MID-YEAR OUTLOOK 2015

US markets to reassert leadership

Investors have two main concerns about the prospects for the US equity markets – earnings and valuations – but neither of these is likely to bring an end to the six-year-old bull market yet.

In fact, the outlook for the second half of the year and 2016 is positive, and the US will reassert its leadership among global equity markets on its dominance in intellectual property sectors and a favourable outlook for interest rates.

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FIRST-HALF EARNINGS PRESSURES WILL PROVE TEMPORARY

There is no denying that US company earnings were down considerably in the last quarter of 2014 and the first quarter of 2015, falling in many instances by 20% or even 30%. However, I expect earnings growth to recover as the year progresses, lasting into 2016.

The main culprit for the fall in earnings was the country's large energy sector, where profitability was badly affected by the 2014 oil price collapse. However, the benefits of these lower energy prices on the wider economy will only emerge in the second half of the year, led by higher consumer spending on discretionary and staple items.

Dollar strength has also weighed on earnings of companies that have sizeable businesses abroad, for which profits are recorded in foreign currencies and are therefore worth less in dollars as the dollar rises. Large-cap companies derive a much greater share of their revenue from abroad than smaller US businesses, meaning that leading equity indices like the S&P 500 are disproportionately affected compared to, for example, small-cap indices. If the dollar continued to strengthen throughout the year, we would see further earnings adjustments, but I think this trend has now run its course.

VALUATIONS ARE NOT STRETCHED

I am also not concerned that US equity market valuations are overly stretched. For one, interest rates are low and will remain so, both in nominal and in real terms. This will be the case even when the US Federal Reserve starts normalising rates, as rate hikes will be small and very gradual.

Secondly, healthy dividend yields and earnings growth will enable equity markets to make further progress, as equity valuations are not expensive compared to other asset classes. Combined equity returns in high single digits will compare favourably to very low yields for bonds.

US EQUITY MARKETS TO MAINTAIN GLOBAL LEADERSHIP

While the last bull run was fuelled by emerging, energy and commodity markets, the current bull run is driven by growth in intellectual property sectors such as IT, biotechnology and media and entertainment. This theme of intellectual property will continue to take markets higher. As these sectors are most dominant in the US, it is no surprise that US markets have led the global equity market rally.

Many investors shifted into Europe at the start of 2015, confident that the euro's slide to US$1.10 from about US$1.40 a year earlier would boost growth. But this allocation shift has now completed and I fully expect the US equity market's leadership to reassert itself in the second half of 2015.

RISKS: CHINA AND GEOPOLITICS

I believe that the Chinese authorities will be successful in engineering a soft landing for their economy; but if the economy were to take an unexpected turn for the worse, global equity markets could be negatively affected. Any flare-up in geopolitical tensions, especially in the Middle East and Russia/Ukraine, should also be monitored closely.

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MID-YEAR OUTLOOK 2015

Tailwinds to boost global growth

Easy monetary policy and low commodity prices will support global economic growth in the second half of the year, with the eurozone particularly benefitting from a weak euro and supportive fiscal policies. In the coming months, global growth will start to look more synchronised. In the US, the Fed is unlikely to hike rates until December, or even 2016, due to a lack of inflation and wage pressures, uncertainty around the strength of the consumer and the drag from the stronger dollar. The key sources of risks to the global outlook are Greece, the conflict between Russia and Ukraine and any significant slowdown in the US.

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TAILWINDS TO REINVIGORATE GLOBAL GROWTH

In recent months, two strong global growth tailwinds have emerged in the form of lower energy prices and easier monetary policy. This is a powerful combination that is boosting consumption and stimulating activity globally, which I expect to start feeding through more visibly into global growth in the second half of the year. At the same time, there is little indication of rising inflationary pressure anywhere, which will allow more room for monetary accommodation (or a delay of policy normalisation in the US) than markets had envisaged previously. As a result, I expect overall global growth to strengthen in an increasingly synchronised manner.

The recovery in the euro area should pick up pace and broaden out during the year, helped by the global tailwinds but also by the weaker euro and the smaller fiscal drag relative to previous years. Like Europe, Japan is a big beneficiary of the favourable global backdrop so further improvement lies ahead for the economy. In the US, after some initial softening in the first half of 2015, I expect the economy to accelerate again to above trend growth, although the strong dollar drag will continue weighing on exports and company earnings. Emerging markets economies will continue on their differentiated paths, with the best prospects for central and eastern Europe and Asia, which should also be the most resilient to rising interest rates in the US.

