CIO PERSPECTIVE: EQUITIES

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2013: an event-driven year

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AT A GLANCE

- 2013 is likely to be another event-driven year with investors seeking clarity on three key issues:
  1. The US fiscal cliff;
  2. The sovereign and economic crisis in Europe;
  3. The geopolitical situation in the Middle East.
- A positive case can be made for a re-rating in equities; however this is dependent on progress being made on the above issues.
- Within equities, investors should focus on income-generating stocks. High-quality companies with the ability to grow their dividends are attractive on a total return basis.
- Regionally, US equities can continue to outperform if the fiscal cliff is successfully negotiated. Pro-growth policies, an upturn in the housing sector and the positive impact of cheap shale energy will support the market.
- Emerging markets should also prosper, benefiting from more supportive economic growth and capital flows to higher-yielding currencies.

2013 will be another challenging and event-driven year for equity investors to negotiate. Markets face a number of risks with binary outcomes, not least the imminent fiscal cliff facing the US economy. While the prospects for earnings growth in most developed equity markets are now more modest, a positive case can be made for a re-rating of equities, yet this is dependent on progress being made against some powerful headwinds. With major government bond yields likely to stay low and below inflation, investors will continue to seek positive real returns in higher-yielding, income-generating assets and dividend-paying equities remain attractive on a total return basis.

Equity markets in 2013 are likely to be event-driven with much depending on the ability of politicians and central bankers to agree deals and make the right policy decisions. What is certain is that we will see a significant, synchronised expansion of central bank balance sheets throughout 2013. With central banks committed to quantitative easing policies, what was unorthodox only a few years ago has become standard practice. Critically, the signal to bond markets remains the same. Government bond yields are likely to remain low, with real negative yields encouraging investors to seek positive returns in short-duration, income-generating assets.

Equities can be driven higher either by earnings growth or by multiple expansion. The outlook for earnings growth is rather subdued in the developed world, with nominal growth likely to be in low single digits. With profit margins already at historic highs, companies in the US and Asia should see top-line growth of 4-5 % with Europe a laggard. Yet, while there is limited prospect of earnings growth supplying a strong catalyst to equities, we can make a case for a re-rating contingent on progress being made on some key issues. This positive case for equities rests on three supportive factors:

- Equity valuations are reasonable relative to history with P/E ratios of around 13-14 times trailing 12-month earnings. While this is not extremely low, the relative attractions of equities are enhanced when valuations are compared to sovereign and investment grade bonds.
- We have seen sustained outflows from equities in the last few years, so much so that institutional levels of equity ownership are now at 30-year lows. Equities are an unloved asset class and there is growing scope for a reversal of this trend.
- Volatility has subsided. The recurrent curse of equity markets since 2008, VIX volatility has often spiked above the 20% level. I have always believed a reduction in volatility is a prerequisite to any re-rating in equities. Encouragingly, the VIX has fallen back to around 15% having remained below 20% since July.

While these factors make a re-rating possible, there are some considerable hurdles to be overcome which could prevent it. In my view, there are three key risks facing equity markets in 2013:

- Lack of a resolution to the US 'fiscal cliff' would throw the US and global economy into recession. The likelihood of going over the cliff, and detracting c.4% from GDP, is being underestimated given the ideological divide in Congress.
- The economic, sovereign and banking crisis in Europe remains unresolved despite central bank promises having had a favourable impact. With politics in peripheral countries becoming radicalised, there is the potential for more flare-ups. Unfavourable debt dynamics and poor economic fundamentals suggest further deterioration is likely.
- Geopolitics, particularly in the Middle East, could pose a significant and unpredictable risk in 2013, this being the year that the confrontation between Israel and Iran over nuclear facilities is likely to come to a head.

So what can investors do? With government bonds failing to provide a store of value after inflation, investors will continue to search for yield, particularly in short duration assets.

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In this respect, equity income remains an attractive story given the dividend yields available on equities compared to government bonds. In Europe, investors can expect around 3-4% dividends (except in financials where many dividends have been scrapped). Balance sheets are healthy, cash flow is solid and pay-out ratios are low with scope to grow. I think we will see earnings and dividend growth of 4-5% in 2013, particularly at large high-quality companies. So, if you combine 3-4% dividends and estimated growth of 4-5%, we can generate attractive total returns of 7-8%, which should support further flows into equity income funds.

In terms of sectors, I expect the leadership we have seen over the last year to continue. Quality will remain a powerful theme and stocks with high returns on invested capital will continue to attract a premium. I think selected healthcare, technology and consumer stocks remain attractive. There are high-quality stocks available with strong franchises which benefit from structural tailwinds, which are also returning cash to shareholders via dividends; Nestlé, Unilever, and Sanofi are all examples of such quality stocks. With these strong multinational companies, investors can be fairly confident that they will get their money back and in the meantime, they receive a higher income than they would from investing in sovereign bonds. Some pharmaceutical companies are on single-digit PE ratios despite having among the highest returns on capital. Among technology companies too, there is good scope for dividend growth; some of the large technology stocks have matured into stable, lower-growth businesses that offer attractive total returns. While the c.3.5% yield on Microsoft might seem a little low, this is covered about four times by cash. This means that they have the potential to grow dividends in the future significantly ahead of earnings.

Regionally, emerging markets are relatively attractive given their better growth rates and the fact that capital is likely to flow to investments in higher-yielding currencies. Indeed, I expect currency appreciation to be a growing theme in the emerging world given the synchronised balance sheet expansion at developed economy central banks. The Chinese economy is well placed to have a rebound in 2013; inflation has been brought under control and the leadership transition is now out of the way, suggesting policy can be accommodative. Investors appear to have discounted economic growth rates in the 6-8% range and the market should perform relatively better now that these headwinds have passed.

In developed markets, the US looks attractive if the fiscal cliff can be successfully navigated. The housing market is recovering, which is a key bellwether for the broader economy, and consumer confidence is also picking up. In energy, the US could become the largest producer of both gas and oil thanks to the exploitation of its shale reserves. But, it is the broader effect of cheap energy costs on the economy that is particularly supportive; this will give the US a competitive advantage among advanced economies and play a central role in the renaissance of US manufacturing. A wide range of industrial sectors from chemicals to engineering are expected to benefit from significantly lower input prices.

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Notes to editors

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