

5 international markets to watch

Look outside Canada for returns



by MELISSA SHIN,
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Low interest rates and an oil-sensitive economy mean Canada shouldn't be the only place where clients invest. Here are five other markets to consider.

1. Mexican fixed income and equities

Jean Charbonneau calls Mexico a model market. "It's one of the most stable emerging market economies," says the Toronto-based portfolio manager with AGF Investments. The country's rated at BBB+.

Gustavo Galindo, a senior portfolio manager with Russell Investments in New York, adds Mexico has a wage advantage. Chinese workers, traditionally global manufacturing's backbone, are demanding higher wages than Mexican workers, so "the labour cost disparity will continue to provide incentive to shift production to Mexico." Car companies, in particular, are diving in; data service fDi Markets found that, in 2013, Mexico's auto industry received more foreign direct investment than China's for the first time.

These changes bolster firms serving the middle class. "Cement

company Cemex will benefit because there will be demand for housing," says Galindo. And, he likes telecom América Móvil, since "more middle-class people means more cell phones."

He warns, "Valuations are high because the market's aware of these trends, but the growth opportunity is large enough that there will be a chance to find attractively priced stocks."

Mexico only has 60 equity names, and a few dominate the benchmark, including América Móvil. "If you don't like them, you don't like a big portion of the index," he says, making the market ripe for stock pickers.

The government's reliance on oil revenues means low oil prices are challenging the country. Fortunately, "the Mexican government has hedged the price for 2015, but not 2016," Galindo says. "At least this year, they should be fine; next year, they'll know what they're getting into when they write the budget."

Fixed income

Charbonneau's emerging markets bond fund owns both dollar- and peso-denominated

government bonds, and he's overweight Mbonos (the peso version) by 2%. "The fundamentals are the same," he says. "But, the 10-year Mbonos are yielding 5.8%," while the Mexican USD 10-year bond yields 3.2%. "There's an additional 2.6% in going locally, [because] the USD-denominated bond is driven by the U.S. yield curve." He adds that Mexican bonds are on the cheap side.

As for corporate bonds, he likes América Móvil. It issues A+ bonds in USD, and its 7-year bond yield is 2.7%—almost 100 bps more than the comparable U.S. Treasury.

2. European equities

The low-vol approach

Jean Masson, managing director of TD Asset Management in Montreal, is "a little underweight Europe, and a little overweight the U.K." That's because volatility's lower in Britain.

"Given today's high government and household debt, investing in less-volatile equities makes sense." To that end, Masson avoids extremely expensive

companies, saying many tend to exhibit higher volatility.

Thanks to these principles, "We tend to have underexposure to the financial sectors of [continental] Europe," he says, since a possible Greek default is creating uncertainty. Instead, he's exposed to British banks and insurers. He also likes water and power utilities for their low volatility.

He does like strong European brands. One is William Demant Holding Group, a Denmark-based hearing aid manufacturer with global reach. "It's not sensitive to market ups and downs. People replace hearing aids when they don't work, or [get one] when they start having hearing problems. Anybody who can afford top quality would consider their products."

Masson also holds Porsche. "The cars are exciting, but the stock is boring, and we go for boring," he says. "Porsche is close to 1% in our portfolio." He likes it because "in good times, they don't triple their production," meaning consistent demand.

The value approach

Portfolio manager James Harper, who's based in Nassau, Bahamas

with Templeton Global Advisors, is overweight Europe by 15% to 20%. Low crude prices have depressed valuations in the region, "so we looked at the most price-sensitive names: oil services, engineering and construction companies."

He realized the market was discounting sub-\$50 oil prices "almost into perpetuity. We thought that was incorrect, certainly in a five-year view." That's created opportunities, albeit with higher volatility. "These companies are trading at 0.6x, 0.7x book value; below 10x P/E."

Over the last three months, Harper has purchased Petrofac, an onshore engineering and construction company. "We bought that between £6 and £7, or 8x P/E," he says. It's trading at about £9 as of June 9. He also bought Subsea 7, a Norwegian deep-water engineering company, at 0.6x book value, "and we've made about 20% to 25%."

Harper also likes European financials, which stand to benefit when the economy rebounds. "Some companies are discounted 70% to their long-term average multiples. The ones we're looking at are reducing risk-weighted assets, cutting costs and driving returns up organically."

For instance, Barclays is trading at 0.8x tangible book value. The firm "has a strong franchise in terms of its personal banking and credit card businesses." He says the credit card business makes a 23% return on tangible equity, while personal banking makes 17%.

Its investment banking business, however, is struggling due to increased regulation; its overseas businesses are also making low returns. "The market is focused on those short-term issues, but on a five-year view, this could be a much stronger business."

Harper has been underweight utilities in Europe and globally "for a while. We're not finding value. Dividend yields have been growing in other sectors, and it seems irrational to pay up in a highly regulated industry."

3. Russia and frontier market equities

Unloved markets create opportunities for value investors, says

HOW POLITICS IMPACT MARKETS

Issue 1: U.S. presidential election

Ablin: Hillary Clinton will likely win the Democratic nomination; it's not clear who'll be on the Republican ticket. "I would say the election is a non-event for the markets."

Dalpe: "Whoever gets elected, Republican or Democrat, I don't think it'll have a lasting impact on markets." A key reason is the executive branch has limited powers, except under extreme circumstances like war or financial crises. "It's not like Canada, where if there's a majority, the prime minister can do pretty much whatever he wants."

Issue 2: Russia-Ukraine

Ablin: The situation affects European access to natural gas. And, "initially, we saw corn prices rise dramatically. Ukraine is one of the biggest producers of corn, so there was fear [it] would be taken out of the market in some way. But that has

since abated." He adds investors often react to headlines, "but if a headline doesn't stay in the news, it tends to be forgotten."

Dalpe: It's less volatile than earlier in the year. Some argue the turmoil presents an opportunity to invest in Russia: its market "got clobbered in the last 12 months" because of the Ukraine situation, combined with halved oil prices and a falling ruble. While Dalpe says this analysis is probably correct, he's staying away. "We touch pretty much everything, but we don't touch Russia."

Issue 3: If Iran gets the bomb

Ablin: "It changes the calculus on geopolitics, but I'm not sure how it would translate into an actionable investment thesis."

Dalpe: If Iran gets the bomb, the country will be constrained by the same logic that kept the U.S. and Soviet Union from firing nukes: mutually assured destruction. That said, the bomb would enhance Iran's power and status in the Middle East, which would mean more leverage and bargaining power.

Issue 4: ISIS

Ablin: "I don't think it's impacting investment strategies yet. It's a geopolitical uncertainty, so you'll see knee-jerk reactions."

Dalpe: Many argue ISIS is attempting to establish a state on defined territory. "That's why there seems to be more of a concerted effort to attack the situation. Arab countries are getting publicly involved to limit the growth of this organization, perhaps because they feel it has more traction than others." He says it's likely impacting markets, but the effect is hard to quantify.

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