Invesco

Global Market Commentary

Jan. 12, 2012

Old Worries, New Optimism

2012 global investment outlook

Richard Golod
Director, Global Investment Strategies

Executive summary

The new year brings with it some unfinished business, namely the sovereign debt crisis and probable recession in Europe, a potential hard landing in China and improving, but still below-trend, growth in the U.S. However, for global equity investors there are reasons to be optimistic, in my opinion. Most equity markets entered the new year more undervalued than year-ago levels, against a backdrop of declining inflationary pressures, lower or falling interest rates and signs of light at the end of the tunnel with regard to the European debt crisis and global economic slowdown.

- **Overweight the U.S.** Gross domestic product (GDP) growth is likely to be higher this year than in 2011, but still constrained by a number of factors. I believe the S&P 500 Index is likely to move higher as the equity-risk premium (or the additional return compensating investors for the higher risk of equity investing) declines, despite possible earnings disappointments.
- **Underweight Europe.** The implementation of austerity measures and lack of bank lending could amplify and extend the region's economic slowdown. The European equity market remains vulnerable to further declines if recession becomes deeper than expected.
- **Look for buying opportunities in the emerging markets.** Emerging market purchasing manager indexes (PMIs) are beginning to slow their rate of decline, which is the first step toward a potential turnaround, in my view. I believe monetary policy is likely to remain accommodative and beneficial for equities in the second half of the year.

The following pages expand on these insights and examine the implications for global equity investors.

Expect turbulence and potential gains

I believe investors will continue to grapple with many of the same concerns in 2012 that disrupted the equity markets last year: slower global growth, the European sovereign debt crisis, a weak U.S. consumer and a potential hard landing in China. In addition to these factors, this is an election year in several of the world's largest countries, including the U.S., France and China. The outcomes could have important implications for global growth and market returns. Monetary policy will also be a critical factor, as the developed world remains burdened by heavy debt and the developing world deals with decelerating growth.

United States: Overweight

The current consensus GDP growth rate for 2012 is currently 2.1%, according to Bloomberg.[1] It will be difficult for GDP to surprise on the upside for several reasons, in my view.

According to a paper by economists Christine and Vincent Reinhart, in the 15 worst financial crises since World War II, GDP growth averaged 1.5 percentage points below trend for a decade after a crisis.[2]

The U.S. economy's below-trend growth since the 2008 to 2009 recession has not been unusual relative to other severe credit crises in developed and emerging market countries. According to a paper by economists Christine and Vincent Reinhart, in the 15 worst financial crises since World War II, GDP growth averaged 1.5 percentage points below trend for a *decade* after a crisis.[2]

Fiscal and consumer deleveraging will continue in the U.S., which will maintain GDP growth at a below-trend level for an extended period, in my opinion. Politicians have yet to agree upon a solution or time frame to reduce the federal budget deficit, and American consumers have made little headway in improving their balance sheets. Household debt has declined only 4.5% from its peak in 2008.[3] Household net worth is down $9.4 trillion from the 2007 peak.[4] Household income is less than 1% greater today than it was in 1989.[5] The level of employment is actually lower today than it was in April 2000.[6]

As such, the U.S. consumer is not in a financial position to sustainably drive economic growth at an above-trend level, which is needed to materially lower the unemployment rate. The recent improvement in employment has been mostly in low-paying jobs at the expense of high-paying jobs. The 120,000 rise in November payrolls has not translated into total wage gains; average weekly earnings have stagnated over the past four months.[7]

In addition, I'm not convinced the U.S. economy will remain unaffected by the recession that is currently gripping Europe. The recently stronger GDP growth in the U.S. led some to believe that we have decoupled from events in Europe. But I believe we are merely experiencing a lag; it is only a matter of time before we begin to feel Europe's pain.

Despite these challenges, I believe the economy is likely to grow faster than last year and is not likely to deter the equity market from generating a positive return for the year.

U.S. equity market outlook

This year, the S&P 500 Index is likely to continue to trade in the 1100 to 1385 range, in my opinion, with earnings and valuations limiting the downside, and volatility and risk premium capping the upside; at least until there is some resolution in Europe. The consensus S&P 500 earnings estimate for 2012 is $106.30, up 11.66%.[8] I believe the earnings environment will see some dissipation in the tailwind from rapid overseas growth, a cheap U.S. dollar, contracting unit labor costs and tax benefits. But however challenging the earnings environment may be, S&P 500 earnings rarely have a huge miss without a major inventory adjustment or a so-called "black swan" (or extremely unpredictable) event (e.g., the 2008 U.S. mortgage crisis).

