EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Fundamentally no change

- **Although global equity markets have recovered in February, there have been few fundamental changes over the last month.** We remain stuck in an environment of relatively high equity valuations with limited earnings momentum, offset by a strong degree of confidence that central bank actions will push asset prices higher should there be any weakening in economic prospects.
- **Building a portfolio on a single bullish factor – dovish central bank policy – is by definition a very concentrated bet.** While we agree this policy *was* very beneficial to asset prices earlier this decade, previously there were many other good reasons to own risk assets, most recently during periods of stress in Europe. We have to highlight (again) that valuations for mid-cap equities in particular look rather extended.
- **Global rolling program of QE has kept the party going.** The UK may have pulled back from QE and the US is tapering, but the Bank of Japan's balance sheet continues to expand. In Europe, the continuing decline in private sector credit and near-deflationary conditions in the periphery point to an increased likelihood of further monetary easing.
- **Emerging markets key to global growth.** Emerging markets account for 40% of world GDP and 60% of forecast world GDP growth. If the recent volatility in emerging markets turns into a real slowdown then world growth would suffer. Paradoxically, we believe emerging market equities are currently more attractive than developed market equities as valuations are not as extended.
- **Still cautious and favouring large-cap equities.** This is exactly what we said last month and not a misprint. However, we believe investors have to look much harder for value at present. At this point in the cycle investors should also consider emphasising securities whose return potential is highly company specific rather than reliant on macro factors. In bonds, highly rated government yields are now a little under our target of 3% and corporate credit spreads remain very tight in a historical context.

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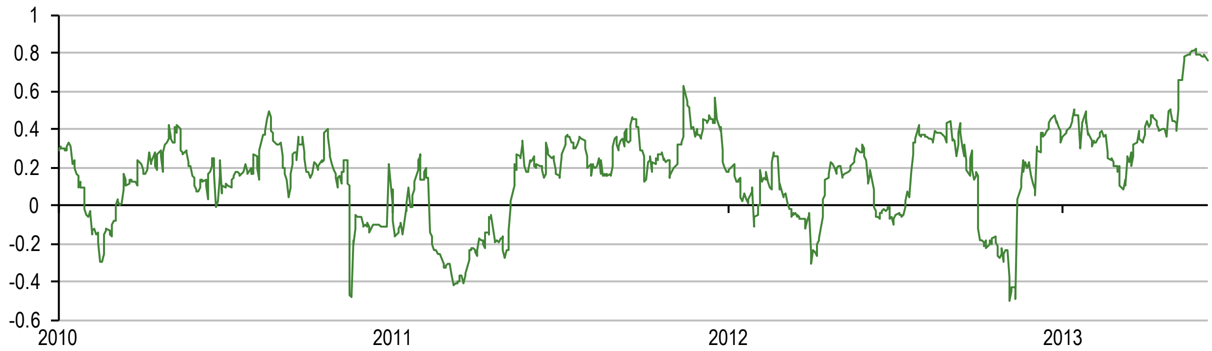
Fundamentally no change

In January, equity markets were sufficiently volatile to give at least some investors pause. Fears of a severe downturn in emerging markets were brought to the fore, although such commentary has more recently vanished following the rapid global equity market recovery in February. But we should be clear that, in our view, the direction of global equity markets – both emerging and developed – remains unusually reliant on monetary policy.

Exhibit 1: 30-day correlation between daily S&P and USD/JPY move



Source: Thomson Reuters Datastream

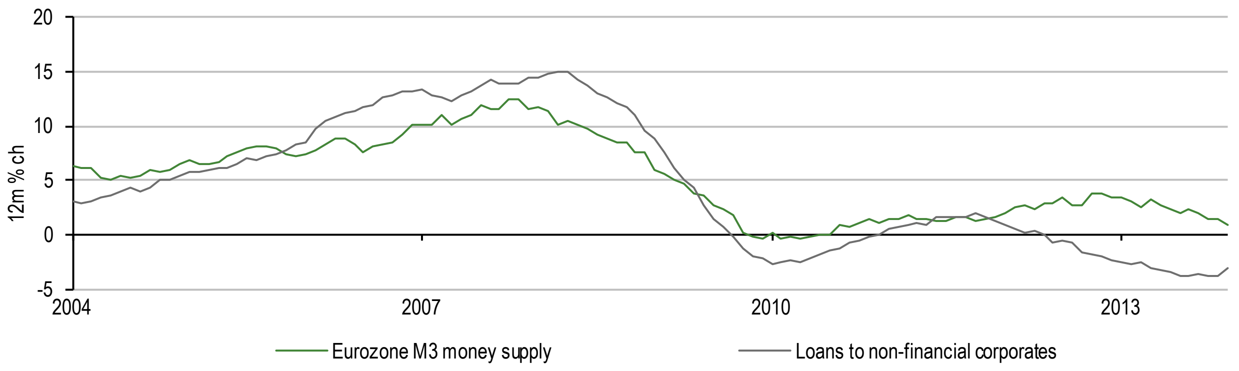
For those following markets on an intra-day basis, the release of Fed meeting minutes or media comments from central bank policymakers can turn markets around from daily gains to losses in milliseconds. If there were any doubts over the links between global markets, the 30-day correlation between the daily moves in the S&P500 and the USD/JPY exchange rate has risen to 80%, Exhibit 1.

