



2015 Global Market Outlook Press Briefing

# GLOBAL EQUITIES

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# Global Equity Outlook: Summary

## ENVIRONMENT

- Remarkable recovery of U.S. stocks off March 2009 bottom, driven by strong corporate earnings—and despite subpar economic growth.
- Divergent economies and central banks' actions in Europe and Japan led to slower earnings and stock recoveries.
- Emerging markets economies less synchronized than ever and regional stock price returns reflect it.

## LOOKING AHEAD

- Certainty of extreme monetary accommodation ending. Liquidity to deteriorate and volatility likely to increase.
- Expect extended, but muted, global economic cycle. Equity returns from here should be more moderate.
- Diversification is important. Little is truly cheap.
- Bottom-up stock selection key to investment success looking forward.

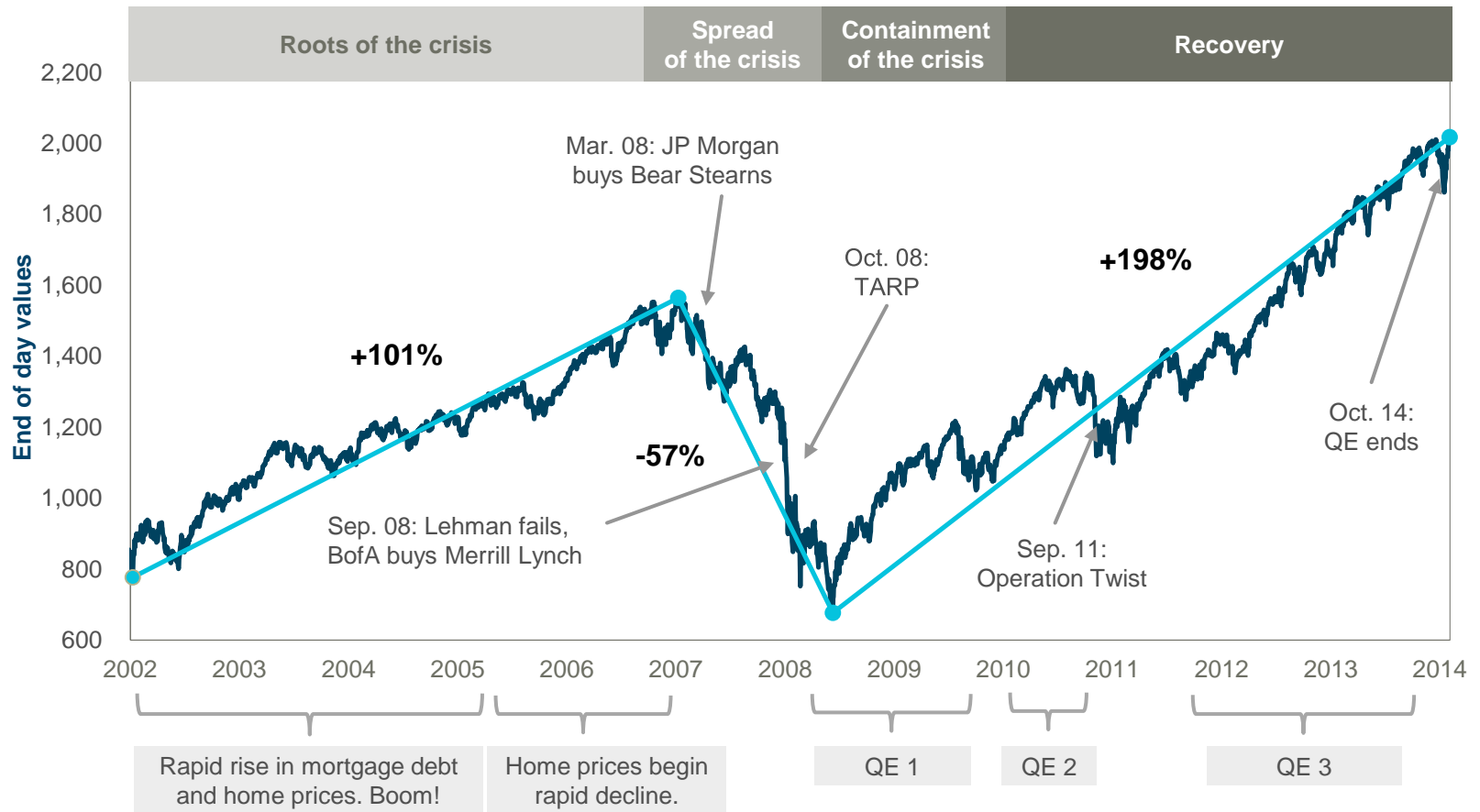


# U.S. Stocks Have Come a Long Way

*Federal Reserve's massive monetary response has worked*

## S&P 500 INDEX

October 2002 to 3 November 2014



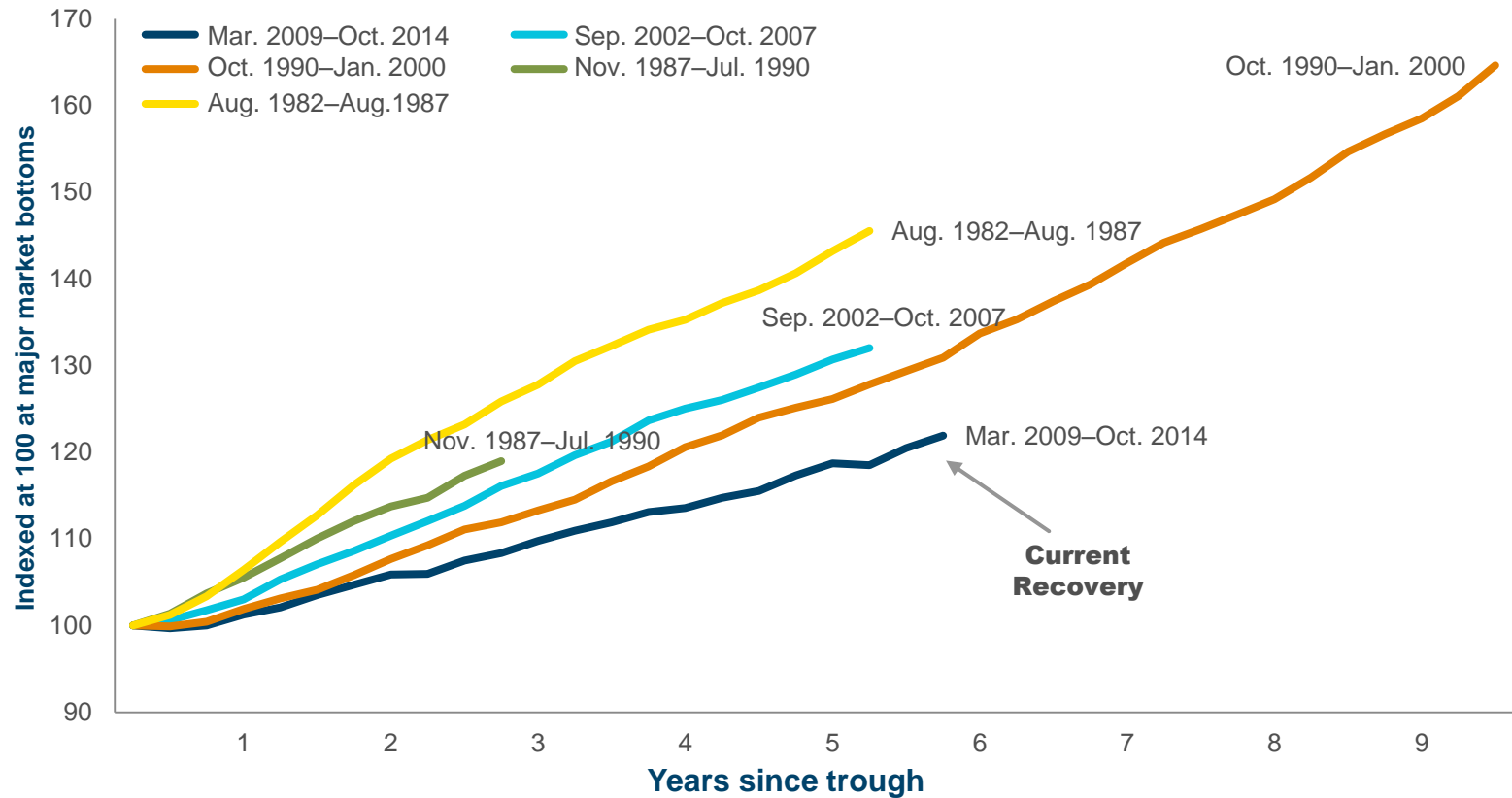
Sources: Standard & Poor's and T. Rowe Price.



# Excellent Stock Returns Despite a Weak Economic Recovery

## NOMINAL GDP CYCLE COMPARISON

As of 31 October 2014



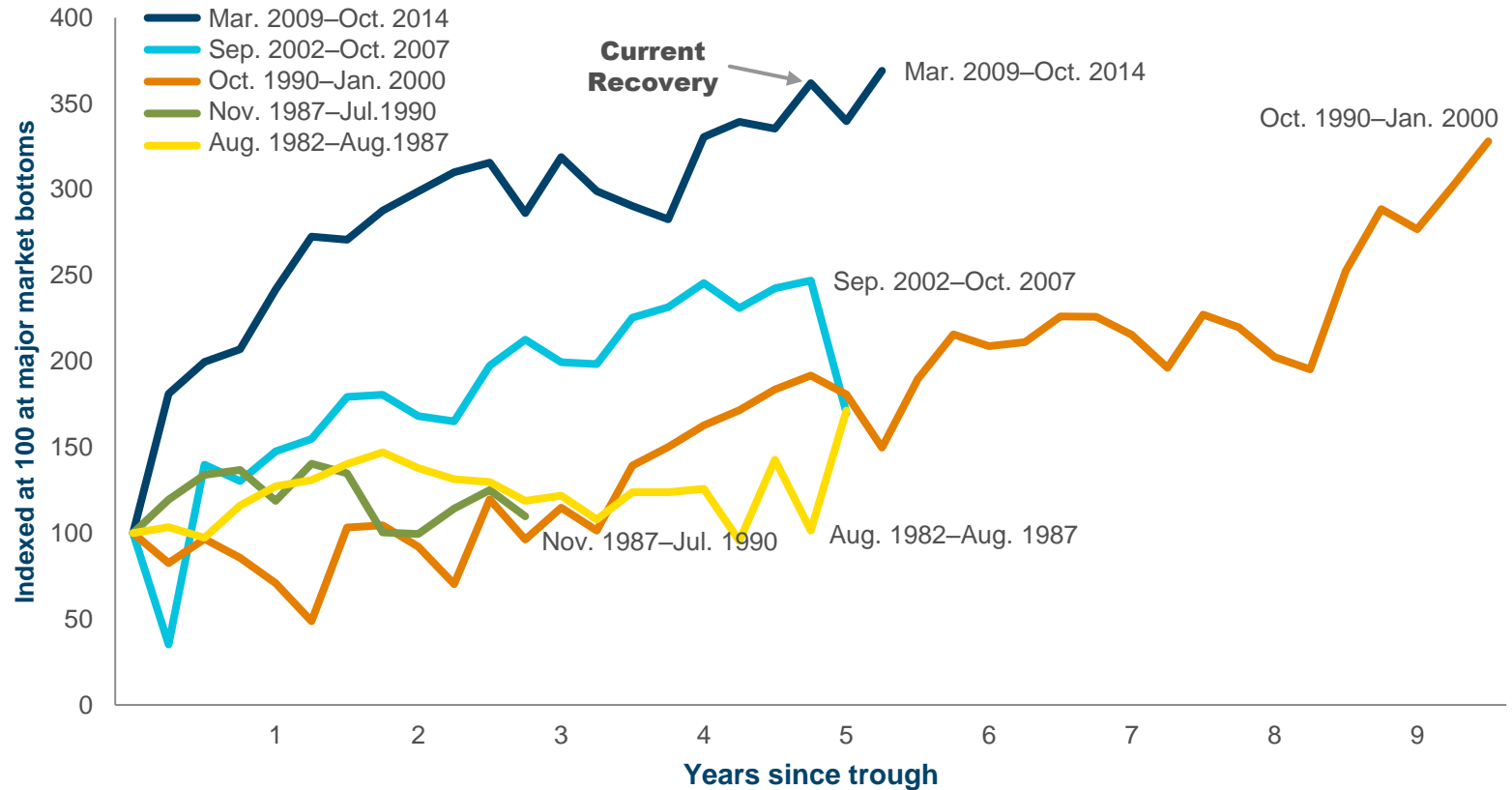
Source: Factset.



