PERSPECTIVES

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Still an equity-friendly environment

While market uncertainty has picked up in recent weeks, I believe we remain in an equity-friendly environment. Indeed, it is significant that the recent falls in equity markets were not accompanied by elevated volatility.

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Equities Underpinned By US Promise

I have been arguing for some time that we need to see a low volatility environment as a precondition for a rerating of equities. In 2008, volatility spiked into the 30-40% range; in the most recent bout of uncertainty, it peaked briefly above 20% before falling back relatively quickly.

I think the reason that equity volatility is so well anchored is because there is more certainty now about the outlook for the US economy than in previous years. The fiscal cliff has been a significant headwind that has dragged down US GDP growth by about 1%. However, private sector growth has been strong, which has allowed the US economy to grow at a reasonably healthy level of around 2%.

Indeed, the US economy is as healthy as I have seen it in the last 20 years thanks to the structural improvements we are seeing in the twin deficits. In 2009, the US fiscal deficit was 10% of GDP, or about US$1.5 trillion. The Congressional Budget Office estimates it will be around US$640 billion or 4% of GDP this fiscal year. This is not only as a result of the 'sequester' and spending cuts but also because rising corporate profits and tax increases are boosting federal receipts. By 2015, the fiscal deficit is forecast to be 3% of GDP, which is comparable to trend GDP growth and allows the US to reach a level of debt stabilization.

At the same time, there has also been considerable improvement in the trade balance. For the first time in 30 years, the trade position has improved during a time of economic growth and the reason for that is structural – shale energy. The commercial exploitation of shale hydrocarbon fields has seen US imports of oil equivalent fall from 12 million barrels per day to 8 million bpd and further declines can be expected.

The improvements in the twin deficits have helped to stabilise the dollar, which is one of the reasons commodity prices have been under pressure. The combination of an improving growth outlook against a benign inflationary backdrop gives the Federal Reserve the scope to gradually unwind its quantitative easing programme. While inflation has been a great fear, it is a dog that has not yet bitten. As the pressures of fiscal drag peter out towards the end of the year, we have the prospect of the US economy growing at 3% in a low inflation environment, which means the Fed can afford to taper QE gradually. This is a broadly supportive environment for global equity markets.

Japan and Europe need more time

The situation in Japan is quite different. The equity market is effectively policy driven. The first two arrows in Prime Minister Abe's radical economic program - fiscal spending and monetary stimulus - should lead to increases in GDP growth in the next 12 months. Even GDP growth of 4% would not be a surprise. Against this backdrop there is room for Japanese equities to move higher but whether this rally will turn into a multi-year bull market is another matter. The answer will depend on Abe's success in tackling his third arrow of structural reform – the most challenging of the three. Japan's long-term real growth rate will not increase unless the workforce is expanded or productivity is improved. There are two possible routes to increasing the workforce; firstly by increasing female participation rates and secondly by allowing greater levels of immigration, however, the latter of these options is less likely.

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Although we've seen some recent signs of recovery in Europe, this should be viewed as a statistical event coming off extremely low levels of growth. There is effectively no inventory in Europe, so any slight shift in demand is likely to have an immediate impact on industrial production and growth. Although there has been some sign of this in Germany, a modest cyclical improvement should not be confused with structural recovery, as the pre-conditions are not yet in place for the latter to occur. There is still the risk that Europe faces a deflationary future given government policies on austerity. Monetary policy remains stubborn – in fact, the ECB is the only major central bank in the world which has refused to expand its balance sheet to support recovery. The Achilles' heel for Europe's equity market remains an under-capitalised banking system exposed to peripheral sovereign debt risk.

Emerging markets need to look for a new model

Emerging markets are in search of a new economic model. They've benefited from some favourable structural tail-winds over the past decade, but now some of these are turning into headwinds. After the 1997/98 Asian financial crisis, emerging markets abandoned the 'Washington consensus' of fixed exchange rates, inflation targeting, privatisation and liberalisation policies that had dominated emerging market economic thinking since the fall of the Berlin Wall. Instead, they adopted a new economic model based on cheap currencies, export-led growth, US dollar reserve accumulation and the development of non-USD sources of financing, such as local currency debt. Although this model has broadly worked well for the past 10 years, it's is now becoming less viable as the developed world moves towards a current account balance. Emerging market currencies are no longer so cheap, and in real terms, have largely recaptured their lost purchasing power of 1997/8.

Emerging markets must therefore turn away from export-led economic models and embrace structural reform. Those that do, such as China, should do well, and those that do not, may continue to face considerable headwinds. It is clear that emerging markets can no longer rely on the benefits of a weak dollar and elevated commodity prices.

New leadership – Intellectual property is back

The current shift in equity market and sector leadership is coincident with this changing environment. Over the past decade, commodity-producing nations have prospered and we saw a general re-rating of sectors and stocks connected to hard assets, such as metal miners and steel companies. Going forward, I think we will see a re-rating of companies with intellectual property in the technology, healthcare and financial services sectors. In the pharmaceuticals sector, for example, we are on the verge of major therapeutic breakthroughs in areas such as oncology. In the IT sector, internet companies remain highly innovative and valuations currently look relatively cheap. Lastly, while regulatory pressures remain a significant headwind in financial services, I think there is scope for valuations to re-rate from low levels over the next few years.