What has become a global rolling programme of unconventional monetary policy has provided extensive support to equity markets and reduced risk premiums in credit markets over the last 18 months. However, we would suggest the UK is close to re-normalising monetary policy, having rejected QE for forward guidance. Market expectations imply the first increase in interest rates is due in Q115. The US follows next as it is tapering its current QE program. In contrast, the Bank of Japan is likely to continue to ease throughout 2014, while the ECB – where the slide into deflation and contraction of credit is most acute – has not even started a broad QE program.

While political difficulties remain, the prospect of QE in the eurozone cannot be discounted, even if credit easing (ie monetary policy designed to promote convergence of credit conditions across the eurozone) is likely to be tried first. Inflation is well below target, credit to non-financial corporates is contracting, and the periphery is close to deflation, Exhibits 2 and 3. Though no formal policy announcements have been made, we note the Bundesbank has reportedly dropped at least some of its opposition to unsterilized government bond purchases. Should current trends continue, outright QE in the eurozone may be back on the agenda.

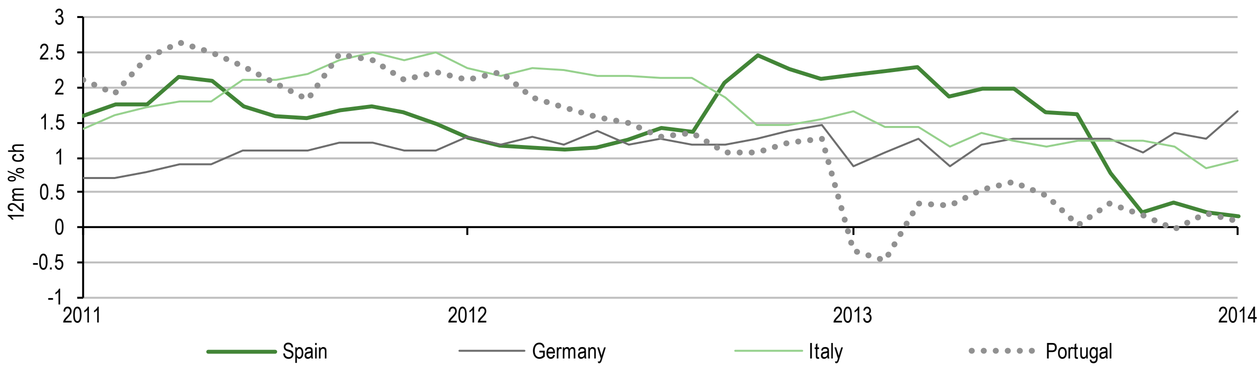
However, even if Japan and the eurozone engage in further QE, we see global markets paying most attention to US monetary policy, and for this reason we believe the point of 'peak' monetary accommodation and thus support for global asset prices may have already passed. The US Fed faces a difficult task over the next year with below-target inflation, easing economic growth, but evidence of effervescence, if not outright bubbles, in both equity and credit markets.

