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2010: A year in global equities

Virginie Maisonneuve, Head of Global and International Equities, looks ahead to 2010



- The near-term outlook should be favourable for global equities. The medium-term environment should provide us with buying opportunities as volatility picks up in light of uncertainties around banking regulations and the withdrawal from quantitative easing
- Investors need to consider how the global financial crisis has impacted companies around the world and the environment in which they operate. Shifts in the dynamics of global competition will, in particular, have a lasting impact
- Long-term structural growth trends including global climate change, demographics and the super-cycle will continue to present compelling opportunities.

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Although markets have rebounded sharply since the lows of March 2009, “things still aren’t quite what they used to be”. Looking forward to 2010, we need to consider how the environment in which companies operate might change as a result of the crisis. An awareness of the long-term trends shaping the global economy also remains, in our view, essential to successful stockpicking.

A tale of two realities

Governments around the world have responded to the crisis with unprecedented synchronised injections of liquidity and ultra-loose monetary policy. Abundant liquidity and, in many cases, historically low interest rates have created an extremely supportive environment for equities.

Moreover, the impact of inventories on economic growth could be quite positive going forward as the end of destocking flatters GDP growth (although we are not seeing yet any restocking movement).

Recent company results have also been encouraging – another supportive factor for equities. Companies have cut costs dramatically over the last twelve months and, as a result, currently find themselves in a ‘sweet spot’ – provided we see an improvement or stabilisation in final demand.

Furthermore, although investors have made significant steps to unwinding the abnormally high cash positions created at the height of the crisis, we believe that most are still underinvested in equities versus cash or bonds.

This all suggests a favourable short-term environment for global equities. However, the medium-term view is less clear cut.

Firstly, the future face of banking regulation remains uncertain. Governments and regulators, particularly in Europe, are still grappling with a wide range of issues across the banking sector. Recent events – such as the announced break-up of ING, which was mandated by the EC – have created some confusion amongst investors with regard to long-term plans and rationale.

The potential medium-term ramifications of actions taken by governments in the developed world to counteract the crisis are also a concern. Governments have leveraged themselves in order to alleviate the impact of the unravelling of consumer and corporate debt and unravelling this leverage in a slower growth environment will take time. Moreover, as demographic challenges increase over the coming years, government balance sheets will be placed under further strain.

Most crucially, nobody can tell how the world will respond as government and central banks withdraw from the policies implemented over the course of the crisis. The timing of the withdrawal of fiscal stimulus (such as quantitative easing) will require careful handling – there is plenty of room for error in this exit strategy. Governments are faced with a tricky dilemma: too late an exit from loose monetary policy could have long lasting consequences, including a potential resurgence of inflationary pressures. On the other hand, a premature return to tightening could create even greater problems (à la Japan in the 1990s).

So far, the only countries to raise rates have been those that were not in ‘the eye of the storm’ (like Australia), however, it is only natural to assume that others will soon follow suit. A gradual withdrawal of stimulus in countries like China has already started. This is encouraging as a measured withdrawal of stimulus from those countries will help to



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alleviate the potential impact of a “late” exit from extraordinary policy by other countries (should that be the case).

Finally, another factor which could cause market volatility is the level and shape of demand post March 2010. While many expect a sharp recovery in demand, I am more sanguine, especially where consumer demand from developed markets is concerned.

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Behind the turmoil: financial crisis and structural shifts

The impact of government intervention has varied by country and company type. Countries with “less sophisticated” financial systems – such as India, China and Brazil – have had a relatively ‘good crisis’ and are well-positioned to weather the implications of withdrawing stimulus.

More generally, developing economies – and global companies selling to those emerging market economies – are likely to emerge from this crisis in far better shape. Indeed, the crisis has served to underline the growing importance of emerging markets to global economic growth – on a Purchasing Power Parity basis, emerging markets currently represent approximately 50% of global GDP. With Chinese and US money supply now at similar levels and the Chinese car market overtaking that of the US, conventional wisdom needs to be stress tested. This is why we continue to focus on identifying successful global companies that can access emerging market growth.

