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POINTS OF VIEW

Change is under way – and it's not just political

Looking to the fundamentals and the long term is the best way to deal with the volatility that the elections of 2017 could bring

BY ALESSANDRO PIU

Few people would have placed their bets on Donald Trump winning the American elections. Even fewer would have staked their money on a positive reaction from the financial markets. If there's one concept that the two major political events of 2016 (Brexit and the US elections) have clarified, it's that the sun always rises, come what may. We would do well to keep that in mind in 2017, a year when Europe too will see its own fair share of elections. The one thing we can be sure of? Increased volatility on the financial markets. But investors have got used to volatility… and the best way to deal with it might just be to ignore it. The fund managers that Wall Street Italia (WSI) spoke to know that. Looking to the long term, and not at the short-term fluctuations, could be the winning strategy.

On the equity market expectations are positive, linked to the shift of the economic stimulus from monetary to fiscal policy. Donald Trump's plans (infrastructure investment and tax cuts) provide a benchmark. But Great Britain will also need to work in the same direction. And what about continental Europe? When European governments decide to follow this route, global economic growth can only benefit. The best-placed equity sectors are cyclical ones, with technological products in the lead. But interest in the banking sector is also picking up.

Turning to the bond market, the consensus view is that it's best to keep well away from developed countries' sovereign bonds. To find good returns, investors need to look to high-yield or corporate bonds, with a preference for products issued by European companies.

ABERDEEN
High-yield bonds? Yes, as long as they're European

David Lloyd-Nolan,
Fixed-income product specialist

In 2017 the Fed will raise interest rates twice, while the ECB will continue its asset purchase programme. David Lloyd-Nolan, fixed-income product specialist at Aberdeen Asset Management, takes this as his starting point to explain why high-yield European corporate bonds could be a rewarding choice in the coming year. "The Fed's manoeuvre will not be a restrictive one", explains Lloyd-Nolan, "but even a limited rise on Fed funds is a challenge for high-yield US bonds. A rise of this sort is usually followed, over the subsequent 18-24 months, by an increase in corporate bankruptcies. And several companies, above all in the energy sector, are already going through periods of stress".

The scenario in Europe is different. "The inflation rate is low and the ECB will go on supporting the markets with quantitative easing, thus preventing an overly abrupt rise in yields". The main beneficiary will be the European high-yield securities market, which already enjoys a lower duration and higher credit quality than its US counterpart and in which the influence of energy companies is low. "The return on lower-than-investment-grade European bonds will be able to comfortably offset a default rate that should be around 2-3%, so at very low levels". However, Lloyd-Nolan advises against investment-grade products. "The yields speak for themselves in this case. 40% of the pan-European market has negative yields, and another 40%, more or less, yields of under 1%. In addition, the duration is, on average, higher".

BANOR SICAV
The quest for long-term value

Eddie Ramsden,
Advisor, North America L/S equity fund

Focusing your analysis on the intrinsic value of companies over the long term means that you don't have to tackle the difficult task of making projections and creating expectations of what the markets will do over a given year or quarter. Banor SICAV's North America Long/Short equity fund, managed by Eddie Ramsden, follows this philosophy. "We're value investors: we invest in companies that we've examined in depth, starting from an analysis of their fundamentals. We study companies to identify their intrinsic value and, on that basis, we buy their stocks when the discount is significant. The approach is to 'cover yourself' by selling over-valued companies and buying those that are under-valued".

When investors follow this approach, events like the US elections are less of a cause for concern. In Ramsden's opinion, however, "the wrong monetary policy would be very significant". In general, he takes a lukewarm view of the United States and the US equity market, which is reflected in the current net exposure of the fund, at around 55%. "The fund's portfolio has been concentrated recently on financial stocks. Although they outperformed after the American elections, our choice isn't connected with any electoral position. The factor driving banking stocks is the hope for a less rigid regulatory framework and a jump in interest rates. We've felt for some time that these stocks are better value and safer that they've ever been and their adjusted earnings can provide excellent returns".

SCHRODERS

Change is under way, in equities too

Simon Webber, global equities fund manager

The positive reaction of the equity markets to the election of Donald Trump as US president was a surprise, but we shouldn't forget that even before the vote the global economy was sending out positive signals. The turning point, according to Simon Webber, global equities fund manager at Schroders, was "the improvement in the economic growth outlook after three years of disappointments. If Donald Trump has any merit, it's that he helped fuel this optimism". How? With the promise of cutting taxes and investing in infrastructure, which confirms the transition to an economic stimulus of a fiscal nature.

"When the European authorities also decide to make this transition, the driving force for the global economy will be even stronger". In Webber's view, this new era will translate, in the equity markets, into a good outlook for cyclical securities. Especially technology products: "In this segment we have companies that are developing fantastic technologies that will enable them to overcome any difficulties posed by the global economy. Examples are SAP and ASML in Europe and Tencent and Alibaba in Asia, but there are American companies too". Interest in European banks, however, is less of a given. However, "the regulatory constraints of recent years are settling out and share prices are interesting. In addition, banks have cut their costs and can now benefit from the higher interest rate curve we're currently seeing at the global level".

HSBC
Focusing on the fundamentals

Steven Major
Global head of FI research

Political uncertainty will be the tricky issue for bond markets in 2017. "Every two or three months we'll see a new election or referendum, and that will be a constant source of volatility", underscores Steven Major, global head of fixed income research at HSBC. "It's important to look beyond these events which, although capable of generating volatility, will not exactly bring about the end of the world. When you construct a strategy around bonds you need to look beyond the background noise caused by cyclical or political factors and focus on the fundamentals that are driving the markets. Rather than trying to understand what the central banks plan to do, I prefer to try to understand what the economy can accept. And the current scenario is an economy that is still fragile and where interest rates can't rise. With regard to the Fed, too, I don't think we can expect more than one interest rate rise a year".

As Major sees it, in this scenario the strategy of investing in European corporate bonds could be the ace in the pack. The ECB has recently launched its corporate sector purchase programme (CSPP) under which, according to our estimates, it could buy securities for up to 500 billion euro. Even if the high-yield market is outside the scope of the assets the ECB can purchase, it would benefit indirectly. And there's more: bank bonds could also be a good opportunity; in fact the ECB could extend its purchase programme to that asset class too".