

Schroders Outlook



2014: Global Equities

Simon Webber, Lead Portfolio Manager, Global and International Equities



2014 has scope to be another good year for global equities. What's more, as the dominance of macroeconomic factors on equities recedes, market leadership should begin to transition towards companies able to thrive in a more normal economic and monetary policy environment.

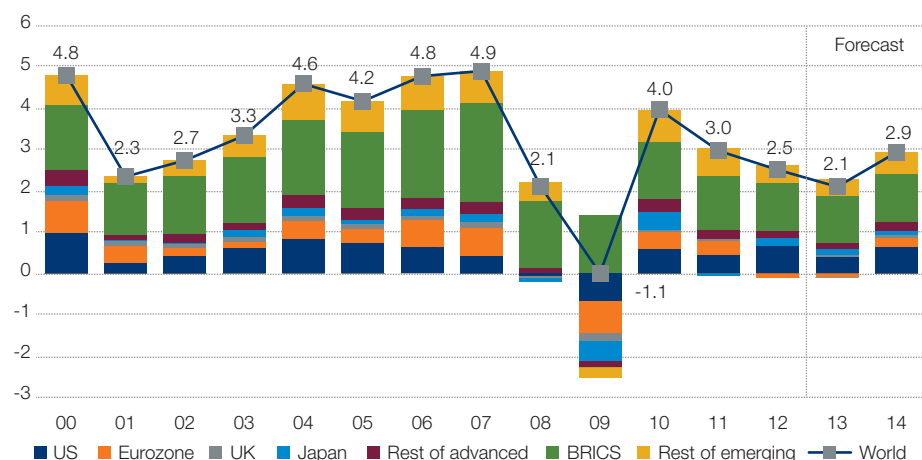
Economic backdrop

Having retreated since 2010, global growth in 2014 should accelerate with full year global GDP growth likely to be in the region of 2.9% (see figure 1). We expect this improvement to be driven by Western economies, with Europe and the US both growing faster than in 2013.

- As corporate confidence gradually improves, capital spending should recover, benefitting capital goods and investment-related sectors
- Low rates and the search for yield have left companies with high expected future dividend and earnings growth looking extremely cheap relative to high yield equities
- Markets anticipate and will price in future interest rate rises, benefitting companies that can thrive in such an environment.

Figure 1: World GDP forecast

Contributions to World GDP growth (y/y)



Source: Thomson Datastream, Schroders, August 2013 forecast.

A year for stock pickers

We are confident next year will be good for stock pickers. Since the 2008 market crash, financial markets have been buffeted by macroeconomic events, be it the 2008 financial crisis, the eurozone sovereign debt crisis or unprecedented money printing by central banks. However, as the growth and policy environment begins to normalise, markets will naturally lengthen their investment horizon and should therefore increasingly focus on companies' long-term growth prospects.

Markets have already been less impacted by macroeconomic events in recent months. This is in part because of a real and perceived reduction in structural risk, but also because there is a growing resilience and breadth to the economic recovery – note the far more muted market response to the US budget and debt ceiling crisis in 2013 compared to 2011.



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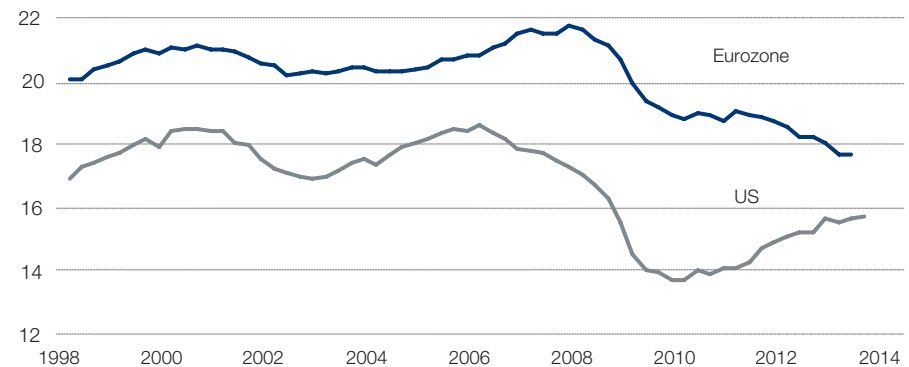
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Confidence to invest

Despite the improvement in economic conditions this year, consumer and corporate confidence has been slow to adjust. Companies have been reluctant to invest, as shown in figure 2, which illustrates that fixed capital formation – a measure of investment – remains below average in both the US and the eurozone. This is despite the fact that large company balance sheets are generally still very healthy (because of the still largely cautious corporate mind-set).

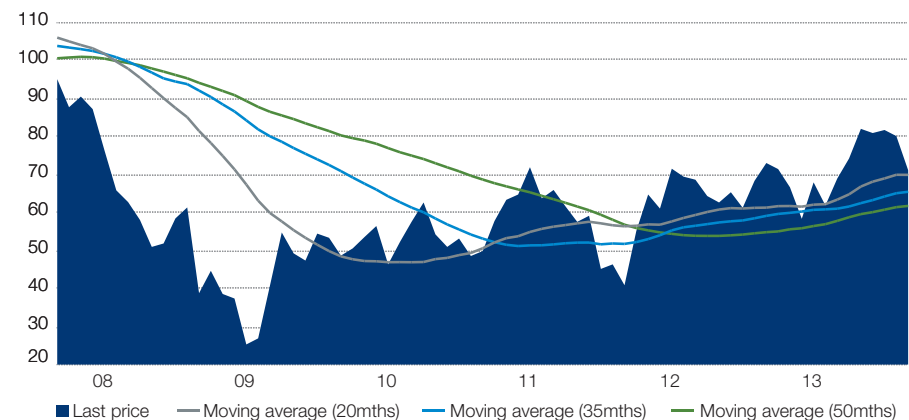
Figure 2: Gross fixed capital formation (% of GDP)



Source: Deutsche Bank, as at November 2013.

