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2011: A year in global equities

Virginie Maisonneuve, Head of Global and International Equities, looks ahead into 2011



2010 has been a year of transition as the developed world painfully rebounds from the abyss and starts to settle into the 'new normal' environment. This is a world in which the developed market continues to slowly deleverage and brings fiscal discipline into an economy with high unemployment and low trend growth. The 'new normal' is also a bipolar world where emerging markets continue to take an increasingly large role in the global economy, supported by global demographic trends.

- This year has been one of transition to the 'new normal' world
- Looking ahead, the outlook for global equities is strong, although short term volatility is to be expected
- Structural adjustments are leading to a new level of equilibrium in the current bipolar world: will the medicine for the ageing developed world become a poison for emerging markets?
- The competitive forces in 2011 will be emerging markets' appreciating currencies and an increase in the relative competitiveness of the US.

Valuations are attractive and companies are in good shape

Looking forward to 2011, what are the opportunities and challenges we face as global investors? While there are clear headwinds, some strong tailwinds are also emerging creating a favourable environment for global markets amid another volatile year. There are several factors supporting global equities over the next 12 to 18 months. First, company shares are attractively priced. For global equities, we are expecting earnings growth of over 16% over the next 12 months and a valuation, as measured by the PE 12 months forward, of only 13x.

Second, the combination of low interest rates and high liquidity levels mean that the case for investors to increase their exposure to equities is compelling. In fact, when considering various asset classes, investors are currently underweight in equities overall, while they have a high exposure to bonds compared to historical norms. We therefore believe that there is room for increased asset allocation into equities.

Third, companies are generally in good shape. Survivors of the crisis are leaner thanks to cost-cutting measures. Many have shed risk-prone management teams, leading to a renewed cautious management style. Overall with profits to GDP at high levels and investment to GDP at low levels, the corporate world is ready to embrace a new wave of growth. This growth will be financed differently from the past given the reluctance of developed market banks to lend in an evolving regulatory framework: companies with strong cash flows will be advantaged.

The global economy remains fragile

We must, however, acknowledge that the global economy is still fragile. Developed economies are continuing to deleverage and with low interest rates and the need for fiscal discipline, scope for economy-boosting policies is limited. Sources of risk in 2011 include the unravelling of the structural issues in peripheral Europe and how it deals with the past excesses of the EU integration process. As we speak, Ireland is going through a painful adjustment and more countries might follow during 2011.

There has been much talk about a potential 'currency war' given the impact of QE2 on the US dollar. Clearly, the US can use its currency as a weapon but it is hard to see who is truly capable of engaging in 'war'. Japan has little room for manoeuvre given its lack of fiscal flexibility and close-to-zero interest rates while Europe may not have the choice of using quantitative easing to weaken its currency either. In fact, the problems of peripheral Europe might weigh heavily on the Euro until Europe's structural issues are 'dealt with'.



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Structural adjustment

A further source of risk in 2011 is the potential impact of QE2 on emerging markets. These economies have done well since the financial crisis compared to their developed market counterparts. Their economies are strong and supported by powerful structural trends.

For some time now, inflationary pressures have built up. Interestingly, we believe China's inflation may be structural as its economic success has increased per capita income noticeably which has in turn spurred diet changes (such as eating more meat and vegetables). This has put pressure on food prices at a time when arable land in China, because of continued urbanisation and to some degree climate change, has not grown. This structural food inflation is compensated by other price weaknesses in the economy, however, so we should not yet fear excessive overall inflation. It will, though, continue to worry its government.

The combination of negative real interest rates in China and the inflow of ‘hot money’ into the country has led it to take a series of rapid moves with interest rates and reserve requirement increases. The potential headwind for the global economy is the fear that China, which was instrumental in helping the global economy during the worst of the downturn, now might over-tighten and ‘ruin the party’.

Regained US competitiveness?

Another interesting area to monitor closely looking forward is US manufacturing which is becoming increasingly competitive. Many companies we talk to anticipate increasing manufacturing bases in the US largely because of cost advantages. The weakness of the dollar and high unemployment has reduced the cost of doing business there. Indeed, many companies believe costs in the US could be half of what they are in Europe.

Three themes shaping the future

Looking longer term, we still believe the key three themes that will continue to forcefully mould the global investment environment are: demographics, climate change and the ‘supercycle’ (or the role of large emerging markets on the global economy).

Looking at demographics, many countries are at tipping point. With labour forces in Europe and China peaking in 2010 and 2015 respectively, the case for reforms will continue to increase while emerging market consumption trends will not abate. This might even lead to further social pressure in Europe in 2011 and reinforce China's goal to promote domestic consumption further.

From a climate change perspective, with global average temperatures through July being the warmest since 1860 and highly disruptive weather patterns in many parts of the world, the theme is likely to be at the forefront of the global agenda once again. Disappointing harvests in Europe, Russia, Australia and parts of North America have sent agricultural commodity prices soaring over the summer. It shouldn't be any surprise, then, that climate change concern has been increasing globally: HSBC's annual global consumer survey showed climate change as the third largest concern after global recession and violence.

The ‘supercycle’ theme has been discussed above and we see the theme as continuing to impact the global environment both from a growth and demand perspective.



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Conclusion

2011 could be a year of crucial global shifts. As the medicine for the weak developed world turns potentially into a mild poison for the emerging market world via appreciating currencies and inflation, the realities of dealing with the 'new normal' in a bipolar world may not be smooth. This will force some structural adjustments and increase our conviction that as investors, we must continue to focus on attractively priced high quality companies with strong earnings growth and a sustainable competitive advantage.

Looking forward, we believe the superior earnings growth will continue to include companies capitalising on emerging markets domestic growth, whether they are listed on emerging market or developed market exchanges. Another strong source of earnings growth, in our opinion, will be in the global commodities and industrial space. We remain cautious of financials, particularly those in developed markets as we see little scope for strong loan growth while capital issues are still key.

We believe that fears of China over tightening given its inflationary pressure will bring short term volatility in the markets but that this headwind is likely to be temporary. It will give investors with a medium term time horizon the ability to accumulate positions at attractive levels. Importantly, understanding the forces impacting the global equilibrium as they unfold in the 'new normal' and how they are linked to the structural adjustments mentioned above is critical.

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