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# Illumination: Equity strategy and market outlook

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# Global perspectives: Are you being speculative?


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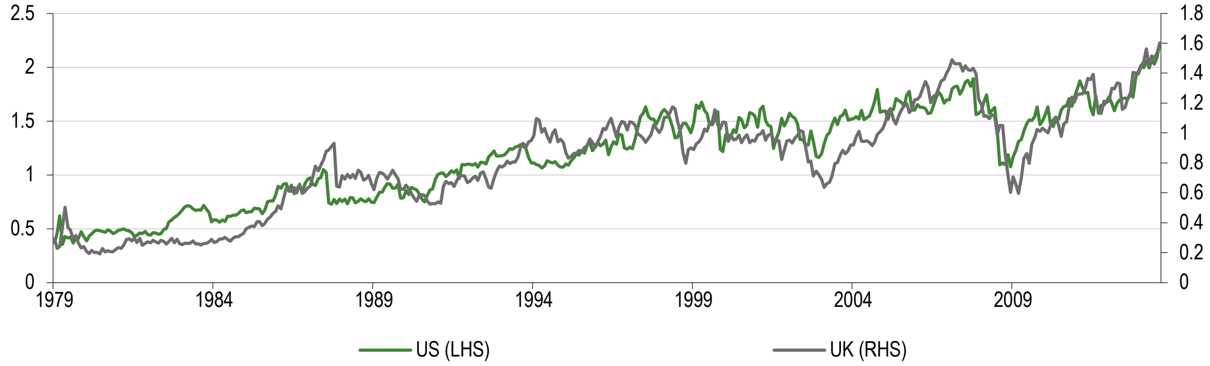
- **The urge to speculate is strong in trending markets.** Investors starved of returns are now increasing their exposure to riskier assets. This is even after valuations have risen to levels historically inconsistent with adequate medium-term returns. Investors are prone to cloaking speculative behaviour in the language of investment, leading to big mistakes on the way in – and on the way out. We suggest that if you must speculate – and it can be a perfectly viable strategy - then at least have a good speculative thesis.
- **The doorway marked "EXIT" is small.** Despite equity indices hovering around all-time nominal records, UK share trading volumes have shrunk markedly in recent years as a percentage of the total market capitalisation. If sentiment turns there will be only a few sellers able to exit the market close to current prices**.**
- **Fed taper debate continues.** Event risk remains high for both US monetary and fiscal policy. The US Federal Reserve continues to debate the starting date for tapering the QE program. The substitution of forward guidance in place of QE is unlikely to be as supportive of risk assets. A rerun of the debt limit negotiations is also in the calendar for Q114.
- **Earnings forecasts diverging from survey data.** We have noticed the feel-good factor evident in survey data has not translated into corporate profits forecasts and GDP forecasts have shown only limited improvement outside the UK. 12m-forward consensus earnings estimates have declined sharply in Europe over the last month, have fallen in the US and Asia and are no longer rising in Japan.
- **Can the ECB reconcile diverging economic objectives?** Deflationary conditions and ultra-high unemployment in the periphery of Europe are consistent with very loose monetary policy. However, in Germany unemployment is low. Loose monetary policy here could stoke domestic inflation or asset prices. It remains to be seen how far the ECB can pursue unconventional monetary policy such as QE or negative interest rates given the political dimension.
- **A time of heightened investment risk.** We remain cautious on equities, but are warming to US and UK bonds, especially as they edge nearer yields of 3%, which would discount some of the technical effects of QE tapering. Real yields on bonds are now at levels consistent with the 2000-08 period and would offer diversification benefits in the event of a valuation-induced correction in equity markets.

## Are you being speculative?

Speculation is the art of holding an asset without regard to its intrinsic value, but instead with the intention of selling it to another party for a higher price. In our view, speculation is not immoral or of any less economic value than investing or short-selling. But it is intrinsically a high-risk activity as little or no regard is paid to the long-term value of the asset under consideration. If the analysis of short-term behaviour of other market participants is incorrect, losses can be severe. For this reason, speculation is stressful and the psychological response for the non-specialist tends to be to frame a speculative purchase in the same terms as an investment proposition. This can cause a great deal of confusion.

As at present when traditional valuation metrics become more extended, Exhibit 1, they no longer provide the comfort needed to convince a market participant that he or she is an investor, rather than a speculator. Thus it is often necessary for it to be "different this time" so that traditional parameters can be adjusted or ignored, thus concealing the speculative nature of the activity.

