



## Equity market outlook - 2012

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### **Continued lack of clarity over economic outlook**

2012 will be the fourth year post the financial crisis, yet the global economic outlook remains as opaque as ever. Equity markets continue to swing between 'fear' (of recession) and 'greed' as valuations look attractive. With huge, co-ordinated fiscal and monetary stimulus the global economy avoided transforming the 2009 recession into a depression and although growth remained elusive, corporate profits and asset prices recovered much of their losses. However, now budget deficits have ballooned and interest rates have been cut, further stimulus is hard to find and governments around the world are being forced to cut spending and raise taxes to reduce their debt burdens. Nowhere is this more apparent than in the Eurozone periphery, where interest rates have risen to unsustainable levels and austerity measures threaten severe and lasting recessions.

### **European QE will be eventually be needed**

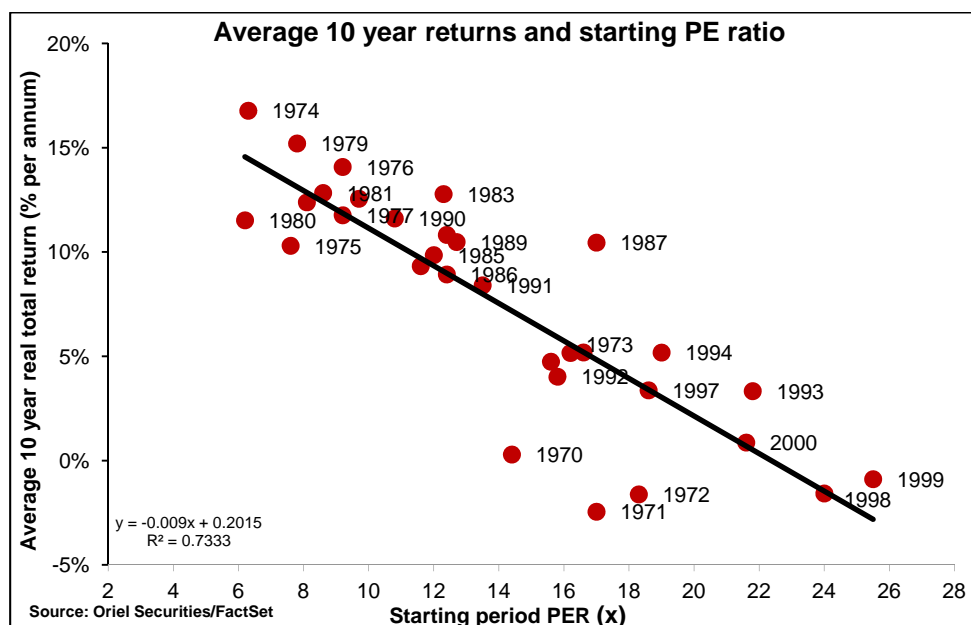
The debt crisis is dominating market direction and so far the politicians have failed to present a credible and comprehensive solution. Their current stance is increasingly limiting the policy tools available to manage economic cycles and threatens to cause so much widespread economic and social pain that a Euro breakup no longer seems unthinkable. We (and markets generally) still believe they will eventually offset some of the fiscal tightening with quantitative easing, although recent ECB statements render this less likely, at least in the short term. Either way there is a strong likelihood of renewed recession in Europe next year, as austerity, uncertainty and lack of bank credit squeeze consumers and corporates alike.

### **Corporate health benefiting from low interest rates**

More positively, US economic newsflow has surprised to the upside and whilst Chinese growth is slowing from very strong levels, there is much scope for the authorities to loosen monetary policy to control the speed of decline. Meanwhile UK and US interest rates are very low and look set to remain so for at least all of 2012. Companies have generally weathered the storm relatively well, rebuilding balance sheets as margins and cashflows recovered, despite lower revenues, helped by cost-cutting and lower interest rates.

### **Markets can deliver good returns from current valuation levels**

On current earnings, markets look attractively valued, in most cases at or significantly below levels from which equity investors have historically made good returns (see chart). Markets already imply lower long term growth than in previous decades and with dividend yields well above bond yields, they are looking for significant falls in nominal profits and subsequently dividends. In a global recession this is likely, but in our base case scenario of low but positive medium term growth and a tendency for politicians to inflate away debt, this is likely to prove too aggressive and the attractions of equities will be realised.



### Market environment favours companies with greater pricing power

Market volatility will remain and we may not have seen the worst of the Eurozone crisis or fears of a double dip recession, therefore I favour those companies with better predictability of profits and greater pricing power, either due to their lack of cyclicality or dominant market positions and strong finances. Balance sheet strength buys a company time and independence from banks and markets during difficult periods and gives more options to increase shareholder value through acquisitions, buybacks and dividend increases when life improves.

### Areas with overseas exposure continue to be favoured

Until the European situation improves, we will continue to favour sectors and stocks with greater exposure to the US and Asia. Quality growth stocks are likely to re-rate further whilst the uncertainty lasts, although we will be looking for any signs that the ECB intends to move to QE as a signal to revisit the heavily sold off cyclical companies which are very cheap on long term valuation measures such as price/book or price to sales. Despite very weak performance, the banking sector remains toxic in our view, particularly in Europe, due to the high risks around funding and impairments and several more nationalisations are likely before the Euro crisis is resolved.

### Concerns over oil price remain

The main risks to our view that equity markets will end the year in positive territory revolves around a complete breakup of the Euro and/or a sharp spike in oil prices. Last year's Arab Spring led to high oil prices in 1H 2011, which should mean easy comparators in 1H 2012, resulting in falling inflationary pressures and improved consumer disposable income. However, recent developments in Iran make the prospect of serious disruption to oil supplies increasingly likely and a spike in prices back to \$130 a barrel or more could extinguish the nascent US growth and send investors back towards ultra-defensive stocks as well as 'big oil'.

Source: rlam as at 21 December 2011 unless otherwise stated.

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