EQUITY

Could the Rally in Global Equities Keep Rolling?

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Although global equity markets have rallied recently, some investors may feel unsettled about the changes occurring in many parts of the world—and what those changes could mean for their portfolios. While Cindy Sweeting, director of portfolio management, Templeton Global Equity Group, says investors' concerns are well placed, she has found reasons to be optimistic amid the shifting landscape. Join Sweeting for a virtual around-the-world tour where she presents the factors—both the favorable and the foreboding—that she believes may sway stock performance going forward.

A continuation of the rally in equities globally and growing confidence in the forward-earnings power of more economically sensitive value stocks will likely depend on continued improvement in global economic growth and, consequently, improving prospects for profit margins and earnings.

It will also likely depend on a successful transfer of the policy baton from a world where extraordinary monetary measures have been the primary (if not the sole) policy underpinning attempts to reflate the global economy out of the excess leverage, low-investment, low-growth and low-productivity limbo it has been mired in for some time.

As we saw in 2016, interest-rate repression down to zero and into negative-rate territory has had some significant and unintended adverse consequences, which may have exacerbated a deflationary mindset, causing higher savings and lower spending from both consumers and corporates. It has also handicapped the financial sector overall, and the banking sector in particular, to the detriment of both their profitability and their ability and willingness to create credit.

Given that backdrop, we can understand the market's enthusiasm for supportive fiscal policy measures, pro-growth tax reform and a more normal interest-rate environment, which would, in our view, improve corporate confidence and lead to increased investment.

We believe higher investment spending would, in turn, better underpin longer-term global economic prospects, improve weak productivity and bolster both corporate earnings and equity valuations. It's a tall order for such a regime change, but the market so far seems to be enthusiastic about the prospects.

In the United States, market performance going forward will likely depend on President Donald Trump's anticipated pro-growth policies actually coming to fruition. These policies include lower corporate taxes and overall tax reform, infrastructure spending, investment incentives and rollback of regulation, along with a gradual normalization of interest rates from still-low levels. We believe this all would need to occur, however, without detrimental protectionist policies that could potentially dampen growth and invite retaliation.

US stock valuations are not cheap, and the market has been highly anticipatory that pro-growth and reflation policies are right around the corner. So, some pause in the market's level of optimism may be expected.

China: The Deal with Its Debt

Looking internationally, China, in our view, needs to take measures to tackle its corporate debt problems before they become a major drag on sustainable growth in the world’s second-largest economy. Many investors are now aware of the dimensions of China’s debt, which we have noted and analyzed for some time, and the problems it has precipitated.

These include overbuilding in real estate and an overhang of unsold properties, especially in lower-tier cities, along with excess capacity in related industries such as steel, cement and coal.

The combination of heavy borrowing and falling profits and cash flow led to excessive debt loads. This has become evident particularly among state-owned enterprises that benefited from preferential access to financing and implicit government guarantees, which lowered their cost of borrowing and incented them to keep on adding leverage.

Because China’s credit creation comes almost exclusively through the largely state-controlled banking sector, the banking sector bears the problem of non-performing loans that continues to build.

The solution, of course, is not easy or painless. So far, the Chinese government has prioritized growth and jobs over structural reforms to right-size leverage, to limit vulnerabilities in the financial sector and to put the economy on a slower but much more sustainable growth path over the medium and longer term. In the meantime, markets will continue to focus on the government’s ability to stem the declining level of foreign-exchange reserves with its capital-control measures on outflows and balance that with their need to use those reserves to control and steady the currency’s depreciation. So far, China has been able to control a managed decline in the renminbi rather than face a disorderly, sharp decline.

With China’s issues increasingly well known, we are finding that value at the stock level is primarily among what we believe are cheap H-share companies (those domiciled in mainland China but trading on the Hong Kong Stock Exchange or other foreign exchange) operating in consumer-oriented growth industries. We have largely avoided the vulnerable and opaque banking sector, state-owned enterprises and the oversupplied industrial complex.

Europe: Earnings over Elections?

In Europe, we believe earnings and not elections could actually be the key driver of equities going forward. After stagnating for a multi-year period, we believe earnings and profit margins are poised to improve. In particular, we assess that companies in Europe appear well-positioned to benefit from a global economic reflation, given their high operational leverage, a relatively weak currency, below-trend margins and profitability and low-starting-point valuations.

That being said, the political and geopolitical backdrop will offer no respite for the European Union (EU), and the euro project seems likely to face tests. The year ahead will see fragile negotiations begin over the United Kingdom’s departure from the EU (“Brexit”), the need for Greek debt and Italian non-performing loan resolution, and ongoing worries over terrorism, migration and relations with Turkey and Russia, which are on tender ground.

This all coincides with a busy election calendar in core and southern Europe that has the potential to cause market disruptions. Probably the biggest single risk we see for Europe this year would be a Marine Le Pen victory in France. While we assign a fairly low probability to this outcome, as does the current consensus, we recall, of course, that the base-case consensus was also that Brexit would not occur and that Donald Trump would not win the US presidential election.

Although political risks are real, we believe that the ultimate outcomes could actually be more benign than the market is currently pricing in. But we do realistically expect that equity-risk premiums will likely remain elevated until the French and German elections are behind us.

During 2016, economic indicators in Europe steadily improved with little fanfare, and the European Central Bank has evolved into a much more credible backstop for the banking and financial system. While the economic outlook still depends in large part on what the rest of the world does, we believe growth in Europe is now actually decent, loan growth is positive, inflation is picking up, fiscal austerity has been shelved in favor of modest stimulus and the region is on pretty sound economic footing. All in all, it's a solidly different economic backdrop for Europe than at the beginning of 2016, when deflationary fear ruled.

Emerging Markets: A Potential Change in Trade Winds

Overall in emerging markets, we continue to remain selective stock-pickers. While the strong dollar has been a headwind and global trade has been sluggish, medium-term fundamentals have improved along with China's economy and the recovery in commodity prices, and we believe valuations are relatively attractive.

On the flip side, the recent shift in political control in the United States has certainly increased the risk of potential policy changes related to trade. In particular, given Asia's high-trade dependency and its significant participation in regional and global supply chains, it would likely be one of the most impacted regions, given that Asia accounts for a significant percentage of the US-goods trade deficit. So, investors need to be aware of the possible implications of any potential changes in US trade policy on Asia, and then the potential response from Asia policymakers, especially China.

While prognosticating is an interesting diversion, the reality is we don't yet have a great (or even a good) map of what may occur on the policy front. Things could happen that could radically change the course of events, as we now have an environment where politicians and electorates are making decisions, the landscape is shifting and markets have moved already in anticipation of pro-growth and reflation policies.

If a policy-driven boost to growth doesn't materialize, the markets, which have moved on the possibility of real change, could reverse just as fast. In this environment of uncertainty as to exactly what new policies will unfold and the timing of when they will unfold, we plan to keep a good focus on both valuation anchors and a sense of realism about potential policy impacts.

The main risk for the year ahead—and there are always risks—may be that a lot of good news has been anticipated and priced in. However, the main opportunity is that if we are correct in where we are assessing better-than-expected earnings growth—earnings growth which has been hard to come by in many regions and sectors for a number of quarters—that could be the real positive outcome that would propel value stocks and, indeed, overall markets further as 2017 unfolds.

What Are the Risks?

All investments involve risks, including possible loss of principal. 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. 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.