Illumination: Equity strategy and market outlook

April 2014

Published by Edison Investment Research

Global perspectives: Top of cycle investing

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- **Central banks have distanced themselves from hawkish comments made during March.** In response markets have recovered their poise and are ignoring the declines in corporate profits momentum, a slow but steady escalation of geopolitical risk in Eastern Europe and signs of a slowing Chinese economy.
- **Median forecast revenue growth for non-financials has fallen to less than 5% pa, compared to 10% pa recorded before 2008 in both the US and Europe.** Investors should stay alert to the fact that the equity bull market is still driven by a re-rating; improving economic prospects do not seem to be feeding into consensus forecasts to date.
- **Merger and acquisition activity moves into a higher gear in 2014.** Initially it was telecoms, but large-scale M&A and restructuring in Europe has spread to healthcare. Within the last week, Pfizer has announced an effectively hostile US$100bn approach for AstraZeneca, while US$28bn of assets have been traded between GSK, Novartis and Eli Lilly. GE's potential bid for Alstom has generated competing interest from Siemens. We see this M&A activity as further evidence of the latent value in the large-cap segment of the market.
- **A variety of indicators points to an ongoing slowdown in China's economy.** We note ongoing currency weakness, a sharp decline in the Baltic Dry shipping index, pressure on iron ore and copper prices and subdued Chinese PMI data. Paradoxically, given the significant de-rating of the mining sector, investors should be considering closing out underweight positions.
- **Tilt portfolios to large caps with M&A or restructuring potential; remain cautiously positioned overall.** We believe large caps offer better relative value than mid- and small caps. At present the FTSE 100 index remains at 4-point P/E discount to the FTSE 250, even after outperforming in recent weeks. Deal activity demonstrates that value-creating transactions are possible even in the largest capitalisation segments of the market and UK large caps have been outperforming mid-caps in recent weeks. However, we remain cautiously positioned overall as risk premia in both equity and credit markets are at the low end of historical ranges, in our view.

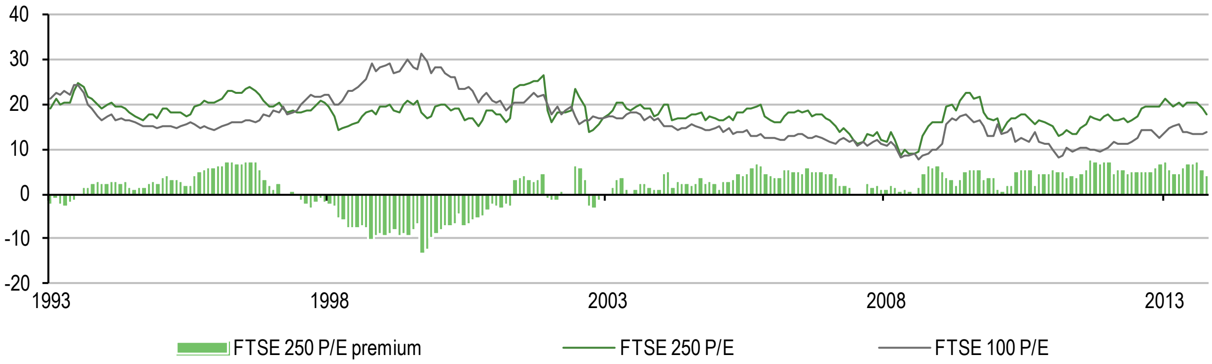
Top of cycle investing

For the first time since the financial crisis we can observe all the characteristics of a stock market at or close to the top of the business cycle. In both Europe and the US, valuations for all but the largest-cap stocks have expanded and are now relatively high; IPO activity is strong; profits momentum has subsided and margins may have peaked. Finally, we have something of an M&A boom in recent weeks, which was the key missing element for much of 2013.

Opportunities to make money exist, but in an environment where many securities look expensive investors need to have a laser-like focus on value and event potential. General market risk or 'beta' is unlikely to attract the same level of return as at earlier points in this cycle. We would pay particular attention to large-cap equities, which have sat out the mid-cap rally and have attractions to corporate buyers in whole or in part.

Valuations for mid-cap equities in the UK remain at a significant premium to larger peers, Exhibit 1, and there is still time for profits to be taken. In bond markets, high-quality 10-year government bonds at yields close to 3% may offer diversification benefits. For credit, the recent decline in corporate credit quality and yield that has accompanied the increase in issuance is well documented – and no place for the prudent investor in our view.

