Video Transcript

CIO Virtual Roundtable | Top Questions from Our Clients – June 2024

Tapping into Global Earnings Power

Willem:
Hello everyone and welcome to our second edition of the CIO Virtual Roundtable where I bring together the four regional CIOs from the Americas, EMEA, the UK and Asia to tap into their expertise and to answer the clients questions that we have had during our Asia Investment Outlook Roadshow and our discussions on the Investment Outlook around the world.
So, today we are going to cover the following areas.
Firstly, broadening of the global cyclical momentum and what it means for markets with the US being quite resilient. But the question whether the US stocks can continue to outperform. There are diversification opportunities in Europe, Japan and Asia, which we will discuss.
We'll talk about the prospect for bond yields and of course the US election and what it means for markets.
So if I were to summarise client sentiment that we have encountered over the last few weeks, clients are relatively optimistic. Almost no one is talking about the prospect of recessions in the US or around the world. The feeling is that China has bottomed and of course the Fed has also helped because by saying that there won't be a rate hike but only rate cuts going forward that has increased the optimism in the bond markets.
Now, last week we conducted a LinkedIn poll where we asked people what will drive markets over the next few months. And the main driver will still be central banks according to people. Followed by earnings growth driven to a large extent by the technology sector, it seems here which has been the case and may continue to be the case indeed in the future. There is a low score for belief in the Chinese growth pick up. That's interesting in itself. So I'm sure that we will discuss this.
Fan, in terms of client questions, though, is my summary correct?
Is there anything else that clients are raising with you?

Fan:
Hi Willem, I want to echo your observation that clients in Asia generally expect China's recovery path would remain uneven and the property market challenge will need to take a longer time to resolve. Clients in the region expressed strong interest in growth, opportunities in the equity market especially the AI related themes.
But clients are now getting a bit nervous after the strong rally of the US stocks which have hit new record highs in recent weeks. Clients wonder if the global equity bull run can sustain as the valuations have priced in high expectations.

Willem:
And Jose, anything to add from your side? Any other clients questions that you get?

Jose:
Sure, clients are concerned about valuations in US equity markets, understandably. Well, they have expanded. Remember, the leading companies in this bull market are making money. So we don’t think valuations will exceed prior bull market highs.
In terms of fixed income, we're clearly at a point, as you mentioned, Willem where the Fed's tightening cycle has paused. And we think the next step is for the Fed to begin easing in the second half of the year.
The result is very positive for fixed income and equities. So a lot of these questions come back to the broadening of the different exposures that we take around the world and of course therefore also the broadening economic cyclical momentum that we foresee. So maybe let's start the discussion with that.

Willem:
Jonathan, can you explain why we foresee that broadening of cyclical momentum?

Jonathan:
If you look at last year, large cap stocks in the US really helped drive earnings and if you take them out, earnings growth was generally flat or negative in some sectors last year. If you look in Europe where GDP growth stagnated, earnings fell. This reflected the pressure on consumers and companies that were dealing with higher inflation and a more difficult economic outlook.
With inflation now falling and real household incomes growing once again, this pressure eases, particularly in Europe. This is reflected in the data. A number of surveys are now pointing to improvement outside of the US. As you can see in the PMI surveys. These are all in expansionary territory now which certainly wasn't the case six months ago.
So as a result you can see that broadening out geographically and this should be reflected in a kind of broadening out and improving in earnings growth as well.

Willem:
Now Fan, in terms of broadening out it's not just Europe. In Asia as well, you have a bottoming of some of the economies and even an acceleration in some other countries. What's your take on this?

