FINANCIAL TIMES

MARKETS INSIGHT

Last updated: January 16, 2013 11:09 pm

Biggest growth story is outside the US

By Russ Koesterich

With bad news priced in to risk assets, havens look expensive

The market had hoped for a “Grand Bargain”. Instead, it got a small, ultimately insufficient fiscal deal. The best to be said of the agreement hammered out on New Year’s eve is that it beat the alternative. While investors still cheered, nobody should mistake this for an economic, fiscal, or financial positive. Ideally Washington would have crafted a deal coupling long-term tax and entitlement reform with short-term stimulus. Instead, we got the opposite. The US now faces significant fiscal drag on an already sluggish recovery.

The drag might have been justified had the agreement actually addressed the long-term fiscal outlook. But it failed to tackle the US tax code’s dysfunction or the sustainability of major entitlement programmes. In abdicating any effort to stabilise the national debt, Washington now risks an eventual loss of international confidence in the US. Short term, it is not even clear that this deal does much to address the deficit. With significant fiscal drag still embedded in the deal, the economy is unlikely to grow as fast as current budget estimates assume. If growth disappoints, as it almost surely will, revenue will be below expectations and deficits above.

Investors face the same challenge of the past several years: how to generate positive real return in a zero-rate world. While the next episode of Washington’s fiscal soap opera – lack of clarity over the debt ceiling – will expose investors even further, they should fight the temptation to abandon stocks and other risky assets. Policy chaos has been the norm throughout the past three years. Despite the lack of progress, equities and other risky assets have climbed the proverbial wall of worry; those willing to take on risk have done well. The reason: while the world is far from perfect, much of the bad news is already reflected in equity prices. Ironically, it is “haven” assets that appear most expensive.

Rather than abandoning risky assets altogether, investors should tap market segments most geared to faster global growth and less exposed to US consumption. Practically, this suggests lowering exposure to small and mid-caps and favouring large and mega-cap companies, which benefit the most when global growth accelerates and are the least sensitive to a slower domestic economy.

To benefit from global growth even more directly, investors can reduce their overall US allocation. For most of the past three years, the US has been a safe port in the storm. Part of the reason is an incredibly resilient corporate sector, which until recently has effectively delivered double-digit earnings from low single-digit economic growth. But US competitiveness was not the only factor. On a relative basis, the US has been the unintended beneficiary of an unexpected slowdown in emerging markets, Europe's existential crisis, and an aggressive Federal Reserve.

Today, while US companies are still reasonably priced, they are relatively expensive compared with the rest of the world (the S&P 500 trades at a 40 per cent premium to international markets based on price-to-book). Given the near-term outlook for slower growth, more volatility, and a debt-ceiling showdown, that premium may no longer be justified. At the same time, the rest of the world is in marginally better shape. Given the shift in relative fundamentals, investors should consider reallocating some portion of their holdings out of the US and into emerging markets, smaller developed markets and European exporters.

For example, many smaller developed markets – Australia, Singapore, Hong Kong, Switzerland, Canada – came out of the financial crisis much better positioned than the larger, developed countries. Generally, their labour markets were less traumatised and their fiscal situation looks credible and, in some cases, quite good. While these nations have their own challenges, valuations are generally more forgiving and growth estimates may be less prone to disappointment.

Few bargains exist on the fixed income front, thanks to the world's central banks, but credit looks relatively more attractive. While low rates and relatively tight spreads suggest opportunities for capital appreciation are limited, high-yield bank loans, structured credit and even municipal bonds still offer attractive relative yields. Conversely, US Treasuries are both expensive – with a negative real yield – and deceptively risky. A low coupon payment translates into a high rate sensitivity. Even a small increase in yields will quickly erase a year of income.

Washington has not offered investors an easy ride. Yet, investors still have better alternatives than a permanently high allocation to cash. Fundamentals are improving in much of the world, with even Europe looking somewhat less scary than a year ago. While policy paralysis is likely to keep volatility high, given the alternatives, it may still be worth the ride.

Russ Koesterich is chief investment strategist at BlackRock