The 14 investments our experts wo

How might QE in Europe affect markets? And where should investors look for profits? John Stepek chairs our Roundtable

John Stepek: The European Central Bank (ECB) is edging closer to doing quantitative easing (QE) in Europe. Is the eurozone crisis over?

Andrew Herberts: It's too early to say, but monetary policy will certainly diverge over the next year or so. The ECB will be loosening, while the UK and US are tightening. If America and the UK keep tightening, it should be a reflection of pretty strong fundamentals. If that's the case then stocks should do all right, even though they had a great year last year. But the impact on bonds might be more significant.

Chris Kitchenham: Currency markets are likely to see the biggest reaction. You'd expect the dollar to strengthen and the euro to weaken as American QE is tapered away. A stronger dollar would have an impact on just about every company and country in the world.

Jonathan Compton: I'm not so sure. I think by 2020 we'll have seen QE round four or five. I think this is just the first round of central banks desperately fighting deflation and not knowing how to do it. Wages worldwide are still going down. So I think they'll try to taper and end up with deflation, so they'll print some more, then try to taper a bit – oops! – deflation again. This is going to go on for a long, long time.

John: So you think there's going to be QE indefinitely?

Jonathan: If politicians allow serious tapering with the current economic data, they'll lose the election. That's why I think it won't happen, until deflation magically disappears, which right now seems unlikely.

Talib Sheikh: But the debate in America has moved on from QE. QE is the ultimate form of 'trickle down' – you inflate asset prices, make rich people richer, and you hope some of that eventually hits the real economy. But this trickle-down effect has been incredibly muted, and now the Fed is getting worried about financial stability. So the hurdle for doing more QE, certainly within America, looks very high.

Jonathan: But the alternative is economic and political suicide. I don't know what else politicians can do if they want to stay in power.

John: So you don't see any recovery in wages? No sign of inflation ever returning?

Talib: By the end of this year, American consumer prices could be rising at an annual rate of about 1.5%-2%. But whether that feeds through to wage increases is a totally different question. Wage inflation around the world is incredibly low. As an investor, that's fine – it means profit margins can be maintained, and even if inflation picks up, it never gets out of control – so monetary policy can remain accommodative.

Andrew: There are pockets of massive inflation – in UK construction competition for staff is fierce, and wage and cost inflation are rampant. But these are isolated. As far as QE goes, the problem is that the transmission mechanism – banks actually lending this money to people – is broken. Regulators have been telling banks to sort out their balance sheets, so they haven't been lending. If you can deal with that, QE would become enormously effective.

> "I think by 2020 we'll have seen QE round four or five"

Chris: Yes, I think the problem is that tighter regulation has left the QE money just sitting on banks' balance sheets, plugging black holes that emerged from the credit crunch.

John: But those holes must be close to being plugged by now, in the US at least.

Is Europe on the brink of its

Talib: You're right, the Americans recapitalised their banks pretty aggressively and quickly, and US data does show lending now growing – albeit off incredibly low levels.

John: But aren't we then in danger of being a bit complacent about the strength of the recovery and potential inflation?

Jonathan: The recovery is a failure. Every QE dollar the US government put in generated just $0.32 of GDP growth.

Talib: Yes, but they're not borrowing this money – they're printing it. So if it engenders any growth at all, that makes it a success. I expect real growth in America of 3% for the second half of this year. Is it perfect? No, but it's a lot better than post-credit-crunch Japan.

Chris: And we don't know where we would have been now if we hadn't done QE at all.

Talib: I think Europe probably demonstrates that. It looks more like Japan than any other economic region.

John: Yet most developed markets are hitting all-time highs right now. Is this

ould buy into now

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s own printing experiment?

just the start? Or as good as it gets?

Jonathan: It's entirely rational – if interest rates are zero – that the price/earnings (p/e) ratio of the market should be infinite. So the real question is: do you think they will taper QE to a standstill? Given that they have no plan B, I'm not sure they will. I wouldn't be surprised to see interest rates are still at these levels in two, three or four years' time.

Talib: One potential criticism of QE is that it actually causes deflation: it enables zombie companies to continue when they should have gone bankrupt, meaning the system is never refreshed. And when interest rates are at zero, and companies can issue debt at, say, 1%, they can just buy back their stock and boost earnings per share (EPS) that way. So why bother building a factory? Take Apple – it's one of the most innovative companies in the world. Yet the brightest idea it has had recently was to issue a $19bn bond to buy back its stock.