I believe the S&P 500 Index could make an important bottom this year, triggered by a policy mistake in Europe that is quickly reversed and sets the stage for a new secular bull market.

I believe the S&P 500 Index could make an important bottom this year, triggered by a policy mistake in Europe that is quickly reversed and sets the stage for a new secular bull market. There could also be stimulus in China that could bring investors back into the market. Reduce the risk of a sovereign debt crisis in Europe and I believe the equity market could break above last year's high of 1363.

Therefore, market dips should be bought, in my opinion. If the S&P 500 Index moves closer to 1100, I would consider adding to cyclicals and underweighting noncyclicals. If the S&P 500 Index moves closer to 1385, I would consider adding to defensive positions and reducing holdings in the more cyclical sectors — at least until one of the before-mentioned catalysts unfolds. Longer-term investors with a buy-and-hold approach should consider overweighting high-quality, large-cap-growth stocks that pay dividends, since economic growth is likely to remain tepid for some time. Small-cap stocks are more economically sensitive and, in my opinion, are currently expensive relative to large-cap companies.[9]

Europe: Underweight

One of the lessons learned from the Great Depression is that there are only three ways out of a debt crisis: grow, default or inflate. The debt-laden "periphery" countries (Portugal, Italy, Ireland, Greece and Spain) are uncompetitive. Therefore, in some respect growth is out of the question without a weaker euro to mask their inefficiencies.

The option of default is still a possibility, although the European Central Bank (ECB) has recently taken multiple steps to avert disaster.

I believe the only long-term solution is for the European Central Bank (ECB) to inflate its way out by printing money, which should weaken the currency.

I believe the only long-term solution is for the European Central Bank (ECB) to inflate its way out by printing money, which should weaken the currency. The ECB has been either unable or unwilling to be the lender of last resort and aggressively expand its balance sheet without first instituting austerity measures. The problem is that markets move faster than politicians.

I believe this is a "make or break" year for Europe given the upcoming refunding calendar. The competition for capital could place upward pressure on interest rates. The euro area's weighted-average 10-year government-bond yield was 5.5%, as of Nov. 17, 2011.[10] European sovereigns need to refinance €1.1 trillion ($1.5 trillion) this year with most of that coming in the first half of the year.[11] In addition, European banks need to refinance €750 billion this year with one-third of that demand coming in the first quarter.[12] They also need to raise €3.5 trillion in the absence of a capital raise to meet their capital ratios (the amount of the bank's capital required per amount of risk assets held).[13] This could lead to a potential downgrade of French sovereign debt, which would jeopardize the European Financial Stability Fund's (EFSF) financial firepower.

Despite the upcoming challenges for the ECB, I believe the euro will survive, but the cost will be low growth. Fiscal austerity will be the price of staying in the European Union. Bank deleveraging will further detract from growth, increasing the odds that a recession lasts longer than expected.

I would continue to maintain an underweight position in Europe, but not as much as in the past.

I would continue to maintain an underweight position in Europe, but not as much as in the past. I'm inclined to add to positions on pull backs with the belief that most of the bad news is already priced. I would focus on European multinationals that pay dividends in the energy, health care, and industrial (autos) sectors.

Emerging markets: Look for buying opportunities

For emerging market equities, I believe macro factors are likely to continue to trump local ones until global risk aversion abates. However, there is data that suggests a bottoming process is beginning. PMIs around the world are beginning to reverse direction and/or decline at a slower pace, which has tended to be an early sign of reversal, in my opinion. The JPM global manufacturing PMI index increased in December, reaching its highest level since June 2011.[14]

China is too big to ignore. Its economy remains fairly underleveraged, and unlike the U.S. and Europe, its central government has substantial firepower to stimulate economic growth and avoid a hard landing. I believe current economic weakness is likely to reverse, as monetary policy becomes more accommodative. Investor concerns over the property market seem exaggerated, in my view. The loan-to-value ratios (a measure of lending risk used in the mortgage approval process) are averaging well below 50%, and the residential-investment-to-GDP ratio of 6% is at the low end of the range.[15] Bank lending to property developers represents just 7% of overall bank credit.[16] The equity market remains in a downtrend, but could potentially reverse as investors anticipate a policy response to combat economic weakness.

