

Built to last...

- In 2014 we expect the FTSE to reach 7,400; the S&P to hit 1,940; and the Nikkei to breach to 18,000.
- We have long argued that this is a long and arduous recovery...
- ...but fortunately that bodes reasonably well for equity returns.
- Interest hikes tend to foretell the end of the bull phase of the cycle, as inflation forces policymakers to tighten policy.
- We are hopeful for equity prospects with inflation trending downwards in the developed world.

Investor anxiety has grown as US equities have reached new all-time highs. Expectations for economic growth are modest but we expect another good year for developed equities in 2014 as part of a recovery which has been built to last.

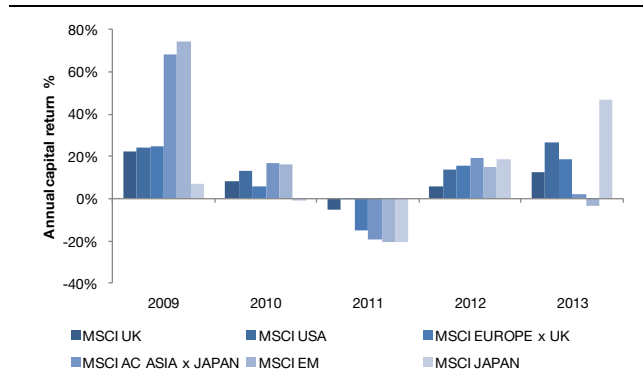
We can rationalise strong returns for equities from this point in the cycle because there are few signs that the bull run will end. The critical thing to watch for would be an increase in interest rates which normally means the end of the bull market will arrive within the next couple of years. There is a market expectation of rising interest rates, but not in 2014, and we are sceptical about the prospect of rising interest rates in 2015. That might imply a bull market stretching beyond 2017! Of course a lot could happen in the meantime and rising interest rates are not the only thing to watch out for.

It is unusual for excessive valuations to derail a bull market without interest rates going up, but nevertheless, cautious investors should consider the possibility. What makes an excessive valuation in the current environment is a contentious subject in itself. We have written before about how the CAPE offers poor predictions of equities, except over a very long term timeframe.

Instead, for a fair valuation, we estimate the changes in market's discount rate, risk premium and sustainable growth rate. We see US equities as being relatively low risk and, by implication, low return. That said, the tailwinds for US companies are enviable. Not only does the index contain some of the most profitable companies in the world, it also benefits from cheap local energy at a time when the rest of the world remains hindered by expensive power. The US embodies the spirit of disinflationary expansion which characterises our view of developed market equities. Although we conservatively raise our forecast for the risk free rate (ten year treasury yields) this is an environment in which monetary policy is set to remain extremely loose.

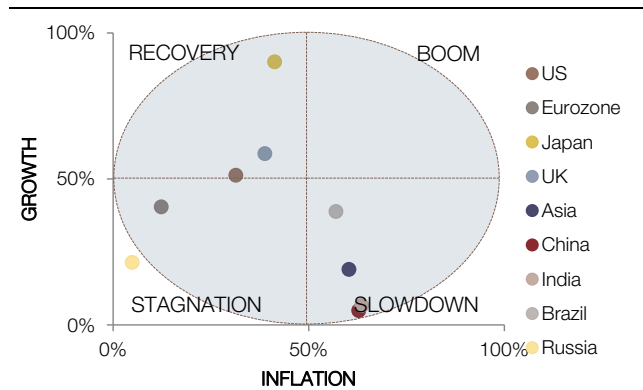
Labour slack in the US remains high, despite the impressive rate of job creation expected during 2014. But labour slack in the Eurozone is even greater. The risk for the Eurozone is not the cyclical return of rising interest rates but rather the secular imposition of deflation. Deflation seems set to be a theme of Spain, as it has been for Greece over recent years. This all serves as part of the adjustment process. For Spanish employment to become competitive prices need to fall, just as they should in Italy and probably even France. By contrast Germany must see prices rise.

Chart 1: Can markets maintain the pace of previous years?



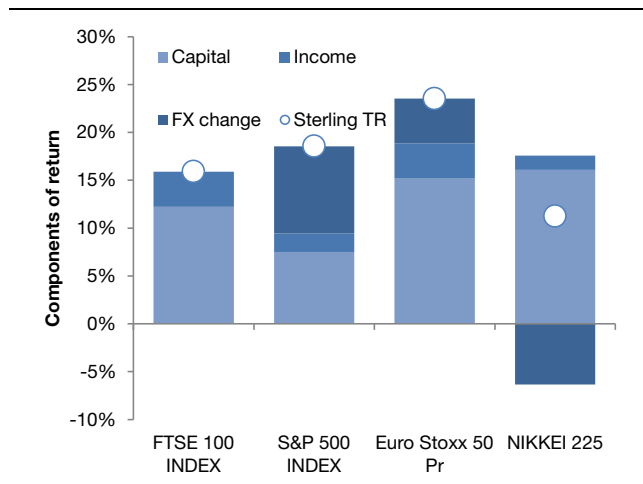
Source: MSCI, Bloomberg

Chart 2: Developed markets remain in, or are entering, the recovery phase of the investment cycle...



Source: Brewin Dolphin, DataStream

Chart 3: We expect strong returns from developed equities...