# Corporate Earnings Matter Most to Stocks—and They Have Been Terrific

## S&P AGGREGATE EARNINGS CYCLE COMPARISON

As of 31 October 2014



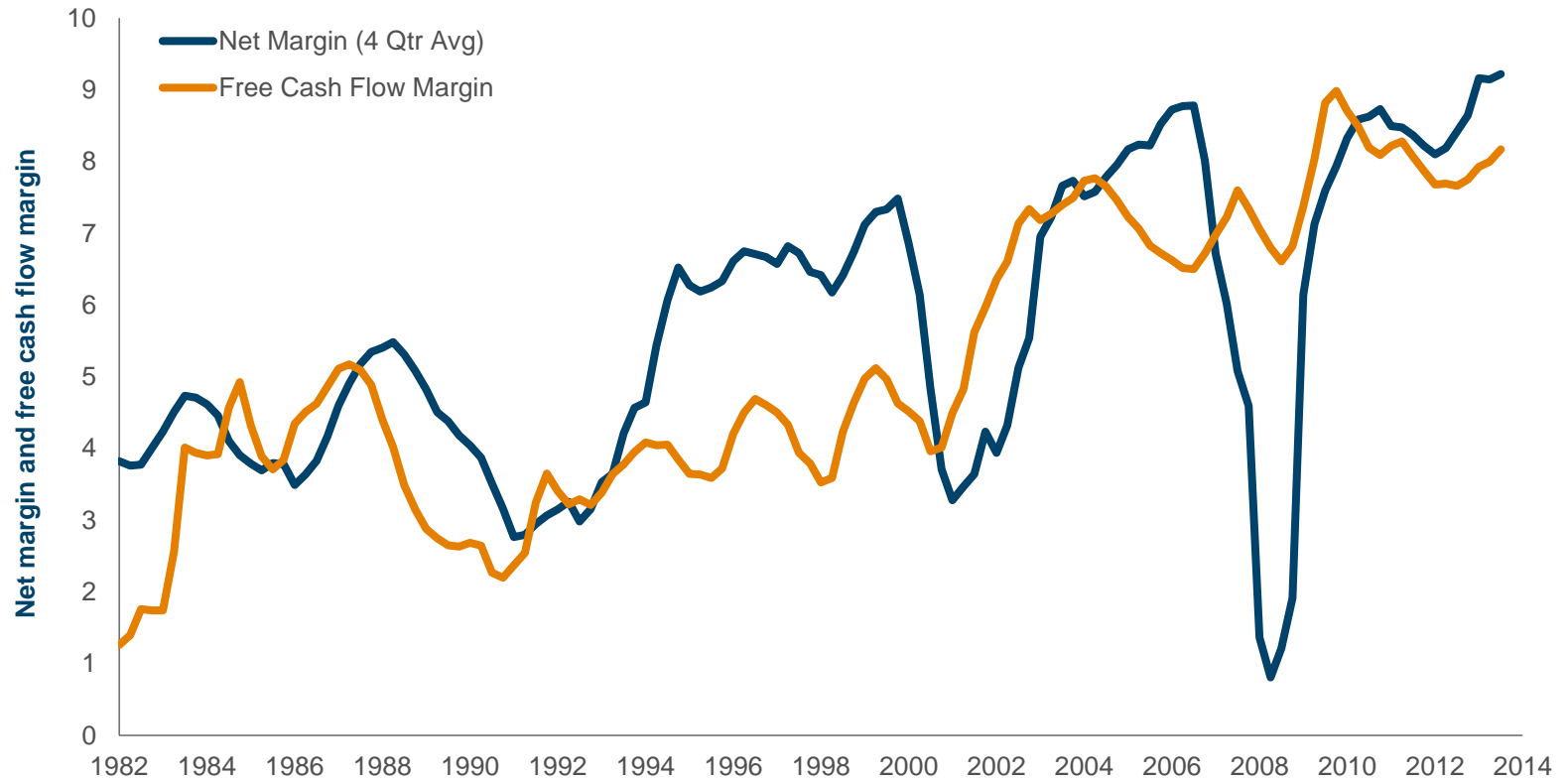
Source: Haver Analytics.



