Regional equity views

Fidelity's regional equity heads and heads of equity research discuss their views on key market drivers and reveal where our portfolio managers are finding the most attractive investment opportunities.

Regional equity viewpoints from:

- **Richard Lewis**, Head of Global Equities
- **Paras Anand**, Head of European Equities
- **Tim Orchard,** Head of Equities – Asia ex-Japan
- **Alex Treves**, Head of Equities – Japan
- **Henk-Jan Rikkerink**, Head of Research – Europe, US, EMEA & Latin America
- **Matthew Sutherland**, Head of Product Management – Asia.

Q: WHAT'S YOUR VIEW OF GLOBAL MACROECONOMIC CONDITIONS?

Richard Lewis: The underlying financial environment remains unchanged as developed economies continue to reduce their large debt burdens in the wake of the global financial crisis. The prevailing combination of low growth, low interest rates and high corporate profit margins has been good for assets, which supports a five-year bull run for stock markets. We remain in an environment conducive to asset-price inflation and valuation expansion, with the current conditions potentially continuing for a few more years.

There is a clear case for emerging markets to attract a larger share of global market liquidity. Emerging market (EM) valuations are particularly attractive and corporate growth stories will inevitably attract attention given the low-growth environment. I think the long-term story for emerging markets is intact given that EMs have ridden out US dollar strength relatively well, but this is likely to be tested again before long. Certain large-cap stocks, including Petrobras and some of the Chinese banks, are performing well, though this appears unsupported by fundamentals, which could be a sign that asset allocators are investing in EMs again via exchange-traded funds.

Q: DO YOU THINK CROSS-BORDER M&A MOMENTUM WILL CONTINUE?

Richard Lewis: There has been a notable pick-up in M&A activity and rumoured deals, but we've recently seen a slight fall-off in terms of execution rates. There is some political pressure on the tax inversion aspects of crossborder deals which feature US acquirers, as in the high-profile case of the Walgreens and Alliance Boots deal which purposely didn't include a tax inversion element. However, given that corporate taxation rates, which are at the heart of this tax inversion debate, polarise political views in the US, it is doubtful that Washington can come to an agreement and pass its opposition into law any time soon. I think many acquirer companies actually undertake M&A deals to consolidate the market (although they would never admit this despite the fact it's a perfectly rational reason). Many large companies want to extend their global reach so that more of their earnings are effectively outside of tax and regulation structures. In the brewing market, we have seen this kind of consolidation-inspired M&A in recent years.

Henk-Jan Rikkerink: The type of M&A we have seen in recent years has been more conducive to acquirers extracting some value from deals and has not been the bad type of M&A we have seen in previous cycles. We are seeing more M&A based on higher post-global financial crisis cash piles and lower rates of capital investment by companies. On balance, it has been less likely that acquirers inevitably destroy value.

Q: CAN WE EXPECT TO SEE A MORE POSITIVE PICTURE EMERGE IN EUROPE?

Henk-Jan Rikkerink: GDP growth in Europe of around 1% with 0.3% inflation means there is still no real support coming from regional aggregate demand, barring companies with external, global or EM growth drivers. The Ukraine-Russia crisis and volatility in the Middle East have been headwinds. While the bailout of Portuguese bank Espirito Santo raised concerns, this might have been symptomatic of broader issues in the Iberian banking sector. At the margin, the news flow remains negative and we are sticking to high-quality names based on longer-term fundamentals. These names would also be less exposed to external weakness caused by some kind of macro shock or conflict escalation. We believe the rally in the periphery and domestically exposed stocks in Europe in the second half of 2013 means they look expensive. Cyclical stocks are now at mid-cycle stage which means that catalysts now have to come more from supply side/stock-specific drivers rather than the demand side.

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Paras Anand: Mario Draghi's recent announcement was widely expected given the low levels of inflation that we have seen. While it is uncertain the extent to which this will have a meaningful impact on the pace of recovery across the region, it is far more significant that it implies a backdrop where the euro continues to weaken on a trade-weighted basis and particularly against the US dollar. I see this as being positive for European shares as the corporate sector earns the majority of its profits outside the eurozone and the moderation in the level of the euro will not only be a positive in terms of translation but will also increase companies' underlying competitiveness.

I think that the groundwork has been laid for quantitative easing (QE). First though I think there is still a desire to see a positive impact of the ECB's targeted long-term refinancing operations (LTRO) to stimulate growth as well as waiting to see if global growth in aggregate picks up later this year. It is important to note that the downward adjustments in real wages across the region would have suppressed both demand and inflation. However, the positive effects of this, in terms of meaningful recovery in employment, are yet to really come through, although there is clearly some evidence of improvements at the margin.

Richard Lewis: Calls for the European Central Bank to launch a full-blown QE programme will achieve little in the real economy and will only inflate financial markets further. The widespread use of QE as a policy tool means there are few if any catalysts sufficient to reverse the established upward trend in markets. My own view is that debt write-offs offer a better way forward, but bondholders wouldn't allow this approach given their strong influence on policy.

Q: IS THE OUTLOOK LARGELY POSITIVE FOR THE UK ECONOMY?

