# Global Equities and Commodities

**Towers Watson Research Article**

MJW Investments

**Febuary 2015**

The following article is taken from a recent publication by our global colleagues at Towers Watson.

## Developed market equities – neutrally valued

US equities have been the most notable developed market performer over 2014, returning roughly 14% to investors, although sharp declines in commodity prices over the last quarter of the year modestly increased the volatility of US equity returns and negatively impacted related sectors. This volatility has continued into 2015 as commodity prices have continued to fall.

Robust company fundamentals supported US equity returns in 2014. Earnings per share and sales per share grew steadily throughout the year, albeit in-line with expectations, with company payouts to shareholders also remaining attractive. Nevertheless, it was primarily falling cash rates and a modestly declining equity risk premium that boosted prices over 2014.

The discounted cash flow model, our preferred valuation metric, indicates that US equities are now discounting a level of long-term real earnings growth of around 2%. This is reflective of the continued normalisation of economic conditions in the US, with investors pricing in a reasonably strong future growth path for company earnings over the long term. Other valuation metrics such as the price earnings ratio (18x) indicate similar earnings growth expectations are being priced in by investors.

### Limited upside for US equity returns over the medium term based on current valuations

Current market valuations do not appear attractive relative to history, but we believe corporate fundamentals will continue to support returns over the short term. For 2015 we anticipate US equities to return in the region of 4% to 8%.

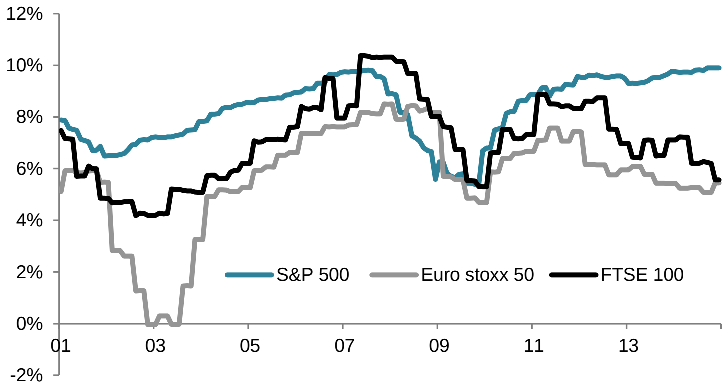


**Figure 1. Developed market profit margins.**

Source: Bloomberg LP, Factset, Towers Watson

We are confident that the US economy will continue growing above trend in 2015, with employment gains and consumer spending providing support to the recovery. Profit margins at ~10% are at historic highs, but it is our view that market forces will not exert downward pressure over the coming year. Wage growth has been lacklustre despite improvements in the labour market, a short-term trend we expect to continue. We also believe the fall in oil prices will have a net positive effect on the equity market. Energy-related sectors have suffered and could continue to suffer as oil prices remain unstable, however we expect the extra disposable income available to consumers to act as a consumption boost, and thereby support aggregate earnings growth.

We do not believe US equities will provide attractive returns over the medium term, based on future prospects for equity fundamentals and given current valuations. In our view investors could expect to earn nominal returns in the region of 2.5% to 6% p.a. over five years.

We see greater downside risks to growth and inflation around our base case. We expect mounting wage pressures to cause profit margins to decline from 2016 onwards, materially impacting earnings. Also, the strong performance of the equity market over the past couple of years has moved valuations to higher levels, lowering our expected returns.

### Euroland and UK valuations attractive but incertain growth prospects temper return expectations

Euroland and UK equity returns were much more subdued than in the US over 2014, with investors achieving total returns of 4% and 1% respectively. Stagnant demand, political uncertainty and commodity price volatility weighed on equity performance. This has been reflected in company fundamentals with corporates from both markets reporting negative earnings per share and sales per share growth for the year.

For both equity markets current market pricing suggests a weak growth environment is anticipated by investors, with long-term real earnings growth discounted at 0.6% and 0.5% for the Euroland and the UK respectively.

