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Brexit, the US elections and the new normal. There are just so many things that can trip up the savviest of investors. In this edition, T. Rowe Price portfolio manager Scott Berg gives us a flavour of what it's like to be a global equities specialist and the numerous factors at play that they need to monitor.

A message that stands out is how we've moved from the time of the raging bull to the 'ageing bull', which comes with a fresh set of investment opportunities – and pitfalls.

It takes less than three minutes to read this article but it's time well spent. As Berg says, the world is evolving fast and so should an investor's perspective.

Michelle Baltazar
Director of Media & Publishing

Global Equities: Volatility, Uncertainty and the Ageing Bull Market

Macroeconomic headlines dominate 2016

Macro and top-down events are dominating markets like never before in 2016. Rising uncertainty is to be expected when you combine the fact that we are eight years into the second longest bull market in history, in a US election year, and in an environment where many of the pillars of past returns are evolving. The result of the UK referendum on European Union (EU) membership has added to the list of macroeconomic and political risks facing markets.

The Brexit result will impact the UK economy as companies hold back investment in the face of uncertainty surrounding the UK's relationship with Europe. Continental Europe may suffer a similar fate, an unwelcome outcome for a region that is growing slowly and still at the beginning of its economic recovery. Ongoing stimulus from the European Central Bank to support the European economy is highly likely and affirms the view that interest rates are likely to remain low for a prolonged period of time.

This adds to investor concerns over an equity bull market, which has become increasingly more complex. This complexity centres on the question of whether global corporates can deliver better earnings in a more modest growth world. As further bottom-up improvement has been called into question, top-down factors — including the outlook for China, concerns over Europe, and volatility in energy and commodity prices – have taken centre stage in driving stock prices.

On the other hand, those fearful of an aggressive US Federal Reserve tightening cycle may at least have their concerns allayed given rate increases are now likely to be more measured based on Brexit and global growth concerns. Regardless, macroeconomic concerns will persist in the near term, as investors put more weight on these issues rather than the underlying fundamentals of individual companies.

Earnings improvement presents opportunity

While the economic picture remains confusing for many, one comforting factor is that we continue to find numerous companies displaying better fundamentals, even in a modest-growth world. In addition, this perspective is set against a starting point where valuations remain reasonable, especially when considering free cash flow based metrics. The broadening out of the perspective to include cash-based metrics is important because changes in cash flow trends will help us judge the evolution of the equity cycle over the near and medium terms. It will also help support the return of capital to investors in the form of share buybacks and dividends.

With monetary policy remaining accommodative and inflation still low (although with the potential to turn upward), we believe this is a solid starting point to generate attractive returns from global equities. In particular, it will support stocks with compelling and unrecognised growth characteristics, given the ongoing scarcity of broad based macroeconomic growth trends.

When considering the equity cycle, however, the absence of profit delivery over the past few years remains a legitimate concern. That is important for us when we invest, that we continue to ask ourselves whether we can see clear signs that stocks will begin to deliver on profits after a period of distinctly narrow growth signals.

Potential growth pockets

Although earnings have been poor at an aggregate level, there remains interesting pockets of growth. We have identified stocks that have earnings improvement potential in the next stage of the economic cycle. Within the emerging world, there is still potential for change and market share gains in particular. Elsewhere, while the developed world growth outlook is subdued, building exposure to select contrarian and cyclical segments of the market, when the opportunity is afforded, can be a sensible approach in our view.

Valuations are reasonable but will not drive future returns

With global equities, including emerging market equities, trading around 15-times 2017 earnings (Factset, September 2016), the days of extremely cheap valuations are over, but valuations remain reasonable in the context of the economic cycle and especially given alternative avenues for capital.

While valuations will not drive aggregate returns moving forward to the extent that they did in the early part of this equity cycle, at the same time, they should not be a barrier. Importantly, the lack of bullishness in the world has continued to keep broad-based bubbles at bay, and valuations have, therefore, remained at sensible levels.

The environment for equity investing, however, is more nuanced than in previous years. Investors have been cautious of stocks with cyclical characteristics through much of this equity cycle, while continuing to treasure stocks with defensive qualities and lower-volatility profiles. However, as markets have been shaken by growth concerns, a key opportunity has arisen: the chance to buy high-quality growth and improvement stocks on weakness.

Where do we go from here?

Challenging data points will continue to lie ahead for the global economy, but this will inevitably lead to opportunities in certain areas. The major cycle-ending risks are always hard to call, and we should acknowledge that cycles rarely come to an end due to mirror images of previous crises. In short, the world evolves, and so should an investor's perspective.

Rising political tensions and the impact on economic growth, a prospective deterioration in the credit cycle stemming from lower oil prices, and the likelihood of corporate defaults in China stand out as the most prevalent risks. However, further rate increases are now less likely, and monetary policy around the world remains generally accommodative. Bull markets usually end with a broad-based recession or due to valuation bubbles bursting — we see no signs of either.

Given these factors, we remain constructive, but market returns are likely to be more modest. As we have witnessed during the past few years, sentiment is likely to ebb and flow. This will provide opportunities to invest through periods of stock-specific volatility. But while the outlook is more stock-specific and complex than it has been for some time, patient investors should continue to be rewarded over the long term. FS

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