Getting investors prepared to navigate 2017

Improving global growth but rising political risks calls for investors to maintain a well-diversified portfolio, says Thorsten Becker of J O Hambro Capital Management (JOHCM).

An improvement in economic growth combined with firmer commodity prices is lowering the risk of deflation and improving prospects for global equities in 2017.

That was the view Thorsten Becker, senior fund manager of JOHCM US Small Mid Cap Fund, speaking at a professional investor roundtable in Bangkok in late March.

PMI data from around the world suggests business activity has been picking up over the past six months. Indeed, many analysts believe that global economic recovery has now reached a point where central banks can assess whether ultra-easy monetary policies begin to be tightened.

In the US, for example, the tightening process is already underway, with a new rate hike in March. While maintaining a forecast of three rate hikes three year, the Federal Reserve's action was widely perceived as 'dovish' by investors, leading to a surge in global risk asset prices.

Becker says the optimism in risk assets is being driven by the perception that the Fed's action indicates the US is well on its way to economic recovery.

In addition, the expectation of three rate hikes this year also indicates the path to interest rate normalisation will be gradual, he explains.

POLICY SHIFTS TAKING PLACE

The consensus belief is that as the year progresses, the Fed's focus will shift to shrinking its balance sheet.

To some extent, the impact of Fed tightening will be offset by easy monetary policies in Europe and Japan, although it seems likely that even the European Central Bank (ECB) and Bank of Japan could embark on some form of monetary tightening policies this year.

THORSTEN BECKER
J O Hambro Capital Management

According to Becker, there is a much higher risk of a policy mistake by the ECB. Last year in December, for instance, the ECB scaled back its bond

purchases but said the programme would continue until the end of 2017, three months longer than expected. Recent reports suggest the ECB is being pressured into cutting back its USD2.5 trillion asset purchase programme even further by conservative nations after inflation in the 19-member currency union hit a four year high of 2% in February. In March, however inflation fell to 1.5%.

The broad view among investment specialists is that with no sign of a sustained rebound in inflation, and growing political risk from upcoming elections in two of the eurozone's biggest economies (Germany and France), the ECB should not be hasty and pull back on easing measures any time soon.

Europe's central bank has a history of tightening too quickly; an interest rate hike in 2008 proved disastrous even as the global financial system was imploding, followed by another similarly disastrous move in 2011.

If something similar happened again because of pressure from ECB hawks, markets could react very badly, says Becker. In the case of Japan, meanwhile, tightening is likely to happen in the form of a target for 10-year bond yields.

Overall, Japan's economy is improving, adds Becker, boosted by higher export volumes. Nevertheless, consumer spending remains weak, and there are concerns that the Japanese consumer hasn't benefitted greatly from the Abe government's slew of reforms.

But, as most experienced Japan-focused investors note, there are always good Japanese companies to invest in, irrespective of the policies and macroeconomic conditions. There are many robust local companies that represent the real investment opportunities; those firms which are focused on domestic demand, those which can compete in the global arena and those that can capitalise on Asian expansion.

Even the UK could be contemplating monetary tightening given its economic performance, although Brexit will make any tightening much harder to implement.

ERA OF CHEAP MONEY IS OVER

Overall, Becker believes there will be less divergence in policy within the developed world over the course of the next two years. It also means that the global economy is moving into a new phase for growth.

The era of endless cheap money is reaching an end, he adds, even though central bank policy will remain supportive of growth. Typically, this phase remains conducive for risk assets – real interest rates provide enough stimulation, while there is enough excess capacity in the economy so that earnings growth outweighs higher interest costs.

The big risk, of course, is interest rates rising too quickly, especially for investors in more developing financial markets like Thailand, given the paucity of financial instruments that can help manage duration. As a broader theme, Becker says the focus of investors will shift from learning to survive in a low-growth, low interest rate environment, to surviving a rising rate environment.

That calls for a move away from fixed income – typically preferred by Asian investors – as these investments will become increasingly vulnerable, and a shift in favour of riskier assets such as equities. Improving global growth will be positive for equity markets, according to Becker. ■

Stay diversified

With the US ahead of other developed nations in terms of growth, and the Fed handling the interest rate normalisation process adroitly, investors could consider US equities as part of a well-diversified portfolio. Even with new US president Donald Trump in power, the prospects for the economy appear positive as many of his government's policies are pro-domestic growth, says Becker.

Despite the anti-trade and anti-immigration rhetoric, the expectation is that the Republicans will focus on boosting the economy through tax reforms, raising infrastructure and defense spending.

As a result, Becker believes that investors looking to position themselves in such an environment would do well to focus on sectors poised to benefit from 'Trumpnomics' – defense, infrastructure, cybersecurity and domestically-focused companies. A more inward-looking US could also spell good news for smaller and medium-sized companies.

The key is to be selective in an equity market that is overall quite expensive. This means finding companies that have strong growth prospects and reasonable valuations. Becker says that investors should focus on a well-thought out portfolio of small- and medium-sized companies that have the potential to become large companies in the long term.

At the same time, he says investors should also not forget that irrespective of market conditions, a well-diversified portfolio is best positioned to protect and grow assets.