Exhibit 1: FTSE250 trading at historically high P/E premium to FTSE 100



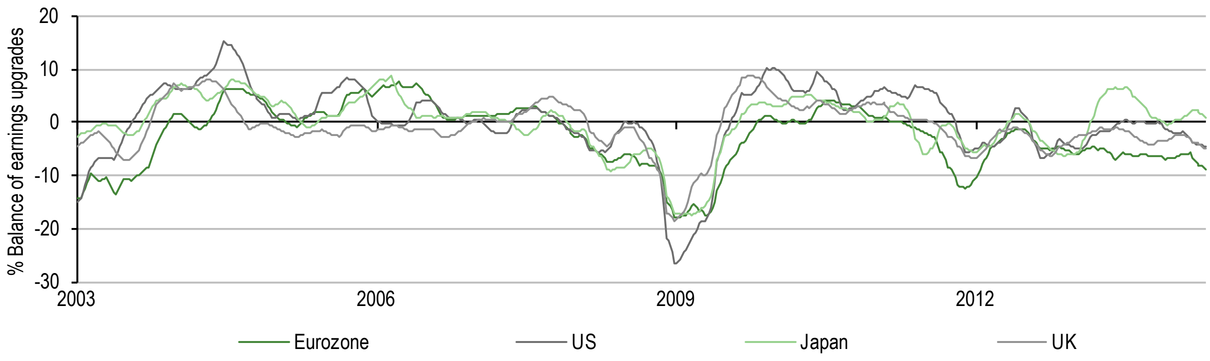
Source: Thomson Reuters Datastream

Negative revisions highlight slowdown in revenue growth

Consensus earnings per share forecasts are declining in developed markets, Exhibit 2. It is something of a surprise that despite a sharp improvement in global economic optimism during the last 12 months, EPS revisions are accelerating to the downside. In the US there is the possibility of weather-related effects affecting Q1 figures and in Europe the strength of the euro has hurt the results of some high-profile exporters. However, these factors were known well before the end of the reporting period and should have been factored into forecasts.

While earnings revisions data are useful for tracking the shorter-term changes in the profits outlook, we believe it is important to consider the top line, Exhibit 3, as prospects for revenue growth strongly influence corporate behaviour. While slower revenue growth tends to disincentivise capital expenditure, it also encourages merger and acquisition activity and corporate restructuring.

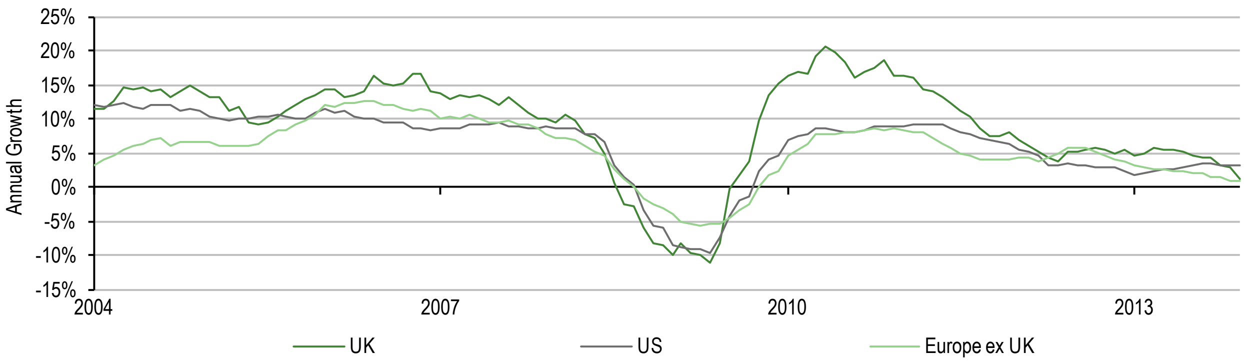
Exhibit 2: Earnings downgrades accelerate during 2014



Source: Thomson Reuters Datastream, I/B/E/S

Exhibit 3 shows that for the median company in the stock market there has been a marked slowdown from the revenue growth expectations compared to the pre-2008 period. At that time, the median revenue growth expectation was relatively steady at 10% pa. Following the 2008 financial crisis, revenue growth briefly matched earlier periods during the cyclical recovery of 2009-10, but since then forecasts have steadily declined to less than 5% in each of the US, UK and continental Europe.

