



Equities to take center stage

Equity markets have had a jittery start to 2010 with the MSCI World Index down - 2.72% YTD at the end of February – its first monthly fall since last October. After such a strong year in 2009, is this an anomaly or an indication of trends for the rest of the year? Bill McQuaker, Head of Equities, explores the possible outcomes.



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Head of Equities

During the financial crisis, not surprisingly, a huge number of investors sold out of equities. While they have returned to risk assets since the markets' low point last March, for the most part, this has involved investment in riskier bond-focused assets rather than in equities. Currently, most investors remain underexposed to equities after an enormous amount of selling in the second half of 2008, but this will change if – and I believe it will – the recovery in global equities continues. In my view, there are two strong arguments for this: first, profitability in the corporate sector. This collapsed in the second half of 2008, but since then there has been a sharp recovery and as a consequence investors are likely to see a change in business practice. Businesses are either in expansion mode or contraction mode, they don't stand still and do nothing; hoarding cash went out of fashion in the 1980s!

The second argument centers around the major impact that cash flow will have this year. Corporate cash flow in the US as a proportion of GDP¹ is at its highest level in 40 years having had a remarkable spike in the past 12 months. The corporate sector is effectively awash with cash. This has three potential implications:

- first, a rise in capital expenditure following a sharp rise in chief executive confidence;
- second, continuing improvements in the labor market as companies look to hire staff; and,
- finally, a strong upturn in merger and acquisition activity this year and next

Chief executives will not want cash burning a hole in their pockets for long. Additionally, valuations are not expensive so there are no valuation constraints on equities moving up.

US free cash flow as a proportion of GDP at an all-time high



Source: Datastream, Credit Suisse as of December 2009. Past performance is not an indicator of future results and is not a representation of any Henderson Global Funds results. This chart demonstrates corporate cash flow in the US as a proportion of GDP is at its highest level in 40 years.



So what about the risks? The main risk is inflation: commodity prices are already ratcheting up and in some instances are close to the peaks of the previous cycle. Additionally, for the past decade, the developed world has been able to import price deflation from emerging markets, particularly Asia, but this is unlikely to continue as those economies face inflationary pressures as well. That said, I believe that the inflation risk will be contained, at least in the near term.

As we move out of the recovery phase in the economic cycle and into the growth phase, I think the environment will become easier for equities and trickier for bonds. The expansion so far has been driven by cyclicals and financials and, while cyclicals should continue to move up, history suggests that we are coming to the end of that phase. In the medium term, the valuations argue in favor of defensives with a high yield dividend flow.

For example, Asia (ex Japan) has in recent history offered both a good level of yield, which is sometimes slightly more than the US, together with a dividend cycle that means dividends tend to be evenly distributed throughout the year. The fundamentals of the Asian markets - balance sheet robustness and a low debt environment - are encouraging. Moreover, the growth dynamic has changed; Asia used to be seen as a leveraged play on the US consumer, but recently, domestic consumption has become far more important, particularly in China where retail sales actually grew during the global recession. There is also the potential for a 'currency kicker' since most Asian currencies have traded at lower levels than they were before the Asian crisis in the mid 1990s. At some point, I believe this situation will change offering extra potential return.

In summary, over the past two years, markets, sectors, and stocks have become highly correlated². However, history suggests that as recovery moves into the growth phase, these strong correlations will break down and there will be greater differentiation between and within markets. In this environment, passive management may not reward; instead we believe active management – careful asset allocation and stock-picking – will be vital to investment success.

¹GDP: Gross Domestic Product is the total market value of all final goods and services produced in a country in a given year.

²Correlation is a statistical measure of the interdependence of two or more random variables. Fundamentally, the value indicates how much of a change in one variable is explained by a change in another.

The MSCI World Index is a free float adjusted market capitalization index that is designed to measure global developed market equity performance. You cannot invest directly in an index or average.

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