Market outlook

Q2 2011

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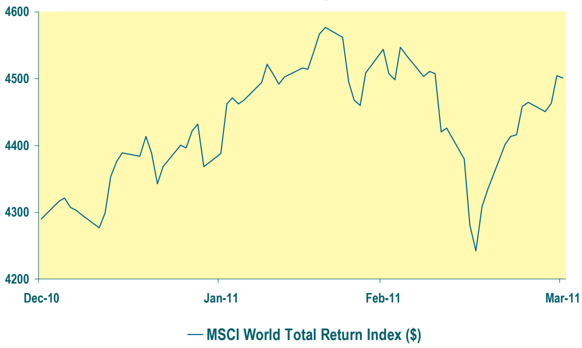
Summary of outlook for the second quarter of 2011

- Market participants appear to be changing their perceptions of risk
- Volatility is likely to persist in all asset classes
- However, there is significant compensation available in selected risk assets

Developments so far in 2011 have not prompted us to change our assessment of long-term valuation signals but there are suggestions that perceptions of risk are shifting among market participants. Crucially, while the risk aversion that has been part of the investment landscape since 2008 is still in evidence, the surprising resilience of global risk assets and the divergence of behaviour across markets suggest that valuation is having a more significant influence on pricing than was the case during the indiscriminate 'risk on/ risk off' environment of 2009 and 2010.

This raises a number of important issues from an asset allocation standpoint.

Risk assets: value 'biting'?



Source: Thomson Datastream as at 31 March 2011

Global equity markets generally appreciated over the first quarter in spite of a background of heightened tensions in North Africa, continued Chinese monetary tightening, Portuguese sovereign debt concerns, and the Japanese earthquake. That these events have not prompted broad declines in equity markets appears to be a sign of value 'biting' – ie, that assets are offering such high levels of compensation for risk that it would take particularly negative outcomes to prompt significant market falls. Indeed, there could well be a meaningful re-rating of risk assets to more neutral levels – and resultant positive return from equity markets – should the environment remain as it is for a sustained period or even positively surprise.

Emerging versus developed markets

An environment in which investors place greater weight upon value is also characterised by greater discrimination on the part of the market in its treatment of assets. Rather than blindly selling anything risky, as tends to be the case when fear grips the market, investors have been more discerning in their responses to newsflow this quarter.

This is reflected in the difference in performance between developed and emerging markets over the period. In our previous outlook we noted the relative attractiveness of the West versus some Asian equity markets, and this appears to have been telling as Western markets performed well while many Asian markets declined (even before the earthquake in Japan). Such is the level of idiosyncrasy that even broad distinctions such as emerging and developed markets have been less relevant; for example, Thai equities were hardly affected by events in Japan.

This diversity is not only in evidence across asset classes, but also within them. Foreign exchange markets have seen a divergence from the trend seen in equities: many emerging market currencies have performed strongly over the period relative to low-yielding Western currencies. Again, our contention is that this is a function of markets not only recognising more attractive yields available in emerging markets but being prepared to back this theme as perceptions of risk have shifted.

How long this trend of independent behaviour will persist is very difficult to judge, and it must always be kept in mind that correlation in risk assets can very easily spike in short-term phases of market stress. However, in our view attractive opportunities exist across and within asset classes at present which potentially offer a high degree of useful diversification from a portfolio-construction perspective.

Growth fears versus corporate dynamics

The risks to global growth at present are well acknowledged; they feature prominently in the popular press, and the brutal reminder of risk that 2008 gave investors still looms large. This is the clearest explanation of why risk assets are attractively valued; investors are seeking more compensation for these risks than they had done prior to 2008.

Against this background however, delivered profits and corporate data continue to surprise positively. Not only does this provide greater comfort in the degree of faith that can be placed in valuation signals, but has also been reflected in Western corporate credit spreads over the period. These have narrowed while displaying far less volatility than equity markets, suggesting that a long period of strong corporate data has allayed fears over default risks.

How safe are 'safe havens'?

Source: Thomson Datastream as at 31 March 2011

Cash and short-dated government bonds continue to look highly unattractive despite short-dated US bonds having sold off over the quarter, as the chart above shows. Investors continue to accept negative real returns in exchange for avoiding the volatility of other assets, a more knowable loss being seen as preferable to uncertainty. Changing perceptions are an important element behind the likely prospective returns of these and other 'safe havens'. Should riskier assets perform well prospectively and the memories of 2008 fade, investors could well be unwilling to continue to accept these negative returns from low-volatility assets, prompting continued sell-offs in 'safe havens' as a result.

Long-dated bonds more attractive than cash

Volatility at the short end has been mirrored across the curve, with US 30-year bonds at points displaying greater volatility than the S&P 500 Index; a reflection of continued confusion in pricing caused by quantitative easing. More generally however, the long end of the yield curve has tended to rally in periods of market stress while not selling off significantly when risk appetite has improved. This has been an attractive property in its own right and has provided useful diversification for a basket of risk assets over the quarter. Such correlation patterns are not static, and the long-term attractiveness of this asset has been reduced by its positive performance in recent months.

Summary

Despite the important developments noted above, little has changed in longer-term valuation signals over the quarter. Positive price moves in global equity markets have failed to keep up with delivered earnings growth in many cases, meaning that selected markets still offer as good, if not better value than they did at the start of the year. Cash and short-dated government bonds on the other hand still offer extremely unattractive returns, in spite of sell-offs at the short end of the yield curve in recent months. Volatility in all assets could well continue to be a feature of the investment landscape in the period ahead; however, our view is that the investor is being well compensated to tolerate such volatility in risk assets given the meaningful upside on offer over the medium term.

M&G International Investments Ltd
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