Exhibit 3: Forecast sales growth in US, UK and Europe ex-UK



Source: Thomson Reuters Datastream, Edison estimates

The ratio of capex/sales in developed market non-financials has been falling, as would be expected given the declining revenue growth outlook, Exhibit 4. Part of this decline may be due to the increasing share of emerging markets in the most capital-intensive industries where there is often less of a focus on return on capital. However, the decline in sales growth rates has also reduced the need for investment. The corporate sector has responded by recycling surplus cash flows into increased dividends and share buybacks.

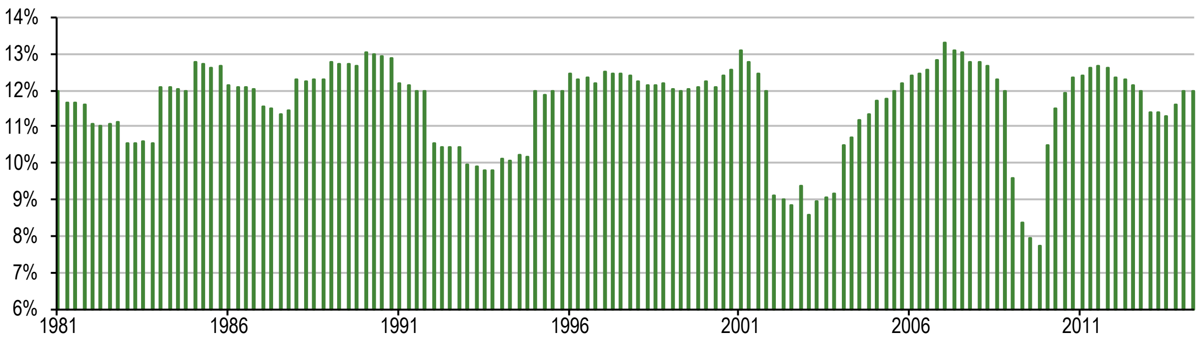
Exhibit 4: Capex/sales ratios for selected markets

Source: Thomson Reuters Datastream

Investors should remain attentive to the slowing of revenue growth, even as they benefit from higher cash returns during a period of very low interest rates. While the income will have been welcome, cash returns do not create long-term value unless investors themselves can redeploy the cash into other projects with higher returns on capital.

Our fear is that at least some investors believe they can have their cake and eat it; reduced growth prospects do not seem to be reflected in current equity valuations. Slowly growing businesses offering high margins are a magnet for new competition, as demonstrated by the historical volatility and mean reversion in profit margins, Exhibit 5. On the other hand, should the global economy reach a higher growth trajectory, investors may be unprepared for cash flow to be diverted back to capital expenditure to restore revenue growth to pre-2008 levels.

Exhibit 5: Historical volatility and mean reversion in US non-financial EBITDA margins



Source: Thomson Reuters Datastream

Theoretically, equity returns are the sum of the dividend yield and the dividend growth rate in the long run. While a dividend yield is clearly observable, the dividend growth rate is subject to a high level of uncertainty. At present as profit margins are high and dividends close to a peak proportion of earnings, sustainable dividend growth is unusually dependent on revenue growth.

For example in the UK, forecast revenue growth rates have fallen by half to less than 5% per year since 2008, yet median dividend yields are currently close to 25-year lows. One interpretation is that some investors are pricing in a return to the growth rates that existed before the 2008 financial crisis. Although this may yet prove to be correct, in our view this is a rather aggressive assumption, being such a long way from consensus expectations.

An alternative explanation for relatively high equity valuations in a low profits growth environment is that investors are prepared to use a much lower discount rate than in the past. The discount rate is itself composed of two components, namely the risk-free rate and the equity risk premium. We believe using current risk-free rates of 2.7% for equity valuations is inappropriate, for as long as central banks are targeting nominal GDP growth in the region of 4%, comprised of real growth and inflation in roughly equal proportions. A risk-free rate of 4% would be a safer assumption in our view, especially as 2015 is likely to bring the first interest rate increases for many years.