Source: Brewin Dolphin, Bloomberg, various

For once Europe's fragmented political system may actually be helping with the transition. Assuming that Germany's proposed grand coalition government between the CDU/CSU and SPD takes control, the agreed national minimum wage would create some much needed rebalancing for Germany, a country whose current account surplus belies an under-consuming workforce.

The political and social risks which accompany the painful transition the Eurozone still needs to come out of this crisis are reflected in the high risk premium we impose on European equities – although there are few obvious catalysts for such troubles in a year which is forecast to be mercifully short of elections. 2014 may well see a sharp increase in earnings, given the high level of operational gearing that characterises European shares. Nevertheless, for our sustainable distribution growth rate we retain a modest forecast, particularly given the risks of very low price increases for the region as a whole.

To UK equities we assign a lower equity risk premium. The UK remains a safe haven from political turmoil in the Eurozone and the cause and effects of tapering from the US to the emerging markets.

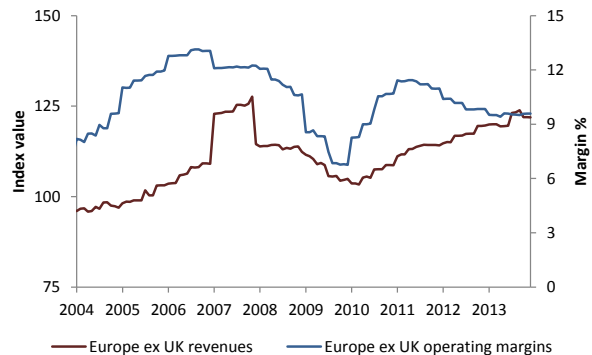
By contrast, the UK money markets have developed a very hawkish view of UK monetary policy in a rebuttal of the Bank of England's new forward guidance framework. With real income falling rather than rising, the impact of administered inflation dwindling and high utility prices being more disinflationary than inflationary, the evidence currently suggests that something of a secular downshift in UK consumption patterns has taken place. This is most clearly evidenced by increasing rates of overpayment on mortgages, even as the economy recovers and house prices start to surge.

We remain optimistic on the Japanese market based partly on the impressive progress made so far by the Bank of Japan. There are few reasons to think that the Bank would waiver in their conviction with growth, employment, prices and profits surging so demonstrably. The remaining factor is wages which still struggle to break decisively into positive territory. Many also lament the lack of supply side reforms but it is important to note that, to the extent that such reforms are forthcoming, they will likely benefit employers by reducing wage pressures. Lower wages would greatly erode public support for the Abenomic revolution so we remain content with the monetary and fiscal arrows. The supply side can wait until recovery is entrenched.

Finally we see the returns from investing overseas as looking attractive too. Currencies are driven by real interest rates and, while the UK has been enjoying the market's hawkish assessment of its prospects, we suspect that investors will come to realise that only Japan has lower interest rates in real terms and we base our foreign exchange expectations accordingly.

We believe the developed markets remain in the recovery phase of the market cycle. That may seem hard to believe when they are making all-time highs and growth has endured for four years in the US, but that is precisely why we have long argued that this will be a longer, slower and less inflationary cycle. In that context, a bull market stretching beyond 2017 remains a distinct possibility.

Chart 4: Modest European margins mean equities should be operationally geared into any revenue recovery...



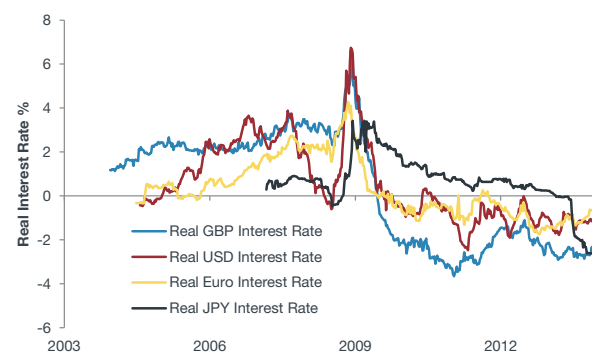
Source: Bloomberg

Chart 5: Total return expectations for developed equity markets

Index	FTSE 100 INDEX	S&P 500 INDEX	Euro Stoxx 50 Pr	NIKKEI 225
Current	6,601	1,807	3,080	15,655
EPS	484	111	218	783
Payout ratio	0.60	0.36	0.62	0.32
DPS	243	35	113	235
Sustainable distribution	315	72	142	509
Risk Free (Rf)	2.85	2.80	1.74	0.62
Forecast Rf	3.30	3.20	2.75	0.80
ERP	4.95	4.75	5.25	5.25
Growth	4.00	4.25	4.00	3.25
Forecast index	7,408	1,942	3,547	18,172
Capital return	12.23%	7.50%	15.17%	16.08%
Total return	15.90%	9.45%	18.84%	17.58%
Exchange rate		1.64	1.21	168.60
Exchange rate		1.50	1.15	180.00
FX change		9.09%	4.68%	-6.33%
GBP Total Return	15.90%	18.55%	23.52%	11.25%

Source: Brewin Dolphin

Chart 6: UK "real" interest rates are the lowest of major economies except Japan



Source: Brewin Dolphin

Important Notes:

Main source of information: Company Report and Accounts, Bloomberg

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