# Record Profit and Free Cash Flow Margins

## S&P NET PROFIT MARGIN AND FREE CASH FLOW MARGIN

December 1982–30 June 2014



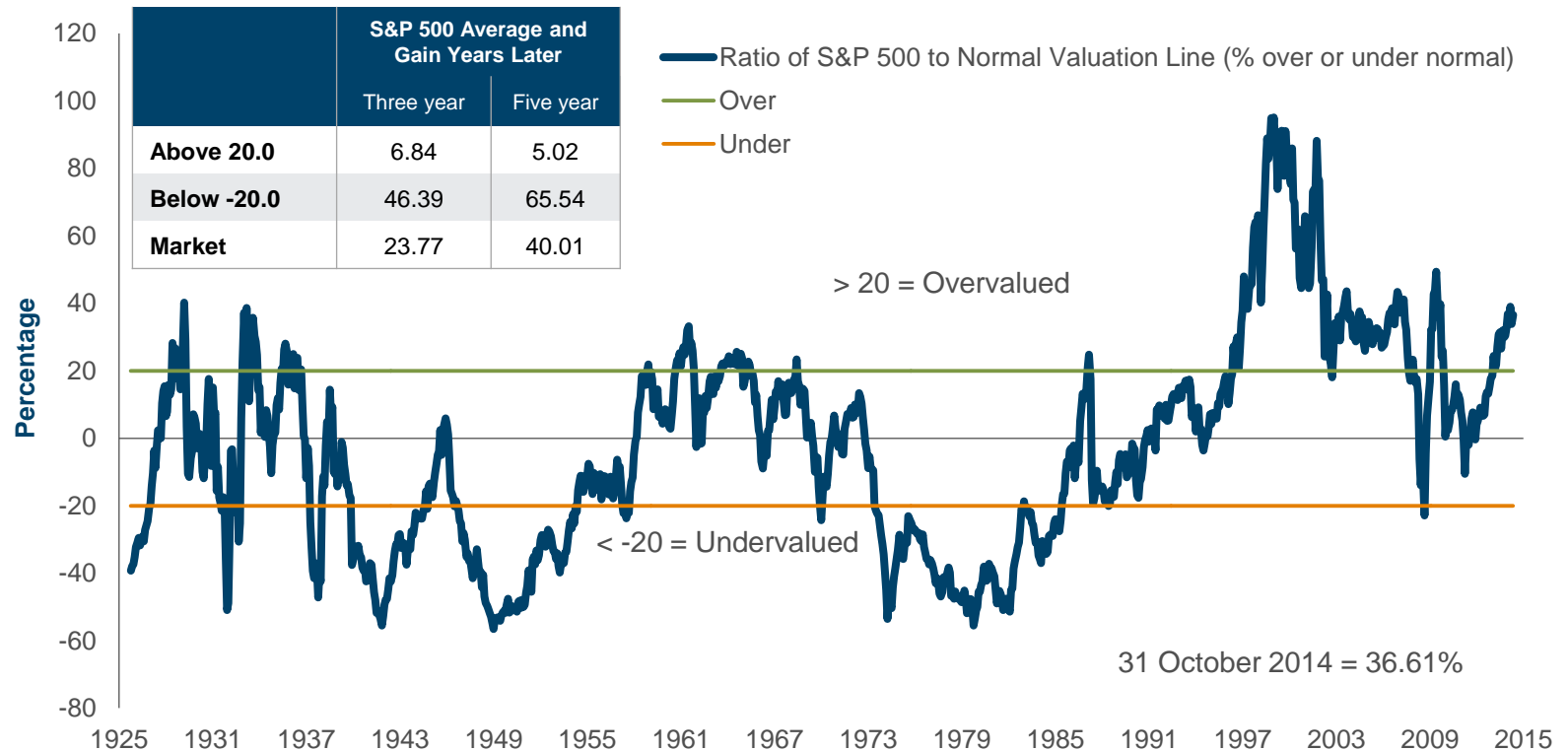
Sources: Net Margin: Strategas; Free Cash Flow Margin: Empirical Research.



