EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Position for transition

- **A new direction for monetary policy?** A coordinated shift in emphasis from QE towards forward guidance by the US Federal Reserve, the ECB and perhaps the Bank of England marks a new phase in post-crisis monetary policy. The re-introduction of market risk premiums into credit markets should be welcomed by investors starved of returns.
- **Forward guidance may be a slower burning and ultimately more effective strategy.** Though the initial rounds of QE were helpful in eliminating excessive discounts on credit instruments, in our view the subsequent QE episodes inflated asset prices rather than returning the world's developed markets to growth. Forward guidance allows investors to progressively return to their role in pricing credit without creating the conditions for a spike in interest rates.
- **Bond yields capped by Bernanke's commentary.** US bond yields have eased from their highs of 2.75% in recent weeks following soothing commentary from Fed Chair Bernanke. We are not at all surprised by these comments as an uncontrolled rise in yields would have quickly sent the US recovery off-track. A softer period of growth and inflation data gives the US Federal Reserve room to maintain a dovish stance on interest rate policy.
- **Position for transition.** Investors should position themselves for a shift to forward guidance from QE. While interest rates are very likely to remain low for the foreseeable future, the speculative element – in terms of further QE in both equity and credit markets – is likely to ebb. We believe that credit markets have discounted the likely new regime more quickly than equities in this regard.
- **Emerging market equities look better value.** We also highlight the sharp underperformance and de-rating of emerging markets. With the rise in the dollar halted for now, value investors may wish to consider increasing emerging market allocations.

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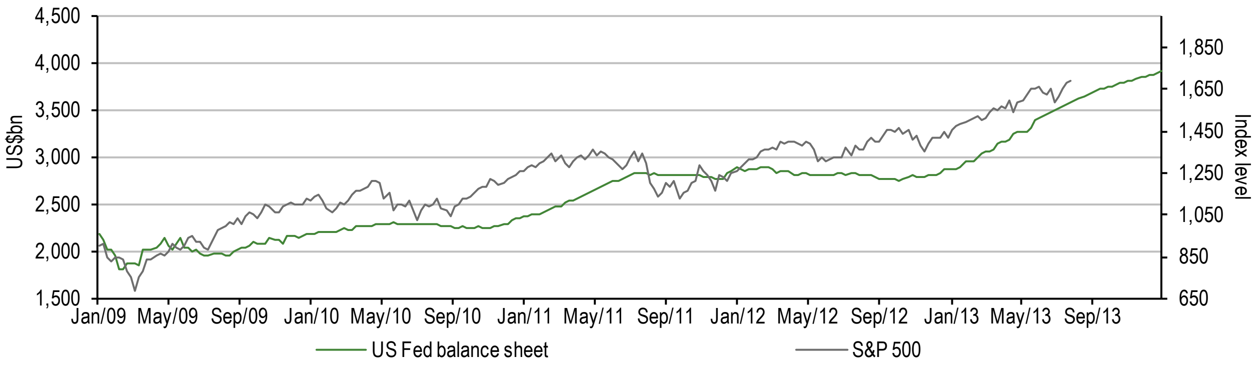
A new direction for monetary policy – forward guidance

In recent weeks it seems that a new direction for monetary policy has been taking shape. With the question of tapering of US QE now appearing to be a matter of timing rather than of principle, the US Federal Reserve is re-emphasising forward guidance on interest rates. In Europe, the ECB's governing council is now expecting key ECB interest rates to remain at present or lower levels for an extended period of time. For the UK it may be too early to say, but it was intriguing that the incoming governor of the Bank of England, Mark Carney, did not vote for an extension of the UK's QE programme at its most recent meeting.

Although both QE and forward guidance are intended to stimulate economic activity, the implications for markets may be rather different. QE has been criticised in the past for driving asset bubbles rather than the real economy, Exhibit 1, as we have previously highlighted.