FIRST FED RATE HIKE NOT UNTIL END OF 2015 OR 2016

In the US, as the weather-related disruptions of the winter and the energy sector adjustments start to fade, all hopes are pinned on consumers who initially saved the income windfall from lower energy prices. Historically US consumers have been responsive to changes in oil prices, but there is some uncertainty as to whether the financial crisis signified a structural shift in consumer behaviour. However, given high consumer confidence readings and the relative strength of the labour market, household spending seems likely to recover – although when it does, inflation and wage growth will rise only gradually. The Fed will therefore wait for definitive signs of accelerating household spending over the next few months and then tread carefully. Importantly, given the widening monetary policy differential between the US and other major economies, a stronger dollar will remain a drag on exports and inflation. In my view, this means that the Fed will be able to keep rates lower for longer, acting only in December with the risks skewed towards 2016.

GREECE, GEOPOLITICS AND THE US OUTLOOK WARRANT ATTENTION

The key potential sources of disruption for the global economy are the situation in Greece and the conflict between Russia and Ukraine, although the degree of uncertainty about both is very high. A slowdown in economic growth in the US would also hold back the global recovery; but on balance, this might not be too negative for the rest of the world as it would likely push out the timeline for the Fed's monetary tightening.

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PERSPECTIVES

MID-YEAR OUTLOOK 2015

Europe: A reversal of fortune

The strong market rally early in 2015 was unusual but European equities still have further upside potential. Investor expectations and positioning point to a well-supported market and corporate earnings are likely to surprise on the upside. The market's modest earnings expectations do not reflect the opportunities created by the more competitive euro, ongoing corporate renewal activity, and lower cost and input prices.

HEALTHY OUTLOOK FOR EQUITIES

Investor interest in Europe surged at the start of 2015, leading to gains of more than 20% in some markets in just a few months. The rally was fuelled by the inauguration of quantitative easing (QE) in the eurozone, boosting expectations that the European economy is on the turn. Although the 20% increase in some markets amounted to no more than 8%-10% when adjusted in US dollar terms, the market's performance was exceptional, raising questions about its sustainability. Yet while the magnitude of those early gains may not be repeated and investor's initial enthusiasm about QE may ebb, a combination of investor positioning, market expectations and economic tailwinds nonetheless points to further equity market gains during the remainder of 2015.

INVESTOR POSITIONING IS SUPPORTIVE

Although some positions have been closed, the average investor remains underweight European equities and European markets are far from bubble territory or the point of euphoria. The earlier surge this year was powered as much by fear as by greed, represented in market leadership: the strongest stocks in the market are companies that are generally regarded as highly conservative. These companies have high and predictable dividend yields or very visible organic growth, and their stocks have seen a significant re-rating over the recent past. In other words, the market is paying a premium for low volatility, leaving a greater economic rent on offer for those who are prepared to take on that volatility that other people do not want. Valuations can be suppressed, for example, for otherwise solid companies with strong franchises and healthy economic prospects that are dealing with short-term operational or management issues. Still reeling from previous episodes of misplaced hope in corporate revival, investors have also scaled back their expectations for corporate earnings growth substantially. Earnings forecasts are now considerably lower than they were at the start of 2014 and at the start of 2013. At about 6%-8%, they are well below the global average and significantly lower than for the US.

POSITIVE CORPORATE EARNINGS SURPRISES LIKELY

There are in fact good reasons to believe that earnings in the European corporate sector will surprise on the upside. For one, the weaker euro acts as a tailwind to corporate earnings growth, given that the majority of revenues and profits for European companies is earned outside of the eurozone. This has an immediate translational benefit when these earnings come in, but in due course companies will also benefit from their strengthened international competitive positioning , which will help them gain market share and enhance their profitability. Second, European companies are in the middle of an upturn in corporate activity, something that started fully 12 to 18 months ago with growing M&A, market repositioning and corporate renewal. Investors are yet to see the positive impact on earnings of the many deals that were concluded during this period, and those that are likely to be done over the coming quarters. And last but not least, European companies stand to benefit from lower cost and input prices throughout the rest of this year. In certain markets, labour costs have been falling, but key input costs such as energy and other commodity prices have also declined, supporting margins and earnings growth.

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