# Valuation Composite Shows Stocks Expensive

## S&P 500 PERCENT OVER/UNDER VALUED: S&P “NORMAL” VALUATION

As of 31 October 2014



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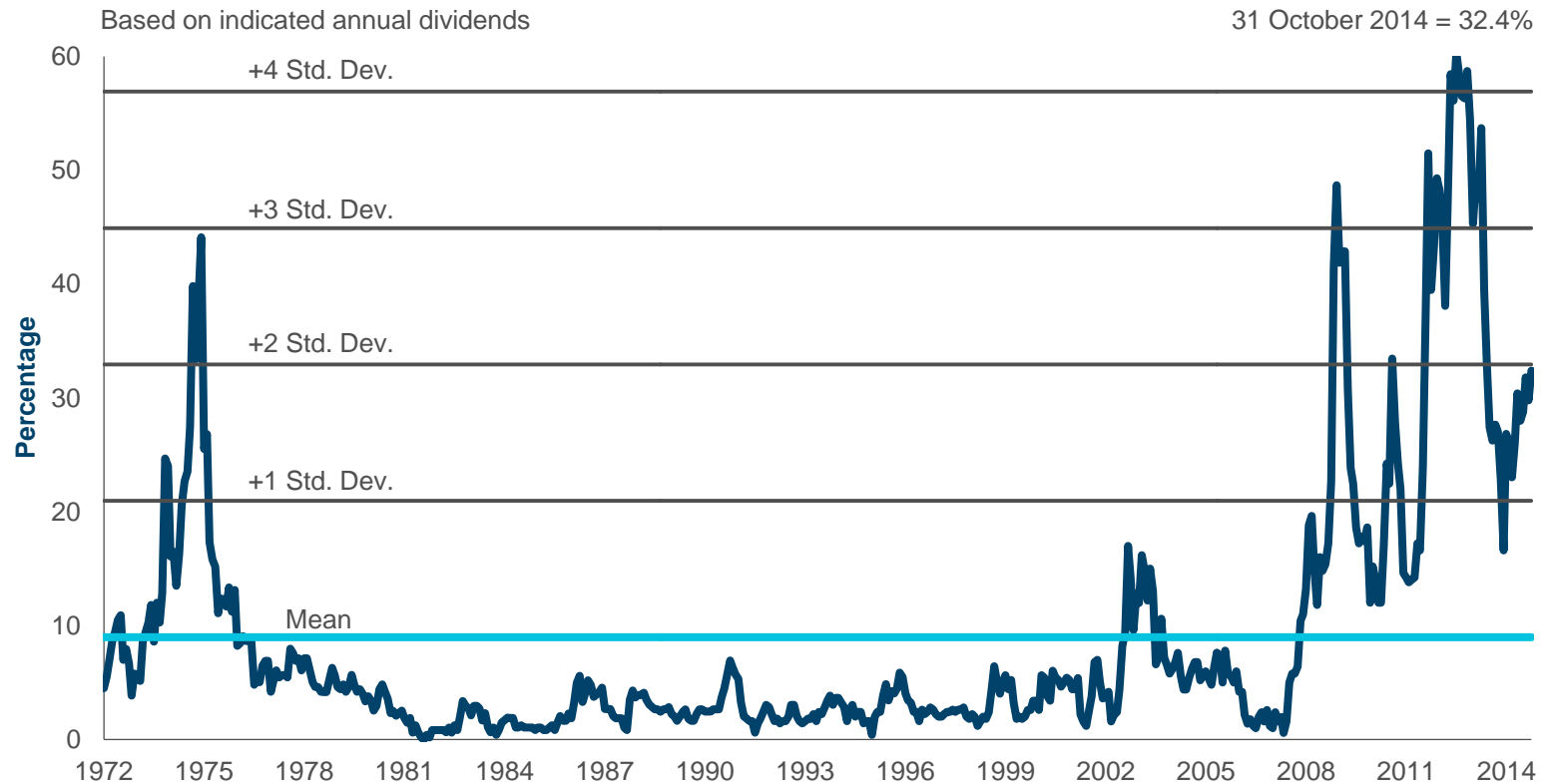
The normal valuation line is calculated from six independent valuation lines based on: dividends, earnings, cash flow, sales, CPI-adjusted P/E, and trend. Each month represents the median of these six measures.

Source: Ned Davis Research.



# Stocks Only Look Cheap When Compared to Bonds

## PERCENTAGE OF S&P 500 STOCKS WITH DIVIDEND YIELDS GREATER THAN 10-YEAR TREASURY YIELDS



Source: S&P Capital IQ Compustat.

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# Sentiment is Surprisingly Balanced

## Room for further gains...

Market Week Pullout Good Earnings Lift Dow 1.6% Friday, Leaving It Off 1% on Week Page M3

# BARRON'S

The Dow Jones Business and Financial Weekly Vol. XCIV No. 42 [barrons.com](http://barrons.com) October 20, 2014 \$5.00

**ALL-STAR ADVISORS** SPECIAL SECTION INSIDE

**UP & DOWN WALL ST • 7**  
Another manic Stocktober

**STREETWISE • 13**  
Amid the market wreck, some gems

**SUCCESSFUL LAUNCH • 21**  
Barron's Asia covers trends, stock picks

**TOLD YOU SO • 18**  
Why oil will fall to \$75

**IT'S SHOWTIME • 24**  
New revenue ideas may buoy CBS 25%

**6% DIVIDEND • 26**  
Zurich Insurance offers 20% upside

**EYE ON APPLE • 38**  
The press missed the point on iPad

# TIME OUT!

Professional money managers see stocks' recent skid as a needed pullback, not the end of the bull run. Big Money Poll, page 29. Also, why the market is now fairly valued. Five stocks worth buying, page 22.

**DOW JONES**  
Subscriptions/Customer Service: 800 544-0422

Source: Barron's, 20 October 2014.



