Opportunities after the storm

Market turbulence has created new opportunities, says Andrew Cole

The storm that swept the markets in February rattled nerves, but it ended up changing very little in the investment landscape. The global economic expansion has further to run. Corporate profits are still rising. And while central banks – led by the US Federal Reserve – are still tightening monetary policy, they are doing so gently.

Over the medium term, that's a combination that should favour equities over bonds – any short-run bouts of volatility notwithstanding. In fact, such turbulence can prove useful.

With some of the froth having been swept out of the market in recent weeks, we actually feel more comfortable investing in equities now than we did at the start of the year, particularly in cyclical sectors.

Emerging markets are particularly well-placed to benefit from the surge in global exports, which rose 4.4 per cent in 2017 – their fastest pace in six years. According to Pictet Asset Management's economics team, a 1 per cent increase in international cross-border goods flows lifts EM economic output by 0.26 percentage points.

Within the developed world, Japan's stock market tends to do especially well in times like these, as its exporters thrive when trade is buoyant. Not only is the country's economy in good health – unemployment is at its lowest in a quarter of a century – its equity market also looks attractively valued, compared to both US and European counterparts.

In contrast, we are more cautious on Europe. This view isn't so much based on its economic data (which is still solid, if possibly starting to plateau), nor on the valuations of its stock markets (which have improved markedly in recent weeks). The problem is that European equities continue to be a source of volatility. Indeed, they were among the worst hit during the recent sell off. The ongoing political uncertainty engulfing much of the continent – amplified by populists' strong showing in Italy's general election – has left corporations and international investors wary.

Therefore, until we can see a clear catalyst for sustainable outperformance of European stocks, we will focus our attentions elsewhere.

Banks and techs

When it comes to sectors, we prefer stocks in cyclical industries such as materials, energy, financial and techs. The last two should fare well if interest rates rise. For financials, higher rates is an advantage – banks' borrowing tends to be more short term than their lending. So when yield curves steepen, their lending margins improve. Techs, meanwhile, have low borrowing levels and large cash piles. That means they should be more insulated from the negative impact of higher rates than companies that have taken on more debt.

Defensive utilities and consumer stocks will probably prove the most vulnerable to higher rates and rising inflation, as they have limited ability to pass on any cost increases to their customers.

In fixed income markets, bond yields are gradually grinding higher, and attractive investment opportunities are harder to find than in equities. But that doesn't mean that they don't exist – and sometimes in quite surprising places.

The US, for example, is now one of the few developed markets which offer a positive real return on 10-year government paper. Inflation-linked bonds there look particularly attractive.

The risk would be if the fixed income market suddenly started to discount much higher levels of inflation than are currently expected. That could lead to a sharp steepening of the yield curve, hurting investors in longer-dated bonds.

Another risk is that credit growth may not be strong enough to offset the monetary tightening deployed by the Fed and other major central banks, which would lead to an abrupt deterioration in financing conditions worldwide. A 2007-style credit crunch certainly does not look likely right now, but we should remain alert to any signs of stress.

The third threat to our portfolio is China. There, economic growth is slowing as authorities in Beijing make yet another attempt to deflate the country's credit bubble. So far, thanks to healthy demand for Chinese exports, the tightening of monetary policy has not done too much damage. But if, as seems likely, the pace of credit growth slows further and US President Donald Trump enacts additional protectionist measures against China, the prospects for emerging markets and the rest of the global economy will look less rosy than they did a few months ago.

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