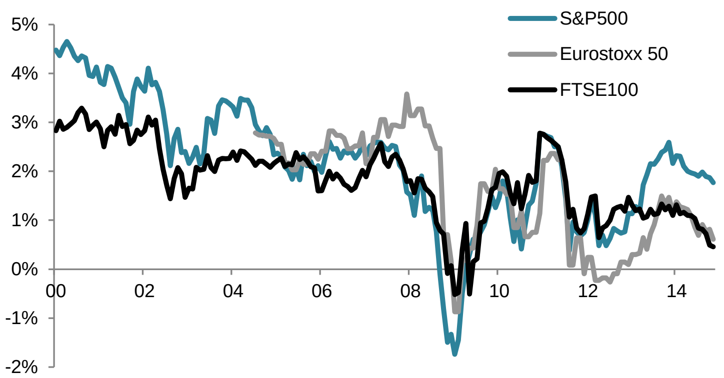


**Figure 2. Discounted long-term real earnings growth for developed market equities.**

Source: Federal Reserve, European Central Bank, Bank of England, Bloomberg LP, Factset, Towers Watson

Given the low starting valuation, we believe Euroland equities look attractive albeit volatile over the short term, with possible 2015 returns of 4% to 13%. A pick-up in domestic growth combined with steady global growth would allow cyclically low profit margins (5.5%) to rise, and drive earnings higher. The consumption benefits of a lower oil price, a weaker Euro and benign wage pressures should also support earnings growth. Additionally, any QE implemented by the ECB could reinforce the competitiveness of Euroland corporates. Although current valuations are similarly attractive in the UK, we fear the recent commodity price falls (commodity sectors account for 22% of the market) and secondary effects will anchor earnings growth over the next couple of years. We expect 2015 returns in the region of 2% to 6.5%.

Concerns over medium-term economic conditions and corporate profitability temper our medium-term forecasts, with 5 year return expectations of 3% to 8% expected for both equity markets.

**Emerging market equities are now neutrally valued in aggregate**

Emerging market equities experienced a turbulent 2014. Markets in aggregate suffered a sharp sell-off at the start of the year but showed some resilience and continued to recover rather well from the February lows. However, geo-political tensions arising from Russia, global growth concerns, and commodity price falls caused returns to be volatile. Investors achieved total local currency returns of 5.5% over the period.

At current levels, the dollar-denominated MSCI emerging market index is discounting a level of long-term earnings growth which is over 2% p.a. below 2011 peaks and consistent with 2003 levels. A similar story emerges on a relative basis, with emerging markets discounting their lowest level of earnings growth versus the US since 2003.

Nevertheless, divergence within emerging markets by country and industry is likely to be highly significant. Individual countries are experiencing their own specific challenges as they undergo reform and change, whether that be rectifying structural imbalances, rebalancing the economy towards more sustainable growth or regime changes, to mention a few. Taking the full distribution of risks into account we believe that in aggregate, emerging market equities are neutrally valued.

However, from a dynamic allocation perspective we believe the divergent economic prospects across emerging markets will provide attractive but selective investment opportunities over the short term.

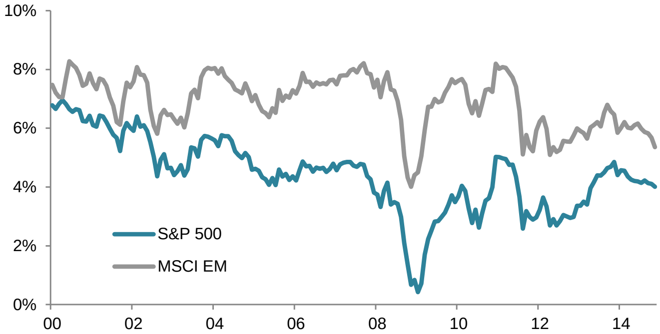


**Figure 3. Discounted long-term nominal earnings growth.**

Source: Federal Reserve, European Central Bank, Bank of England, Bloomberg LP, Factset, Towers Watson

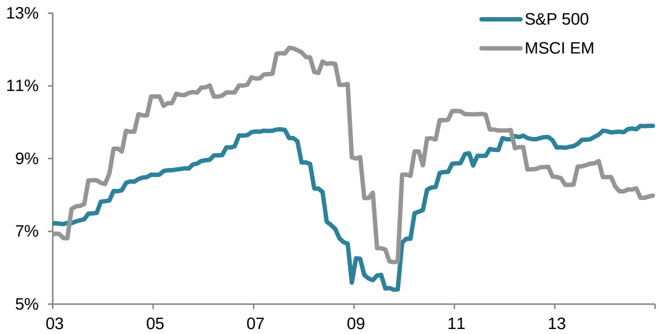


**Figure 4. US vs MSCI EM profit margins.**

Source: Bloomberg LP, Factset, Towers Watson

## Commodities – significant declines in oil prices

Close to a 50% fall in oil prices since mid-2014 have impacted correlated markets across the globe. During this period, future oil price curves have moved from a backwardated state into contango, steepening further over December, with a 1-month roll contract now costing around 10% p.a.