**Exhibit 1: Traditional valuation metrics look extended – median price/sales for UK, US**



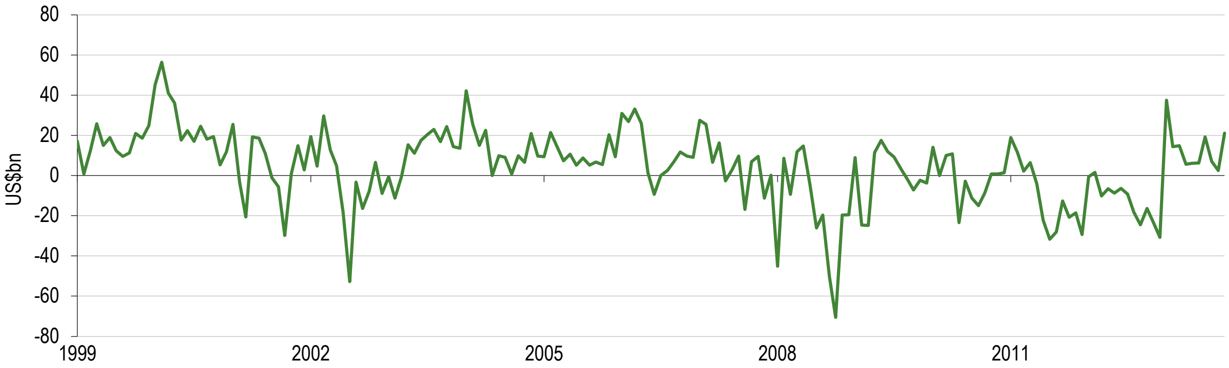

Source: Datastream

Framing speculative activity as an investment both facilitates the purchase of expensive assets and can lead to the wrong emotional response when the time comes to cut losses or even take profits. If an asset is genuinely bought for sound investment reasons, if the price falls significantly (absent new information) the correct response may be to hold or buy more. For a speculative position, an adverse market move largely defines the error in the analysis of market conditions and the correct response is likely to be to cut the loss.

As with other endeavours, speculation is most successful when there is little competition. For example, two years ago one could have speculated that there would be a ready market of potential investors wishing to buy on the basis of valuation after prices bottomed following the acute phase of the eurozone debt crisis. This essentially self-reinforcing dynamic helps to explain why an initial rally out of a bear market can be so powerful.

However, at present the speculative nature of the whole market is becoming increasingly obvious. The speculator should therefore carefully consider who is left to sell to. In equities, prices decoupled from the rather weaker economic momentum some time ago. The "different this time" argument is currently based on high corporate profit margins into perpetuity, possibly recycled into EPS growth via share buybacks. We would argue that the high margins and cash flows currently being recorded by the corporate sector are, on the basis of decades of statistical experience and clear evidence of a business cycle, more likely to prove transient.

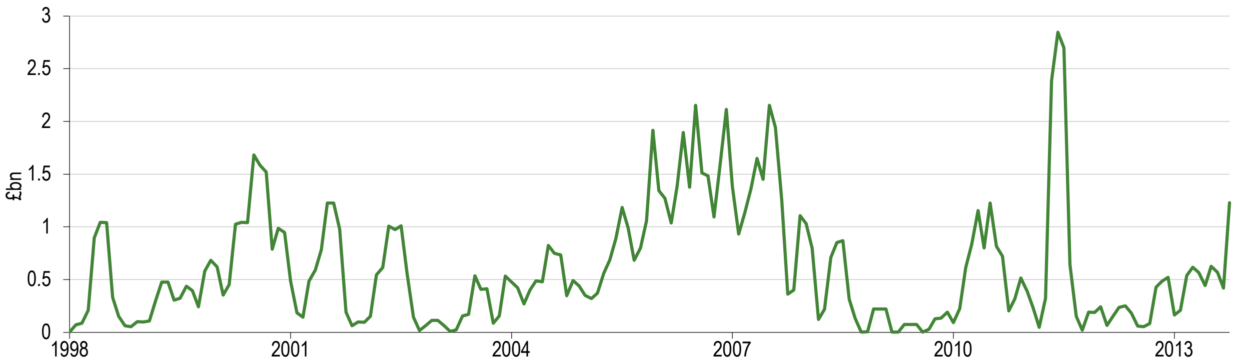
**Exhibit 2: US mutual fund inflows**




Source: Investment Company Institute

Perhaps smaller investors finally “get” Fed policy and are now happy to exchange their zero interest (but zero risk) cash deposit for a US equity portfolio yielding perhaps 1.5% after investment costs – but based on only recent historical experience with the risk of 30% swings in value. That does not feel like an attractive proposition to us but Exhibit 2 shows US equity mutual funds have seen a sharp improvement in inflows since the start of 2013. The IPO window is firmly open as amounts raised from IPOs on the LSE grow, Exhibit 3. In the US, the WSJ’s interview with an administrative assistant determined to invest $1,250 in the Twitter IPO regardless of price may yet prove to be a classic.