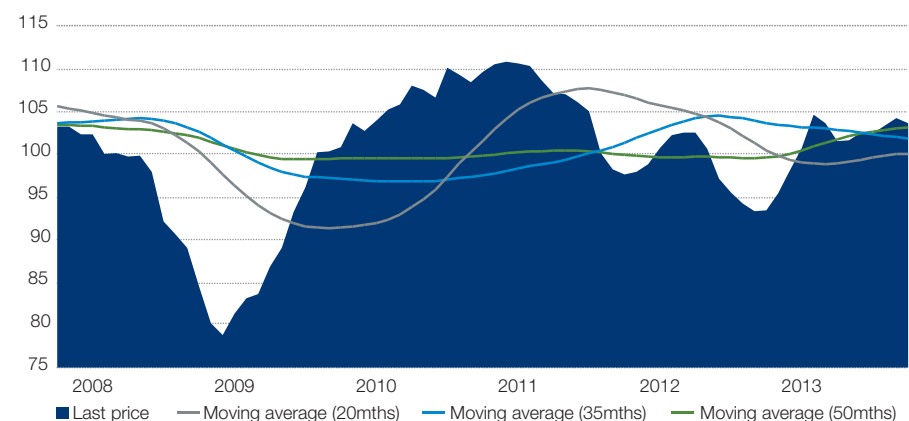
However, we are now seeing signs that confidence is returning. This is highlighted in figures 3 and 4 which show, respectively, US consumer confidence and German business sentiment. We therefore expect that as confidence continues to recover next year, companies will step up investment. This will be particularly good for industrial cyclicals and capital goods industries. It will also give further momentum to the economic recovery.

Figure 3: Conference Board US Consumer Confidence



Source: Bloomberg, November 2013.

Figure 4: German IFO Business expectations



Source: Bloomberg, November 2013.



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Simon joined Schroders in 1999, initially as a research analyst, and later as a portfolio manager on the US desk. In 2004 he joined the Global and International Equities Team as a global sector specialist and has covered multiple sectors including utilities, autos, telecoms and consumer discretionary.

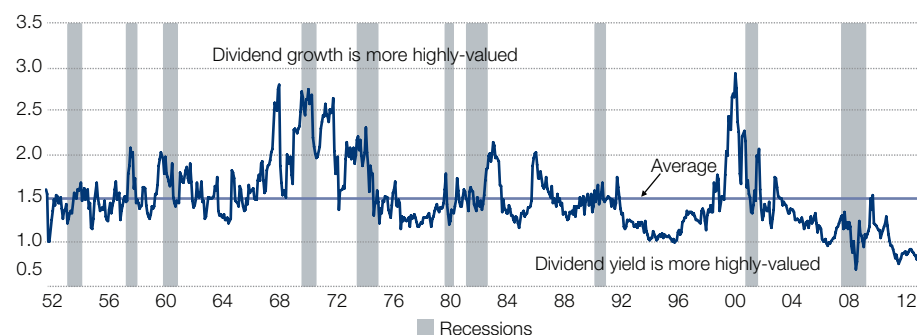
He became a portfolio manager for International mandates in 2009 and has managed the Global Climate Change strategy since its launch in 2007. Simon is a CFA charterholder.

Positioning for higher rates

After years of loose monetary policy across the globe, markets in 2014 will have to wrestle with the timing and implications of interest rate rises. The vast amounts of money being pumped into the global economy via quantitative easing programmes have given many indebted companies an easy ride, and among other things, propped up real estate markets around the world.

Furthermore, depressed bond yields have forced income-focused investors to search for income in higher-yielding parts of the equity market. This has pushed up the valuation of higher-yielding stocks as investors have searched for bond-like returns from stocks with minimal equity risk. This has left companies with prospects for strong future earnings and dividend growth looking exceptionally good value relative to income stocks. This is illustrated in figure 5 below which shows the relative value of the top 20% of high dividend yield stocks relative to the top 20% of stocks with high dividend growth.

Figure 5: Highest quintiles of dividend growth and yield ratio of trailing-P/E ratios¹



Source: Corporate Reports, Empirical Research Partners Analysis, November 2013. ¹Capitalisation-weighted data.

The low interest rate environment has therefore distorted equity markets in recent years. For patient stock pickers, this opens up opportunities for future outperformance: next year, investors should look for companies that can thrive in a rate-normalising environment. This will have impacts across almost all sectors; for example, banks with very strong deposit franchises and life insurance companies which will earn better returns on their investment portfolios. Individual companies with strong brand and pricing power should also perform well in this environment, as should later-cycle cyclical sectors like capital goods.

Global competitiveness is shifting

One country which will likely buck the trend of a rising rate environment is Japan. Japan's government under Shinzo Abe is positively encouraging a more inflationary environment and if the current policies are not successful, its central bank will likely step up its quantitative easing efforts further. Current monetary policy should continue to be good for Japanese exporting companies after many years of a strong currency headwind. However, any further weakness in the Japanese yen will also further affect the competitiveness of companies competing on a global stage. In particular, German, Korean and Taiwanese exporters are likely to feel some pressure, and this is something we are monitoring carefully across our investment portfolios.

When the tide goes out

Ultimately, throughout 2014, we will be moving to the next phase of the economic cycle. Momentum in early cyclical stocks will inevitably move to later-cycle areas of the market. Complacency in the market about the low interest rate environment will open up opportunities for astute investors. To paraphrase Warren Buffet, when the tide goes out, we will see which companies, and perhaps which investors, have been skinny dipping.