Investment Intelligence Online

Highlights of a discussion with Nick Mustoe, Head of Global Equities, and Stephen Anness, Global Equities Fund Manager, on the impact of the Brexit Vote on the global economy and financial markets

Invesco Perpetual Global Equities

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Introduction
On 6 July 2016, Nick Mustoe (NM), Chief Investment Officer and Head of Global Equities, and Stephen Anness (SA), Global Equities Fund Manager, answered questions from financial advisers on the impact of the Brexit Referendum outcome on the global economy and on financial markets, and discussed where they see potential opportunities and their outlook on monetary policies, industry sectors and the broader equity markets.

Has the fallout from the Brexit vote been as you would have expected it?

NM. Largely, yes, although the extent of it maybe has been more extreme than I expected. Obviously, sterling has taken the brunt of the focus of markets, really acting as the proxy for investor sentiment about the UK. And that's likely to continue. The other moves in equities are pretty logical: hitting the mid-cap 250s, the domestic names, particularly house builders and property, but also gilts, obviously, rallying, yields going down. Perhaps surprising that yields are so low. That's perhaps something of an overreaction, but continuing, really the theme that we've seen in fixed income markets for quite some time.

But overall, it's all about everyone rushing to anticipate a recession, to downgrade the UK economy. I don't think it's going to be as simple as that. There will be some mitigation. A weak currency helps economic growth, and there will be some policy responses. So I think that there is an element of the market rushing to get there in lots of areas.

What is your view on the prospects for global growth now?

SA. I think, if you look back a few weeks, that data generally had been alright. And if you think about the way the market was in January/February in the early part of this year, people were very nervous about a hard landing in China and continued slowdowns almost everywhere. And actually, economic data has generally been surprising slightly to the upside. It wasn't particularly positive growth, but it was reasonable – the sort of muddle through was continuing.

I think there will inevitably be a reaction in the UK, and UK economic growth will suffer a hiatus of some description as consumers and businesses react to what was, frankly, a bit of a shock result. That will probably have some spillover effects into Europe. But what the transmission mechanism for that is to the US and to China, I don't really see at the moment. I think those major economies will continue broadly as they were; therefore, economic growth globally will probably slow a little, but I don't see a dramatic slowdown.

Has monetary policy reached the limit of its effectiveness?

SA. Broadly, I think it probably has. Rates are very low globally. We've got bond yields continuing to fall in the last couple of weeks. And I do think part of what we're seeing in terms of the rise of populism and some of the concerns we see in electorates globally is related to the policies that we've had. This continuation of quantitative easing monetary policy, it's delivering an outcome for certain parts of the population, but not others. I do think we probably need to move on, and to have policies that are more inclusive. And that will have to include fiscal policies, perhaps tax changes, perhaps incentivising corporates to invest rather than just act as cash machines. I do think we need to change policies, certainly; and yes, I don't think there's a lot you can do, frankly, on the monetary side.

I think it's certainly effective. Borrowing rates are very low. Corporates can borrow very cheaply and those that want to can invest. They can buy other companies. They can continue to act in a way that should boost their own prospects. From a personal level, consumers can borrow quite cheaply – not, perhaps, as cheaply as central banks would like them to – but, generally, consumer borrowing costs have come down a lot. And if you look at the US, for example, 30-year bond rates are very low. People can refinance very cheaply. I think it's around 2.5% now for 30-year money in the US. The US housing market should benefit from all of this, so it's certainly helpful. I guess my point is: what more can be done?

NM. I think there needs to be a broader economic response from governments. So, for the next phase, fiscal policy needs to change. It's most likely that we're going to see this happen perhaps in Japan, maybe in the UK, maybe even in the US post-election, depending on who wins. But I think we need to have something more than just trying the same approach, which has just delivered a very muted reaction from the underlying economies. I think that's really the next phase from governments.

Does the political risk represent the greatest threat to equity markets at the moment?

NM. I think definitely. It's unusual for us. We look at the macro and the political risks probably more than we ever have in assessing prospects. Normally, we spend more time looking at companies and the bottom-up; but the political risk is what has caught everyone out. After all, the market's been wrong-footed by Brexit. It was wrong-footed by the result of the UK general election last year. We've still got a number of political events to come in the next year: We've got the constitutional referendum in Italy, the elections in Germany and France and the US election. So there's plenty to actually worry about.