**Exhibit 3: LSE IPO volumes (three-month average)**

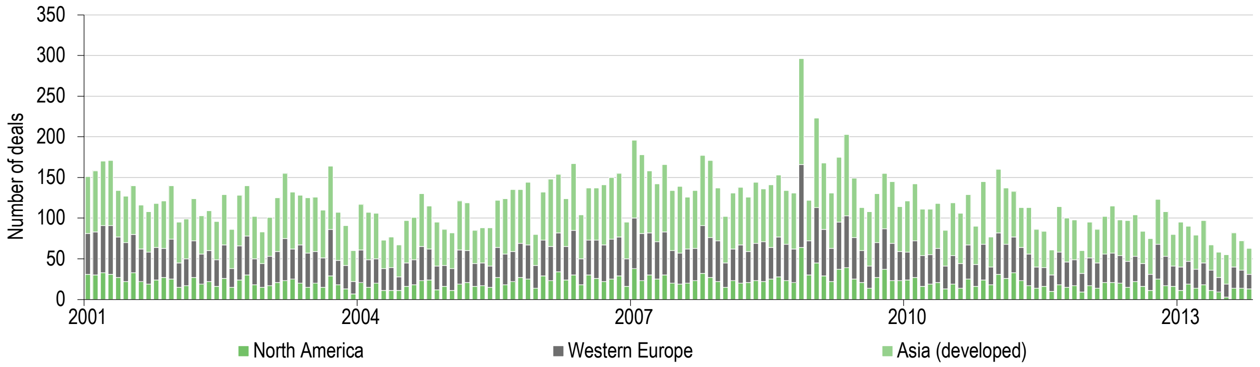



Source: London Stock Exchange

In credit markets covenant-lite debt issuance in 2013 to date has surpassed the previous issuance record set for the whole of 2007 by a factor of two, according to S&P Capital IQ. Covenant-lite debt has also accounted for over 50% of all leveraged loan issuance, which is another record. Warnings earlier in the year from Fed Governor Jeremy Stein on the propensity of markets to substitute inferior quality securities to maintain yields in hot credit markets appear to be prescient.

However, a significant market participant remains on the sidelines. The non-financial corporate sector remains relatively inactive in the M&A market despite recording very high profit margins since 2010. Share buybacks are being favoured over M&A, Exhibit 4. The emphasis on reducing outstanding shares will mechanically generate a degree of per-share earnings and dividend growth even if profits stagnate. However, it sends a clear signal that there are few investment opportunities currently worth pursuing, and in which case where is the future growth?

**Exhibit 4: Number of M&A deals by region**

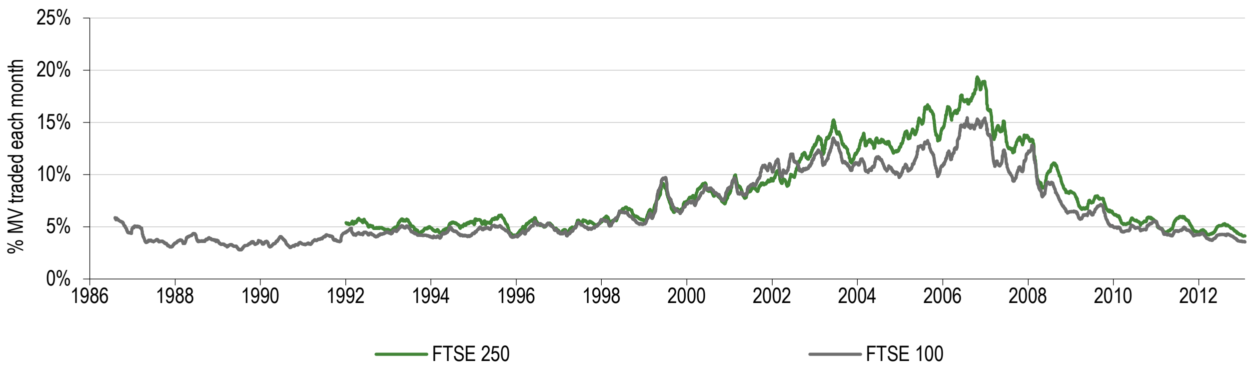



Source: Thomson Reuters

## The door marked "EXIT" is small

Even as stock markets are at or near their all-time highs, volumes as a percentage of market value have continued to decline in Europe. This is particularly notable in the UK, Exhibit 5, where the monthly value of shares traded on the LSE is now less than 5% of the total market capitalisation. Even though approximately 50% of trading has moved to other venues, this still represents a significant decline in market liquidity. For all but the smallest institutional portfolios, any market timing strategy is therefore likely to prove difficult to implement. Furthermore, the new market structures that include large high-frequency trading and ETF flows are yet to be tested in a distressed market environment.