The Latin America economic outlook is not great but should improve as monetary easing lowers interest rates and weakens currencies. Lower interest rates tend to drive investors toward equities and away from fixed income. Renewed demand could be positive for equity returns, especially as the MSCI Latin America Index is trading at 11 times earnings.[17]

I believe investors may want to consider using the Euribor spread (a measure of banks' willingness to lend to one another) as a proxy for banking sector risk in Europe. Presently, the spread is at elevated levels and suggests waiting to add to emerging market equity positions.[18] A peak in the Euribor spread could suggest a peak in the equity-risk premium and signal a time to add to emerging market equities, in my opinion. The major emerging market countries that I believe appear attractive because of their lower price-to-book ratios are Russia, Brazil, Israel and China.[19]

A peak in the Euribor spread could suggest a peak in the equity-risk premium and signal a time to add to emerging market equities, in my opinion.

For the asset class overall, valuations look attractive, in my opinion, with the MSCI Emerging Markets Index price-to-earnings ratio trading at 10.6 at year end, 23% below its 10-year average.[20]

Summary

Disappointing equity returns in 2011 were not a function of disappointing earnings (except in Europe), overvaluations or higher interest rates (except in emerging markets). Rather, returns were driven by volatility or, to be more accurate, a rise in the equity-risk premium resulting from uncertainty about how Europe's sovereign debt crisis would be resolved.

Until the debt-crisis risk dissipates, investors are likely to experience the same roller-coaster ride as last year. Europe has the means to resolve its problems; right now it lacks the will. It's just a matter of time, in my opinion. Current valuations and expected earnings growth suggest the risk could be worth the wait. Consider continuing to overweight the U.S., underweight Europe and Japan, and look for a buying opportunity in the emerging markets in the first half of the year. With markets facing many of the same risks as last year, the same asset classes and sectors could outperform this year. Consider overweighting high-quality, large-cap stocks that pay dividends, with a modest overweight in the noncyclical sectors.

Important information

The opinions referenced above are those of Richard Golod as of the date of this report and are subject to change at any time due to changes in market or economic conditions and may not necessarily come to pass. These comments are not necessarily representative of the opinions and views of other Invesco investment professionals. The comments should not be construed as recommendations, but as an illustration of broader themes. Past performance is no guarantee of future results.

All investing involves risk including the risk of loss. Diversification does not eliminate this risk. Investments in foreign markets entail special risks such as currency, political, economic and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with foreign investments. Small- and mid-cap stocks carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies.

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time based on the business prospects of the company.

This material is for educational purposes only and does not contend to address the financial objectives, situation or specific needs of any individual investor. It is not a solicitation, or an offer to buy or sell any security or investment product.

1 Source: Bloomberg, L.P., Dec. 31, 2011
2 Source: "After the Fall," Carmen M. Reinhart and Vincent R. Reinhart, NBER Working Paper No. 16334, September 2010
3 Source: Thomson Reuters-Datastream, June 30, 2011
4 Source: Gluskin Sheff, Dec. 13, 2011
5 Source: "Economists in Majority Don't Let Improving Data Undermine Gloom," David J. Lynch, Bloomberg News, Dec. 1, 2011
6 Source: Gluskin Sheff, Nov. 15, 2011
7 Source: Gluskin Sheff, Dec. 12, 2011
8 Source: Bloomberg, L.P., Jan. 6, 2012
9 Source: Bank of America/Merrill Lynch, via Reuters Knowledge, Dec. 6, 2011
10 Source: BCA Research Inc., Nov. 17, 2011
11 Source: Gluskin Sheff, Dec. 12, 2011
12 Source: Gluskin Sheff, Dec. 12, 2011
13 Source: Gluskin Sheff, Dec. 12, 2011
14 Source: Bloomberg, L.P., Dec. 31, 2011. The JP Morgan Global Manufacturing PMI measures global manufacturing conditions and is considered a gauge of economic and business conditions.
15 Source: Citigroup Global Markets Inc., Nov. 28, 2011
16 Source: BCA Research, January 2012
17 Source: Bloomberg, L.P., Dec. 30, 2011. The MSCI EM (Emerging Markets) Latin America Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The MSCI EM Latin America Index consists of the following five emerging market country indexes: Brazil, Chile, Colombia, Mexico, and Peru (as of May 30, 2011).
18 Source: Bloomberg, L.P., Jan. 5, 2012
19 Source: Credit Suisse, Oct. 10, 2011. Price-to-book ratio is a common valuation metric for stocks which compares a stock's share price to its book value per share.
20 Source: Bloomberg, L.P., Dec. 30, 2011. Price-to-earnings ratio is a common valuation metric for stocks that compares a stock's share price to its per-share earnings. The MSCI Emerging Markets Index is a free float-adjusted market-capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey (as of May 30, 2011).