

Threadneedle thinks

Conference call highlights



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Multi-speed world

We expect global growth to be positive in 2012, both in real and nominal terms (real growth plus inflation). Growth will not, however, be uniform. At one extreme is the emerging world, where economies will continue to grow relatively strongly, albeit at a slower pace than in recent years. At the other end of the spectrum is Europe, where we expect the economy to contract over the year. And in the middle is the US – a surprise in some ways as it is a developed economy, but one that is growing faster than previously feared and enjoying some positive momentum. Indeed, we have recently upgraded our forecast for US growth in 2012.

Asian monetary policy loosening

Policymakers across Asia tightened monetary policy in 2011 in the face of rising inflation. That process achieved its objective – inflation is moving lower, as food prices fall and energy prices compare favourably with a year ago. China is a good example of this. As a result, the People's Bank of China has been able to loosen monetary policy. We expect this to continue in 2012, with interest rates falling and lower reserve requirements for commercial banks. We do not expect a hard landing in Chinese economic growth in 2012. While it may slow from the heady levels of recent years, we still expect growth of 7-8%, a rate that is the envy of Western policymakers.

Chinese growth dynamics to change slowly

An interesting side effect of China's maturing economy will be a slow-but-sure change (perhaps over the next two decades) in the emphasis of the economy – away from a dependence on fixed asset investment towards a consumer-led economy. Investment in infrastructure has been an important driver of growth in the past decade but, as wealth spreads through the economy, consumers will increasingly have the means to increase their spending on discretionary items. We do, however, expect the government to manage this transition to prevent a bubble from forming. This is a key theme in our global portfolios – investing in companies that can benefit from long-term growth in demand for global brands.

Risks to growth are led by Europe

The sovereign debt crisis in Europe is a key risk – for our economic outlook and for sentiment towards global equities. It is possible we will see a default this year. There are lots of important dates, which seem to pass, after which investors move on to the next deadline. Currently this is 20 March, when Greece has to roll over a significant chunk of its debt. Meanwhile, the European Central Bank has been more active in providing liquidity to the banking sector through its LTRO facility – Long Term Refinancing Operation – which is essentially a backdoor approach to quantitative easing and which is providing some breathing space to embattled EU political leaders.

Oil poses a potential risk

Europe is not the only risk on the horizon. There is scope for a shock in the oil market, with Iran and Nigeria providing the main source of concern at present. Offsetting the risk to growth of a potential oil shock is the US natural gas price, which has fallen significantly as a result of new extraction techniques. This latter point is underpinning a revival in the US industrial sector as input costs fall.

The US deficit is a longer-term concern

Europe is leading the way in terms of deficit reduction and austerity. The US also needs to act in this regard, but this is extremely unlikely in an election year – President Obama's focus will remain on creating growth and jobs. Austerity is likely to be more of an issue for 2013 and beyond in the US. The improving trajectory of US growth, however, is good news for the deficit in the meantime.

Valuations support equities

Current pricing in stock markets suggests that investors are factoring in these risks. On our preferred measure of valuation – price to book value – US, European and other developed markets are trading at their lowest levels for 20 years (barring a period in April 2009). Our optimistic outlook is also supported by strong corporate balance sheets – the best in 25 years – and healthy levels of cash flow in most areas of the market. Meanwhile, dividend payout ratios are low when compared with history, and nowhere near the highs of recent years.

Companies to go spending

The implication of low interest rates, low equity valuations and strong balance sheets is that investors can expect mergers and acquisitions, share buybacks and reorganisations that add value. For companies with strong balance sheets, low interest rates mean they can borrow at extremely attractive rates of interest; this is not the case, however, for weaker companies – the ones that arguably have a greater need for financing. As a result, we believe that quality companies with strong balance sheets will prosper in 2012 while those with weaker franchises and/or high levels of debt are likely to struggle.

Opportunities in sustainable growers

With growth in developed markets likely to be low, we look for companies that are able to deliver sustainable earnings progression. In recent days, we have seen several leaders in their markets – Nestlé, McDonald's and Apple – report excellent results, proving that it is possible for good companies to grow their businesses. We have also seen some European companies start to benefit from the weaker euro, though we must be careful to review these on a company-by-company basis. We also see opportunities in Japan, where the yen has come back down from its recent high against the dollar, providing some relief for Japanese exporters.

Overweights in IT, consumer discretionary and Europe

Our largest overweight is in IT, where valuations of technology stocks in the US are remarkably low; Apple, for example, is valued at 10x earnings and growing fast. Our overweight in the consumer discretionary sector focuses on exposure to growth in emerging market consumer demand. Examples here include German car companies and chemicals manufacturers. Meanwhile, our largest regional overweight – Europe ex-UK – is not a function of our outlook for the domestic European economies. Rather it reflects emerging markets exposure, low valuations and the weak euro.

Underweights led by defensives and financials

Meanwhile, the financials sector is, on the face of it, our largest underweight position. However, given the stocks we hold, some of which are typically more volatile than the market, the fund's beta-adjusted underweight is much less significant. Our other significant underweights include telecoms and utilities, which are low growth areas; utilities are also susceptible to government intervention to raise taxes.

Conclusion – challenges and opportunities

In summary, markets continue to face a number of challenges and these are likely to produce further volatility in the coming months. However, recent actions from the European authorities have improved liquidity and sentiment and equity valuations are attractive relative to history and to other assets. Well-managed companies should be able to make money against the low-growth backdrop we are forecasting and this should allow markets to make progress over the course of the year.

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