EQUITY

Navigating an Uncertain Second Half

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Receding political anxiety and a gathering economic recovery in Europe helped global equity markets advance in the first half of 2017. Yet Templeton Global Equity Group's Cindy Sweeting and Tony Docal say investors should be somewhat cautious in the second half of the year. They believe rich stock valuations and shifting central bank policies could lead to bouts of volatility.

Global equities advanced solidly during the second quarter, capping a strong first half of 2017 and a similarly strong one-year period. Developed and emerging-market equities benefited from resilient corporate earnings, abundant liquidity and broad growth across most regions and sectors.

In retrospect, the markets' lurch lower in the aftermath of the United Kingdom's Brexit vote one year ago marked the bottoming phase of what had been a challenging and volatile time. It set the stage for a renewed advance in this multi-year bull market.

As we enter the second half of the year, markets now appear to reflect a somewhat cautious, if not uncomfortable, optimism. Experimental central bank monetary policy across the globe has fueled global stock price appreciation, but a dangerous dependency on stimulus to generate ever-higher market returns is a possible side effect. This could present challenges for future equity market performance as major central banks gradually move to normalize extraordinarily supportive policy measures.

In the current environment, we think long-term investors should not buy equities indiscriminately. However, we do see pockets of opportunity in certain markets and sectors across the globe. We believe this is an environment where value discipline and active risk management will be rewarded over the long term.

China's Year of Calm

The Chinese government's recent measures to rein in credit creation and fiscal stimulus while avoiding a major economic slowdown appear to be proceeding steadily. We expect these themes to remain dominant ahead of this fall's 19th National Congress assembly, where President Xi Jinping is likely to further cement his authority.

Nevertheless, we cannot ignore the country's sizable and unresolved credit excesses, the result of an investment boom that led to overcapacity in real estate and industrial sectors. If China's economy slows too much, we believe China is likely to shelve its newer reforms and return to past measures to boost growth.

China's issues are well known. So in large part, we've avoided the vulnerable and opaque banking sector, state-owned enterprises and the oversupplied industrial complex. We see value in companies with underappreciated growth potential, mainly in the health care, insurance and information technology sectors. Certain franchises in the telecom sector where we find a combination of cheap valuation and strong free cash flow also appear attractive to us.

Uncertainty in the United States

Despite the ongoing resiliency of the US economy and equity markets, we have a few concerns.

Investor confidence in President Donald Trump's ability to enact pro-business policies appears to have diminished since last year's election. At this time, it's unclear if his administration's plans to lower taxes or boost infrastructure spending will actually materialize in legislation.

It's also hard to ignore the fact that, after eight years of unconventional Fed stimulus, US stocks are on the second-longest winning streak since World War II. We believe Fed members face challenges as they transition to a more traditional and sustainable monetary policy framework.

In our view, US stocks aren't cheap and do not adequately reflect the political and market risks we see. However, we do see value in select technology, financial and health care stocks, and in the beaten-down energy sector.

It's been a tough year so far for oil, with concerns about excess US inventory among factors driving prices lower. While we believe that current energy market fundamentals justify an oil price of $50 or above, we also note that productivity gains in US shale fields have increased the elasticity of supply from these critical swing producers, a factor that could cap any significant price appreciation. As such, we expect oil prices could stay range-bound in the near term, and we will remain opportunistic at the stock level amid expected price fluctuations.

Europe's Move to Growth

During the past six months, positive economic growth, supportive monetary policy and market-friendly election results have benefited European markets.

Recently elected French President Emmanuel Macron's consolidation of power in the legislature offers opportunities for pro-business reforms. In our view, his plans to loosen labor laws and cut both taxes and spending look promising for the country and the eurozone at large.

Overall, the euro-area economy has been experiencing a broad recovery and transitioning to a multi-year growth cycle. In fact, European GDP growth has outpaced US growth over the past year and corporate profits have been accelerating.

We also see signs that interest rates are moving upward in some countries, with the potential for further increases ahead. Financial stocks, in particular, stand to benefit from higher rates, as well as from the increasing demand for credit in the eurozone. These factors, combined with declining loan losses, more favorable regulations and tighter costs controls are boosting bank earnings growth expectations.

We continue to find attractive opportunities in financial stocks, as well as in the industrials, materials and the energy sectors.

United Kingdom's Political Disarray

The United Kingdom has had a tougher time than broader Europe. Prime Minister Theresa May's grave electoral miscalculation was the latest episode in the unfolding spectacle that is Brexit. After calling early elections, May squandered her Conservative Party's parliamentary majority and breathed new life into the opposition.

Despite the justifiable macro concerns in the United Kingdom, we see value in certain stocks there. With a few exceptions, we favor predominately multinational corporations with sizable overseas revenues. These types of companies, while domiciled in the United Kingdom, should have less exposure to domestic economic pressures.

Indeed, despite noisy political headlines and genuine domestic economic threats, we think the United Kingdom remains a relatively attractive equity market. UK stocks (as measured by the FTSE 100 Index) offer the highest dividend yield of any major region (as measured by the MSCI World Index).[1] UK valuations are the cheapest relative to the rest of the world in 15 years.[2] What's more, FTSE 100 Index companies with more than 70% of their revenues from abroad stand to benefit from the weaker pound.

Opportunities in Emerging Markets

Emerging-market valuations appear attractive when compared with developed markets based on a number of metrics.[3] However, we remain selective stock pickers.

Weakness in the Asian tech cycle, global trade or a more notable slowdown in China's economy could negatively impact equity market returns. A slump in commodity prices and waning US dollar liquidity as the Fed downsizes its balance sheet are two additional risks that could negatively impact emerging market equities.

We've found most of our emerging market bargains in Asia, where we see corporate governance slowly improving. Management teams are engaging more with minority and foreign shareholders. We believe transparency, liquidity and market access are generally moving in the right direction.

Japan is also moving in this direction, but among Asian emerging markets we would point to South Korea as perhaps the best example of the corporate governance improvements and reforms in the Asian region. In our view, newly elected President Moon Jae-in is likely to deliver fiscal stimulus, work to begin to reform the anti-competitive and opaque practices of powerful conglomerates known as "chaebols" and move to normalize economic ties with China. The country's banking sector stands to benefit from this political stability, in addition to economic growth and rising interest rates. Despite these favorable trends, South Korean banks are still trading at undemanding valuations.

Putting it all Together

In our view, corporate earnings and cash flow generation will matter most for equity returns going forward. We remain highly focused on corporate business trends and company fundamentals.

We think central-bank policy will continue to demand market attention in the second half of the year. Over the last several weeks, it has become increasingly evident that many of the world's central banks are looking to wind down the extraordinary monetary stimulus that has supported asset prices since the global financial crisis.

As fundamentally oriented investors, we would welcome a return of policy normalization.

With that in mind, we also think investors should consider preparing for rising volatility following an unusually quiet period for global financial markets. We are most interested in stocks that appear currently undervalued relative to long-term business fundamentals, as well stocks that offer some degree of counter-cyclical or contrarian defensive characteristics should the US-led, central bank-fueled bull market eventually run out of steam.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Value securities may not increase in price as anticipated, or may decline further in value. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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1. Source: JP Morgan Global Equity Research, Equity Strategy: July Chartbook. UK stocks are represented by the FTSE 100 Index. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges. Past performance is no guarantee of future performance.

2. Ibid.

3. Emerging markets represented by the MSCI Emerging Markets Index. Developed markets represented by the MSCI World Index. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.