Exhibit 1: Equity market performance and Fed balance sheet

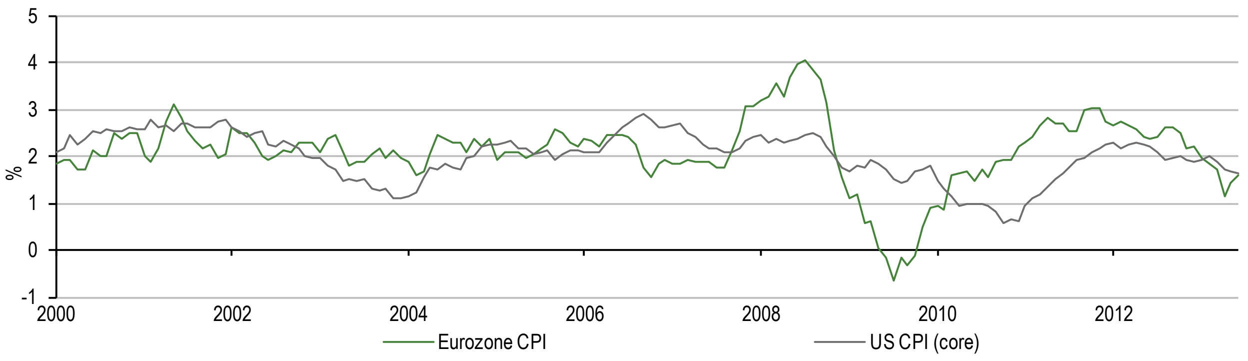


Source: Thomson Reuters Datastream

QE also seemed more appropriate during periods of financial market stress where unwarranted discounts on the prices of credit instruments risked creating a self-sustaining decline in the availability of credit. But the world has moved on since the dark days of 2009. The most recent round of US QE drove yields on riskier credit securities such as high-yield bonds to record low levels, aiding a surge in issuance of such securities. With the albeit modest recovery in the US economy and tightening of fiscal policy the share of government bond issuance that was being monetised was also reaching uncomfortable levels.

Any shift in emphasis to forward guidance will lower the level of central bank intervention in government bond markets. The implication is that longer-dated risk-free rates will rise to market-determined levels. With US rates now between 2.5% and 3% this process appears largely complete. Any further steepening of the yield curve would risk choking growth. Both the US Fed and the ECB are at pains to highlight the benign outlook for interest rates for the foreseeable future and with core CPI measure running significantly below target in both regions, they would appear to have ample room to manoeuvre, Exhibit 2.

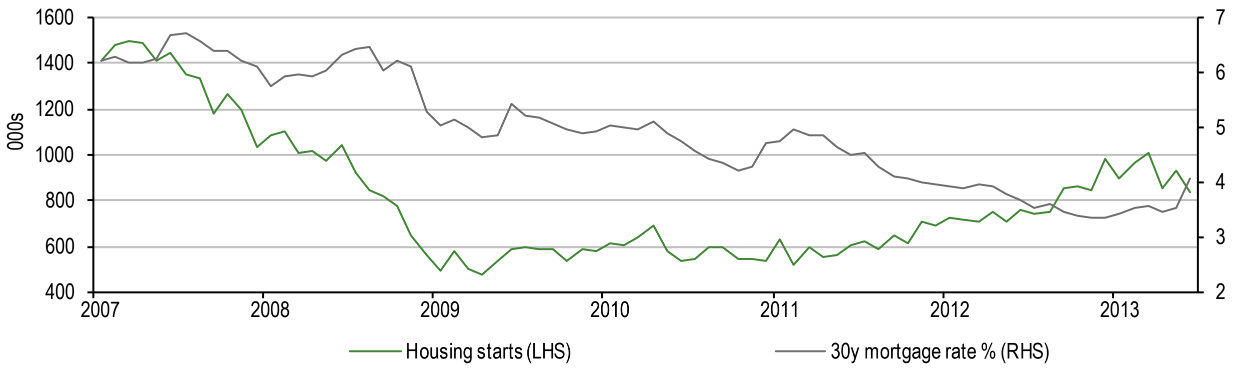
Exhibit 2: US and eurozone inflation



Source: Thomson Reuters Datastream

In terms of credit spreads, removing the buyer of last resort is forcing the market to properly price credit quality as the originate-and-distribute (to the Fed, in the case of mortgage-backed securities) model has been called into question. Over the medium term the withdrawal of the world's central banks from capital markets will allow investors to be properly compensated for the risks they take. In effect, tapering of QE removes one of the most severe forms of financial repression since the onset of the 2008 credit crisis.

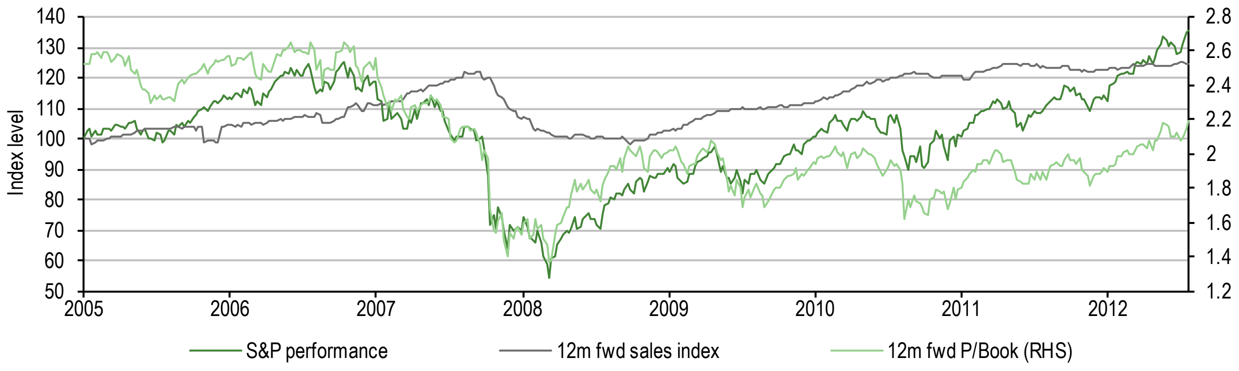
Exhibit 3: US housing starts and 30-year mortgage rates



