Investment Insight

Friday, 6 March 2015

Mario's money: *Next week sees the beginning of Mario Draghi's bond purchase programme. Financial systems engorged by the excesses of global debt will swell still further. The long term consequences are as yet uncertain, although there are good grounds for concern as to how over-inflated asset prices will be restored to something resembling "value". Absent several years of global GDP growth, falling asset prices may be the only way to restore equilibrium.*

However, that's not today's issue. More immediately, European equities are likely to receive a boost from the ECB's activities, and investors with an overweight in Europe stand to benefit. In this week's ***Inside Track*** *we share the views of one European equity manager, Schroders' James Sym, on the prospects.*

Tech-tock*: Compared to other sectors, US tech stocks have the lowest ratios of debt to market capitalisation in the S&P500. As a result, the clock is ticking on a spending spree of share buybacks and enhanced dividend payouts.*

Apple, Cisco, Google and Microsoft between them have over $350 billion in cash reserves which represents almost a quarter of the total cash reserves of US companies. In ***Pic of the Week*** *we take a look.*

The Inside Track

James Sym manages over €1 billion in European equities at Schroder. Having made good returns in 2014 from early-cycle recovery stocks, his focus has now moved to finding economically sensitive stocks that will benefit from a weak Euro, cheaper oil and low funding costs. The following are his recent views on the opportunity set.

The share price gains over the past couple of years were driven by a relief rally as fears over eurozone break-up subsided. However, corporate **earnings in Europe still remain at very depressed levels**. While US earnings are around 13% above their previous peak, eurozone earnings still languish at around 32% below their prior peak.

Many in the market expected eurozone earnings to recover in 2014 but this failed to come through as the eurozone economy appeared to slip into the slowdown phase of the economic cycle. We would argue that **the conditions are in place for eurozone corporate earnings to surpass the US this year and drive the next phase of share price gains**.

Bank earnings, which have been particularly under pressure, look poised for an improvement this year. A metric that we follow closely is the European Central Bank's bank lending survey. This has shown that **credit conditions are now easing in the eurozone** after the twin credit crunches of the global financial crisis (2008-10) and the eurozone crisis (2012-13). We monitor corporate demand for credit especially closely, as it is investment that can ensure any economic recovery becomes self-sustaining.

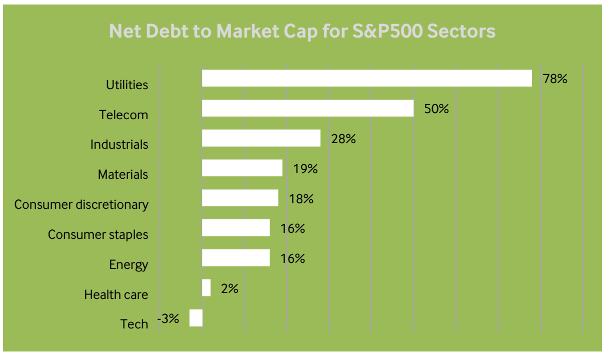
Capital expenditure by corporates has fallen in most eurozone countries and is near lows as a percentage of sales. Leading indicators such as **consumer and business sentiment surveys are supportive of a pick-up in capex growth**, though this has not materialised yet. Should it do so, this would go hand in hand with improved earnings, particularly if corporates start to make up the shortfall in investment witnessed over the past few years.

Given the backdrop outlined above, we feel that **cheaply valued and cyclical stocks** (*i.e.* those that are most sensitive to the economic cycle) should be **best placed to outperform**. The segments of the market that we currently favour are consumer cyclicals (such as autos or media) and industrial cyclicals (such as construction).

After recent underperformance and given a likely pick-up in the economy, as well as the attractive dividends on offer, we now have **a preference for higher quality banks**. In our view, these kinds of stocks are the ones with the greatest potential for earnings recovery. By contrast, growth defensives (such as food producers or healthcare) are less sensitive to the economic cycle and so likely to benefit to a lesser degree from economic recovery. As higher quality stocks, they also command a premium which we think will look less justifiable as profits recover elsewhere.

Pic of the Week

The debt to market capitalisation ratios of the S&P 500 tells an interesting story. At the top of the pile (most indebted) are the slow and steady utilities and telecoms. However, with their elevated share prices, indebted balance sheets and the prospect of US interest rate rises this year, there may well be more fertile hunting ground in the cash-rich tech sector for those in search of income.



Market View

	Last 7 days	YTD	5Y Ann.
Global equities	-0.2%	+4.9%	+8.9%
US equities	-0.5%	+2.0%	+13.0%
European equities	+0.8%	+14.8%	+8.5%
Emerging market equities	-1.6%	+1.9%	-0.0%
Irish equities	+2.0%	+15.2%	+14.9%
Commodities	-1.7%	-2.5%	-5.5%
Hedge funds	+0.3%	+1.8%	+1.3%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.9%	-0.6%	+3.5%
Germany	+0.3%	+0.1%	+1.4%
USA	+2.1%	-0.1%	+2.4%
China	+3.5%	+0.8%	+7.3%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.10	-8.9%
EUR:GBP	0.72	-6.9%
EUR:CNY	6.90	-8.5%
GBP:USD	1.52	-2.2%
Bitcoin	270.55	-14.7%

Commodities	*Current*	*YTD Δ*
Gold	1,199.06	+1.2%
Copper	5,857.00	-8.0%
Oil	60.74	+2.6%
Wheat	481.25	-19.0%

Week ahead: Key events

09/03 Ireland Construction PMI
09/03 EU Investor Confidence
09/03 Ireland New Vehicle Licences
10/03 China CPI
11/03 UK Industrial & Manufacturing Production
12/03 EU Industrial Production
12/03 Ireland Bond Auction
12/03 Ireland GDP & CPI
12/03 US Retail Sales & Initial Jobless Claims
13/03 UK Construction Output
13/03 US University of Michigan Sentiment

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

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