# U.S. Equity Outlook

*Expect positive returns—but modest long-term upside*

## **BULLS**

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1. Healthy EPS growth
2. Low inflation
3. Low interest rates
4. Valuations not **extremely** expensive

## **BEARS**

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1. Profit margins already high and U.S. dollar strength is a headwind
2. Wage growth picking up as unemployment falls
3. Certainty of monetary accommodation ending
4. Valuations not cheap either

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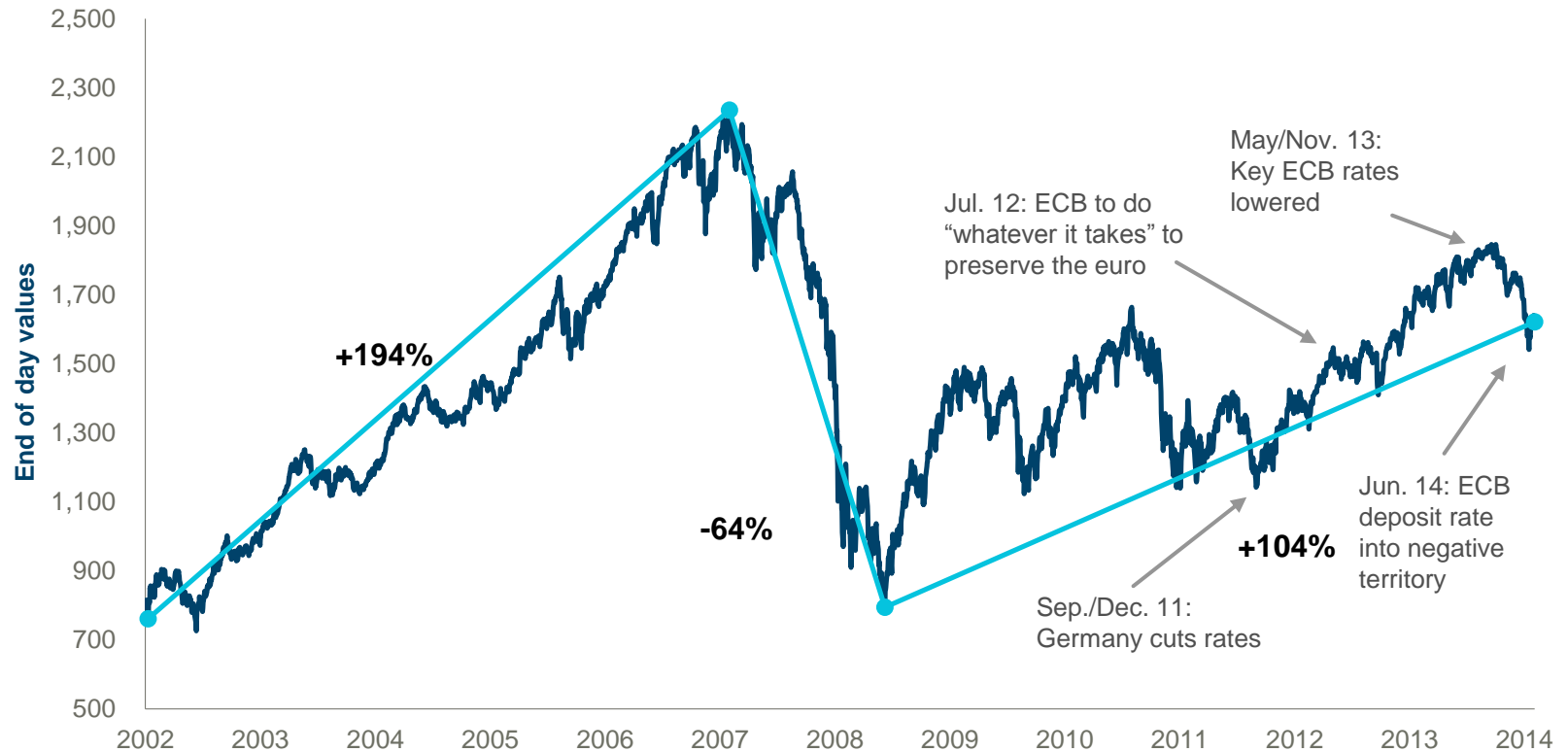
Conditions are ripe for further stock gains. Upside is likely limited due to moderately high valuations and already high profit margins.



# Subpar Stock Recovery in Europe...

## MSCI EUROPE INDEX

October 2002 to 3 November 2014



Sources: MSCI and T. Rowe Price.



