Local and the new normal

In September once again all eyes were on the Fed to know whether or not it would hike rates. Even if the devil is always in the details, nevertheless we are convinced that to hike or not to hike is not a real debate. Zero-something is indeed the new normal, even in the US where we are talking of simply nudging rates two notches higher, which would still leave us in zero something territory. From this point of view the Japanese case is by far the most compelling, with forward guidance now no longer focused on short-term interest rates but on ten-year bond yields, for which the official target has now been set at around zero. Coming from negative territory, we would be tempted to stay that flat is the new move up.

This new normal also has implications for equity investors. It is obliging us to think differently about the kind of returns we should expect from equities. We are now talking not of double but of single digit returns, of which nearly half will be generated by dividends.

Another material change is related to global trade where also recent trends have been disruptive. For the first time, global trade is not just growing at a slower pace than the real economy, it is in fact actually stagnating if not stalling. Fortunately at the same time world economic growth remains in the region of 3% thanks to other growth drivers. We see clearly that after growth fuelled by global trade during the 1990s and 2000s, followed by growth fuelled by monetary policy from 2009 till the present, going forward internal demand and fiscal policy will be taking up the slack to maintain global growth at a decent level. Local/domestic spending is now the key driver, wherever we are, helped by central banks which by maintaining interest rates at zero are paving the way for fiscal spending, and stimulated by the rise of populism and increasing pressure in favour of protectionism.

This reshaped context definitely marks a break from the last few years. It is not however incompatible with decent albeit lower returns. It calls for a different investment approach and the need to assess the relevance of each investment case in this new context.

Emerging markets: supported by stronger growth momentum

The virtuous cycle scenario we had drawn in our 2016 market outlook, back in January, has eventually started to gradually take place. The general improvement of external accounts bodes extremely well for a stabilisation of currencies. Central Banks have been able to buy U.S. Dollars, thereby growing foreign exchange reserves which is fuelling domestic liquidity along with portfolio inflows. We are seeing an emerging markets debt rally currently unfolding leading to declining bond yields which will in turn benefit emerging market equities through higher domestic investment and consumption.
Past performance is not a reliable indicator of future results or a guarantee of future returns

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Renewed interest towards the emerging asset class should stay for the coming months. Global monetary accommodative policy should be positive for growth, while political credibility and focus on the economics could benefit emerging markets in contrast to Europe where uncertainty over the United Kingdom exit from the European Union could linger.

Emerging markets benefit from still low valuations, improving macro-economic prospects thanks to the already well-advanced economic adjustment that started more than three years ago, and, ensuing prospects of a rebound of corporate earnings (from depressed margin levels) helped by prior years capital expenditure reduction. Emerging Markets continue to show medium-long term growth advantage vs advanced economies, albeit at a lower level than during 2000 to 2014.

Small & Mid Caps: a haven of growth in a slowing world

In a world of persistently sluggish growth and modest equity returns, small and mid caps offer one of the last growth niches.

This universe of 1,300 stocks is extremely diversified, both from a geographic and a sector point of view, with a strong exposure to innovative sectors such as tech and biotechnology. In addition, leaders of niche sectors, too narrow to interest the big groups but offering high margins, are almost exclusively present in this universe.

Small and mid caps, being more agile and innovative, have several key advantages which enable them to generate profits more rapidly than large caps, such as for example business concentration, interest rate sensitivity, capacity to locate rapidly in dynamic geographic regions or to invest in new segments, not to mention their ability to restructure quickly.

This universe has a sector bias, with a pronounced tilt towards so called “cyclical” sectors (such as capital goods or consumer discretionary). This explains the higher operating leverage of small caps in an economic recovery.

Certain small caps are also developing in structurally buoyant sectors benefitting from long-term secular trends independent of the economic cycle. Several investment themes thus offer strong growth prospects, such as care for the elderly, automation of production processes, digitalisation of the economy, energy efficiency or outsourcing.

