Our

Multi-Asset themes for 2015

by Philip Saunders,
John Stopford and
Michael Spinks

Investec
Asset Management

Our Multi-Asset themes for 2015

CO-HEADS OF MULTI-ASSET

Philip Saunders

John Stopford

Michael Spinks

Global growth will remain positive, but desynchronised

Above-trend growth in the US should keep the global economy growing at 3% on a purchasing power parity basis in 2015. This US growth will be primarily domestically driven, helped by loose monetary policy, financial and household sectors (which have deleveraged), minimal fiscal drag, the shale oil boom, the resulting reduction in energy costs, and technological innovation. Elsewhere in the world, growth should continue to muddle through, held back by rebalancing and the limited efficacy of further policy easing. Downside risks dominate, but leading indicators suggest a recession outside the US is unlikely.

Suggested investment implication

- Steady, if unspectacular, global growth coupled with subdued inflation should keep interest rates low and be generally supportive of corporate earnings, which should be good for equities. Cyclical divergence should be supportive of the US dollar, which should remain in a cyclical bull market against most other currencies.

Our Multi-Asset themes for 2015

(continued)

Emerging economies and commodity prices are adjusting to a lower growth path

With developed economies providing less support for global trade and China transitioning to a lower, less investment-driven, growth model, emerging economies and commodity prices are adjusting to a tougher environment. This adjustment appears well advanced, but we think the risks are still to the downside. Some emerging economies and markets have taken more progressive steps to deal with this. Others remain too dependent on global demand and cheap foreign capital for their growth. The good news is that generally well anchored inflation rates compared with prior cycles give policymakers room to manoeuvre, which suggests that they are more likely to let exchange rates take the strain and will be less compelled to push interest rates higher, depressing domestic growth rates.

Suggested investment implication

▶ Constructive for selective emerging equity and local currency bond markets.

Disinflation is still the dominant trend, but US monetary policy is at an inflection point

Broadly, the economic backdrop is disinflationary with output gaps proving to be slow to close and commodity prices soft. This will underpin an easing bias to monetary policy in many countries, notably Japan and the euro zone. It may also limit the speed of interest rate normalisation in the US, but balancing this is improving activity and momentum in the domestic labour market; policy will increasingly diverge between the major economies.

Suggested investment implication

▶ Any interest rate increase in the US is likely to remain modest, and real long-term interest rates should remain low. Currency weakness is likely to be the main transmission mechanism for further monetary easing in Europe and Japan. This will put pressure on the more open economies, which compete with them, to follow suit. Growth and policy divergence should help to support the US dollar and cause US Treasuries to underperform most other major bond markets. Against such a backdrop, Treasury-exposed investors might want to consider a more global, unconstrained approach.

Our Multi-Asset themes for 2015
(continued)

This global business cycle may turn out to be longer than normal

The end of the current business cycle may still be some years ahead, ironically because of the anaemic and desynchronised nature of the current global economic recovery. Cycles do not typically die from old age, but rather because spare capacity is all used up and the economy overheats, or because of a shock. The latter is a risk, rather than our central scenario.

Suggested investment implication

▶ Equities typically only peak towards the end of the business cycle, signalling the imminent onset of a recession. Barring a severe shock, the current bull market cycle in stocks could have a number of years to run. Furthermore, with a 12 month forward multiple of 14x, equities are reasonably good value and likely to be supported by earnings growth of around 10%. 2015 promises a good rather than a great year for equities, though it could be better if markets are re-rated.

Japan still stands out amongst developed equity markets

We believe Japan offers the best combination of value, earnings growth, earnings upgrades and central bank liquidity among developed markets, so we expect recent strength to continue. Monetary policy is set to remain very supportive and the fact that domestic institutional buying led the recent market advance suggests that the current cycle differs fundamentally from the foreign-led bear market rallies that have punctuated Japan's secular bear market.

Suggested investment implication

▶ Maintain material allocations to Japanese equities on a currency hedged basis.

Shrinking to prosperity

We have been wary of the global mega-cap stocks that dominate many markets, believing that although they appear cheap and offer tempting yields, their best days are over. However, a number of these companies, often under new management, are showing a willingness to 'shrink to prosperity' by spinning off or selling businesses as the best route for securing higher returns for investors. We expect this trend to gather momentum in 2015.

Suggested investment implication

▶ Invest selectively in mega-cap value stocks in the US and the UK markets.

Still important to be selective in emerging market equities

Emerging market equities continue to trade at valuation discounts to developed markets that have been associated with sustained outperformance in the past. However, operating performance of emerging market companies has continued to disappoint and macro headwinds, most notably weak commodity prices, are showing no sign of abating. Reform efforts are providing reasons for optimism in India, China, Mexico and Indonesia, but structural issues have yet to be addressed elsewhere, especially among the main commodity exporting economies.

Suggested investment implication

▶ Favour markets where value is complemented by improving operating performance, rising free cash flow yields, and the likely implementation of reforms.

Our Multi-Asset themes for 2015
(continued)

Equity income preferred to corporate bonds as a source of yield

Financial market volatility looks to have troughed, with the tapering of US quantitative easing (QE), changing rate expectations and the data dependency of US Federal Reserve policy introducing uncertainty into asset pricing that has been largely absent during the era of forward guidance. This looks most damaging for high yield and other corporate bond yields, because spreads tend to sell off with higher volatility. US high yield is also vulnerable to any rise in Treasury yields. Equities have historically been better able to weather volatility, which may cause temporary corrections, but typically does not end bull markets. Equity valuations look less stretched than credit markets, as equity yields have risen on a relative basis, and in previous cycles corporate bond returns have peaked well before the final peak in equity prices.

