocation to continental Europe, the US, and Japan. There will likely be significant earnings leverage in European **company** earnings this year given just how lean many cost structures have become after five years of cost rationalisation. It is unclear how Prime Minister [Shinzo] Abe's unconventional plan to reflate Japan's moribund economy will end, but we are impressed by the zeal with which he and his government are addressing the problem. Even a modest success for "Abenomics" is likely to **lead** to more foreign investment in Japan.

McFarlane: We look for consistently profitable companies that produce more units each year to self-finance growth and still have something left to pay dividends. The top three holdings in the Apostle Dundas global **equity** fund are US-listed stocks Microsoft, The Walt Disney **Company** and American Express. Rounding out the top five are Swiss-listed pharmaceutical giant Roche, and Coloplast – a Danish-listed **company** that makes products for bowel disease patients. We like the outlook for growth in the aviation industry but prefer to own Rolls-Royce, which manufactures aircraft engines over airlines. We are bearish on banks, telcos and miners.

Anness: As a high-conviction investor based in London we do have better opportunities to review European and UK companies because it is easier to hold management meetings. That's convenient at the moment because UK and European markets are trading cheaper than their 10-year price-to-earnings ratio, while the US is more expensive than its 10-year average. Two favoured stocks are Swiss-domiciled pharmaceutical companies Novartis and Roche.

Beesley: Korea has the potential to be interesting, though an aggressive devaluation of the yen could hurt, given its strong trade links with Japan. We are not currently invested in India though will be watching the coming elections with interest.

McFarlane: Of the 61 stocks in the portfolio only three are listed in emerging markets, but about 20 per cent of the aggregate profitability is derived from emerging markets. One of the biggest holdings in the portfolio is British hardware chain Kingfisher. The retailer is strongest in the UK and France but also has a very big business in Poland and an emerging business in **China**. Another favoured stock is US-listed Walmart – the world's largest retailer, it has huge growth potential in Mexico and South America.

Anness: At the moment we prefer to invest in emerging market growth themes through developed-market stocks. A favourite exposure to **China** is French-listed liquor **company**Rémy Cointreau. We bought in during the fourth quarter of 2013 when the stock dipped nearly 50 per cent on worries about a clamp-down on "gifting" rules. It is a fabulous business with a very high barrier to entry for competitors.

Nogueira: We are particularly bearish on big commodity exporters that also have internal issues – such as Brazil, South Africa and Russia. But there are still good opportunities such as Aspen, a South African healthcare **company** that is the lowest-cost manufacturer of generic pharmaceuticals in the world. We feel better about the governments and long-term growth potential in India, Turkey and Indonesia. Part of the reason India and Turkey have large current-account deficits is because they import a lot of **oil**, but we expect **energy** prices to fall, which will help those nations. I'**m** particularly bullish on the Philippines. The economy is growing at about 7 per cent this year and the **equity** market has done well even through the emerging market sell-off.

Beesley: The second-order effects of tapering, and disappointing earnings growth. World markets rose during 2013 in anticipation of faster growth in corporate profits this year. This needs to come through in the reported numbers in 2014, or markets will fall.

Torrance: It comes down to confidence in the European Central Bank's Mario Draghi and the Fed's Yellen. Both face different challenges. In Europe, the debate is around disinflation and the potential policy response from the ECB and other authorities. In the US and the UK, the risks are around the normalisation of interest rates as those economies appear to have reached escape velocity.

McFarlane: There are always plenty of things to worry about, but I'd put monetary policy at the top of the list. Central bankers and governments like to give us the impression of control, but it is an illusion.

Nogueira: Currency forecasts are very hard to get right, especially in emerging markets. So we try to deal with that risk by balancing out the exposures. **China** is a tough market to invest in, with classic signs of investment and debt levels a worry. We are wary of exposure to **Chinese** banks and anything leveraged to asset values. But it still has the appeal of being the second-largest economy in the world. We mostly own internet and food stocks in **China**. One of the best ways to hedge against the risk of inflation in emerging markets is to buy food retailers, which can usually pass the price increase on.

Anness: Market sentiment can be very dominated by what is going on at the macro level. It is good to look for companies that have things going on at the micro level that more than compensate for the macro upset, and use the opportunity to buy them at a discount. The Brazilian stockmarket is down about 60 per cent relative to the US since peaking in 2010. In December we travelled to Brazil to meet with some companies and are currently conducting due diligence with a view to investing there.

CO fed : Federal Reserve Board

RE russ : Russia | usa : United States | austr : Australia | crimea : Crimea | uk : United Kingdom | apacz : Asia Pacific | asiaz : Asia | ausnz : Australia/Oceania | bric : BRIC Countries | devgcoz : Emerging Market Countries | dvpcoz : Developing Economies | eecz : European Union Countries | eeurz : Central/Eastern Europe | eurz : Europe | namz : North America | ukrn : Ukraine | ussrz : CIS Countries | weurz : Western Europe

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