And picking up on what Stephen said earlier, we can all see that the popular vote and the population is shifting in terms of what it wants and, because of where economic policy has disenfranchised large parts of populations, you're seeing some sort of revolution from that. But that creates uncertainty for markets, and markets hate that.

Do you still prefer equities over other assets?

NM. Despite the volatility, I do. Obviously, the whole backdrop that we've had over the last three or four years of real anxiety about economic growth and very low interest rates has distorted valuations of lots of asset classes, particularly the income-producing ones: obviously, fixed income with negative rates, a very flat yield curve. Equities still stand out as a very attractive asset class. It's just that everyone is quite nervous about owning it. But there are a lot of companies and sectors out there that offer good cash flow and good dividend-paying ability, so yields are still very attractive. You can still put together a portfolio yielding 3%, 4%, 5%. And that, to me, looks very attractive, if you take the longer view.

Stephen, would you agree with that?

SA. Yes, I would. I think one of the things that we're seeing in equity markets is that equities that look most like bonds have performed incredibly well. And there is, therefore, a sort of price for safety. Markets are very uncertain at the moment. You mentioned political risk. It all creates uncertainty; markets hate that and, therefore, there is a price for safety. And, if I think back six, seven years, pre-financial crisis, when we were concerned about leverage, about the banking system, you could actually invest in a number of very safe equities at very attractive valuations. I feel that's not really the case now. There are very attractively valued equities, but many of them are in the sectors that the market is concerned about.

What is your assessment of equity market valuations currently?

SA. At a headline level, valuations are broadly in line with long-run averages; the US perhaps a little bit above. There are certain emerging markets that are definitely below that and Europe also. Within that, though that sort of masks the point I was making, there's been this very significant divergence of valuation between companies that people really want to own and have sought safety and duration in equities and some companies and sectors that trade at 50-to-70-year lows (in terms of relative valuations) that are just hated by the market because of this uncertainty.

Your focus is global. But what are your views on UK equities now that the referendum is behind us?

SA. Sitting here in the UK I think is quite an advantage at the moment, given what's going on. I'm actually becoming more bullish on certain UK equities. I'm not entirely convinced that the economic backdrop is as concerning as the market has sort of automatically assumed it will be. We have actually introduced a new UK domestic position in the last week that had fallen around 35% from its recent share price pre-referendum.

The market has very quickly decided that it doesn't want UK domestic exposure, and it wants international, dollar-based earners. We have a number of those, and those have enjoyed very significant foreign exchange (FX) tailwinds; but there are a number of companies that are more domestically focused, where there is almost no price for them at the moment. And these are great businesses with really good franchises, great balance sheets and good management teams. And they've just got 40% cheaper. I think there are certainly babies being thrown out with bathwater at the moment, and it's our job to look through the uncertainty and pick those winning franchises.

Emerging markets have been under pressure for the past three or four years. Do you see any value coming through in that area?

NM. Yes, I think it's a lot more interesting than it has been. We've had the rally in commodity prices, which helped emerging markets. Also, currencies have at least stabilised and with the likelihood that US interest rates are not going to rise rapidly given this current backdrop that actually makes investing in emerging markets a much more attractive prospect. And as Stephen says a lot of valuations are very low. So yes, I would think it is an interesting area.

Which equity markets are you most positive about currently?

NM. Other than looking at emerging markets, it's still Europe. Europe has been caught up in the downdraught of Brexit, and we've had lots of downgrades from lots of stocks. But we've also seen that happen across Europe. Everyone's forecasting a recession in Europe or a massive slowdown from where we are; and yet, that doesn't seem as likely. Just prior to Brexit, we were seeing pretty decent economic numbers coming out, particularly on the domestic economies within Europe. Lots of the reforms that have been put in place over the last two or three years, the weaker currency and so forth have really helped Europe. For us as investors, valuations are still pretty low; so there are a lot of interesting stocks out there. If you can look through all of the short-term fear and focus on Brexit, Europe still looks like a very good place to invest.

Turning westwards, how do US equities look to you at the moment?