Exhibit 2: Eurozone credit to corporate sector continues to contract



Source: Thomson Reuters Datastream

Exhibit 3: Inflation divergence a challenge for the ECB

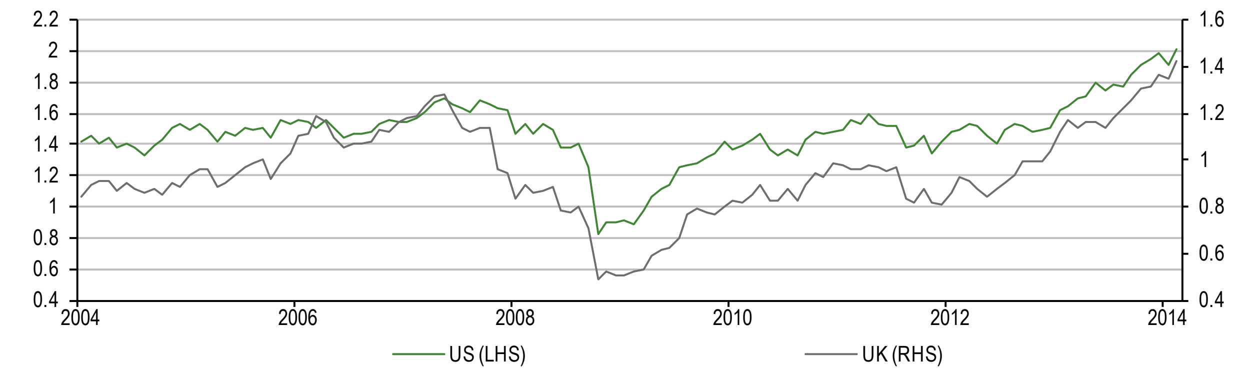


Source: Bloomberg

US and UK equity valuations remain elevated

US and UK equity valuations are at the upper end of their valuation ranges on a price/sales basis, Exhibit 4. For these charts we use the median rather than the weighted average, as the largest-cap names hide some of the rather extended valuations in the mid-cap sector. On alternative measures such as the 10-year cyclically adjusted P/E ratio, US equities also look expensive in aggregate.

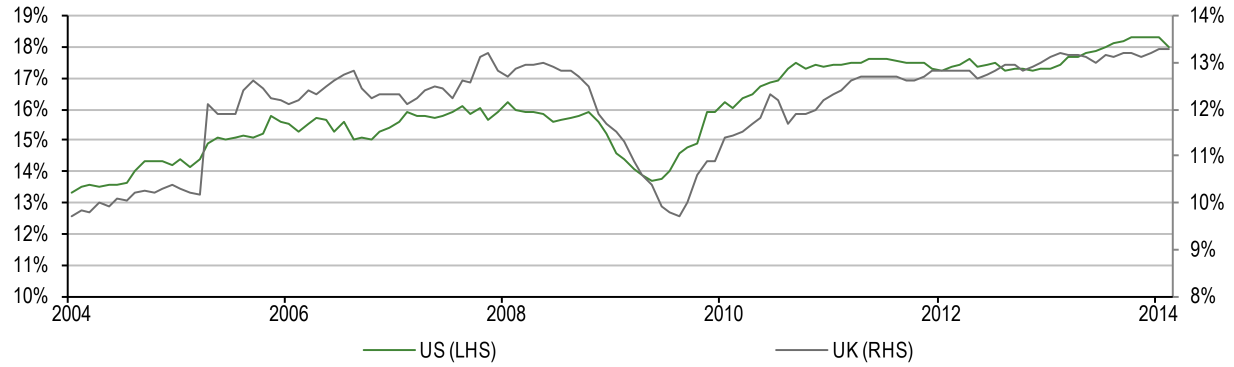
Exhibit 4: Median valuations of US and UK equity markets – price/forecast sales



Source: Thomson Reuters Datastream, Edison calculations

We also note that forecast profit margins are extending beyond the 2007 peak in the UK and US. That is why we de-emphasise P/E ratios when valuing markets; the current levels of profitability look unlikely to be sustained over a cycle. In contrast to the outlook for profit margins, analysts continue to forecast very little sales growth for the corporate sector, in line with still modest levels of global economic growth.

