

Taking centre stage

With developed economies expected to lead global growth in 2015, developed markets equities will be in the limelight

By FAN CHEUK WAN

GOING into 2015, we expect a moderate global growth acceleration led by the developed economies, particularly the US. What is promising is that the US economy appears to have shifted to a self-sustaining recovery track, while the eurozone is likely to escape recession due to decisive quantitative easing (QE) by the European Central Bank (ECB).

We expect the US economy will remain the most robust among the advanced economies in 2015. The debt burden on US households has been reduced, and the public sector now also has some leeway to boost spending. Gains in employment and wages support consumer spending which is encouraging companies to increase investment spending. Lower energy prices are adding to consumer purchasing power and reducing costs for most industries.

The economic outlook for the eurozone and Japan is far more subdued in 2015, as deflation concerns underpin policy needs for the ECB and the Bank of Japan (BOJ) to intensify monetary easing. The ECB's EUR 1.14 trillion asset purchase program is a powerful and credible policy action to reflate the economy. The ECB leaves the door open to extend QE beyond 2016 if it is necessary to bring inflation back on track toward its 2 per cent target.

In Japan, the postponement of the consumption tax hike from October 2015 to April 2017, aggressive BOJ quantitative easing and the weakening of the Japanese yen will support growth recovery.

European and Japanese equities

The diverging paths of growth and monetary policies will remain key drivers of global equity markets in 2015. We favour regions where central banks remain accommodative and where investors' perceptions of growth are subject to greater upside surprises. Hence, we expect European and Japanese equities to outperform the global benchmark in the next three to six months due to supportive drivers of monetary expansion, weakening currencies, low investor expectations and better earnings outlook.

With monetary conditions expected to stay loose and growth momentum improving, the first half of 2015 is anticipated to provide a constructive investment environment for European and Japanese stocks. The 12-month forward P/E (price-earnings) ratios of European and Japanese equities at 14.1 and 14.0 are more attractive than the global average of 14.9 and the US market's 16.5.

From the growth perspective, Europe and Japan are projected to deliver stronger 2015 earnings growth of 14 per cent and 12 per cent, respectively, ahead of 7 per cent growth expected in the US and 0.2 per cent growth in the UK.

While the US economy is expected to lead the global recovery, the expected commencement of the Fed rate hiking cycle from mid-2015 is likely to add volatility to the US equity market. Historical data show that US equities have performed well in the run up to the first interest rate hike. While equity performance after the start of rate hikes has been positive on average, the range of outcomes suggest that low to negative returns are possible after the first hike.

Taking into account the over-valuation of US equities versus the global average and its own historical average, together with the less favourable policy driver, we maintain a neutral

view on US equities in the next three to

six months, after the market has delivered two consecutive years of outperformance against the MSCI World.

US large caps and M&A beneficiaries

Within the developed markets, we see attractive investment opportunities in three top investment ideas, namely US large caps, beneficiaries of mergers and acquisitions (M&A) and European value stocks. After the global financial crisis in 2008, market participants have focused on small and mid-cap stocks in the US, which have benefited from the Fed's quantitative easing and the continued decline in bond yields. Performance of small and mid-cap stocks has been able to outpace large caps by almost 8 per cent per annum since the US equity market trough in 2009. As the US economic recovery matures, we expect a change in equity market leadership in favour of large caps over small caps.

Historically, during periods of US dollar strength, rising market volatility, lower central bank liquidity and a flattening yield curve – all of which we foresee in 2015 – US large caps have outperformed small caps. A particular advantage of US large caps is that they provide stability during periodic bouts of volatility, which are now becoming more likely as a consequence of monetary policy uncertainty.

Within US large caps, technology and financials are our preferred sectors. Driven by innovation and delayed capital investment, US technology stocks should benefit from continued earnings growth. US financials are positioned to benefit from the cyclical growth recovery and improved demand for lending.

In the current low interest rate environment, high cash levels, low leverage and cheap financing options should incentivise management to drive top-line growth through M&A activities. From a sector perspective, we believe global healthcare, European telecoms and the global technology sectors will continue to drive the bulk of deal volumes, while we believe M&A activity around speciality chemicals could start to increase now.

European value stocks

Growth in the eurozone has been challenging throughout 2014, but we believe that European equities would deliver better performance in 2015 given that current valuation reflects an overly pessimistic growth expectation. The aggressive sovereign QE by the ECB and the euro weakness should offer positive drivers for European equities. In this context, we particularly favour European exporters and banks, given the benefits of the euro depreciation and credit demand recovery. Valuation of European banks is significantly below book value and investor positioning is conservative, offering an attractive entry point into the sector.

Notably, the sharp depreciation of the euro against the US dollar will strongly support earnings recovery of the export-oriented sectors in the eurozone, especially the German DAX companies which generate 60 per cent of their revenues from outside the eurozone.

Within the eurozone, Germany remains our favourite market due to its export-driven earnings profile and attractive valuation. We believe European value stocks offer attractive catch-up potential due to their profit margin improvement potential, which should help close their valuation gap with their US counterparts with an improved recovery outlook in 2015. **W**

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