NM. US equities have really been the best. It's been the best performing equity market of any size since the financial crisis. It's been incredibly consistent. We all know the reasons for that. But valuations are pretty high. US corporates have been really efficient in terms of how they've used their capital. We've seen lots of share buybacks. So, profitability and returns have been very good from US corporates. And although there are some attractive stocks we can find, in aggregate, the market looks like it's highly priced relative to something like Europe.

Are you concerned about a slowdown in the growth of corporate earnings and dividends??

SA. Yes. I think, actually, it touches slightly on some of the things that Nick just mentioned. The US in particular has effectively boosted earnings growth and dividend-per-share growth through the use of leverage, and the US corporate sector has re-leveraged enormously post the crisis. There was a good deleveraging during the crisis but, after that, balance sheets have expanded again. And a couple of the guys on my team were in the US in March. What we found was that a significant number of companies were two, two and a half, three times levered in terms of net-debt-to-EBITDA.

They're on quite rich valuations already and in a world of very slow economic growth, as I said earlier, we're not necessarily forecasting a recession. But I think the muddle through and slow growth continues – that's a trick you can only perform once. You can re-lever the balance sheet, you can buy back a lot of shares; but once you've done that and you've created that financial model and structure, there's not much more to do. I think, inevitably, we will see a tailing off, particularly in the US, of some of the earnings growth that has been artificially boosted, if you will.

Are defensive stocks overvalued relative to cyclicals?

SA. In the broad sense, I personally would say so, yes. Inevitably, there are overvalued areas of the market. We hold a couple of stocks in the healthcare sector that we don't think are overvalued at all. We have very little in the consumer staples area because we do think it is richly valued at the moment. As I mentioned earlier, people have sought safety in the reliability of growth. And if you look at stocks that have low volatility characteristics, they are trading at a premium that they have never traded on for ... ever, frankly. There is a price for that safety, low volatility. People want to minimise drawdown, which I totally understand are very attractive characteristics, but the price you pay for them I find concerning.

Ultimately, as valuation-based investors, we are finding the valuation anomalies sitting in other areas. We hold a number of US financials. For example, in the Global Opportunities Fund, we don't have exposure to UK or European financials. But the US financials, through the Comprehensive Capital Analysis and Review (CCAR) process, are now able to give a lot of cash back. The CCAR numbers that came out last week allow JP Morgan and Citibank, for example, to give back north of 8% of their equity in cash between the dividend and the buyback every year. Now, an over 8% cash yield back to you as an investor is obviously quite a significant chunk of your market cap coming back. Some of those areas, I think, are where we may see income investors moving to and a realisation that the sector has become more robust through time.

Nick, any thoughts on that area from your point of view?

NM. Yes, I think financials generally and other markets, too. It's been a global theme. It's really been the area that everyone's loved to hate, and it doesn't seem, at current times, that valuation has been any support. But you have to really take the longer view, and that's what we're doing in our portfolios. Some of the European financials, as well as the US financials, are trading at very low price-to-book ratios, very strong capital ratios. The market really has been trying to look at, 'Well, what happens if there's a recession? How bad could this get?'

Certainly, if you actually back out the numbers and look at a stress test of saying, 'Well, if you repeat anything like the global financial crisis, where are capital positions?'. And it's very telling that, when you look at a lot of the better banks, their capital ratios are actually very strong despite that type of stress. But because of the fear of markets at the moment, nobody wants to own these assets. The longer-term potential return for us looks interesting.

Do you see value in the commodities sector and, if so, where?

NM. Yes. Commodities, as I said earlier, have generally rallied. For us, really, it's been the oil sector that has been our big focus. We've had big positions in the oil companies through the latter half of last year and all the way through this year. Obviously, that's performed very well, but we still like this sector long term. All of the ingredients look right for the oil sector. In terms of what is happening to production, it's been cut by major producers. Companies are cutting capital expenditures. They're becoming more efficient. They're focusing on shareholders. We can see cash flow improving. And we also get very, very good dividend yields. So, it looks a really attractive sector going forward, and particularly in this environment.

What about mining?

NM. The mining companies are always harder to value and take a view on because there's so much operational gearing in the mining stocks. And with the rally in spot prices in a lot of the major metals, valuations do look low. But it's a very much more cyclical area. And so, actually, I prefer the oil sector.

