5 Key Issues Shaping Current Investment Strategy

1	**The equity-bond conundrum: Has QE distorted financial markets?**
2	**Increasing dispersion: Equity market returns are diverging by sector, region and style**
3	**Trouble in the eurozone: The ECB's latest move could be too little too late**
4	**Reforming Japan: Corporate governance standards are improving**
5	**UK commercial property: Investors might want to locate the exit points**

Has quantitative easing distorted markets?

- Over the past five years the world's major central banks have purchased large quantities of assets through their quantitative easing (QE) programmes.
- The scale of these purchases has led to concerns that the economy is dangerously imbalanced, asset prices are overvalued, and the relationship between bonds and equities has become distorted.
- We believe that adjusting properly for inflation, bonds do not look quite as expensive relative to equities as popular wisdom suggests.
- Meanwhile, although private sector debt is high, the rate of saving is outpacing investing, which runs against the idea that QE has encouraged over-indulgence. As investment increases, these conditions should support equities.
- We remain aware of the various weaknesses in the global economy that may be agitated when central bank stimulus is withdrawn. But we do not believe policymakers have distorted financial markets to an excessive degree.

Figure 1

When we adjust bond yields to account for inflation, they do not look overvalued.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Earnings yield

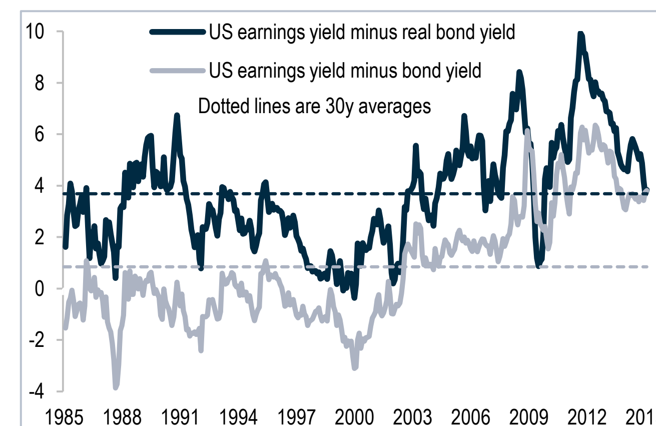
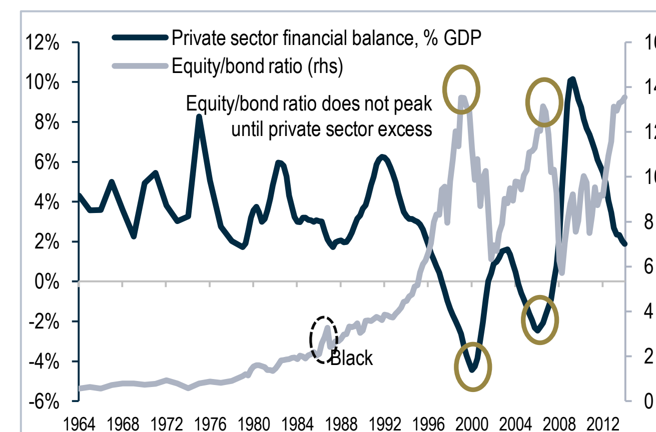


Figure 2

In 2000 and 2006 the equity-bond ratio peak coincided with excess private sector debt. With the private sector saving more than it is investing today, this ratio does not look stretched.

Source: Datastream, Rathbones Asset Allocation Strategy Research

A prudent private sector



Equity market returns are diverging

- Following the 2007–08 financial crisis most politicians and policymakers focused on pulling their economies out of recession and strengthening their financial systems.
- Today the world economy is running at different speeds and there is no one dominant macro event.
- As a consequence, performance of equity markets is increasingly diverging by industry sector, global region and investing style.
- For example, US companies with higher domestic exposure have benefited from the consumer recovery and outperformed those with more global exposure.
- Meanwhile, defensive equity sectors, such as utilities and pharmaceuticals, have outperformed cyclical sectors. This trend has been driven by demand for "bond proxies" from fixed income investors.
- As a result of the increased dispersion, individual stock selection has become more important in a world of increasing risk and uncertainty.

Figure 3

Low bond yields have encouraged fixed income investors into equities that offer high and stable dividend payments.