Exhibit 5: UK and US 12m-forward profit margin forecasts

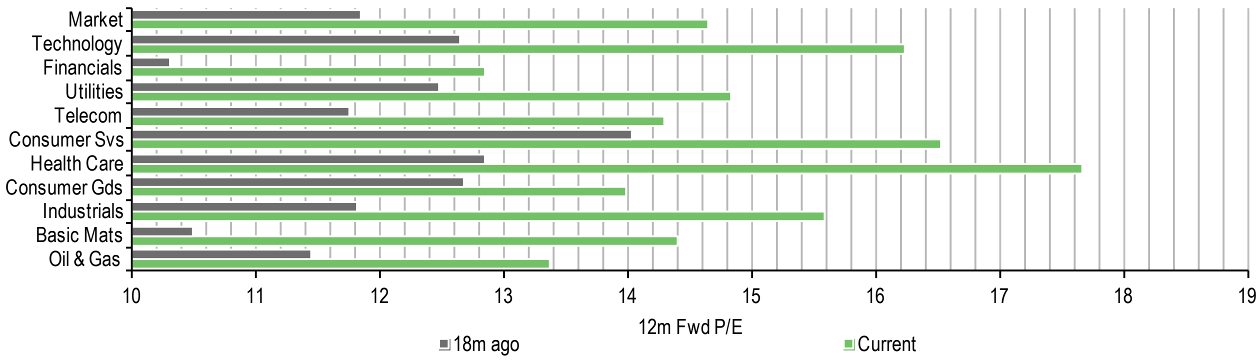


Source: Thomson Reuters Datastream, Edison calculations

An opportune time to list

For stock market investors, these are therefore challenging times as the competition for investments is high. Issuers can take advantage of these conditions and it is no surprise the number of initial public offerings (IPOs) has increased sharply over the past few quarters. Issuers are being drawn to markedly higher prospective multiples across almost every sector compared to 18 months ago, Exhibit 6. The logic of an IPO (from an issuer's perspective) is currently compelling.

Exhibit 6: Developed markets – increase in forward P/E multiple by sector



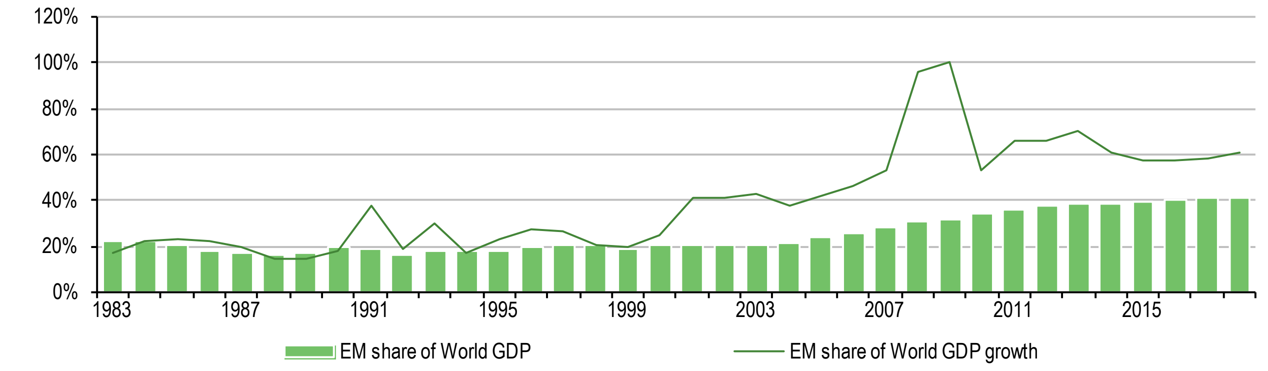
Source: Thomson Reuters Datastream, Edison calculations

In contrast, the other side of capital markets activity, mergers and acquisitions, remains at relatively low levels. We believe this is in part due to the rapid increase in valuations, which has driven a wedge between what industrial buyers are willing to pay and sellers' expectations, but also a desire for structurally stronger balance sheets in what remains an uncertain economic environment.

Emerging markets – decoupling unlikely

January's market declines were driven by emerging markets. In addition to country-specific factors, judging by ETF flows, the tapering of US quantitative easing appears to be encouraging investors to repatriate some their emerging market allocations. Several years of underperformance of EM stock markets versus a resurgent S&P500 have encouraged investors with a shorter-term time horizon to fold.