The question is, if we do see a fall initially, will that then, over the following few days, be followed up by a rally in the markets as people watch the dust settle and try to think through the implications of a weaker sterling?

SA. Just to add on to that point, I think the simplistic way of thinking about it is that the mining sector is exposed, if you will, to global capital expenditure whereas the oil sector is more exposed to operational, day-to-day expenditure. It's easier to have a view on whether oil demand is likely to shift very considerably or not, and the oil market, in terms of demand, is reasonably stable. It may move by one or two million barrels a year, but that tends to be it. And as Nick said, there's been a huge capital expenditure reduction from the oil companies, production has been cut and the market is moving back towards a supply/demand balance.

I was in Canada two weeks ago and one of the places we visited was Calgary, which has been at the forefront of some of this. And it is interesting to understand corporate behaviour: Whereas, previously, they were very keen to put production on and to get wells up and running, now they're saying, 'Look, for greenfield, for new production, we'll need to see a US$60-US$65 oil price per barrel for 12 months before we, as a board, are going to sanction new projects.' Now, that's not necessarily true for brownfield, bulking up existing production. I think we will see some of that coming on stream. But, in terms of new production, I think we're going to have to see oil prices probably at the current level and a bit above for a considerable period of time before we see companies rewriting cheques to drill new wells.

Nick's talked about the strength of the banks at the moment. Are you expecting the financial sector to outperform?

SA. Firstly, let me just say the financial sector is a very broad sector. So, in the portfolio I manage, we have a very significant financials exposure, but that includes banks, payment companies such as MasterCard and it also includes things like the S&P ratings business. There're a number of different parts of that sector. And as I talked about some of the US financials we have very big positions in, we think they're much further through, building up capital levels. They're now redistributing that capital back to their shareholders. Given the level of uncertainty and the pressure on bond yields, frankly it probably is quite hard to see the sector outperform in the very short term.

Over the long term, if you look at where we are now in terms of those bond yields, in terms of the valuations of some of those companies, particularly considering this isn't just about bond yields, some of these companies in the US particularly are now delivering a reasonable amount of credit growth to the economy of between 5% and 8%. So they are growing lending. They're able to repurchase their own equity at around 0.6, 0.7 times book value, which is a very attractive book value per share for those of us who then continue to hold your shares.

I think there's more going on,. But, in the short term, the market just looks at the bond yield and says, 'Right, bond yields are down. I don't want to own banks.' And I think, in the short term that may continue. In the medium-to-long term, I think that's the wrong reaction and, actually, valuations will matter over time. We're continuing to maintain our positions – but it's not just about banks. There are lots of other financials within that space.

Nick, do you feel similarly about financials?

NM. I do very much. It all is caught up in the emotion of markets; and nobody can see their way through in terms of financial returns. And lots of sectors within the financial group have been caught in this. There's been a lot of basket trading as well. It's not just been about looking at individual stocks; I think there's been a large element of investors just saying, 'Get me out of financials'. And so I do think that there is a long-term opportunity there.

Has the referendum result thrown up any interesting opportunities?

NM. It has, and we're working our way through them at the moment. Look, let's face it: Lots of share prices are down 20%-30% if you're in the wrong sectors; anything domestic, UK, anything in financials, things in cyclical areas. Everyone's been looking for safety for the last couple of years and, particularly, has been avoiding cyclical areas. The Brexit referendum outcome really has just given that another shove. And it means that there are lots of stocks out there where valuations are very low and really do discount a lot of very bad news. The key is working your way through that, and taking that longer view is really important.

How long is it going to be before the referendum fog disappears and these things appear with some clarity?

NM. It's really hard to say, isn't it? Because we know that the political backdrop of the result is going to be with us for some time, because of implementing any exit from Europe, whether that happens, how it happens and the extent that any of this will happen.

There are all sorts of twists and turns to this plot already to the extent of trade agreements. We're actually going to have quite a lot of news to come, and it's not going to all happen this year.

What medium-to-long-term thematics are influencing your current investment thinking?