# ...And in Japan

## MSCI JAPAN INDEX

October 2002 to 3 November 2014



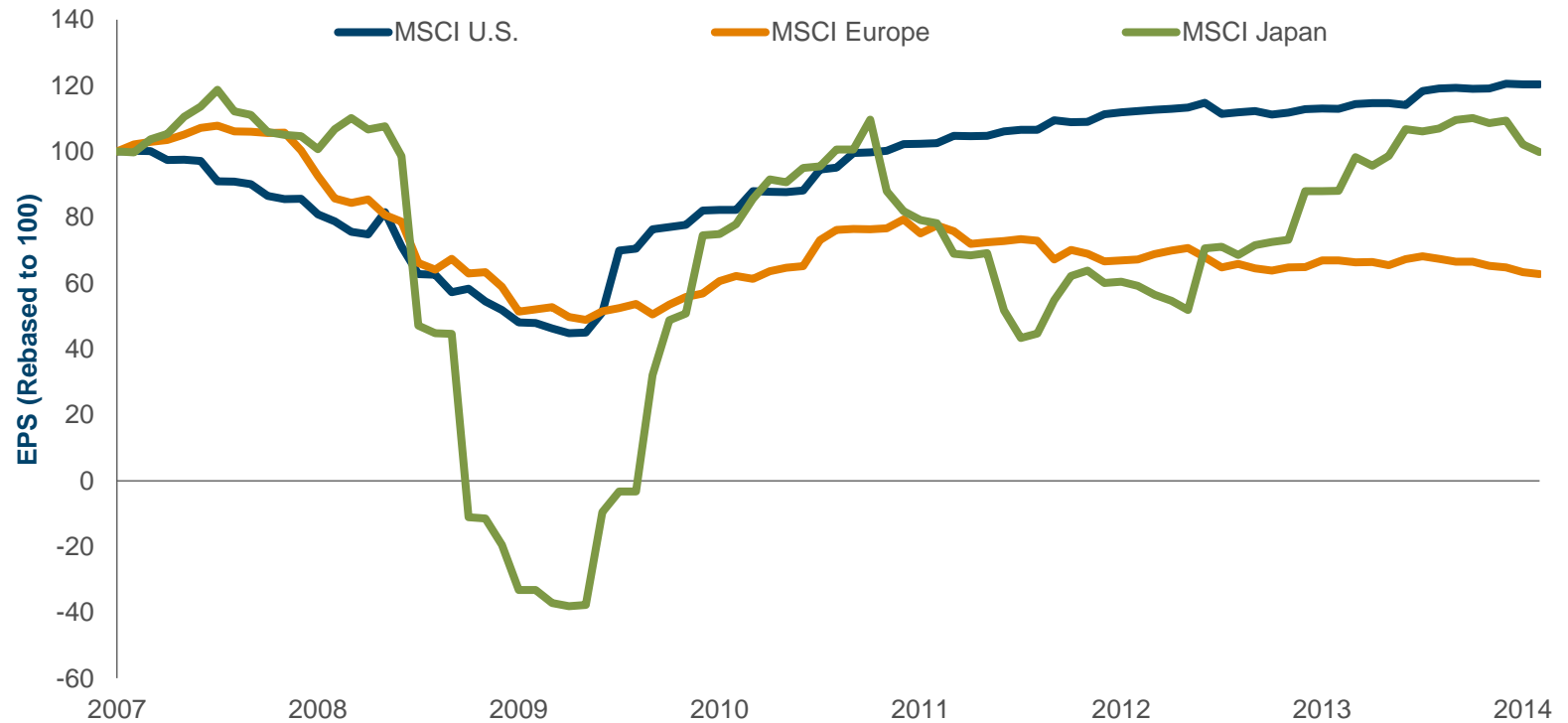
Sources: MSCI and T. Rowe Price.



# Earnings Growth in Europe and Japan Has Lagged

## TRAILING EPS

September 2007 to 31 October 2014



Source: FactSet.



# Consensus Thinks Europe Will Struggle



- Pessimistic sentiment on Europe—BUT
- Recessionary conditions have led to serious cost-cutting.
- Even modest sales growth could cause surprisingly positive earnings recovery.
- Stocks relatively cheap and could surprise on the upside.

### SHILLER P/E RATIO: EURO AREA

As of 31 October 2014



Source: *The Economist*, October 25, 2014, BCA Research.



# Euphoria of Abenomics Has Waned

## *Upside remains if corporates continue to restructure*



*The Economist*, May 18, 2013.

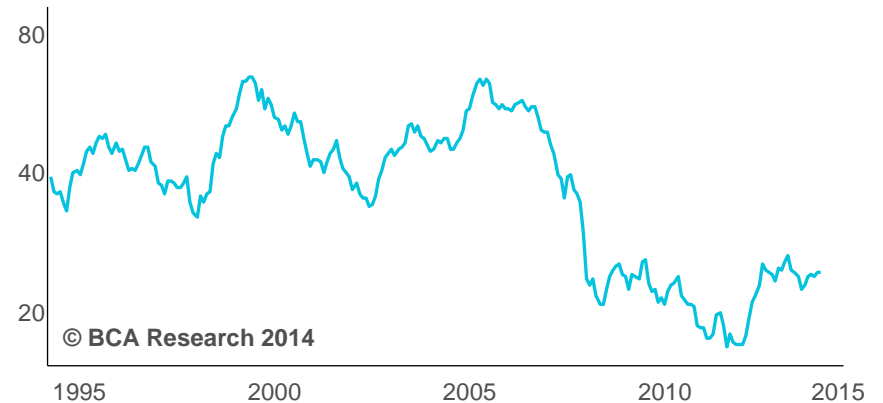


*The Economist*, June 15, 2013.

- Firm government and central bank resolve.
- Low energy prices help Japan a lot.
- Stocks still reasonably priced.
- Evolution toward stronger corporate governance a big positive.

### SHILLER P/E RATIO: JAPAN

As of 31 October 2014





# Emerging Markets Stocks Underperforming Since 2011

*Largely because earnings growth has lagged*

January 2002 to 31 October 2014



Source: FactSet.