Exhibit 7: Emerging market share of world GDP and world GDP growth

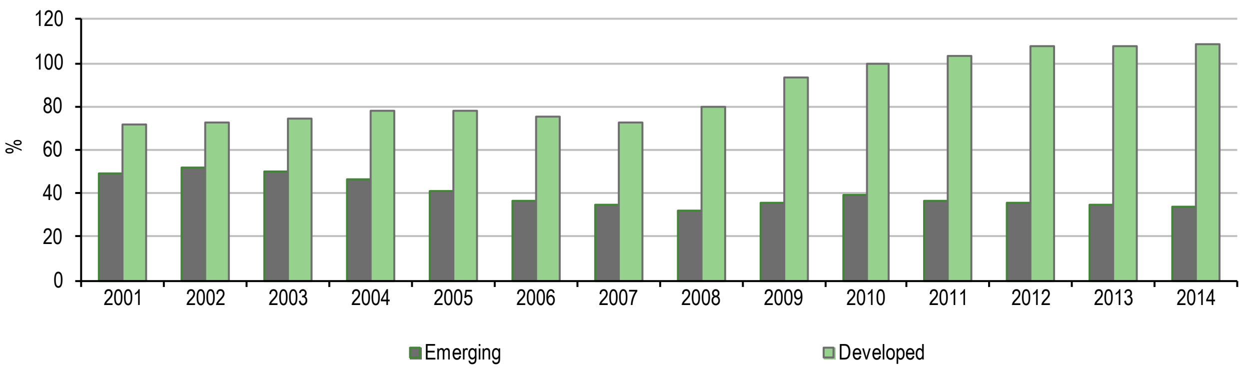


Source: IMF

However, the argument that emerging markets are facing difficulties so investors should rotate into developed markets equities makes no sense in our view. Emerging market growth is forecast to account for 60% of world growth and currently represents 40% of world GDP, Exhibit 7. In this context an emerging market decoupling from developed markets seems unlikely. Should there be a meaningful downturn in emerging markets, in our view, it would be only a matter of time before the world's central banks would have pay more attention to overseas developments for domestic reasons.

Structurally, potential EM growth rates are forecast to fall from earlier periods but this still leaves these nations growing much faster than developed markets. Realising this potential will require an increased focus on structural reforms and moving into higher value segments of the world economy, a process which will take time and move in fits and starts. But many emerging markets (China is a clear exception) do not have the burden of excessive sovereign or private sector debt which burdens many developed nations, Exhibit 8.

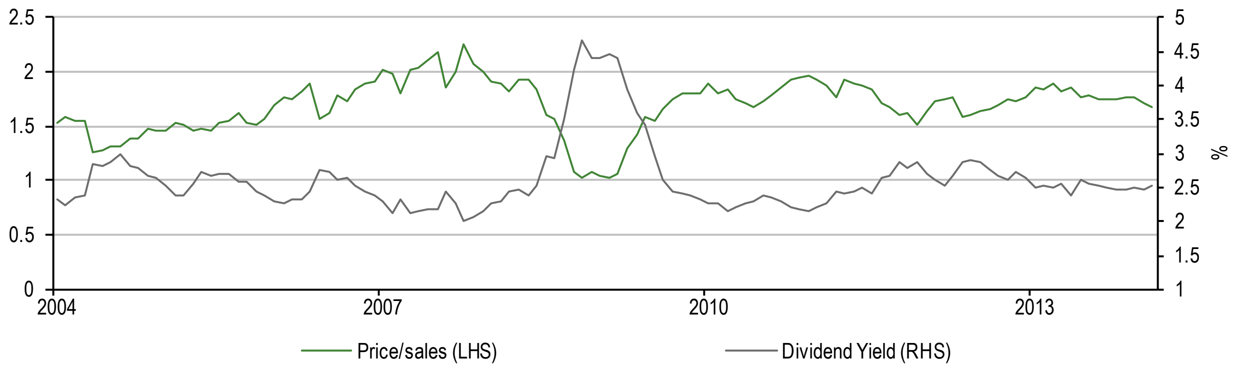
Exhibit 8: Comparison of government debt/GDP



Source: IMF

We had little enthusiasm for emerging markets when valuations were at a large premium to developed markets. For much of the last decade the faster growth rate in earnings was fully embedded in valuations. This is no longer the case due to the large divergence of performance between the two regions over the last 18 months. EM non-financials, while not yet at bargain levels, are currently trading modestly below long-run average valuations, Exhibit 9. Forecast profit margins have also declined to the lowest levels in the last decade which gives more scope for positive surprises than in, for example, the US and UK.

Exhibit 9: EM valuations not expensive



Source: Thomson Reuters Datastream, Edison calculations

While investing in emerging markets still carries a relatively high degree of risk – which is not a new observation – we believe the current level of pessimism offers investors focused on the long term a better opportunity to consider the merits of an allocation to emerging market equities.

Conclusion

Our position is unchanged as the data are unchanged, and we stick with our cautious outlook. We believe risk premiums across equity and credit markets remain compressed by ultra-low interest rates and unconventional monetary policy. These effects are more pronounced in higher beta sectors such as mid-cap and technology in equity markets and the riskier end of the credit spectrum in credit.

Within an overall cautious positioning we see opportunities among some of the larger-cap names that have not participated in the 2013 rally and also in emerging markets where, in our view, investors should look to take advantage of volatility to increase positions. Furthermore, at this point in the cycle we suggest investors consider weighting portfolios to investments where the outcome is company or situation-specific, rather than reliant on continued loose monetary policy or a benign economic environment.

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