Andrew: Your point about zombie companies raises something that's been niggling me. There's no point – as a bank – in keeping a zombie loan going if you can use the money more efficiently elsewhere. So if the banks really were strong and ready to lend more and get out there, surely they'd be killing off a lot more loans? Perhaps these aren't really zombie loans – perhaps it's just that low interest rates are allowing companies to keep paying the debts, rather than banks being reluctant to describe them as bad debts. But I'm still amazed at how little debt has been called in – what does that say about banks' balance sheets?

John: Markets in Europe have also shot up a lot over the last two years – do you see that continuing?

Talib: Yes. The ECB did three things last week that I thought were impressive. They almost guaranteed a four-year commitment in terms of their long-term repurchasing operations activity. They also said very clearly that they could do more if the market started to question it. Thirdly, this was a unanimous decision. That's a particularly powerful sign, because so far the Bundesbank [the German central bank] has been so opposed. So money in Europe will remain incredibly easy. That will help to boost banks' earnings. It's also probably the only developed market that still trades below its historic averages. Put those together, and Europe looks attractive.

John: What about peer-to-peer (P2P) lending? That's another potential transmission mechanism, isn't it?

Chris: P2P is one of the most interesting areas around. The people using P2P are the ones the banks should be desperate to lend to, yet they're doing nothing for them. Meanwhile, the largest P2P lending platform in America is doing millions and millions of dollars-worth of business every month. I thought this was a cottage industry at first, but in fact it's already huge and it's going to get bigger.

Jonathan: You have to remember, UK banks are incredibly low-tech. I recently moved an Isa from one bank to another. It took them nine weeks and eventually they admitted that they had moved the cash between banks using a cheque.

Chris: The guys in the P2P sector say they can analyse a potential borrower in about a second. For a bank to do so, you have to sit down, talk to someone, fill a form in, get it processed at another office – it can take weeks to get a decision. Also, banks aren't sophisticated at pricing for individuals. Everyone pays the same rate on their overdraft, no matter if they're earning £200,000 a year and have a £1,000 overdraft, or if they're on benefits and have a £500 overdraft.

John: Will UK interest rates go up at all next year, or even this year?

Jonathan: Of course they will, because Bank of England governor Mark Carney's got to show that he's a real man. The myth is that he saved Canada. Now he's got to prove he can save Britain too. So he'll do the macho thing and raise rates by point-zero something. But I can't see a significant trend reversal in the next couple of years.

Chris: I think Carney wants to wait for as long as he can. He keeps setting barriers to raising interest rates, and every time the barrier is reached he doesn't do it. But I do think he will raise

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Our panel

Jonathan Compton
Former managing director, Bedlam Asset Managment

Andrew Herberts
Deputy head of private investment management (UK), Thomas Miller Investment

Chris Kitchenham
Director at Walker Crips Stockbrokers

Talib Sheikh
Fund manager, JPM Multi-Asset Income Fund

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them next year. He needs to test the markets by going somewhere towards normalising the situation.

Jonathan: Think of the politics of it too. Before Carney came over here, he was seen as potential prime-minister material for Canada. So if the Canadian property market goes badly wrong (which I think it will) and its banks are chronically overexposed (which they always are), and it all blows up, then once he's finished his job here in two-and-a-half-year's time, he can go back to Canada, say "I've saved Britain – let me save you", and run for prime minister.

John: So Chris, where are you actually finding value at the moment?

Chris: I like **easyJet** (**LSE: EZJ**). It's had really good customer growth, it's starting to break into the business market, and trade is buoyant against European peers such as Alitalia or Air France. Accounting for the £1bn of cash on the balance sheet, it trades on a p/e of about 12, and a 2.5% dividend. But what I really like is the shareholder base. The biggest shareholder is still the founder, Sir Stelios Haji-Ioannou, and his family. They own about 35%, and they're basically your allies as a shareholder, because he's constantly pestering the board to increase the dividend. It's a nice company with a strong balance sheet and you're not overpaying for it.