Empirical studies show that since 1990 topline growth in small caps has amplified world GDP growth by 2.5x. Annualised profit growth for the Stoxx Small 200 over the past 10 years stands at 3.3% compared to -1.2% for the Stoxx Large 200. The superior profit growth of this segment has translated into outstanding market performance over time (+96% over 10 years for the Stoxx Small 200 NR, vs 49% for the Stoxx Large 200), without exaggeration or excessive p/e inflation and with lower volatility than for large caps.

Underpinned by global growth which remains at a decent level of 3%, persistently moderate commodity prices and low interest rates, small caps this year will once again achieve higher profit growth (+13% expected for the MSCI Europe Small Cap compared to -5% for MSCI Europe Large Cap). For 2017 the consensus continues to expect higher growth for this segment (+23% vs +14% for large caps). The upside remains significant as margins are still well below the 2009 peak, especially in South Europe (including France).
The asset class today thus offers one of the highest earnings yields in Europe together with the strongest growth. This pool of growth stocks is a hunting ground for big groups looking for external growth. Over the last two years, takeover bids have been multiplying with often very high premia (60% for Italcementi for example) and the increasing participation of foreign acquirers (US, Japanese and above all Chinese for the most recent operations such as Aixtron or Kuka).

**US election update**

As we near November 8th it is interesting to examine the current state of play and to consider the policy impact of the new White House incumbent. Firstly, this is a surprisingly tight race. In Europe few of us noticed how Trump was creeping up on Clinton post the disastrous Republican Convention. By the end September the odds calculated by polling expert Nate Silver suggested a coin toss between Trump and Clinton with Trump having a 47% chance of victory. Since the first Presidential debate and a calamitous week for Trump he is now trailing Hillary Clinton but the nature of the US Presidential Election (it depends on the 538 strong Electoral College, not the popular vote) means that it is still very close, though favouring Clinton. Florida, Ohio and North Carolina remain critical swing states, particularly Florida given its large number of votes. With a large number of “undecideds” and the UK Referendum experience where polls were wrongfooted badly, this election is very close to call.

Second, we should remember that there are elections in the Senate (currently Republican) and the House (also Republican). The combination of President and which way Congress swings will be of critical importance in terms of legislative programme and success. Currently there is a good chance that the Senate swings towards a tiny Democrat majority, simply because the Republicans are contesting more seats this election than the Democrats and Trump has offended a large number of traditional Republican voters. It is mathematically very unlikely that the Democrats could control the House. The most likely outcome – but by no means certainty - is a Democrat in the White House and a split Congress.

A Clinton administration is likely to be more business friendly than the typical Democrat administration, however it will bring risks in certain areas, particularly healthcare and foreign policy. Clinton is likely to bring forward a tax reform and fiscal stimulus programme that will boost GDP and benefit companies with stranded cash (tech and healthcare suffer disproportionately) by allowing repatriation of overseas earnings at a reduced tax rate. This is what the economy needs and is a positive as monetary policy has probably run its course. On healthcare, the threat is probably more perception than reality. Congress will not allow Ms. Clinton a free reign and she will likely be restricted to administrative orders to effect change. There could be some limited impacts on drug pricing but she will not have a mandate for wholesale reform or the extension of “socialized medicine” in the US. Hillary is likely to be a foreign policy Hawk: this is likely to increase geopolitical instability in both Asia and the Middle East and the discontinuity with the Obama White House could be a surprise to markets. An obvious consequence of this would be higher energy prices. Risk premia could also rise and defence stocks will do well.

So what happens if Trump wins? Will the world come to an end? If Trump wins it is plausible that Congress stays Republican as Hillary would have had to do something to “lose” at this point. He would therefore have a co-operative legislature for his programme. On the plus side there would be a large amount of deregulation and probably a much larger stimulus. He has talked about a $550bn programme, about 2x the Democrat plan. A large and front-loaded programme could offset the waning of Chinese stimulus and extend the current rally in commodities. On the negative side, foreign policy risks would be high, again raising risk premia. Most alarmingly, a Trump White House would likely try and curtail the Fed. This could have a whole string of dangerous consequences as the Fed’s independence is important: at the very least Janet Yellen will likely not see her term extended beyond 2018 as Trump has repeatedly attacked her in the campaign.