Suggested investment implication

▶ For investors looking for income, we see better value and more upside in equity than corporate debt markets. The environment for corporate bonds looks already to be past its best.

Emerging market bonds offer a decent risk premium

The taper tantrum sell-off in 2013 pushed emerging market bond yields to more attractive levels in both nominal and inflation-adjusted terms. The yield premia offered are closer to the upper end of their historical range and we think better compensate investors for the risk of investing in these markets. In addition, local bond markets are supported by soft growth and inflation data, which is discouraging central banks from raising interest rates. In a world, however, where global capital is less free flowing and policy in the key US economy may soon be tightened, it is important to be selective about which emerging markets to hold and which to avoid.

Suggested investment implication

▶ Favour local emerging bond markets offering decent real yields, but with relatively strong balance of payments positions and contained inflationary pressures.

Our Multi-Asset themes for 2015
(continued)

Changing market structure can be exploited to create a range of alternative, defensive and uncorrelated exposures

Increasing regulation and stretched balance sheets are opening up areas of financial markets which traditionally were the preserve of governments, banks and insurance companies to a wider investor base. Some of these areas can be used to create defensive positions capable of protecting returns during equity market sell-offs, while others offer a range of more uncorrelated return profiles. Among the former, long volatility strategies can take advantage of reduced involvement by investment banks in option markets to capture spikes in volatility when they occur, and can be used as an alternative to expensive government bonds as a hedge against falls in equity prices. Among the latter, we would highlight opportunities to fund high quality infrastructure projects as governments seek to limit the calls on public sector finances, and to invest in collateralised reinsurance investments as increased capital pressures force insurers to off-load some of their risk.

These investments tend to have different return profiles from more traditional assets and can be used to diversify portfolios. We recognise that valuations have become stretched in some of these areas so selectivity is important, but we expect that the general market background to remain supportive in the medium-term.

Suggested investment implications

▶ Selective exposure to long volatility strategies, infrastructure investments and reinsurance vehicles are among the areas where we see potential over the coming year and beyond.

AUSTRALIA
Level 23, The Chifley Tower
2 Chifley Square
Sydney, NSW 2000
Telephone: +61 2 9293 6257
Facsimile: +61 2 9293 2429

BOTSWANA
Plot 64511, Unit 5
Fairgrounds, Gaborone
Telephone: +267 318 0112
Facsimile: +267 318 0114

CHANNEL ISLANDS
PO Box 250, St Peter Port
Guernsey, GY1 3QH
Telephone: +44 (0)1481 710 404
Facsimile:+44 (0)1481 712 065

EUROPE (EX UK)
Woolgate Exchange
25 Basinghall Street
London, EC2V 5HA
Telephone: +44 (0)20 7597 1999
Facsimile: +44 (0)20 7597 1919

HONG KONG
Suites 2602-06, Tower 2
The Gateway, Harbour City
Tsim Sha Tsui, Kowloon
Hong Kong
Telephone: +852 2861 6888
Facsimile: +852 2861 6861

NAMIBIA
100 Robert Mugabe Avenue
Office 1, Ground Floor
Heritage Square Building
Windhoek
Telephone: +264 (61) 389 500
Facsimile: +264 (61) 249 689

SOUTH AFRICA
36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 416 2000
Facsimile: +27 (0)21 416 2001

SINGAPORE
One Fullerton #02-01
1 Fullerton Road
Singapore, 049213
Telephone: +65 6832 5052

TAIWAN
Unit C, 49F, Taipei 101 Tower
No.7, Section 5, Xin Yi Road
Taipei 110, Taiwan
Telephone: +886 2 8101 0800
Facsimile: +886 2 8101 0900

UNITED KINGDOM
Woolgate Exchange
25 Basinghall Street
London, EC2V 5HA
Telephone: +44 (0)20 7597 1900
Facsimile: +44 (0)20 7597 1919

UNITED STATES
666 5th Avenue, 37th Floor
New York, NY10103
US Toll Free: +1 800 434 5623
Telephone: +1 917 206 5179
Facsimile: +1 917 206 5155

www.investecassetmanagement.com

Important information

The information discusses general market activity or industry trends and should not be construed as investment advice. The economic and market forecasts presented herein reflect our judgment as at the date shown and are subject to change without notice. These forecasts will be affected by changes in interest rates, general market conditions and other political, social and economic developments. There can be no assurance that these forecasts will be achieved. Past performance should not be taken as a guide to the future, losses may be made. An explanation of technical terms can be found at www.investecassetmanagement.com/glossary

The information contained in this document is believed to be reliable but may be inaccurate or incomplete. Any opinions stated are honestly held but are not guaranteed and should not be relied upon.

This communication is provided for general information only and is not an invitation to make an investment nor does it constitute an offer for sale. This is not a recommendation to buy, sell or hold a particular security. The specific companies listed or discussed herein are included as representative transactions of the strategy. No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.

In the U.S., this communication should only be read by institutional investors, professional financial advisers and, at their exclusive discretion, their eligible clients, but must not be distributed to U.S. persons apart from the aforementioned recipients.

In Australia, this document is provided for general information only to wholesale clients (as defined in the Corporations Act 2001).

In Hong Kong, this document is intended solely for the use of the person to whom it has been delivered and is not to be reproduced or distributed to any other persons; this document shall be delivered to institutional and professional investors only. It is issued by Investec Asset Management Hong Kong Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

In Singapore, this document is issued by Investec Asset Management Singapore Pte Limited (company registration number: 201220398M) for institutional and professional investors only.

In South Africa, Investec Asset Management is an authorised financial services provider.

Outside the U.S., telephone calls may be recorded for training and quality assurance purposes. Issued by Investec Asset Management, November 2014.

Investec
Asset Management

19773 — 11/14