Estimates of the equity risk premium are subject to some uncertainty; longer-run studies suggest a range of 3-4% is appropriate, giving a total expected return for equities of 7-8%. Using this hurdle rate, the median dividend yield of just over 2% for UK non-financials implies long-run corporate growth of 5-6% pa, yet actual growth forecasts are currently some way short of that.

We believe investors are currently willing to accept lower returns on equity portfolios, being starved for returns elsewhere, but they may also have underestimated the slowing revenue growth profile of the corporate sector. This view underpins our cautious stance on mid-cap equities that are relatively highly valued and have suffered the larger absolute drop in forecast growth prospects compared to large caps.

The ‘need’ for M&A

The corporate sector has until recently responded to the slowdown in revenue growth by cutting investment and returning cash to shareholders. However, as the cyclical profits expansion fades M&A becomes one of the few ways of growing the top line as the economic expansion matures.

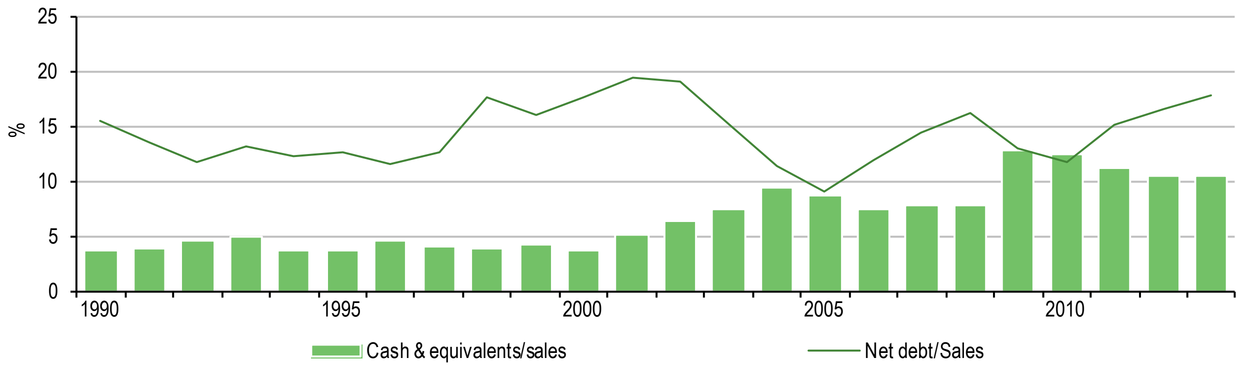
While rather late in coming, possibly due to the eurozone sovereign debt crisis of 2011, large-cap M&A is rebounding in 2014. In previous merger waves, following a significant transaction M&A can spread throughout an industry as the perceived optimum company size increases and management is pressured to go big or go home. The initial deals tend to be the ones that contribute the most to shareholder value.

By sector, over the past 12 months the focus has shifted from telecoms to healthcare. Pfizer’s approach for AstraZeneca may be the highest-profile deal if consummated at US$100bn, but within the last week US$28bn of assets traded between GSK, Novartis and Eli Lilley. These transactions show how value can be created in the large-cap sector through M&A, without necessarily resorting to public offers. GE’s and Siemens’ competing approaches for Alstom’s energy business also indicate that M&A appetite has returned to the industrial sector.

So far we see limited evidence of irrationality as the industrial logic (especially when including US tax synergies) of recent deals has been strong. Many deals, such as Vodafone’s sale of Verizon Wireless to Verizon, which completed in February, have been widely rumoured for many years, but had to wait for the right conditions in the debt markets.

For the remainder of 2014, while there is in certain quarters a view that in excess of US$2tn is sitting on US company balance sheets and available for deals, we would treat this figure with caution. We still see very good reason for an increased liquidity preference within the non-financial corporate sector, Exhibit 6, given the exceptional volatility within the global banking system in the last decade. Exhibit 6 also shows that the net amount of debt within the US non-financial sector relative to sales (rather than cyclically strong EBITDA) is towards the higher end of the historical range. With the first US interest increases forecast for 2015, the recent surge in deal flow may instead be related to the sense that the window for ultra-low debt finance may be closing.

