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Increase your equity exposure?

Flash note from Multi Asset Solutions | 16 October 2014

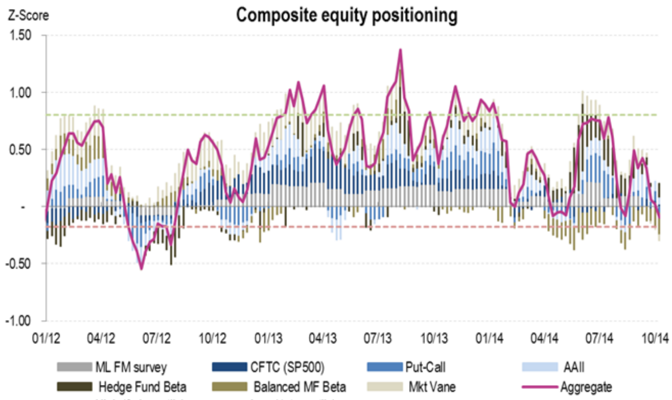
For Professional Investors Only

SUMMARY

- **So far, the recent market turmoil in risk assets reaching limits of the other selloffs in the bull market**
- **An opportunity to increase global equity exposure and reduce government bonds**

Last June, we reduced the equity long positions in our model portfolios since we felt equity markets had gotten ahead of the economic and corporate fundamentals and additional good news looked unlikely in the shorter term. We maintained our high-yield and credit positions. Our scenario at that time was to wait for a consolidation or pull-back in equity markets and indeed, this was the case in August and again now in October. Global equities have fallen by around 10% from their July peak, leaving the EuroSTOXX 50 index flat over 12 months.

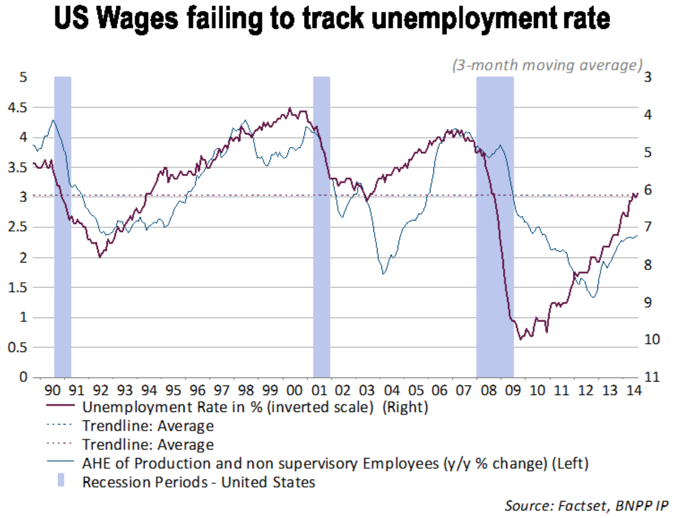
The recent market moves have washed out many of the long positions in equities, so we have reassessed our neutral view on the asset class.



Source: Bloomberg, MLFund Manager survey, SentiTrader.

WHY INCREASE EQUITY NOW?

While absolute valuations are not low, the equity risk premium is still high historically, and taken together with the recent market corrections we believe there is now a stronger case for investing in equities over bonds. Business cycle indicators suggest we are still mid-cycle, backed by a lack of wage inflation around the world and where we are in the interest-rate cycle.



WHAT ABOUT THE MACROECONOMIC OUTLOOK?

Turning to the macroeconomic cycle, we continue to believe that the US economy is on a firm footing and will provide support to the rest of the world. However, we do recognise the risk of the eurozone slipping into a third recession without having reached escape velocity, and that China suffers a 'hard landing'. Crude oil prices have fallen significantly and the US dollar has risen, allowing the US consumer to benefit from cheaper imported goods and lower petrol prices. Policy uncertainty in US is low, standing at levels last seen in 2007, which anchors the risk premium for other assets. The recent weak data in the eurozone is in line with a mid-cycle slowdown, but the low levels of inflation and growth have heightened the market concerns. We feel that we have not seen enough evidence to downgrade the outlook for Europe on our economic scorecard to recessionary double negative from the current single negative.

WILL CORPORATE EARNINGS CONTINUE TO SUPPORT EQUITY PRICES?

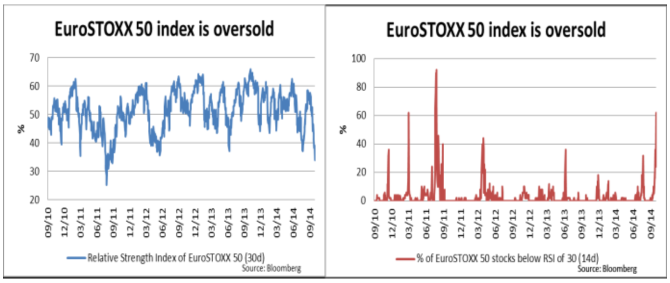
Moving on to the latest corporate earnings season, our core view is that US earnings expectations are low enough (Q314 +5% YoY) to provide an upside catalyst, whereas in Europe, the hurdle is higher and recent earnings seasons have been a serial disappointment. The currency moves should filter through into earnings with a delay. For the US, we expect the impact of dollar strength to be of less concern, since the percentage of foreign-sourced profits is only around 20%.

SPX geo exposure	US sales	Foreign sales
IT	41%	59%
Materials	49%	51%
Energy	55%	45%
Industrials	61%	39%
Cons. Staples	69%	31%
Cons. Discretionary	71%	29%
Financials	76%	24%
Health Care	78%	22%
Utilities	94%	6%
Telecom. Services	100%	0%
S&P500	**66%**	**34%**

Source: JPMorgan

HAVE WE SEEN CAPITULATION YET?

We note that credit markets started to underperform first, but have been more resilient as the selloff in equities intensified. Furthermore, conditions in cyclical stocks, EuroSTOXX 50 and US small caps are now oversold.



WHAT ARE THE RISKS?

The downside risks for the US include a stalling of the economy leading to a downgrade of growth expectations, or the Ebola virus spreading further. In Europe, negative results from the ECB's review of the quality of banks' assets and unfavourable reports on the EU Court of Justice's review of the legality of ECB quantitative easing action, could harm investor sentiment. In Asia, there is a risk that China's slowdown continues unabated, leading to widespread social unrest, and that concerns over bad property debt grows further.

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