**Exhibit 5: Liquidity drying up on LSE order book (three-month average)**




Source: Datastream

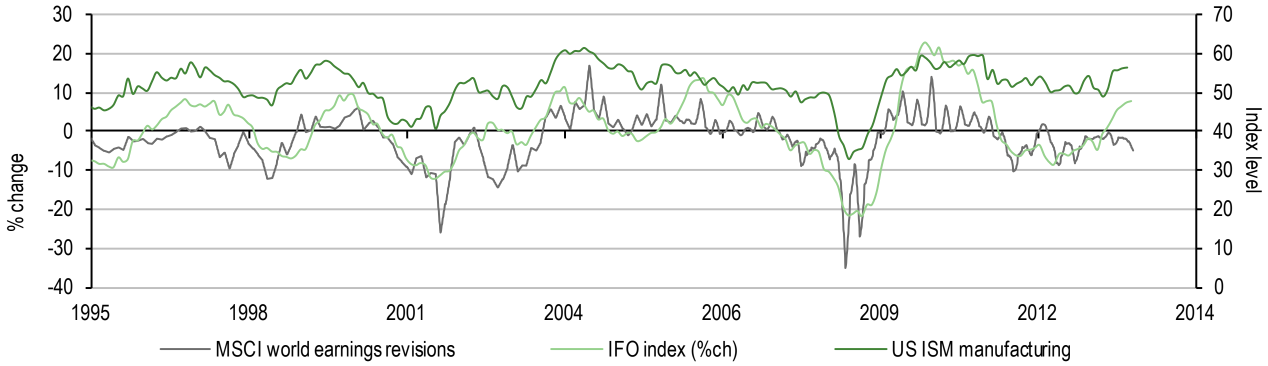
We also note that within the mid-cap segment of the market the liquidity situation is even more acute in absolute terms. As less-liquid mid-caps have outperformed, institutional portfolio liquidity will therefore have suffered disproportionately unless portfolios have been regularly re-balanced to maintain the same weightings by market cap. Regulators are already investigating the possibility of systemic risk among the largest asset managers, where fund sizes dwarf the available liquidity in the underlying asset classes. In the circumstances any dash for the exits could easily create a significant market dislocation.

We note that from the most recent Fed meeting minutes the tapering debate is very much the focus. On the basis of these minutes it would appear that once the Fed is content that two-year yields are anchored by forward guidance, tapering is back on the agenda. We argued earlier in the year that forward guidance may be a better than QE for supporting the economy as it is well understood and avoids an ever increasing Fed balance sheet. However, a point in favour of forward guidance is that it is less supportive of asset prices – speculators beware.

## Global survey indicators and earnings growth diverge

We are intrigued by the widening gap between survey data, which has turned sharply higher in both Europe and the US over the past six months and accelerating downward revisions to global earnings estimates, Exhibit 6.

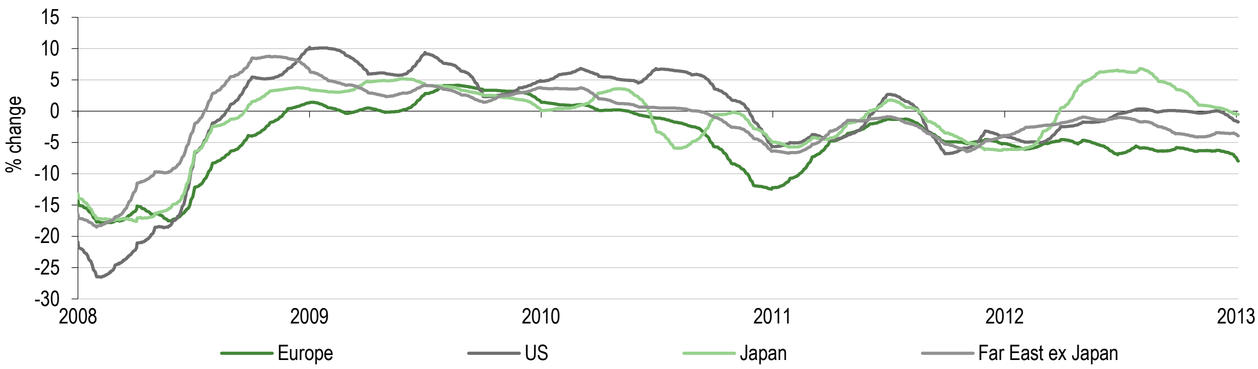
**Exhibit 6: Divergence between survey data and earnings**




Source: Datastream

In Europe the rapid recovery of the euro/US dollar exchange rate explains some of the weakness on the continent, which has accelerated after the Q3 earnings season. However, it does not explain the loss of earnings momentum in Japan or the declines in US earnings forecasts, where the economy is supposed to be recovering, Exhibit 7.