Paras Anand: I think the UK has better scope for returns than the US going forward. The UK has actually underperformed by some margin since 2008; we had the unwinding of the commodity/mining boom (where the UK market had more representation than the US) and the fact that recent US leadership has been focused in areas largely unrepresented in the UK market, such as biotech and mobile software. There is now a wide valuation gap, reflected in a dividend yield in the UK of 4.3% versus 1.9% in the US, and a material price-to-book discount also – this is despite the expected level of returns for the US and UK is similar at around 16.5%.

Although the Scottish referendum result has quelled some market volatility, there is political uncertainty surrounding the upcoming UK general election and EU referendum, which means there is limited scope for the Bank of England's Monetary Policy Committee to make significant policy decisions over the next year. With limited government policy initiatives which could spur the economy, we are entering a phase where the corporate sector will grow as a percentage of economic output relative to the government sector. Sterling weakness will give a boost to UK companies given the greater extent to which they earn overseas versus than the US. I believe investors will reward growth where it happens.

Many UK shares were seen as geared plays on EMs over the last decade. Now that EM valuations have fallen to a 10-year low versus DMs, the UK market offers a way of achieving exposure to EMs through well-established franchises with good governance.

Q: HOW DO YOU ACCOUNT FOR IMPROVED PERFORMANCE IN ASIA PACIFIC?

Tim Orchard: Attractive valuations have been a catalyst for the improved performance of Asian markets. When the price-to-book discount widened to 30% we saw increased inflows. However, there has also been supportive news-flow, particularly in terms of political events

Matthew Sutherland: it's not just about valuations in my view, although they have figured. Regional PMIs have been improving and policy is supportive; China has loosened policy and is making progress on reforms; and Korea is also stimulating its economy.

China's SOEs have benefited most from the early reforms. Nevertheless, we think the ultimate beneficiaries of reform will be the new-economy sectors in the longer run. However, given low valuations, the prospect of reform has boosted companies like PetroChina (where improved capital discipline is expected to be share price positive)

and China Mobile (which should benefit from rational competitive forces with the removal of handset subsidies). Our PMs and analysts have largely stuck with their positions on higher-quality, longer-term new-economy winners (despite the higher valuations) with limited exposure to SOEs.

Tim Orchard: I believe there is a question mark over positioning and participation in this trend given the expensive ratings in the private discretionary area. The reform effort to rationalise some of the sclerotic, smaller SOE sectors may inflate SOE share prices, given their very low valuations, irrespective of other drivers or the fact that many of these companies are. We have quite a significant mid-cap growth bias, meaning we are quite sensitive to rotations into value.

Q: HOW DO YOU ACCOUNT FOR IMPROVED PERFORMANCE IN ASIA PACIFIC?

Tim Orchard: India's new prime minister Narendra Modi and Indonesia's president-elect Joko Widodo both originate from the outside of the traditional ruling elite. This should provide a supportive environment for the world's second (India) and fourth (Indonesia) largest countries by population. Both leaders support reformist, anti-corruption policies that could help to improve governance and grow investor interest in their respective stock markets.

Q: IS JAPAN ON TRACK TO DELIVER ON ITS REFORMS DESPITE SOME RECENT POOR DATA ANNOUNCEMENTS?

Alex Treves: The recent downward revision to the already bad Q2 GDP figure – taking into account April's consumption tax hike – increased the quarter's GDP decline from 6.8% to 7.1%. There have since been encouraging signs of growth in Japan's economy – in July average monthly wages rose by 2.6%, which is the first increase of over 2.0% for a decade. The problem is real wages – while we are seeing nominal wage increases these are not enough to keep pace with inflation. Abenomics has been successful in creating inflation but we need to see real wages come through more strongly now.

There is a sense among investors that there is a Bank of Japan/government 'put' for the Japanese economy and stock market. Given the commitment to Abenomics, if we were to see further economic weakness then the Bank of Japan would respond with further policy easing/QE. The government would be likely to respond, for example, by scrapping the planned additional consumption tax increase in 2015.

Investors are focusing on the third arrow of Abenomics with a combination of corporate sector reforms in the *Ito Review*, new governance and stewardship codes, changes to pension fund policy, and the use of ROE-driven benchmarks like JPX Nikkei 400. The Bank of Japan may be deliberately stepping back to shine a spotlight on these reforms and urge other actors within Japan to play their part.

Q: IS CORPORATE REFORM IN JAPAN LIKELY TO HIT ITS TARGETS?

Alex Treves: There is sufficient evidence and commitment in the reforms to be optimistic on the prospects of corporate reform having a constructive impact. There are some quick wins to be had in terms of raising ROE from low levels – if inflation continues, companies will have to sort out their balance sheets and this discipline alone of having to do more with cash balances could raise ROEs and see valuations rerated by the order of 50%. In summary, things are becoming better and are certainly likely to get better following the recent GDP decline; valuations are attractive; and we have the prospect of reforms coming through.

Q: WHICH SECTORS ARE YOUR PORTFOLIO MANAGERS FAVOURING?

Richard Lewis: In terms of sector focus, our global PMs are favouring growth stories like technology, healthcare and consumer staples. We are underweight industrials, utilities and telecoms.

Henk-Jan Rikkerink: Our European and UK PMs are overweight healthcare, consumer high-performance computing (HPC) and software; they are underweight mining, telecoms, real estate and food and retail. In the US, retail, HPC, autos and semi-conductors are the overweight areas, while technology, hardware and materials are underweights.

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