

INSIGHTS

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Turning Points In 2014



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It is that time of the year when we strategists are expected to step boldly forward, forecasting fearlessly into the future! But look at my photo. I am too old for that. Let us stroll into 2014 and see what turns up.

Four questions are exercising my mind as I think through our options in the coming year. These are:

- ▶ Has 2012/13's income story any steam left?
- ▶ Will the developed economy forecast 2014 recoveries be so strong as to justify today's higher valuations?
- ▶ Are conditions in China (and other cheap Asian markets) so bad as to justify some apparently low valuations?
- ▶ Will 2014 see a switch from expensive Asian "defensives" into attractive Asian "cyclicals". (If you do not know what these are, you soon will).

The elephant in the China shop

"What happens when the US Federal Reserve Board starts tapering?", is a major concern to many. I think we have already glimpsed the answer in 2013's mid-year "Fire Drill". Like many drills, the second often has less impact. In the meantime, the Fed has also done a good job educating investors that "tapering" is not the same as rising interest rates; instead of pumping \$85bn per month into the economy, it might (say) pump \$70bn.

"Free" money is not going away any time soon. The Bank of Japan is also now full steam ahead with its own quantitative easing. When all major central bank capital injections (or otherwise) are added, global liquidity is heading higher; an across-the-board rise in rates is unlikely soon (although economies such as Indonesia and India could raise rates for specific reasons).

Income via bonds or equities?

So, answering my first question, the income story has further to run, it seems. I see the greater issue as being whether one buys an income stream via bonds or high dividend equities.

A major lesson from 2013's fire drill was that bond volatility will rise as an end to low rates approaches. Every bond holder, I think, should ask the question, "Is the return commensurate with the (higher) risk?" If the answer is "No", then one should consider switching into high dividend equity investments; the risk may be higher but so is the potential return.

The bond story is not over. Low US growth has historically been good for US high yields. But I do think bond volatility will rise into 2014. If one is buying bonds, one's focus should be on income not on capital growth.

Can the US and Europe rally further?

With the developed markets having rallied, it is tempting to take profits. Offsetting this urge, are the slowly improving economic data particularly in the US. Clearly one does not want to sell too early. Besides, Fed "tapering" implies a still growing liquidity pool, which should support asset prices.

Valuations, I suspect, hold the answer to this dilemma. They cast our 2014 choices in stark relief. US valuations, for example, are well into "Fair value" territory. But, is the US recovery so strong as to push valuations up to pre-crisis levels? It is possible, but the easy money has long gone.

If we delve deeper, we see that valuations in US sectors exposed to growth (also known as "cyclicals") range from the relatively attractive banks to the outrageously expensive consumer discretionary.

Our options are clearer. US valuations are not flashing "Danger" yet but cracks are there. As long as the economic data improves and the liquidity exists, there are grounds for further rallies. But, the higher valuations rise, the more investors will start looking for reasons to take profits. The European picture is similar.

Both rallies are maturing, but they could go further.

Japan is more than "Abenomics", much more...

"Abenomics" certainly attracted attention in 2014. I am not convinced that it will achieve its stated aims. Its immediate success, in my view, was to refocus attention on what was an attractively valued, but largely overlooked, market.

Many Japanese companies had been restructuring for years, but this fact was seemingly ignored. Debt levels, for example, fell steadily. Many companies are moving into new areas of business and are more efficiently run. It is at the company level that I see opportunity.

Equity valuations remain attractive despite 2013's rally. There still seems to be many companies benefiting from restructuring but still not recognised. If "Abenomics" delivers as promised, this would be the icing on the cake.

My concern is that if investors bought Japan on the basis of "Abenomics", but it only partially delivers, they will depart just as quickly as they arrived. This would be a pity, I think, as Japan's companies have been restructuring irrespective of the politics. **I am a buyer of Japan's stocks not its economy.**

And what do we do about China?

Many investors acknowledge China looks attractive. There are concerns this is a value trap. "Step back from the trees. See the wood", is my counsel.

Valuations, for example, are around the lows of the height of the 2007 crisis, SARS and the peak of the 1997 Asian financial crisis. Can these low valuations be justified? Are conditions in China today that bad? I doubt it.