**Exhibit 7: Regional earnings revisions**



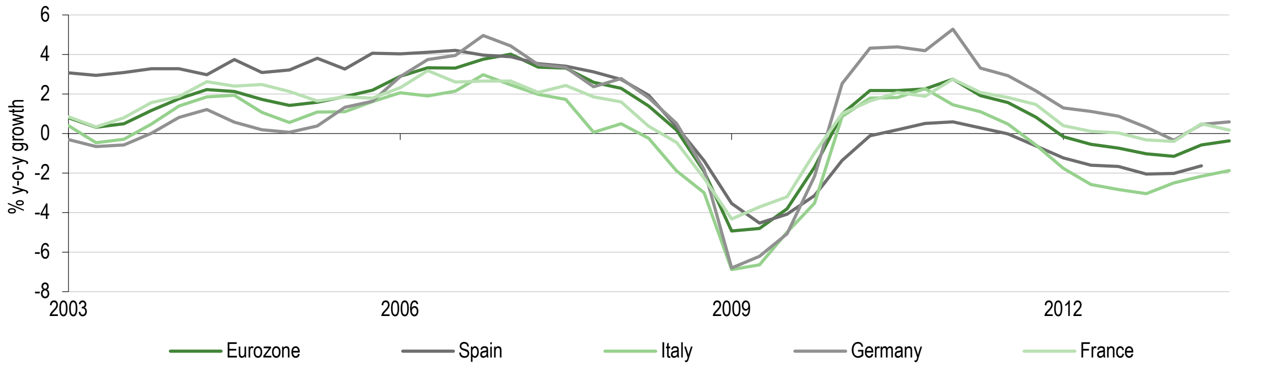

Source: I/B/E/S

## Europe's next challenge – economic divergence

In addition, the pick-up in eurozone survey data earlier in the year does not seem to be translating into a robust recovery in activity. For the eurozone as a whole, the Q3 GDP remains negative, with modest growth in Germany offset by continued weakness in the periphery, Exhibit 8.

The next challenge for Europe will be to recognise that the fiscal (austerity) policies imposed by creditor nations have led to outright deflation in the periphery nations such as Spain. Tighter fiscal policy would normally be offset by looser monetary policy, but it is already clear that any proposal for negative interest rates or eurozone-wide QE will be difficult to agree given clear signals of displeasure from Germany. Low interest rates there have turned into a political issue, as Germans reportedly feel robbed of investment income, a phenomenon at least in part due to their own politicians imposing contractionary fiscal policies on the periphery of the eurozone.

**Exhibit 8: Eurozone GDP growth rates**




Source: Datastream

## Conclusion

We believe it is important to remain disciplined when markets are as strong as at present. There are several key sources of investment error that should be avoided. The first is failing to pay sufficient attention to long-term valuation norms. The second is to speculate on future price gains while cloaking the activity in the language of investment. If the desire to speculate cannot be resisted, it would be better to ensure there is a sound speculative thesis, even if in our view it is rather late in the day. Finally, in a market where most stocks may be overvalued, the probability of locating a value trap rather than a value investment is much higher than normal.

The most recent Fed minutes indicate that the discussion about when, rather than if, to taper the QE program is very much alive. High valuations, high profit margins and slow economic growth do not even warrant the prospect of another round of US debt ceiling negotiations in Q114 to indicate that the portfolio risk dial should be turned to low for equities.

For Europe the outlook may have improved in the near term, but the dead-cat bounce in activity leaves precious little scope for the region to outgrow its debt problems. The next step on the agenda is to combat deflation in the periphery without overheating the German economy, and the ECB has an unenviable task in reconciling the economics with the politics.

We look more favourably on UK and US 10-year bonds as they edge towards 3%, which would put the real yield close to the 2000-08 average and price in a modest degree of US tapering if combined with a firm commitment to forward guidance. In the event of a valuation-driven correction in the equity market, these positions would also offer a hedge against any remaining equity exposure.

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