Source: Canaccord Genuity QuestTM, Datastream, Rathbones Asset Allocation Strategy Research

Bond proxies

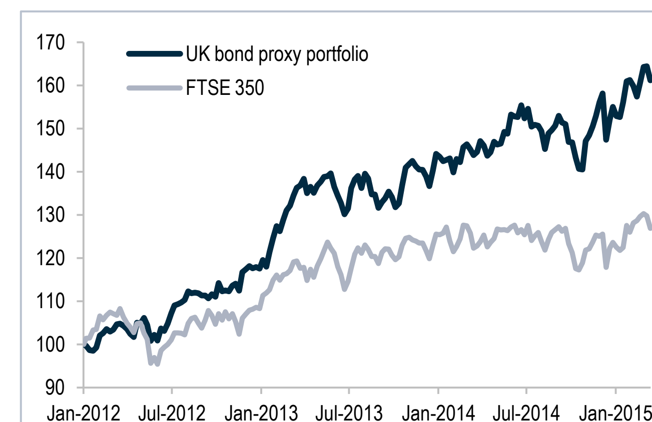
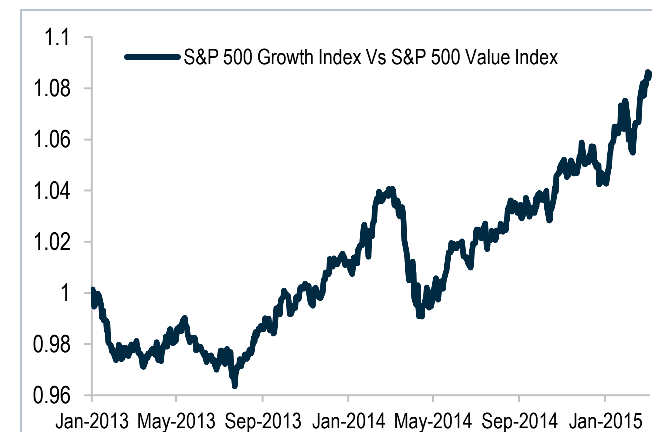


Figure 4

Growth stocks have outperformed value stocks since the middle of 2014.

Source: Datastream, Rathbones Asset Allocation Strategy Research

Growth vs value



The ECB may have acted too late

- In late January European Central Bank (ECB) president Mario Draghi announced that he would begin quantitative easing (QE). Markets have reacted positively but has it come too late to resuscitate the eurozone economy?
- One aim of QE is to encourage commercial banks to increase the amount they are lending into the real economy. But eurozone banks will probably use the additional cash to strengthen their balance sheets.
- QE in the US and UK may have boosted consumption through the wealth effect – people felt wealthier as stockmarkets rose and house prices increased. But Europe is unlikely to enjoy the same benefits.
- Meanwhile, markets have been sanguine about the possibility that Greece could leave the European Union (EU) (figure 6).
- “Grexit” would probably not rip the EU apart but it would raise important questions about the future of the European project. Conversely, a successful debt renegotiation could encourage anti-austerity parties in other peripheral countries.

Figure 5

This chart shows balance sheet expansion as a proportion of GDP at the time of launching QE.

Source: Datastream, ECB, Rathbones Asset Allocation Strategy Research

The ECB's QE programme is relatively small

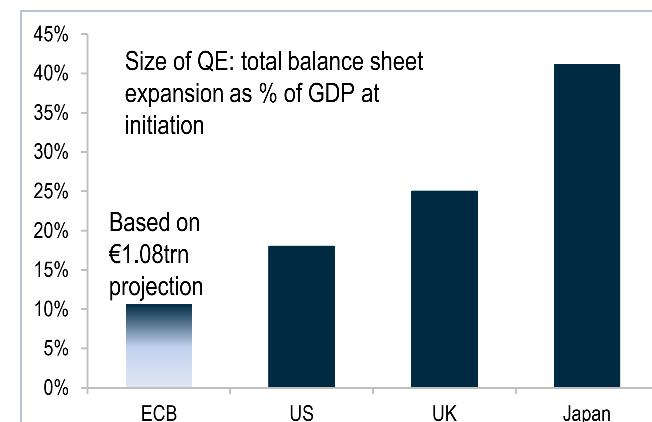
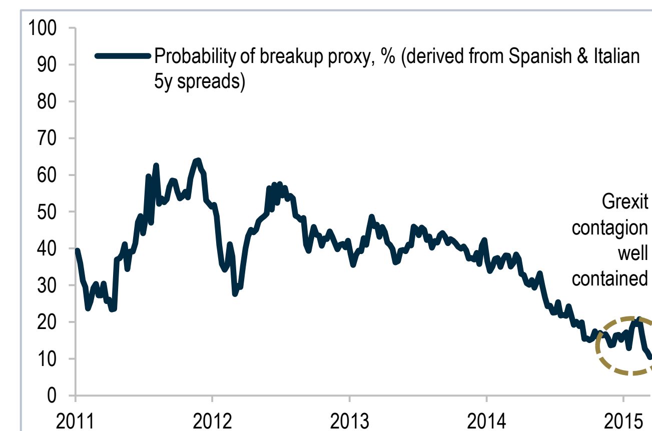


Figure 6

Spanish and Italian five-year government bond spreads suggest markets are not concerned about contagion from Greece.