Fears, today, seem focused on the banking sector as the authorities not only attempt to stamp out the worst excesses of the wealth management products, (Is not heading off a banking crisis good?) but also redirect economic resources away from capital investment and exports towards rising domestic demand (again, surely good for the longer term?)

To me, the higher developed market equity valuations rise, the more attractive China appears; China will snap back at some point, but when? In the interim, one must determine how much of a rise one is prepared to sacrifice in other markets so as to position oneself for potential rallies in China (and other attractive Asian markets). As Japan illustrated, when the rise comes, it can be fast. To be out runs the risk of missing it altogether.

This, of course, is each investor's individual decision. **For me, the switch towards China (how much and when?), is definitely on my 2014 radar.**

2013's headwinds become 2014's tailwinds?

2014's final big call, I think, is when investors will recognise the growing value in Asian cyclicals, that is, those stocks exposed to growth.

Over the past three years, Asian growth fears led investors to abandon these growth focused stocks in favour of those where the underlying demand was more stable.

Utilities, telecom, consumer basics (e.g. food) and healthcare all fall into this category. As Chart 2 illustrates, “defensive” stocks look expensive. The gap between them and the attractive cyclicals is as wide as it was in 2008. When the 2009 rally came, the cyclicals outperformed!

A repeat will be critical to many value investors, including ourselves. After the cyclicals fell in 2011, on the first round of growth fears, many value investors bought these sectors as they looked cheap. But in 2013, when Asian growth fears hit again, investors raced to the already expensive defensives. This rush hurt any value investors with an overweight in the cyclicals.

The tide could be turning. The past few years have been characterised by high Asian growth forecasts being lowered and low developed economy forecasts being raised. This process seems to be running out of steam. In addition, developed market equities then looked attractive; they look less so today.

The bottom line? As Asian growth confidence returns, the stocks best positioned to benefit look attractive.

In a nutshell.

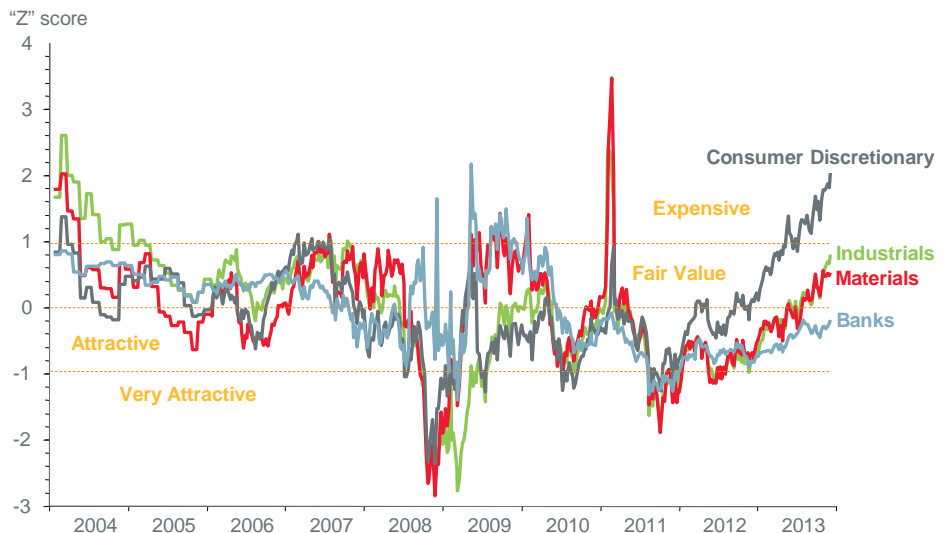
2014 is shaping up to be an interesting year. While the income story can still run further, an increasing exposure to the attractive cyclicals may position an investor well.

Chart 1 : The higher US equities rise, the more attractive China looks



Source : MSCI and IBES and Eastspring Investments (Singapore) Limited from Thomson Reuters Datastream as at 10 December 2013. Note that the "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie. The middle dotted line indicates the 10-year average.

Chart 2 : as US cyclical look increasingly expensive



Source : MSCI and IBES and Eastspring Investments (Singapore) Limited from Thomson Reuters Datastream as at 10 December 2013. Note that the "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie. The middle dotted line indicates the 10-year average.

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