

Investment Strategy

# A more pro-cyclical stance in equities

Investment Strategy  
& Portfolio Expertise

29 March 2017

In light of the economic upturn and abating political risks in Europe, we advocate a regional shift to European equities, at the expense of US equities. At a sector level, we suggest investors to consider switching from energy to industrials, as we are taking an even more pronounced pro-cyclical equity stance.

Positive fundamentals continue to support equities. Global stock markets are experiencing a range of positive conditions: a synchronised worldwide economic upturn is underway, interest rates remain low in absolute terms and double-digit earnings growth is expected this year. Longer-term earnings-per-share expectations are also rising, based on an increase in fiscal spending, which could potentially fuel higher multiples. Stock valuations are not cheap. Higher valuations, however, are counterbalanced by low interest rates, which make equities a relatively attractive asset class. A possible risk to the favourable equity outlook would be faster-than-expected rate hikes in the US, but this is not expected, given the Fed's cautious approach.

## Regional switch: from US to Europe

US stock markets are currently trading around new all-time highs and have extended their outperformance over European equities. Over the last couple of years, US equities have benefited from an accelerating economy. In the more recent past, US equity markets also drew support from President Trump's fiscal stimulus plans. European stocks, by contrast, were held back by lower growth and the debt crisis. This environment is now rapidly changing in favour of European equities: we see signs of improving European economic growth, much stronger upwards earnings revisions than in the US and increasingly attractive valuations. European stocks now trade at 15 times forward earnings (2017), much cheaper than US stocks at 18 times. (See Figure 1.)

Upcoming elections in Europe continue to represent risks. However, we see these risks abating, as polls in France continue to suggest a market-friendly result. We therefore suggest investors to consider selling some of their US stock positions and buying European equities instead, where we previously recommended a balanced regional approach.

### Sector switch: from energy to industrials

After the sharp correction in 2015, the energy sector was the best performing sector in 2016. Energy companies benefited from a recovering oil price and impressed with their ability to cut production costs. In our view, however, the flip side is that especially US oil producers are capable of producing more oil in a profitable way. As a result, the oil market faces further oversupply risks. Valuations for energy stocks have become rich after last year's reversal and we see elevated downside risk for oil prices. We therefore believe the sector will underperform.

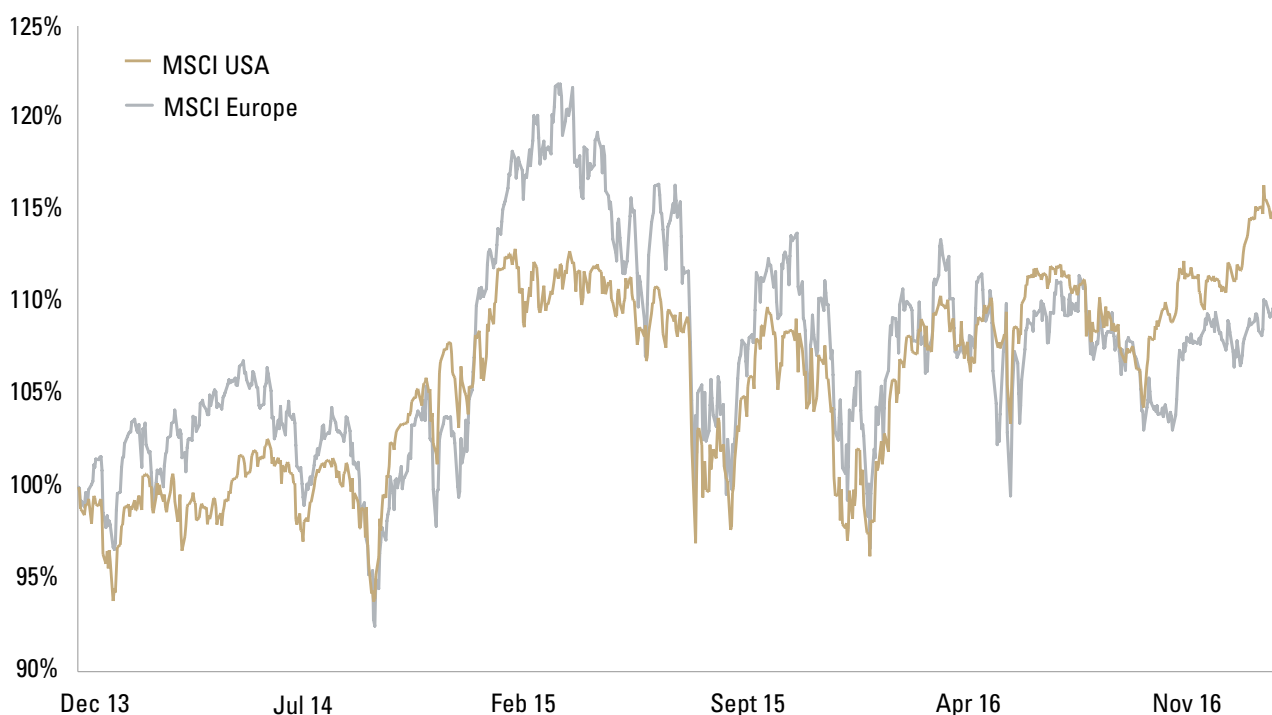
We suggest investors to consider switching from energy stocks to industrial stocks. We believe the industrials sector will continue to benefit from improving global economic growth prospects. So far, the sector has underperformed this year, while business conditions are still supportive for the sector. A confirmation of this view is a growing appetite to invest in growth by companies, partly triggered by

persistently low interest rates. In addition, governments are turning their attention to fiscal stimulus, which should give an extra push to the overall level of capital expenditure. The industrials sector should benefit most from the recovering investment cycle. We therefore expect the sector to outperform.

On balance, our equity stance remains pro-cyclical: we are positive on IT, consumer discretionary and industrials, while taking a negative view on more defensive sectors like consumer staples, telecoms and utilities. Together with our regional preference for European over US equities, we believe this is the most suitable positioning within an environment of synchronized global growth.

Global Head Equity Strategy & Portfolio Management  
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Figure 1: Increasingly attractive valuation of European vs US stocks



Price/earnings ratios (PER) of US and European stocks rebased to 100 as per 31 December 2013. The absolute PER FY2017F is 18x for US stocks and 15x for European stocks.

Source: Bloomberg

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