Source: Datastream, ECB, Rathbones Asset Allocation Strategy Research

Markets are unfazed by the possibility of Grexit



Corporate governance is improving in Japan

- Despite concerns about the slow progress of structural reforms, which make up the third arrow of Abenomics, there have recently been some notable improvements in corporate governance.
- Prime minister Shinzo Abe is introducing a stewardship code, which encourages shareholders to monitor firms more closely and improve oversight.
- Rising foreign ownership of companies is also helping to bring about change. In addition, Japan's old system of cosy cross-shareholdings involving friendly, local banks is breaking down.
- Meanwhile, renewed investor appetite could support Japanese equities. The stockmarket has also benefited from the asset allocation shift in favour of equities by the massive Government Pension Investment Fund.
- Renewed interest from retail investors helped push up the Nikkei 225 Index to a 15-year high in March.
- Japan has suffered from false starts in the past but we believe this time could be different.

Figure 7

The proportion of Japanese companies with external directors has been increasing steadily over the past decade.

Source: TSE

Corporate governance is improving

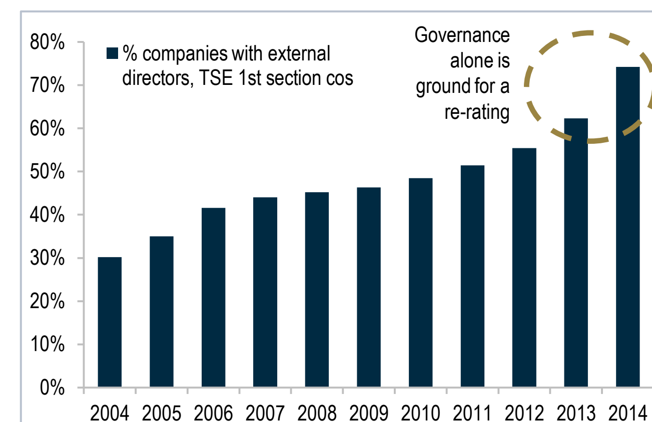
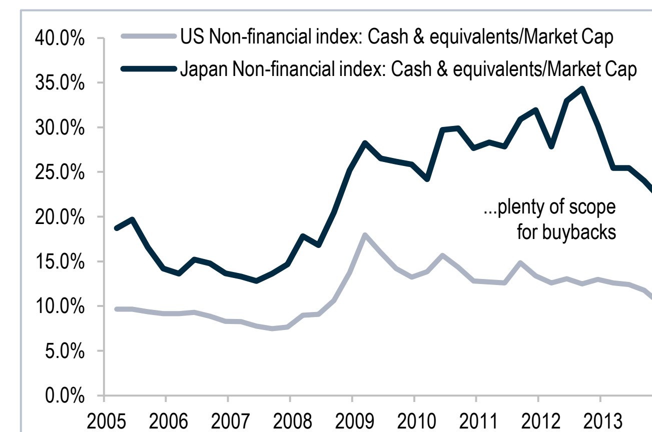


Figure 8

The amount of cash on Japanese company balance sheets leaves plenty of scope for share buybacks.

Source: Datastream, Worldscope, Rathbones Asset Allocation Strategy Research

Cash on the balance sheet



Warning signs about UK commercial property

- Strong returns from UK commercial property over the past few years have made the sector popular with investors, and expectations are running high that this strong performance can continue.
- Yet there are signs that the market may be overheating. In the first instance, the sector is saturated with cash and some funds are struggling to find investment opportunities.
- Performance is diverging in terms of location and quality with prime buildings in the best areas able to demand high prices, while lower-quality neighbours are struggling.
- Although open-ended funds and REITs provide an illusion of liquidity, it is important to remember that this is an illiquid asset class that has suffered substantial falls in value in the past.
- In the short term we see no reasons to suggest money will come flooding out – leverage is nothing like as high as in the past. But recent history reminds us that it is not a good idea to be invested when everyone else is rushing for the exits.

Figure 9

This chart shows the annual changes in the IPD UK Commercial Property Index over the past 10 years. Property values can fall substantially during periods of market stress.

Source: IPD, Rathbones

UK commercial property peaks and troughs

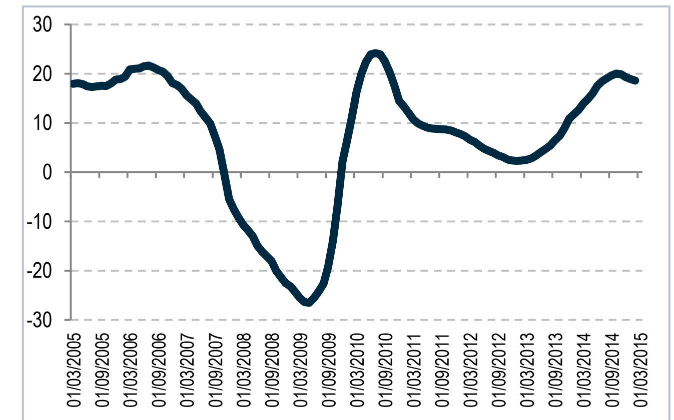


Figure 10

Yield compression on a subsector, such as prime London offices or in the second tier offices in secondary locations.

Source: Datastream, Rathbones

Yield compression