Fan:
Yes, In Asia ex-Japan we expect to see way above global average economic growth of 4.6% this year. India continues to fire on all cylinders and is expected to deliver superior growth of 6.3% this year. And we expect further growth acceleration to 6.6% next year. China has just rolled out a new round of property boosting measures which should curb the downward spiral in the housing market and stabilise GDP growth at 4.9% this year.
Japan has come out of almost two decades of deflation. Japan's reflation trend looks more sustainable with bumper wage hikes and robust corporate spending in AI related investment.
Asia's consensus earnings growth of 23% this year will be well ahead of its global peers. Strong Asian earnings growth will be mainly driven by the sharp turnaround in the semiconductor and memory sector, thanks to the global AI investment boom this will support over 70% earnings rebound in South Korea this year.
India's strong cyclical upswing will support earnings growth acceleration to over 30% this year, sharply up from 7% last year. So in Asia, we are currently overweight on Japan, India and South Korean equities.

Willem:
So it seems in terms of global economic momentum we were quite reliant on the US in the past but now it's broadening. We have more than one engine, which is of course very good for risk appetite. But Jose, we have to acknowledge that in the US economic activity is weakening somewhat but from a very high level to a milder level which could actually be a good thing. So given that the US equity market remains our biggest overweight what is your take on this somewhat more mixed data now?

Jose:
Well, the US economy is clearly slowing somewhat cyclically with the four secular themes of the technology evolution, innovation in health care, nearshoring and onshoring of jobs here in the US and locally. And the re-industrialisation of the US manufacturing base should help keep the economy healthy.
Significantly, technology is lifting productivity and should improve profitability for US equities. If you look at US economic growth it remains healthy and above trend - long term trends. The unemployment rate remains near 60 year lows. Inflation has slowed precipitously and slowed a lot more than wages, Willem and then last but not least corporate earnings are expected to remain strong growing 11% this year and 14% in 2025.

Willem:
So, we think the fundamentals look strong. Now key there, of course is the strong support for US earnings. But some clients worry about the valuations, the multiples on those earnings in the technology sector in particular. What's your take?

Jose:

Well, valuations have expanded but not across the whole sector. Outside the larger companies, valuations look more reasonable. It is important to remember that multiples will remain lower as companies that are leading the market in this bull market are actually making money and earnings are growing as we mentioned very rapidly.
Historically, tech multiples have expanded meaningfully but we think they will not expand as much in this cycle as they have in the past due to those stronger earnings. In addition, new technologies are lowering costs, increasing revenues. As we see the convergence of these different technologies together we will continue to see better productivity and profitability. And as these technologies diffuse through the economy and the different sectors in the market that is going to continue to lift productivity for the overall economy and profitability for the market so we think it's very supportive.

Willem:
George, I'm sure that you get this question around valuations as well. How do you address that?

Georgios:
Yes, we do. Well, our clients continue to favour the US but they also understand the need to widen the opportunity set and diversify in other areas. If we take a look at Europe economic indicators have bottomed, stabilised and are now on a mild upswing. The fight against inflation is clearly not over but the ECB has delivered its first interest rate cut. And if we look at valuations they do trade at much more undemanding levels compared to the US.
Now there has been uncertainty with regards to the outcome and implications of the French elections as well as what that might entail in terms of fiscal slippage risks. But when we look at the revenue exposure of French listed companies we see that only a quarter of their revenues are derived from France and the allocation is even less for Eurozone companies. So when we look at internationally exposed companies that are domiciled and headquartered in Europe we actually see that these companies are much more sensitive to the positive green shoots that we're seeing in the global economy and a weaker euro won't necessarily be a bad thing for these companies.

Willem:
Indeed, the US remains our biggest overweight but there are good opportunities in global companies domiciled in Europe and also in Japan. Fan, we have an overweight there. So what drives that overweight?

Fan:
We upgraded Japanese equities to overweight in February to capture the structural opportunities from Japan's more sustainable reflation trend, the accelerating corporate governance reform and the AI driven investment boom. After the Bank of Japan exited from the negative interest rate regime, it has committed to keeping financial conditions accommodative and remains very prudent in normalising interest rates. Continued weakness of the yen supports the earnings outlook of the exporters. Robust corporate spending in tech investment supports a 12% earnings growth in Japan, this year. Japan provides a success case to show how corporate governance reform contributes to re-rating of the stock market. Nikkei 225 companies returned a total of 20 trillion yen to shareholders last year through dividends and share buybacks. This helped reduce the percentage of Japanese companies trading at below 1x price-to-book to 20% from 40% last year.
As you can see from this chart there is substantial room for Japanese stocks to improve their ROE and price-to-book ratio versus the developed market peers.

