INVESTMENT

Maintaining control

Sandra Haurant looks at the current state of the equity markets given the high levels of political change, and what this means for pension funds

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In a world where the never-ending stream of political surprises just keeps on flowing, it is hard to know just what will happen next. The Brexit vote shook the UK, the run up to the US elections was a time fraught with doubt, and now it's Europe's turn, with a run of elections set to show whether the continent will tip towards populism or stand firm against the tide.

But while the world held its breath waiting to see whether the US would choose to carry on in one direction or take a completely different turn, in the States the markets had a different take on things.

Candriam head of fundamental equity management Geoffroy Goenen says: "Before the elections, we were talking to US investors, who were quite bullish about Trump. Their attitude was that if it was Hillary who won it would be a non-event, but if it was Trump, they were very bullish. On this side of the Atlantic, the perception was that it was a risk. But that was not the perception of US investors, and they are the primary investors of the US markets."

And when the election results were in, global equities took the news pretty well. Unigestion head of equities Alexei Jourovski explains: "Global equities reacted to Trump's election with a surprisingly high level of optimism. Domestically-oriented cyclical and consumer-related stocks witnessed strong positive returns as the markets anticipate pro-business policies and fiscal stimulus," he says.

Indeed, in January 2017 the *Financial Times* reported that in the US stock markets: "Donald Trump's November victory ignited the steepest rally from election day to inauguration for a first-term president since John F. Kennedy won the White House in 1960." The S&P 500 climbed 6 per cent between election day and inauguration.

The proof of the Trump pudding for US markets will be in the policies, and specifically whether or not he manages to implement them. In March, markets came under pressure as a nervousness around the possibility of failure to deliver on some pre-election promises set in, and some commentators expect a bumpy ride ahead. Jourovski says: "Our longer-term forecast is that this optimism will gradually fade and markets will become more volatile as the effective implementation of some of the Trump's policies may be challenged."

Setbacks could have a significant impact on the US stock market, Goldman Sachs Asset Management head of the global portfolio solutions group for EMEA and Asia Pacific ex-Japan Shoqat Bunglawala stresses.

"The challenges that will be faced in actually fully implementing the reform agenda when the market had clearly priced in a fair amount of optimism, has made us somewhat more cautious going into the summer, and we may look to reduce some elements of that pro-cyclical bias risk that we have got, given those headwinds about policy execution."

European politics

And of course, Europe has its own

THERE IS SOME CAUTION AS IT RELATES TO EXPOSURE IN THE US, GIVEN A POTENTIAL HEADWIND AROUND WHETHER OR NOT THE POLICIES THAT CAN BE AFFECTED BY THE ADMINISTRATION ARE LIKELY TO FACE SOME ELEMENT OF RESISTANCE THROUGH CONGRESS

headwinds right now, with a number of elections coming up that could bring about significant change on the continent. In the Netherlands, the Dutch prime minister successfully fought off the threat of the far-right candidate Geert Willders. The German elections will pose a challenge for Angela Merkel while, at the time of writing, the French elections hang in the balance with centrist Emmanuel Macron edging ahead of the far-right Marine Le Pen in the polls for the first round.

There are, says Bunglawala, interesting times ahead. "On Europe, and particularly France, our view going into the year had been that the markets were overly pessimistic in Europe. In some ways this was in contrast to the attitude towards the US, where the uncertainty about Trump's administration being able to deliver a lot of these policies, in our mind,was an issue and yet the markets there were quite optimistic," he says. "In Europe, it was almost the opposite story; the markets were quite pessimistic given the tail risks associated with a potential Le Pen victory," he says.

Markets are quickly shaken by the prospect of instability, and typically prefer things to be stable. The prospect of Le Pen winning the presidential elections, then, is a very real concern, in part because of the impact it could have on Europe as a whole. "A lot of the Front National's policy rhetoric is about seeking to exit the EU, and there is also a lot of rhetoric around trade, which can upset market, and that is certainly the tail risk that markets are concerned about," says Bunglawala.

It is always risky to make predictions, but speaking ahead of the French elections, Bunglawala says: "Our base case is that Le Pen won't be successful in the second round elections in France, and

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the European markets are perhaps overly pessimistic around European growth." Of course, he adds, the risk is still material and there is good reason for investors to be cautious. But, he says: "Le Pen still remains pretty far behind in the polls for the second round, and that window for catching up is narrowing. Given the improving growth outlook, there may be the upside potential in European equities."

Room for growth?

JLT Employee Benefits senior investment consultant Aniket Bhaduri agrees that there is room for growth. "European equities are currently being seen as an asset class with a big upside potential," he says. Indeed, in the first quarter of 2017, analysts at Bank of America Merrill Lynch said that European stocks were at their cheapest level for 40 years compared with their US counterparts. And, says Bhaduri: "Although they have grown by 20 per cent over the last year, there is still potential for more growth."

Geonen agrees. "The sentiment around Europe is still very, very black. The under-positioning is still massive," he says. "What we strongly believe at Candriam is that the PMI (purchasing managers index), which is the leading indicator of Europe, should continue to improve, so we should see further acceleration at least in the eurozone."

While the developed world has more than its fair share of uncertainty at the moment, there has been something of a shift in emphasis towards emerging markets, according to Bunglawala. "We have pivoted away a little bit from the pro-risk being largely in US equities, to one that is more nuanced now," he says. "We are certainly favouring European equities, but also emerging markets, where we think that there is value over developed markets."

He puts this down to three main points within emerging markets.

"First, a significant valuation adjustment over the last few years. The second is related to macro imbalances that emerging markets, certainly selected emerging markets, have ironed out over the last few years and with them having issued more local debts, they have less susceptibility to a rising US rate environment. And the third point is related to those emerging markets that are quite export-focused, and particularly focused on commodity exports," he says. "With the more stable outlook on commodities we have now, relative to the last four or five years, a lot of those previous headwinds have been dying down, and emerging markets are that bit more attractive."

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There is no doubt that these are turbulent times, and there are bound to be surprises ahead. After a year like 2016, that seems to be the only certainty. With that in mind, diversification and a nimble approach are essential. As Jourovski says: "In an environment of continuing low yields, equities have an important role to play in providing a long-term performance driver. However, given the current state of the market cycle, we believe that controlling the downside risk of that equity exposure is paramount." ■