This next one is a bit controversial – **BHP Billiton** (**LSE: BLT**). The miner has had a slightly chequered three or four years. Capital spending has been very high, while Chinese demand has been relatively low. But that seems to be changing. There are signs of green shoots from China, where some numbers have been a little bit better than expected. Meanwhile, the BHP board has slashed capital spending by 25% this year and possibly another 25% next year. The company is also being simplified – non-core assets are being sold off – so you should get a leap in free cash flow. You can buy BHP on 12 times earnings and a 4% yield, and it's got a very strong balance sheet. Just be aware that you'll get a lot of emerging-market-related bumps along the way.

I also like **Vodafone** (**LSE: VOD**). There's been a lot of corporate activity in the stock recently with the sale of Verizon and a huge return of cash to shareholders. There was lots of speculation that someone might bid for the rest of the company, but then the prime candidate – AT&T – made another acquisition, which hit Vodafone's share price. But again, it looks undervalued with a yield of around 5%, a strong balance sheet, and a p/e of about 12. It's a good company at a decent price.

You'll have Stelios on your side

"easyJet is doing well against European peers, such as Alitalia"

Jonathan: The media industry keeps growing and I want to be exposed to it. When I screened global stocks for TV companies about two years ago, Japanese broadcaster **Fuji TV** (**JP: 4676**) came up as the cheapest in the world – ITV was second. The management isn't great, but it's got no debt, good market share, and it's also potentially involved in a casino consortium. If the management could just stop bungling for a week or two, the share price could take off – jut like ITV two years ago.

I also like Brazilian aircraft maker **Embraer** (**NYSE: ERJ**). Short-haul flight is one of the most interesting areas in aerospace right now. If you look at the pattern of flying, it's Shanghai to Beijing, it's Brasilia to Sao Paulo, it's Mumbai to Madras – it's emerging-market travellers becoming more like us in Europe. There are two really good short-haul plane makers – Bombardier, which also makes trains – and Embraer. I think demand for short-haul planes is only going one way.

I'll throw in insurer **Direct Line** (**LSE: DLG**), because we all want yield. It's fallen below its float price – they usually do – but that 5% a year looks pretty safe. And no doubt, eventually some dozy bank will decide to go back into the insurance sector in about 2022, and buy it out.

Then I'll go for **Nexans** (**PAR: NEX**) in France, the world's largest cable maker. It's serially incompetent. The share price in 2000 was €130, the low was €29 two years ago, and it's now at about €42. It's been really badly managed but there are big changes afoot. The main shareholders have finally got rid of about half of the executives, albeit about five years too late. The company has no debt and the cable market is like the aeroplane market and the media market – it's growing. If you buy into a sector that's growing, even if management screws up, it's a much more forgiving backdrop.

Defence is an area to watch too. We've been through something of a peacenik phase over the last ten years or so, which has been nice. But look at Japan and China and India – they've all got nationalist governments – and look at Russia too. I suspect defence orders globally will go up significantly over the next five years for the first time in a long, long, time.

John: Talib?

Talib: The rally of the last five years has been all about compressing the risk premium. The next level has to be driven by GDP growth, which in turn must feed into earnings growth, otherwise equities could look expensive. And diversification will be incredibly important. Both equities and bonds have been going up together. That's been driven by one thing: central-bank liquidity. While policy will remain accommodative, the pace of liquidity injections is likely to slow over the coming years. Markets have become accustomed to this backdrop.

So the one thing that I believe is mispriced globally is liquidity risk. We're looking for liquid stocks, and sectors that could benefit from a slowly improving but still lackluster global economy. For example, we like **Mylan** (**Nasdaq: MYL**). As with most pharmaceutical stocks, it's a 'growth at a reasonable price' story. It's on a p/e of 14 and offers a 5% free cash flow yield.

I also like insurance stocks – with the yield curve steepening, interest margins

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MoneyWeek's Roundtable

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should pick up. **MetLife (NYSE: MET)** in the US trades on 9.8 times earnings and yields 2.5%, which is attractive. Finally, we like European oil and energy stocks. European energy stocks are now quasi-utilities, bought for their free cash flow yield. Take **BP (LSE: BP)**. It trades on ten times earnings. It's got a 4.6% dividend yield, but perhaps more importantly, there are signs it can grow its operating cash flow per barrel, which means it can also grow its dividend and capital spending organically. It's just being run much more sensibly.

John: What's your take on fracking?