Willem:
Now, we're clearly not the only ones diversifying our geographical exposure. When you look at fund flows they are going more and more into some of those cheaper markets in Europe and Asia encouraged by that broadening of that cyclical momentum. So that's all positive.
But Jonathan, we also need to think about the risks. And one of the risks that people mention of course, is what if inflation and rates stay higher for longer? Now, for equity markets that’s not such a big issue because that is linked to stronger than expected activity which boosts earnings But for bond markets, it seems that the central banks are taking a very gradual approach. So what does it mean for the outlook for bond markets?

Jonathan:
Well, the big move in rate expectations happened early in the first quarter where the market dramatically dialed back on the number of rate cuts expected this year. And so this scenario is more in keeping where inflation kind of fell off a cliff rather than the scenario priced in now where there is some stickiness. So actually, if you look over the more recent months, actually rates have been more stable.
Looking ahead, we think there's two reasons that point to yields more likely to go lower from here. Firstly, the market is more cautiously pricing the amount of rate cuts this year. So there's limited room for upside hawkish surprises and secondly, longer run rate expectations still look a bit too hawkish to us. In the US, for example, markets are pricing policy rates bottoming out around 3.75%. This is a far cry from the pre-COVID levels.
So we actually think here this kind of limited room for upside surprise and actually room for kind of downward movement in rates.
Actually, Georgios I'd like to hear your views on this and actually as well how it affects investors particularly those with money in cash?

Georgios:
Thank you, Jonathan. So even though the Fed is guiding for one interest rate cut this year they suggest that we might expect as many as four cuts in 2025. And that suggests that the direction of travel is clear, allowing bond investors to understand that a ceiling in terms of yields has likely been reached.
Now, although the Fed's timing of the first cut might still be a few months away, we know that four other developed markets central banks have already started cutting rates. And if we wait for the Fed to do so it might be quite late. And that's why we recommend to lock in yields in order to avoid a high opportunity cost of staying in cash.
Now, if I can also add the currency market implications here. Seeing that a lot of the central banks are heading in the right direction relative interest rate differentials should still continue to play in favour of the US dollar.
And at the same time, we know that electoral risks and uncertainties on both sides of the Atlantic should also keep the dollar firm in the second half of the year.

Willem:
As we go into the list of risks that clients mention, of course, I need to address the US election So, Jose, let me turn to you. What will be the impact on global and local markets?

Jose:
Well, Willem - clearly a change in the White House could mean new priorities and a different sector focus. Of course, it's going to be difficult to make major changes unless the new president has control of Congress, also. The continuation of the Biden administration would probably mean, a continued focus on social policy domestically, alternative energy, as well as continued investment in US infrastructure.
If Trump were to win the presidential election it would probably result in a shift towards trade issues, traditional energy sources and the defence sector.
Now, if you look at history, history suggests the political cycle should help US equities. Over the past 20 presidential election years, the S&P has finished in positive territory, 18 times. With an average return of 14.6%. Now, during those positive years it has been very positive for US equities and the only years we have missed were in 2000 with the technology situation and 2008 with the great financial crisis.
In terms of the Fed, it's important to remember that the Fed can move during presidential election years. In the past 11 presidential election cycles the FOMC has moved interest rates ten times and of those ten periods they have moved upward five times and they have cut rates five times. Now, of those ten moves in policy rates nine times - they have moved before the election. So the elections do not matter in terms of the Fed.
And remember, we think the Fed is going to cut in September but it is important to remember that they do have a meeting after the election in November as well as December. So it gives them more latitude.