SA. In general, I would say that the repetitive technology change and disintermediation is probably greater now than I've ever known it. And I think, if you were to think about something like taxi driving, would you have said a few years ago that that could be disintermediated? Probably not. Along comes Uber and we have an enormous change in that industry. So, I think we have to be extremely mindful of things like that.

When we're analysing new companies, we are constantly checking: Are these areas of the market that could be disintermediated very easily by technology change? And what technology is doing is allowing parts of the capital stock that have been underutilised to be utilised and generate an economic rent. Cars, for example with Uber drivers, were probably being used 5% of the time, and now they're being used substantially more. Technology is allowing a lot of things to change.

I think the automotive sector in general is probably at the forefront of this: a lot of talk about electric vehicles, battery technology, autonomous driving. So, I think avoiding disintermediation, frankly, is the key for me. I think often, when you have themes that people get very excited about, they very quickly attract valuations that are not something that I consider reasonable. And you've seen the number of unicorns expand so dramatically over the past few years.

Unicorns but necessarily in a good sense, do you mean?

SA. Yes, quite. I guess avoiding disintermediation is really a key theme for us, rather than following themes.

For quite a long time, it was very in vogue about 20 years ago. Does disintermediation excite you, Nick?

NM. It's very much something that's very fashionable. There are lots of conferences looking at the idea. I think, in investment, you have to keep your feet on the ground and not get caught up in fashions. And you have to quite often look where other people aren't. So I think it's maybe a little too in vogue.

A fundamental question: Is the hunt for yield more difficult in a world of negative interest rates?

NM. With low and negative interest rates, we've had a lot of new investors in equities, and investors very much hunting for stability and defensive qualities. It's all about valuation and, for me, it's about sticking to the fundamentals of looking for cash flow and sustainable dividends. But you can find stocks that deliver on those criteria. You just have to be very careful that you don't get pulled into the sectors that have been much overbought because they look like they're safe and stable, when, in fact, a number of the stocks, actually, are not growing.

Do you foresee an increase in mega-mergers, now that successful companies have, as you were observing earlier, such a large amount of cash on their balance sheets?

SA. I think it's actually not just about cash on balance sheets. Given the referendum and what's happened to some of the foreign-exchange rates, I think, if you were an overseas investor, a US corporate looking at companies in the UK, you might think, 'Well, this now is a very good time.' The exchange rate is at a 35-year low or whatever it is today. Mergers, certainly, I think will be part of it, and we've seen a few big ones this year, particularly in the agricultural sector. We've seen Monsanto/Bayer, Syngenta/ChemChina, Dow/DuPont −an industry of six that is effectively trying to go to three. We are seeing it in other areas, and I think that's partly to do with the slow growth world that we touched on: companies are getting together to create cost and revenue synergies. I think, yes we will continue to see it.

The fog of the post-referendum world at the moment may make it tricky for a short period of time. But, I think, once we do begin to see that fog clear – whenever that may be, as just discussed – we may well see more M&A activity, particularly since the UK is open for business as George Osborne said. And a lot of these companies that are very good companies, well-run, great franchises, have just got considerably cheaper.

And how can you, as an investor, as someone managing a portfolio, respond to the prospect of an increase in the number of M&As? Is it something which you can easily anticipate and respond to?

SA. I don't think it's easy to necessarily anticipate where M&A activity will occur, but I think by focusing on companies that you think are undervalued, have strategic value in their particular industry and in an industry with a long-term future that you believe that business will continue to get stronger over many, many years, those typically are the areas where corporates – large corporates – will take advantage of a valuation anomaly and take a longer-term view.

Using the example of Monsanto that I touched on in that industry, I think Bayer took a view that this is a company that had underperformed recently. It's a long-term strategic industry, etc.; therefore, they took a view that now was an interesting time. And that tends to be what happens.

In a certain sense, the acquirers and you – as an investor – are following the same track?

SA. Absolutely yes.

Post the Brexit vote, what is your key takeaway?

NM. My key message is that this is a time for calm – a calm assessment of what is actually happening. For us, it's about sticking to our core, long-term approach of fundamentals and valuation. There are some really extreme valuations out there between what is perceived to be safe and what is not. And if you take the longer view, there's a lot of opportunity, and that's really what we're going to focus on.

So, you might say 'Keep calm and carry on investing'?

NM. Absolutely.