Talib: Fracking is transforming the structure of the American economy. Having a cheap domestic energy source has made American manufacturing incredibly competitive, which can be seen in America's improving trade balance. It also means the US is competing with emerging markets, rather than just being an end sales point – which is one reason we're still relatively cautious on emerging markets. And, of course, none of this is happening in Europe, another reason why monetary policy looks set to diverge.

Chris: Yes, I don't see fracking happening in the UK.

Jonathan: I disagree.

Chris: It won't happen in the same way. We're a much smaller, more densely populated country. In America there are huge swathes of land where no one lives. In the UK, you have to go to Brighton and drill under someone's house. The government can make it attractive from a tax perspective, but it's a completely different set of circumstances.

Jonathan: Fracking's an absolute no-brainer. It's cheap, it's less polluting than other fossil fuels, and it gets you away from the Russians and the Saudis. You just need to deal with the politics. You need to avoid the mistakes the US made early in the process, which is where the government should come in and regulate strongly on the correct use of chemicals. But as far as fracking in Brighton goes, the government just needs to tell Brighton and Hove council: "Here's £10m. Happy?"

John: Andrew, where are you seeing value just now?

Diageo's brands will deliver growth

Andrew: I like **Balfour Beatty (LSE: BBY)**. It's been caught at a bad point in the cycle – it's been suffering from that cost inflation I mentioned earlier. Unfortunately, many of its contracts were written two years ago, and don't escalate with costs. So margins have been hammered. But if you believe that this cycle is similar to previous cycles, then contract terms will catch up. So that's a really interesting opportunity.

I also like **Rolls-Royce (LSE: RR)**. Its shares were hit when it came out and warned that defence spending was slowing. The market had already heard the same thing from about four or five defence companies, and yet investors caned them. It's one of those moments where you just think: "Oh, come on". You're not really buying Rolls-Royce as a defence business. You can value it as a commercial aerospace and engines business and still get to a valuation of about £10 a share. Defence is almost in there for free.

Then I've got a company that's playing a very long-term theme – genetically modified food and agricultural efficiency. In the UK there's a nice company, **Genus (LSE: GNS)**, which provides bull and pig semen for breeding. As emerging markets become slightly more middle class, their populations eat more protein and Genus is a play on that demand – they have some interesting techniques and technologies, and they can sell these traits around the world. It's not desperately cheap, but it's one to tuck away.

Finally, there's drinks giant **Diageo (LSE: DGE)**. The stock's done nothing for about two years, because it's been viewed as an emerging-markets play. It's still not cheap on a p/e of around 18. But it'll deliver decent growth off the back of its brands, so you can buy and hold it.

John: Thanks for your tips. It's interesting – I'm not detecting an awful lot of high conviction around the table.

Jonathan: Yes, no one has pushed a biotech stock, or said you can't go wrong with an IT stock – but the fact that we're all hedging our bets a bit is surely quite bullish.

Andrew: Nobody I speak to right now is table-poundingly bullish. But if you go through the things that could upset the apple cart – geopolitical wild cards, an economic slump in China, or a spike in American bond yields – none seem that likely. Which might mean we are just being complacent.

Jonathan: I think competition between the Chinese and Japanese is fantastically deflationary. You've got a couple of large economies exporting deflation big time. Imagine the discussions at the ECB if the consumer price index falls to minus two. This is one of the reasons I think money-printing is something our grandchildren will still be discussing.

Talib: That's a great point. The renminbi has seen a meaningful devaluation over the last six months because China sees deflation in the economy and export growth drying up. If we saw a re-pegging of the renminbi to the dollar, that would be profoundly deflationary. Then your argument that QE never ends comes to fruition. Right now, we're in this stable equilibrium – but we shouldn't underestimate how fragile it is.

Our Roundtable tips

Investment	Ticker	Price
easyJet	LSE: EZJ	1,446p
BHP Billiton	LSE: BLT	1852.5p
Vodafone	LSE: VOD	195.25p
Fuji TV	JP: 4676	¥1,722
Embraer	US: ERJ	$36.23
Direct Line	LSE: DLG	263.75p
Nexans	PA:NEX	€40.89
Mylan	US: MYL	$50.70
MetLife	US: MET	$54.40
BP	LSE: BP	506p
Balfour Beatty	LSE: BBY	234p
Rolls-Royce	LSE: RR	1,011p
Genus	LSE: GNS	1,045p
Diageo	LSE: DGE	1,888p