Overall a Clinton victory would be modestly positive for the economy and markets; Trump remains a stumble into the unknown.
Making the most of a changing Japan: a thematic equity approach

Against a backdrop of aging demographics, slower consumption and a high debt stock, Japan continues to draw interest as a laboratory on how to tackle the economic challenges of our time. Translating those challenges into investment themes deemed to be effective in the long run, either through higher sales or higher return on equity, can offer a strong proposition for investing into Japanese equities. In the last article of our series, we introduce two new promising investment themes along with illustrations of two companies.

**Infrastructure renaissance**

Japan has a long tradition of high quality infrastructure. In a country often challenged by natural disasters, infrastructure is often seen for legitimate reasons as a life line in many remote areas of the country. No other industry embodies more this pursuit of excellence than the rail transport industry. Launched in 1964, the Shinkansen or “bullet train” was the first high speed train to start commercial operations. Today, infrastructure is old and the replacement pipeline is gigantic. 2020 Tokyo Olympics call for top-notch transportation network and technology infrastructure which Japan, as a nation, will be eager to deliver for the world to see. Totetsu Kogyo is one of these companies that will benefit in such an environment.

Based in Tokyo, Totetsu is a leading railway company which operates in the Kanto and Tohoku areas. Totetsu’s core business is railway-related construction works, such as line maintenance and viaduct equipment. In particular, due to its top-notch range of track maintenance machines, it boasts a market share of 50% in the Tokyo metropolitan area. Platform edge doors are also being installed in train stations across the country, a growing market where the company commands a hefty 50% share thanks to its strong track-record. Since the railway-related construction work is often carried out at night, safety is of utmost importance, and Totetsu has made a clear distinction with the other general construction work companies in this regard.

The government’s positive attitude to the infrastructure development in the run-up to the Olympic Games will provide strong tailwinds to the company operations. We expect Totetsu’s position to remain solid given continued increased sophistication of infrastructure, heightened level of safety requirements as well as its strong footing in the Tokyo region which continues to see its population increase.

Totetsu’s ROE in 2015 was at 14% while its balance sheet is debt-free so there remains room for further improvement.

**Improved Corporate Value**

Fuelled by a sense of crisis, companies continue to restructure and revamp their business portfolio at the age of globalisation. This can be achieved by two means: either get rid of unproductive assets or rationalise the liability side of the balance sheet. Daito Trust has been able to raise its ROE by the two means.

Daito Trust has a unique business model. The company undertakes housing construction and rent the collective dwelling subsequently through a sublease contract on behalf of the land owner. This model has allowed it to develop a monopoly at clients in an integrated manner. In both fields, the company has gained the peace of mind and trust which has turned into a competitive edge. This business model, referred to as a “rental management contract system” can be expected to generate sustainable earnings growth in the future. The company has also a high Return on Equity of 27%.

Of course, as a result of its brand strategy and cooperation with brokers, it has maintained a high occupancy rate. In addition, long-term rent guarantee over 35-year period means that customers are locked up over the long term opening up new possibilities for growth such as installation of residential solar panels or liquified petroleum gas kitchen stoves. Because its business model is asset light, as the customer holds the land, and because there is generally no need for large-scale capital expenditure, the company has been able to generate high free cash flows and set a high payout ratio.

Daito Trust has developed a structure to ensure that corporate governance functions adequately through the appointment of three Independent Outside Directors and efforts to strengthen the oversee of strategy execution by Directors. Meanwhile, its policy for returns to shareholders include the allocation of approximately 30% of consolidated net income to the acquisition of treasury stock under certain conditions which is certainly a testament to solid corporate governance. Coupled with a 50% dividend payment policy out of net income, it makes for a total of 80% of net income to be returned back to shareholder which make of Daito trust a company on par with US and european peers on thes metrics.
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