The crisis has resulted in another important structural shift. While liquidity is currently abundant throughout the world, different companies’ access to this liquidity can vary. While cheap capital was accessible by most corporations in the pre-crisis environment, the post-crisis ‘new world order’ no longer grants all companies the same opportunities. We believe that, while final demand remains uncertain, this may ultimately lead to some less competitive companies, wherever they are located, faltering faster than they might have done pre-crisis. The stockmarkets have in the most recent past “fulfilled the banker’s” role as many companies have been able to raise capital via placements or IPOs. The thirst for equities following the shift in sentiment since March has favoured such actions. The question now is – how long will this last?

Currency movements over the last twelve months have also had an impact on relative competitiveness. The US dollar, for example, has fallen sharply against the Australian dollar (-32%), the Brazilian real (-23%), the euro (-17%) and the yen (-10%). This weakness in the US dollar – combined with intensive company cost-cutting – may result in the US gaining competitiveness versus Japan or Continental Europe in the global game.

Three key trends: Climate Change, Demographics and the Super-Cycle

Looking beyond the financial crisis and its global structural impact, there are three key long-term trends that are continuing to shape tomorrow’s operating environment for companies: climate change, demographics and the super-cycle.

Global climate change

While the general lack of credit availability in 2008 had an adverse effect on the ability of companies to finance some long-term development projects, overall the crisis had a, perhaps surprisingly, positive impact on climate change investment. Interestingly, the combination of the global financial crisis and the globalisation of the climate change challenges has led to the stronger recognition of the role of the G20 from the G7. We view this as a positive move.

Moreover, most of the economic stimulus packages announced over the past year have included substantial investment in green initiatives. China currently appears to be making the fastest progress with its plans – partly because of the speed with which it was able to implement them – and we expect that the pace of the US and European initiatives will increase over the coming months.

World leaders are due to meet in December at a UN conference to agree a strategy to reduce greenhouse gas emissions. While it looks unlikely that a final treaty will be agreed by the end of the year, the significance of the eventual outcome of this process cannot be underestimated. In our view, this may mark the start of a wide-reaching shift toward a low carbon economy.

This all bodes well for the importance of climate change as an investment theme in 2010 and beyond.



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Head of Global and International Equities

Virginie has 22 years of investment experience and joined Schroders in 2004.

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Demographics

Demographics is another key long-term theme. The world’s population is set to increase by 50% in the next 40 years, with almost all of that growth coming from emerging markets. The proportion of people of retirement age will increase in Western economies, with Japan showing the most dramatic trend. By contrast, India will enjoy a demographic boost as a large group of the populace enters the most economically active period of their lives. Urbanisation will continue as governments encourage people to move to cities in a bid to support economic growth.

These demographic trends will present opportunities for companies in a wide range of industries, including healthcare, financial services, infrastructure and age-related lifestyle activities. A rising middle class will present attractive opportunities for global companies to compensate for weaker demand in mature home markets. We also expect to see a marked change in consumption patterns as disposable income grows, with proportionally less spent on basics and more on discretionary goods and services, as well as convenience foods.

In the ageing world, governments will be faced with the complex task of counteracting structural labour growth decline and its potential negative impact on economic growth. This will demand the promotion of an innovative policy framework to encourage growth in productivity.

Super-cycle

Emerging markets, especially China, India, and key Latin American countries such as Brazil, entered the financial crisis in much better shape than the West. As such, these countries were able to support their economies by increasing infrastructure spending. The outlook for spending has strengthened over the last year, with governments outlining plans to develop climate-related projects such as wind farms, power grids and rail networks. Urbanisation trends will also feed through to increased requirements for construction and infrastructure. These projects will all drive demand for energy and materials, underpinning companies in those sectors, wherever they are located in the world.

What impact do these trends have on investors?

While most of the headlines over the next year are likely to focus on short-term ‘market noise’, investors who can look beyond this to the long-term will be rewarded as short-term volatility presents opportunities to increase exposure to quality companies at attractive valuations.

Understanding how companies’ earnings can be affected by the challenges and opportunities presented by long-term structural trends, is essential when analysing their operating environment. Awareness of the potential long-term implications of these trends enables us to distinguish strong leadership and management teams with vision and to find those companies that are best positioned to deliver strong long-term earnings growth.