M&G Multi Asset team

Market outlook

November 2014

Fund manager - Steven Andrew

In our last update in July, we noted that many commentators were concerned about the positive returns seen across most major assets since the start of the year. Since then, equities have sold off sharply and market commentators are looking for plausible explanations. In our view, in the absence of any material change to the fundamental global economic picture, the facts broadly remain very supportive of equities over the longer term.

What has really changed?

As the final quarter of 2014 gets under way, in terms of financial markets at least, we find ourselves in a very different place to this time last year. By the beginning of the fourth quarter of 2013, mainstream government bonds had been selling off sharply over that summer's 'taper tantrum'. Meanwhile, most commentators seemed to be predicting a strong run for equities into the new year on the back of steadily improving global growth prospects.

Twelve months later, markets are facing in the opposite direction – in recent weeks bonds have been rallying, back to their pre-tapering levels, and equities have experienced a painful bout of volatility (see figures 1 and 2).

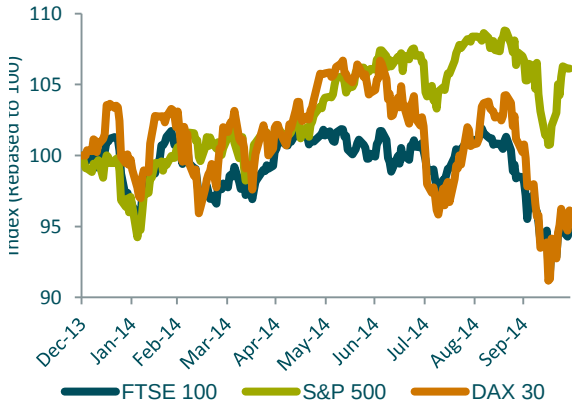
At this stage, it is important to carefully assess what has really changed. In the M&G Multi Asset team, we believe it is vital to look at the facts and ask what, if anything, is different about the fundamental picture, as this is what should inform our investment views.

The first observation to make is that the two key factors that, this time last year, were being touted as the likely major drivers of asset pricing over the following months, did indeed come to pass:

- Over the past 12 months, we have continued to see indications of gradual global economic growth (albeit with significant regional dispersion and some volatility in the short-term data), and
- The US Federal Reserve (Fed) did indeed embark on 'tapering' of quantitative easing, pretty much as planned.

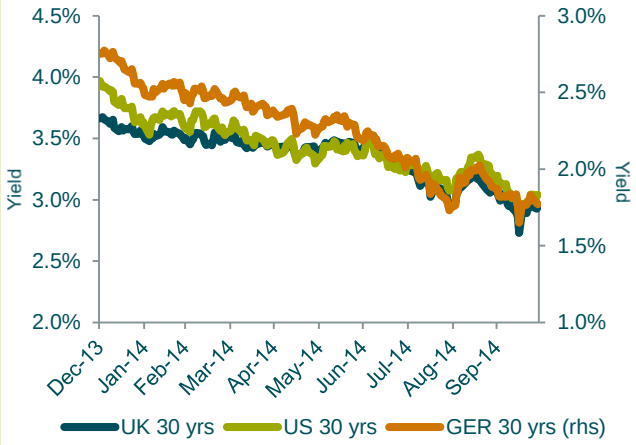
Overall, we remain in an environment in which economies are still broadly expanding, although to varying degrees. Also, despite tapering, global policy makers across the developed world remain very accommodative. As such, we think it seems to be sentiment and beliefs – rather than the facts – that have really changed.

Figure 1. Recent volatility within equity markets



Source: M&G, Bloomberg, as at 28 October 2014.

Figure 2. A strong rally for sovereign bonds



Source: M&G, Bloomberg, as at 28 October 2014.