Willem:
So in terms of the risk lets also think about another potential upside risk, I want to have your take on this, Fan.

You had a bounce in Hong Kong and mainland China equity markets recently. What drove this bounce and can it continue?

Fan:
We view the sharp rebound in the Hong Kong stock market in recent months as a policy led and liquidity driven rally rather than a fundamental re-rating. The Hang Seng Index and MSCI China Index are still trading at a massive valuation discount to the US and other developed markets even after their sharp rebound in April and May. The Hong Kong equity rally has been driven by extreme undervaluation, very conservative investor positioning and strong southbound liquidity inflows attracted by policy tailwinds from China's five new supportive measures to boost the Hong Kong capital market.
But how far can The Hong Kong liquidity rally go? We maintain our neutral allocation to Hong Kong and mainland China equities, as we believe a durable re-rating of this market would require more sustained fundamental improvement in corporate profitability and earnings growth.
But the Q1 earnings result of Chinese companies have been weaker than expected. Investors need to see more fundamental improvement to confirm the Chinese economy is coming out of the debt deflationary cycle.

Willem:
Thanks Fan, I agree with that.
With this, we've now addressed all of the client questions that we summarised at the beginning and therefore we arrive at my favourite part of this CIO roundtable which is around the high conviction themes.
We've published a long list of them in our Investment Outlook and our Themes brochure and every client will pick their favourites. But I wanted to know what are the favourites of our regional CIOs? So I'm very curious.
Jose, can I start with you? What's your favourite?

Jose:
Of course. Well, I have to stick with American resilience and the North American Re-Industrialisation themes. The influx of capital into the US to create a more sustainable and diversified economy has been huge. The investments are focused on new technologies to create a more diversified, productive, technology based manufacturing system. And it's going to be designed to expand productive capacity as well as technological capabilities. So we think it is good for the economy and the financial markets.

Willem:
Georgios, can I know your favourite theme?

Georgios:
I would say The Magnificent Europeans. At the end of the day the first priority of our quarterly Investment Outlook is to broaden geographical and sectoral diversification. In Europe, we've already seen the first cut from the ECB and this has occurred at a time when economic activity is pointing higher.
And that should also support the outlook for earnings which are expected to flip to positive territory in the second half of the year. Valuations are also less demanding and we shouldn't forget that Europe has its own answer to the Magnificent Seven. It includes a lot of international companies headquartered in Europe spread out across a different number of sectors.

Willem:
So who is next? What about you, Jonathan?

Jonathan:
Yes, I'm going to look a bit further to the East and I think the Rise of India ASEAN is just really exciting. There was a concern with the election in India that's now passed. So we think it's going to be less potential volatility around that market. Instead, investors can now focus on the very strong growth rates, the economic reforms. And just really,

India is kind of a growth superpower at the moment. So I think at the moment for our clients, it's just a really exciting area.

Willem:
Thank you, Jonathan. And last but not least Fan, your favourite theme?

Fan:
I want to highlight our new theme on Asian corporate governance reform winners that focus on Asian quality companies with high potential to improve shareholders return by increasing dividends and share buyback and regulators in North Asia are pushing for corporate governance reforms to reduce the market valuation discounts in Japan, China and South Korea, accelerating reforms have pushed more listed companies to raise their dividend payout ratio and increase share buyback improving their re-rating outlook on the back of rising ROE.

Willem:
Thanks, that was great and I guessed three of you correctly. So, all that remains to me is to summarise our investment priorities for our clients. Firstly, we broaden our equity exposure across geographies and sectors. Secondly, as we discussed before we put cash to work in bonds and multi-asset strategies. We tap into private assets and infrastructure. And lastly, Fan has discussed how we unlock the best opportunities in Asia.
All of those priorities of course, are discussed in more detail in our Investment Outlook and our ICs and our RMs can give you more information.
Thank you very much Fan, Georgios, Jose and Jonathan for your insights and this discussion.
I very much enjoyed it and thank you all for watching.