

BlackRock Investment Conference – June 2018

We recently attended an investment conference hosted by BlackRock. The conference covered an overview of the markets and specific views from managers on their regions/sectors. The views contained in this note are the views of BlackRock and do not necessarily reflect our own views.

Market Update

The conference started with a market update. They explained that 2018 has been bumpier than 2017 but within this there have been pockets of strong performance, especially in tech, oil, China and the US. This is different to 2017 where you could invest almost anywhere and get a positive return.

In 2017 growth was pretty consistent with little inflation and no geo-political worries. It was also a good year for earnings. This has shifted in 2018 with inflation coming through and more concerns around geo-political risks.

Earnings are still coming through in 2018 but not as strong. The US is in favour with investors as the earnings are stronger and the opportunities greater; the fiscal package hasn't been felt and this could deliver a range of positive outcomes.

The main pressures are around tariffs which seem to go against everything the US had done for the last 100 years and could be negative for markets. Ultimately, they believe deals will be agreed and the markets will calm down.

Where they see long-term opportunities are in emerging markets. Increased capital spending in the developed economies is having a positive impact in many of the developing economies. A rising dollar is not a problem for many of these economies if it is gradual.

With the UK Brexit continues to dominate and this impacts sterling. There are other factors to consider around interest rates and inflation. It is worth adding that much of the income from the FTSE 100 comes from outside of the UK and therefore a weaker sterling benefits these companies.

Asia

They feel Asia is about mid-cycle. Long term they still see opportunities, but it will not be as easy as has been seen in the last couple of years.

In looking at the growth numbers from China they agree that we cannot trust the growth figures coming out. They normally come out twelve days after the quarter end which is too quick. The figures lack variance and there is some evidence that local governments have to report higher numbers. But the figures tend to focus on old China and don't fully capture consumption, servicing and on-line use. Therefore, to get to the true picture you have to look elsewhere.

As an example, can we trust the information on debt within China? Non-performing loans are 1.5% compared to 4% in the developed world. The way China calculates this is different; if there is enough capital to cover the non-performing loan they don't report it. BlackRock have analysed 3,000 companies to see if they can afford the loans and they showed about 3.8% are unable to do this. Since running the analysis the highest it has been is 25%.

The debt ratio is high, but the rate of increase will slow and we cannot assume it will continue at the same pace. Its debt is high but not as high as Japan and the United States.

Around the region many Asian companies are owned by families which is not dissimilar to the early stages of development in the UK and US. Family businesses can work but often they are not great with governance and have little care about minority shareholders. But there is significant change happening with more companies paying dividends, but the pay out ratio is still low at 32% compared to 47% for the global average.

Korea is perhaps the worst country where 5 families dominate but even here there is change. Samsung for example have seen the pay out ratio go from 5% to 20%, still low but a big improvement.

There is a lot of negative noise around India and the fact that nothing ever gets done. This is not true. Some of the recent reforms include goods and services tax, demonetization, greater freedom for foreign direct investment, improved bankruptcy laws, improved business practices, better banking, food inflation, improvements in labour and changes to the energy sector. It takes time but changes are happening and opening opportunities within the economy.

Although China is spending a lot of money on connective infrastructure, much of the region is not reliant just on China and there is a lot of trade within other economies. The region is more self-contained than many think. The only exceptions are Singapore and Thailand which are export focused.

Fixed Income

The May rate rise didn't happen because the data was not supportive. There is a growing feeling that rates will rise to enable the Bank of England to cut them if there is a down turn. At the moment they don't have any freedom to do this. They expect one rate rise this year.

They had added that the Bank of England seem unable to predict the future, but assuming inflation rises and other data is supportive, this should enable them to raise rates.

UK yields on government bonds remain low and do not seem to be going in any positive direction. In the US the opposite is true with yields rising to 2.5%. It will take time before money will flow back into the asset class.

They expect more volatility within the asset class and in terms of liquidity they feel this is okay but ultimately it comes down to price and what can be sold at the best price.

80% of rate increases end up in a recession. In the US rates should peak at around 3%. The question is whether this will lead to a recession and a global slowdown.

UK Smaller Companies

The biggest concern is Brexit and there are many time points which will bring volatility to the market. The main hit will be sterling. Two years to agree the final deal seems ambitious when the last major treaty took 9 years to agree. The end result is likely to be some form of fudge.

The main changes are consumer and corporate perceptions. Corporates seem to be getting on with it whereas the consumer is starting to cut back on spending as they realise that the end result will not be as expected.

The main impact has been on sterling which has benefited UK companies, unemployment is falling and incomes rising. The global view of the UK is weak but there are opportunities.

In smaller companies there are around 400 global companies so there is a big universe of companies. The returns on small to mid-cap companies tends to be greater than larger companies because they can grow a lot faster over time, they tend to have entrepreneurial management, and many are unique and fast changing to adapt to the environment around them.

It is also an area often under analysed which means many managers operating in this area have a greater chance of finding a hidden gem.

The key to investing in this area is being active, focusing on strong management, looking at companies with a strong market position, are cash generative, have strong balance sheets and have good long-term track records.

Europe

They feel there is a great breadth of recovery across Europe. Unemployment is coming down and the consumer is in a better place compared to 12 months ago. Data remains strong and in places like France and Italy there is double digit growth in temporary staff. Companies like Puma and Lufthansa are benefiting from this and seeing double digit growth.

Where US companies have spent money, this hasn't been true of European companies which have been busy reducing debt. But they have gone as far as they can and they have capital to spend. This is likely to come through more in countries like France, Italy and Spain. Germany has suffered from the pull back in China.

The bull market in Europe hasn't been enjoyable mainly because there hasn't been the earnings growth, but this is no longer the case. This means rather than trading on sentiment the market can trade on actual data.

Bank loans are good but the margins for the banks are tight and will get tighter as demand for borrowing increases, as ultimately it will come down to the price.

There are still question marks around the euro as some economies could benefit from a devaluation of the currency, but not all, and so how do you respond to differing needs?