Source: Thomson Reuters Datastream

However, it is clear that the shift in policy has already created a slowdown in the US housing market as 30-year mortgage rates increase. Housing starts have recently undershot expectations, Exhibit 3. In the long run, forward guidance may represent a more sustainable form of monetary accommodation compared to QE by achieving a better balance between growth and asset price inflation. Shorter-term there may be a transition period of slower growth. Investors who base their strategy on the Bernanke put (or even more speculatively, the QE call) may wish to reconsider their position as US equity valuations look stretched and market momentum still runs ahead of profit growth, Exhibit 4.

Exhibit 4: US equities, forward P/E and sales growth

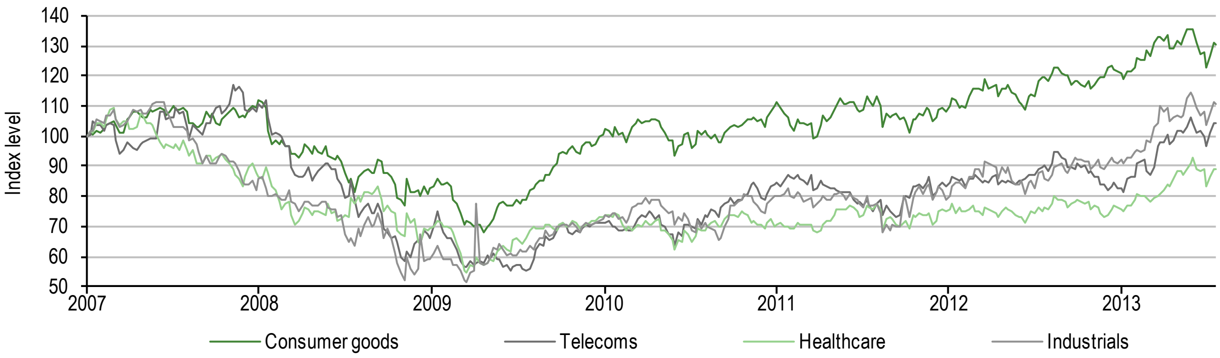


Source: Thomson Reuters Datastream

Equities close to year-highs

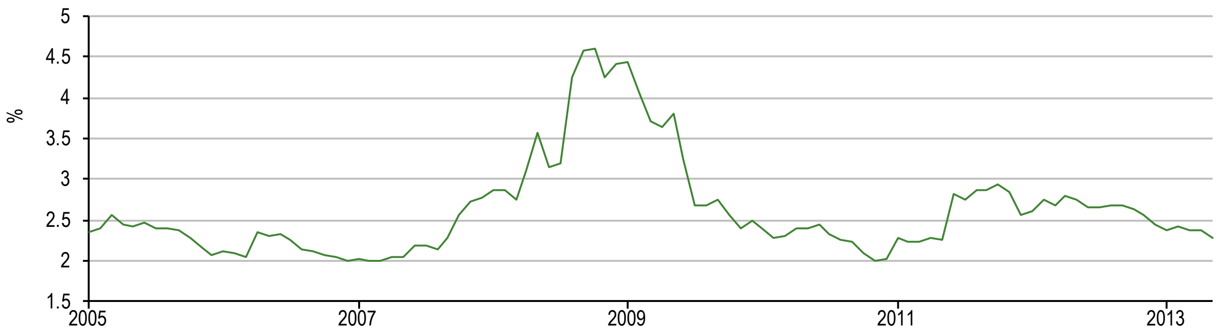
In recent weeks global equities have been volatile, but they are currently close to or at their year-highs. We do not believe the conditions for a continuation of the exceptional returns of the last 12 months remain in place. This view is supported both at the macro level in terms of potentially less aggressive central bank intervention and also from sector level valuations, Exhibit 5. Many UK sector indices now trade at levels in excess of those prevailing in 2007, when growth expectations were significantly higher. Mid-cap equities have continued to outperform large-caps and the median dividend yield of UK equities has compressed, Exhibit 6, even as dividends have risen to record levels.

