

Schroders Live reveals European optimism

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The panellists at the latest Schroders Live event struck an optimistic tone as Keith Wade, Chief Economist and Simon Webber, Lead Portfolio Manager of Global and International Equities, found a number of reasons to be upbeat about both growth and equities, especially in Europe.

Among the other topics discussed was the surprise UK election result, the effect of lower energy prices on US growth, the potential impact on financial markets from US interest rate rises and why investors are more positive about emerging markets.

UK: The Conservative effect

From a macroeconomic perspective, Keith Wade pointed out two key likely ramifications of the recent UK election result. The prospect of a European referendum could have “quite a detrimental effect in the short-term” amid uncertainty for businesses about whether or not the UK will stay in the European Union. From a medium-term perspective, he said: “The Conservative government is aiming for a budget surplus by 2020 so that means fiscal policy will be tighter. It also means that growth will probably be a bit slower in the next couple of years and possibly interest rates may be lower than they would have been.”

However, the UK equity market saw “a big relief rally because markets hate uncertainty and that uncertainty has now been reduced”, according to Simon Webber. He believes the election result will boost domestically-oriented stocks as “there will be less noise around the utility, energy and banking sectors”, he said. These are areas that a Labour-led government had promised to focus on, for example by implementing price freezes in the utility sector, which would negatively affect corporate profitability.

On the topic of whether there will be a mass relocation of banking operations overseas in the wake of proposed taxes and tighter regulations, Webber said: “I don’t think it’s a foregone conclusion. I think we’ll see a response from the government in the months ahead to calm things down a bit”.

US: Good growth, poor profitability

Across the Atlantic, Keith Wade believes that the full benefits from lower energy prices are yet to be felt in the US economy. He attributes part of the recent disappointing first quarter growth figure to the shale gas industry which has been cutting back spending aggressively. The “winners” from the oil price shock are consumers and they will take their time to spend the gain they have received. As result, he expects this to take some time to feed through into growth data. He believes that the underlying growth in the economy is still around 2% and that this will pick up further in the second quarter.

Asked about his thoughts on the equity market, Simon Webber responded that the US is not the Global Equity team’s preference. He agreed with Keith Wade that the underlying economy appears in reasonable shape but pointed out that equities are being affected by the strong dollar, which is impacting both competitiveness and earnings. “Valuations and profit margins are quite high. We are also beginning to see wage growth coming through, which is not good for corporate profitability”, he said.

In terms of the macroeconomic effect of the stronger dollar, Keith Wade said, “The stronger dollar is probably weighing on the trade sector. It’s helping to push down inflation so it’s having a deflationary effect, but it’s not really strong enough to derail the overall economy from where it is at the moment.”

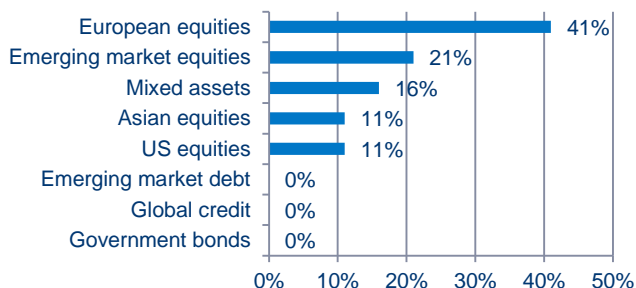
The eurozone’s stars are aligning

Moving onto the eurozone, both panellists found plenty to be optimistic about. “I think that in many ways, the stars are coming into alignment for the eurozone”, said Keith Wade. He pointed to three key factors: the fall in oil prices, further monetary policy easing from the European Central Bank and a more normal banking system which is starting to lend again following the Asset Quality Review of last year. “We are quite confident about the eurozone recovery at the moment”, he said.

From Simon Webber’s perspective, stockmarkets have already priced in a better environment but there are still a number of opportunities. “The domestic recovery clearly helps domestic sectors. You’ve also got export- and tourist-related sectors that are also benefiting from the weaker euro”, he said. He pointed to Germany as a particular beneficiary in the current environment given the proportion of exporters in the country’s stockmarket which stand to gain from better profitability and competitiveness as a result of the weaker euro. He added that “margins are still way below peak levels so there’s also the prospect of a cyclical recovery”.

This positive outlook on the equity market was confirmed by the results of the live audience poll which asked participants where they believe the best investment opportunity lies. The highest proportion of respondents (41%) voted for European equities.

Poll results: Where do you think the best investment opportunity lies today?



Source: Schroders, 19 May 2015

Deflation worries can be put to bed

Another positive development in the eurozone is that deflation risks are fading now, according to Keith Wade. The combination of a stabilisation in energy prices and a depreciation in the euro are helping to reflate the economy. “Going forward, we would expect inflation pick up somewhat as the economy recovers and so I think the deflation worries can be put to bed for now”, he said.

However, the risk of a “Grexit” from the eurozone remains. “We would see it as a fairly short-term issue if Greece left”, Simon Webber said. This is because institutions largely have the right mechanisms in place now to deal with such an event. On the euro itself, Keith Wade expects interest rates to remain low for some time yet, so the search for yield and capital outflows from the eurozone will probably continue. “We think the trend of the euro is still downward”, he said.

Interest rates to shake up equity markets

Looking at the potential impact of rising US interest rates, Simon Webber said, “I believe there will be a very important leadership transition in the equity market. Equities that have just been bought for their dividend yield will come under significant pressure, such as REIT¹s, utilities and some of the consumer staples”. He believes that companies with cyclical opportunities and strong pricing power will be better placed to operate through an environment of rising interest rates.

In terms of the economic impact, Keith Wade said that he expects the first interest rate hike to occur in September and then for rates to be gradually increased into 2016. He sees increased inflationary pressure from the labour market, where wage growth is already picking up, as the primary catalyst for this.

Emerging market optimism

In contrast to the US, the emerging world is seeing interest rate cuts, which Keith pointed out, has been facilitated by lower inflation as a result of depressed energy prices. “The liquidity factor that has been so important for developed markets seems to be having an effect on emerging markets now and it looks like investors are starting to re-focus on asset class again”, he said. This was in response to the results of the poll which showed that 21% of the live audience believe that emerging market equities is the best place for their money.

Simon Webber revealed that his team have been finding more opportunities in emerging markets recently. “Some of these markets’ better fortunes are linked to the currency”, he said. “When the dollar was so strong, it put pressure on commodity prices. There’s a lot of commodity exposure in emerging economies, whether it is Russia, Brazil or Indonesia and they have all suffered. Now we’ve seen a stabilisation in the dollar (or a bit of a fall), and commodity prices have found a floor, there can be a bit more balance brought back to those economies.”

Fixed income out of favour

The poll also unveiled a wariness of fixed income investments and Simon Webber expressed his concerns about those parts of the equity market that have been distorted by the effects of negative bond yields. This is because negative yields make low-paying dividend stocks seem more attractive than they might be in a more normal interest rate environment. “We are looking for genuine growth or cyclical rebound opportunities”, he said.

¹ Real Estate Investment Trusts

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