A look at the facts

When we experience price falls, it can be easy to get gloomy. Certainly, there has been plenty to worry about recently – European or Chinese growth prospects, geopolitical tensions, even the spread of Ebola or unusual weather – and market commentators have variously fixed on these and any number of other

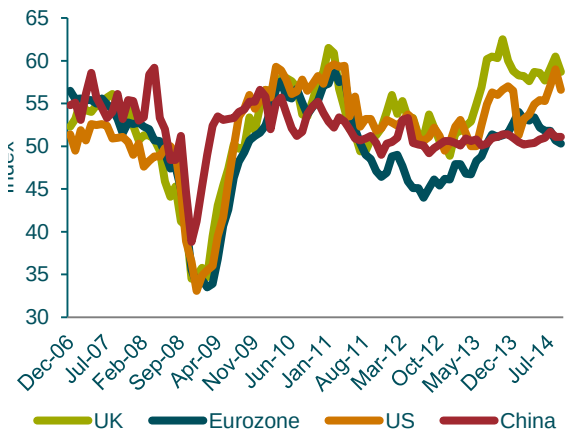
issues to try and explain recent aggressive declines across equity markets. But to us, a lot of this sounds quite 'noisy', especially as longer term pessimism is not really supported by the facts. Yes, there are still some very real challenges to economic recovery, particularly in the eurozone. However, we actually think it is quite easy to draw a great deal of comfort, even optimism, from looking at some of the broader trends in global indicators.

While unemployment remains high in much of the world, there are signs of labour market improvement, particularly in places such as the US, which seems to be having a positive effect on real incomes and subsequently, the underlying demand picture – as evidenced by indicators such as the Purchasing Managers' Indices (see figure 3).

Meanwhile, falling energy prices (such as recent sharp declines in the oil price) also have a positive effect on real incomes. This is more important, in our view, than factors that often grab attention, such as so-called 'expert' forecasts and policy moves. This is because genuine economic growth will most likely come from people feeling positive enough about their own personal finances, so they start spending and investing rather than just paying down debt.

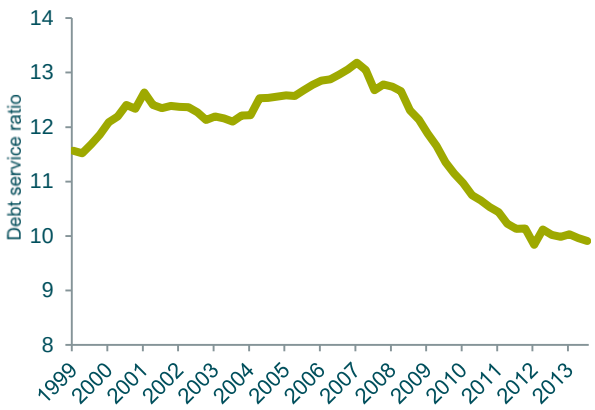
Low interest rates also have a positive effect on real incomes. Consumers are having to put aside less money than ever to service their debt on a month-by-month basis. Debt service ratios in the US for the household sector are lower now than they have ever been (see figure 4). To us, all of this suggests that the prospects for global growth are improving rather than deteriorating.

Figure 3. Global PMIs



Source: M&G, Bloomberg, as at 28 October 2014.

Figure 4. An easing debt burden on US consumers



Compelling opportunities in equities

In a phase such as this, when price behaviour is at odds with the facts, we believe compelling investment opportunities often arise. For some time, our strongest conviction has been in the attractiveness of selected global equity markets, based on the observation that for much of the period since 2008, overly fearful market sentiment has undervalued these assets.

In our view, there has been no material change to the broad global macroeconomic picture recently, which still shows evidence of gradual economic improvement and supportive policy for much of the world. As such, we maintain our belief that the medium-term outlook for equities, as well as maybe parts of credit markets, is still very positive.

Meanwhile, mainstream government bonds are once more looking somewhat dangerously overvalued in the main. Therefore, over recent months, we have been scaling back mainstream government bond exposure in most of our portfolios, and happily increasing equity exposure, especially through this most recent phase of volatility in which the market has offered us these already attractively valued assets at even more discounted prices.

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