Exhibit 5: UK sector price/sales back to 2007 levels



Source: Thomson Reuters Datastream

Exhibit 6: Median dividend yield on UK equities



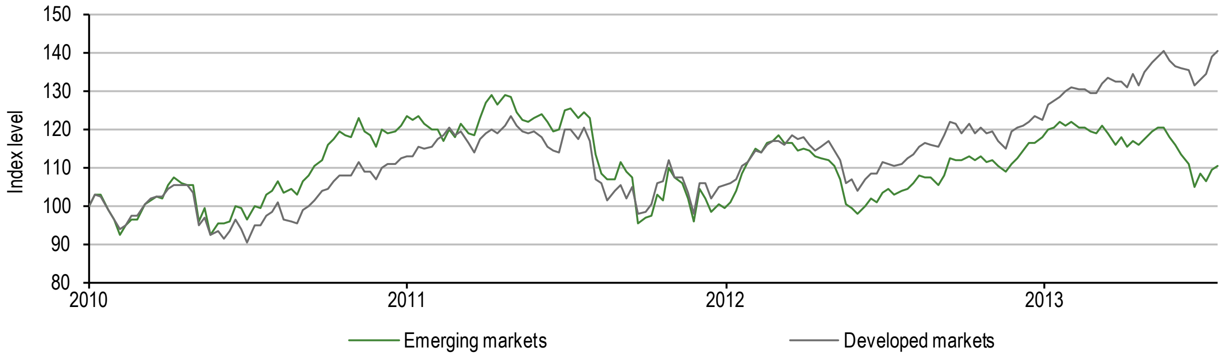
Source: Thomson Reuters Datastream

In terms of the transition to forward guidance from QE, the pressure on the cautious investor to earn an acceptable income has driven many to dividend-paying equities and to date this strategy has been very successful. However, equities are not the natural domain of cautious investors and the combination of higher returns on bonds, due to higher credit spreads and risk-free rates, could cause at least some to question their asset allocation in the event of market volatility.

Emerging value in emerging markets

As expected, emerging market equities have significantly underperformed developed markets during the past three-month period of a modest tightening of global financial conditions. It would appear that a number of emerging markets are now trading close to 10-year lows in terms of forward price/book multiples, Exhibits 7 and 8.

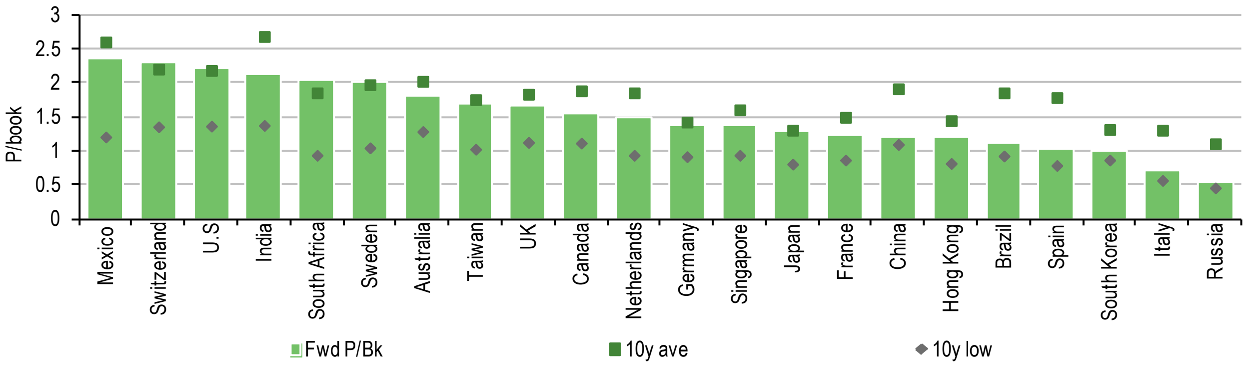
Exhibit 7: Emerging market relative underperformance



Source: Thomson Reuters Datastream

However, the US dollar has halted its appreciation following Bernanke's recent emphasis on the need for an extended period of low interest rates. If valuations are the primary driver of medium-term investment returns, now would appear to be a better time to add exposure to emerging markets than most.

Exhibit 8: Forward price/book multiples highlight emerging markets



Source: Thomson Reuters Datastream

Conclusion

Investors should position themselves for a shift to forward guidance from QE. While interest rates are very likely to remain low for the foreseeable future, any speculative QE premium is likely to ebb in both equity and credit markets. We believe that credit markets have moved more quickly than equities in this regard and yields have already balanced the competing influences of the withdrawal of the central bank buyer and the resulting slowdown in economic growth.

Developed market equities remain at valuation levels that seem inconsistent with limited sales or profits momentum, and within the mid-cap segment performance has been stronger and the stretch in valuations more extreme. For this reason future returns are unlikely to match those seen over the past 12 months. We also highlight the sharp underperformance and de-rating of many emerging markets. With the rise in the dollar halted for now, value investors may wish to consider increasing emerging market allocations.

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