Outlook on **Global Equity Income**

APR
2018

Summary

- The last extended period of outperformance by value over other styles was between 2002 and 2007, and there are increasing similarities between that period and the current environment
- Current conditions—including volatility spikes and shifts in investor sentiment—are consistent with a change in market leadership and a return to a more fundamentally driven market environment
- We anticipate a stronger global rotation away from growth stocks toward more attractively valued companies

Global equity markets rose sharply in January, driven by robust flows into retail mutual funds and exchange-traded funds. However, the rally was interrupted in mid-February by a spike in volatility, driven by increasing signs of rising inflationary pressures. This in turn triggered an indiscriminate sell-off as systematic investors reduced risk, in response to the change in market volatility. The first quarter was in sharp contrast to 2017, when financial markets were remarkably stable and volatility remained at historical lows.

Global interest rates and inflation expectations rose steadily, before stabilising midway through the first quarter of this year, driven by signs of continued synchronised global growth and as macro sentiment was further boosted by US tax cuts and government spending increases. More cyclical emerging markets materially outperformed developed markets, driven by strength in Brazil and Russia. The technology and consumer discretionary sectors outperformed, the latter driven by gains in online retailers, while interest rate sensitive "bond proxy" sectors, such as consumer staples, telecoms and real estate, struggled.

Cyclical value stocks typically perform well when inflation is close to historic averages. The deflationary environment that has persisted since the global financial crisis has been challenging for value stocks and beneficial for growth stocks. Using artificially depressed interest rates to discount the future earnings of growth stocks materially increases their appropriate valuation. In addition, a deflationary environment reduces companies' pricing power and investors begin to chase a shrinking pool of high quality companies, despite stretched valuations.

Since interest rates and inflation expectations began rising in mid-2016, value indices have outperformed in developed markets outside the United States, while the growth style has remained dominant in emerging markets and the United States. We believe this is due to continued enthusiasm for leading internet businesses such as Tencent in emerging markets and Amazon in the United States. Both stocks are prominent components of growth indices.

Despite this, we believe that as companies' pricing power expands globally and as future earnings are discounted against materially higher interest rates, a global rotation toward more attractively valued companies is likely to unfold. Volatility spikes, as experienced in February, often coincide with a change in market leadership. Meanwhile, Facebook is under scrutiny regarding the use of user data, a development that could lead to a shift in investor sentiment on secular growth stocks by highlighting the significant regulatory risk.

The increase in volatility during the first quarter of 2018 led to heightened concerns over the sustainability of the global economic recovery, with the term "late cycle" being used by investors with greater frequency. While the duration of the recovery is indeed extended—having started nearly nine years ago in the aftermath of the global financial crisis—the magnitude of the economic recovery has been lackluster, with cumulative global growth well below that of typical recoveries. In addition, until recently, the recovery has been very disjointed, both regionally and by sector. For instance, while the US economy has steadily expanded since the global financial crisis, the euro zone endured a second recession owing to the European sovereign debt crisis, which has meant that the European economy is at an earlier stage in its economic cycle, compared to other regions. Meanwhile, Japanese growth has been choppy at best in recent years. In terms of sectors, the global industrial sector was in recession towards the end of 2014 and in 2015, as the collapse in the oil price triggered a significant downturn in capital expenditure. In fact, the global economy has only truly been in a synchronised recovery over the past 18 months, with all major regions and sectors participating.

In a late cycle environment, one would expect to see factories operating at peak rates to meet demand, with a tight labour market and rapidly rising wages. However, even in the United States, one of the few economies that can be credibly viewed as being late cycle, capacity utilisation has risen from approximately 75% to 78% in the past year, but remains comfortably below levels where utilisation rates have historically peaked[1]. While the US labour market has tightened—with unemployment at 4%—wage growth has persistently remained lackluster. An economic cycle is typically brought to an end by aggressive monetary tightening, as global central banks attempt to stem rapidly rising inflation. While inflation does appear to be rising closer to historic levels, there are few signs to suggest that it requires an aggressive monetary policy response. As such, we believe that the global economic recovery, while relatively sluggish and underwhelming, could persist for longer than many investors currently believe.

The last extended period when value outperformed other styles was between 2002 and 2007 and we would note that there are increasing similarities between that period and the current environment. Both periods were characterised by accelerating global economies, broad-based strength in corporate earnings and positive revisions to future earnings expectations. Both periods saw inflation rates rebounding from very depressed levels to levels consistent with historic averages. The US dollar was very weak in 2002, weighed down by the rising US federal budget and trade deficits. Since the end of 2016, the US dollar has fallen 12%, also driven by an expanding US budget and trade deficits. Protectionist measures during both periods illustrates another similarity. US President Donald Trump's trade tariffs echo George Bush's tariffs on imported steel in 2002. While it is surprising that the trough in interest rates in mid-2016 has not driven a more forceful rotation into value, we believe trends in the global economy support such an adjustment, and the strategy is well positioned for a shift to a more fundamentally driven market environment.

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Notes

1 Source: Board of Governors of the Federal Reserve System, as at 28 February 2018