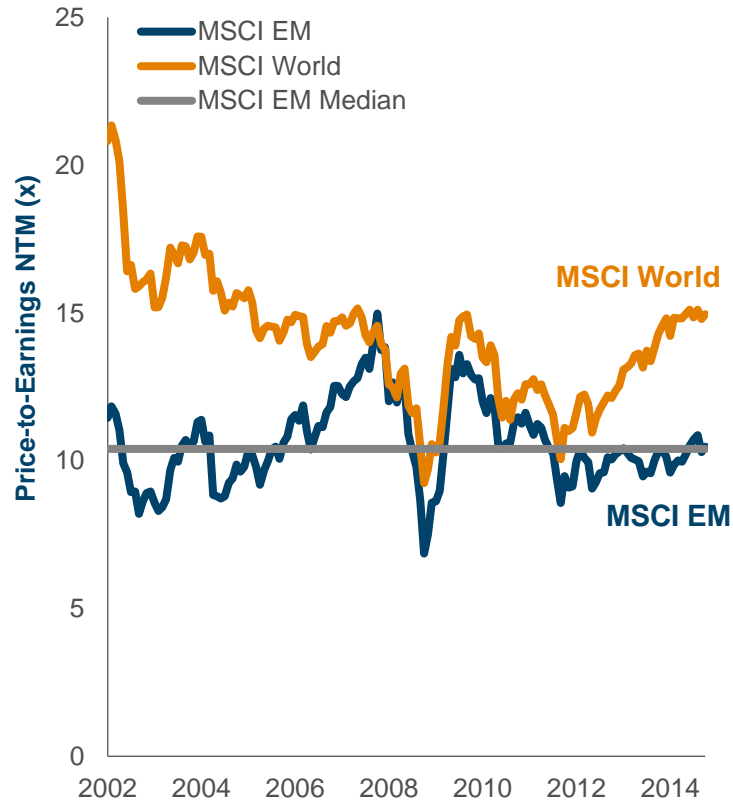


# Emerging Markets Relative Valuation

*Compelling relative to developed markets*

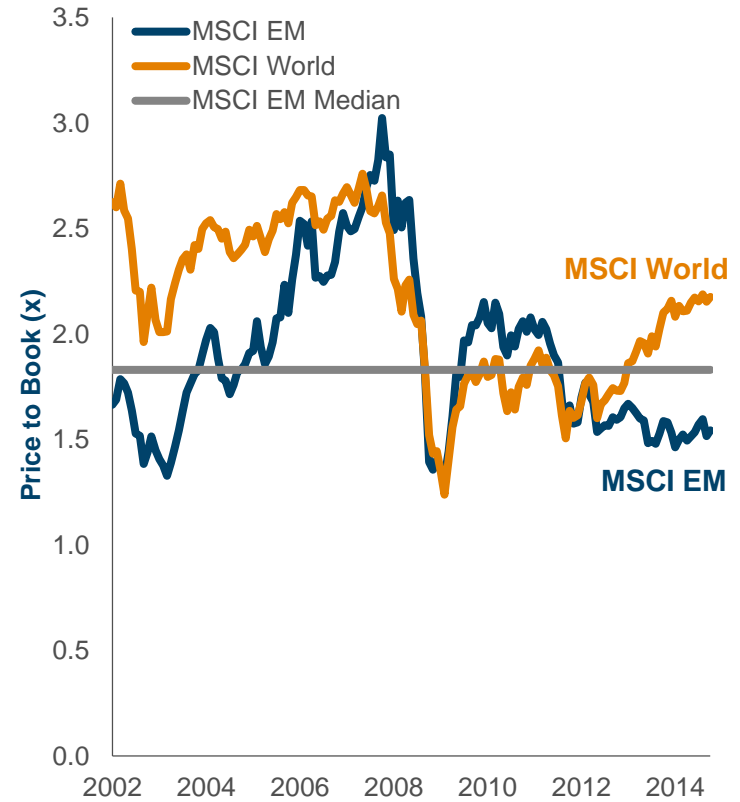
## PRICE TO EARNINGS

29 January 2002 to 31 October 2014



## PRICE TO BOOK

29 January 2002 to 31 October 2014



Price-to-earnings data represent 12- to 24-month forward consensus.  
Sources: MSCI and FactSet.



# Emerging Market Headlines—Divergence

## **EM Central Banks Go Their Separate Ways**

Financial Times - Nov. 7, 2014

## **Modi-mania boosts Indian stock markets**

Financial Times - Nov. 10, 2014

## **As China Opens Stock Market to Foreign Investors, Bargains Await Risk Takers**

Wall Street Journal - Sep. 11, 2014

## **Plunging rouble raises spectra of fresh financial crisis for Russia**

Financial Times - Nov. 9, 2014

## **Emerging Markets to Diverge as U.S. Thrives, China Slows, Europe Lags**

Reuters - Oct. 13, 2014

## **Markets Diverging in Emerging World**

Wall Street Journal - Sep. 30, 2014

## **Brazil's Real Declines as Rousseff Mulls Economic Appointments**

Bloomberg - Nov. 11, 2014



# Returns Vary by Country—and Will Continue

## Fundamental analysis more important than ever

As of 31 October 2014

	Trailing 12-month P/E	Yield	Trailing 12-month return	Representative blue chip stocks
<b>CHINA</b>	9.8x	3.3%	+6.7	Baidu AIA Group
<b>INDIA</b>	19.5x	1.4%	+29.4	Infosys ICICI Bank
<b>BRAZIL</b>	14.6x	4.8%	-9.3	Itau Unibanco Lojas Renner
<b>MEXICO</b>	23.9x	1.5%	+7.1	Walmart de Mexico Grupo Financiero
<b>RUSSIA</b>	5.5x	4.4%	-23.9	Sberbank Magnit
<b>EMERGING MARKETS</b>	<b>12.9x</b>	<b>2.8%</b>	<b>+1.0</b>	

The returns represent those of the respective country MSCI Index for the time period noted and do not represent the return for any security mentioned.

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Based on MSCI indices.

Source: FactSet.



# Conclusion: Keep Return Expectations Moderate

## Diversification is important as nothing stands out as cheap

- Extended global economic cycle likely. Post-global financial crisis economic healing continues. Inflation, the typical cycle-killer, not a near-term threat.
- Conditions ripe for further gains in U.S. But moderately high valuations and already-high profit margins limit the longer-term upside.
- Europe and Japan stocks cheaper than U.S. and potential exists for positive earnings surprises. We would own some.
- Emerging market stocks relatively cheap—though opportunities are country and company specific. Emerging market economic and market cycles more divergent than ever. We would selectively own some.
- Fundamental analysis more important than ever.



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