**Change in the structure of oil markets and fight for market share**

These declines in oil prices can be understood better in the context of the marked change in the structure of oil markets that has taken place in recent years. The emergence of shale as a rival source is placing considerable disruption on the pre-shale industry norm. More specifically, significant increases in non-OPEC net production over the past few years have primarily come from the shale oil boom in the US (the rest has been mainly from Brazil) – these show no signs of abating. In addition, OPEC announced in October 2014 that it would keep its production quota constant until at least mid-2015 thereby ensuring that oil markets were balanced not through supply reductions but by price declines.

| | | Current | Last month | YTD | 3y % change | 5y % change |
|---|---|---|---|---|---|---|
| **Indices** | DJ-UBS | 101.2 | -7.6% | -3.0% | -28.3% | -25.7% |
| | S&P GSCI | 381.0 | -13.2% | -8.8% | -41.5% | -26.0% |
| | S&P GSCI Light Energy | 370.0 | -7.6% | -5.5% | -30.8% | -13.5% |
| **Energy** | Brent | 46.3 | -18.2% | -19.2% | -57.8% | -39.3% |
| | WTI | 45.9 | -19.4% | -13.7% | -53.3% | -40.8% |
| **Metals** | Aluminium | 1780.2 | -8.7% | -2.9% | -18.8% | -20.7% |
| | Copper | 5928.5 | -0.9% | -6.6% | -27.8% | -19.4% |
| | Nickel | 14589.0 | -7.0% | -3.3% | -28.5% | -22.1% |
| | Zinc | 2070.5 | -1.9% | -4.5% | 3.4% | -14.6% |
| | Gold | 1238.8 | 0.7% | 4.6% | -25.5% | 11.3% |

**Figure 5. Moves in the commodity complex.**

Source: Bloomberg, Towers Watson

We expect excess supply conditions to remain for the foreseeable future. However, it remains unclear where the new equilibrium price for oil will settle. This largely depends upon the level of oil prices at which higher cost non-OPEC producers would cut back on capex and reduce supply – it would appear that US shale is the significant swing producer currently. Early evidence indicates that oil companies may be deleveraging their balance sheets and optimising their cost base. Lower operating expenditures would mean that oil companies may not be incentivised to reduce supply in the short term. Such uncertain supply side dynamics may lead to increased volatility in oil prices over the next year or two.

**Position on the investment cycle has determined prices in industrial metals**

Most of the strong price action in industrial metals witnessed in the decade starting 2000 (save the brief but deep 'blip' during the financial crisis) has been underpinned by rising demand, particularly from the strong Chinese resource-intensive investment growth. High prices since the mid-2000s, relatively rapid recovery of commodity prices post the crisis and the expectation that prices would remain supportive over the medium term led to significant capital investment in most industrial commodity markets in the past few years.

More recently, demand conditions have moderated in most of Asia and Europe. China rebalancing towards a lower, more consumer-centric growth path and ongoing deleveraging in most developed nations is expected to weigh on demand. However, aggregate supply conditions have remained fairly robust, which have placed downward pressure on commodity prices, in aggregate in recent years. These dynamics reflect the lagged manner in which investment cycles operate.

Over the next couple of years we continue to believe that overall balance of pressures will remain tilted in favour of supply. This should result in relatively flat spot price action in aggregate and low expected returns from commodities. However, within the industrial commodities space, certain markets have progressed further along the investment cycle. Significant mine closures (due to end of useful lives) have supported zinc prices. Nickel prices, though very volatile, are up year-to-date as Indonesia, a key exporter of the metal, imposed a ban on exports of the metal in its raw form. We remain neutral overall on the commodity complex over the medium term.

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