Exhibit 6: US non-financials – net cash and net debt % sales



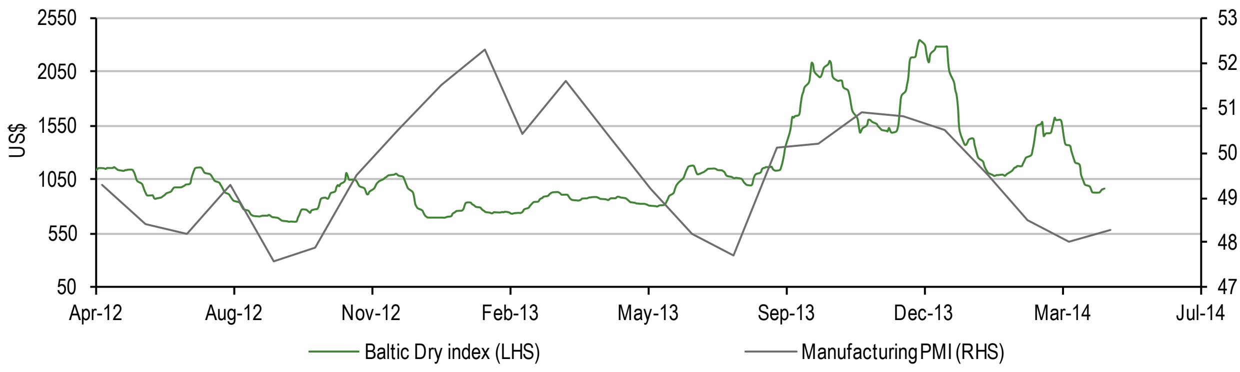
Source: Thomson Reuters Datastream, Edison estimates

Nevertheless, the return of large-cap M&A is a welcome development for markets and supports our thesis of focusing on large and relatively unloved business franchises. M&A has been a key driver of the relative outperformance of large-cap equities in recent weeks.

Rising risks in China and Ukraine

While the headlines are focused on events in eastern Europe, we note that China's economy continues to slow, as measured by PMI data, sharp declines in the Baltic Dry shipping index, industrial commodity prices and declines in the growth of fixed-asset investment, Exhibit 7. The US$/RMB exchange rate has also been depreciating at a rate not seen since immediately before Lehman's failure. Although not a stated policy, allowing the exchange rate to depreciate will cushion the Chinese corporate sector from some of the consequences of any slowdown. This depreciation has already attracted negative comments from US treasury officials.

Exhibit 7: Slowing economic activity in China

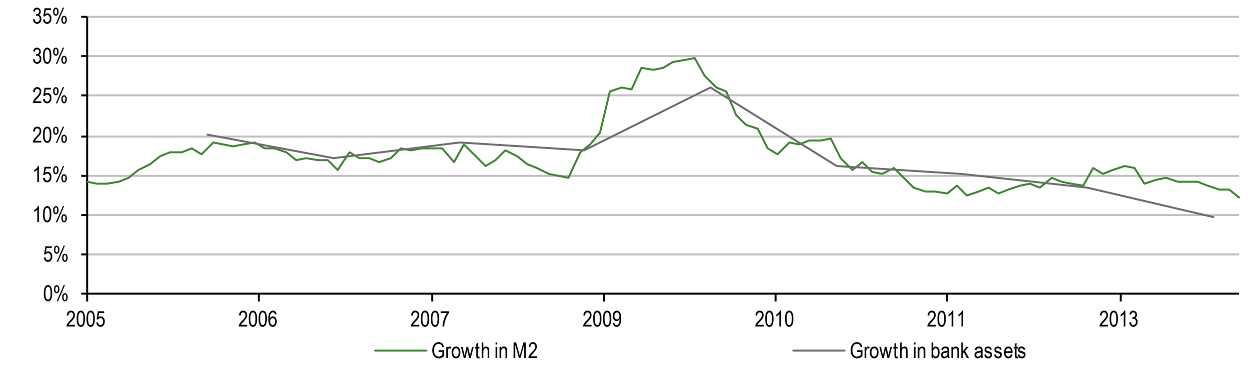


Source: Thomson Reuters Datastream, Edison estimates

China may no longer be the focus for investors that it was during the previous decade and even at current valuations we remain cautious on the investment merits of Chinese equities given a sector composition that is strongly weighted towards banks and other financials. However, China is the world's second largest economy in either purchasing power parity terms or current US dollars and in comparison to Ukraine is much more important to global investment portfolios.

The slowdown in Chinese economic activity has been well flagged and is a response to a steady tightening in monetary conditions over an 18-month period, resulting in M2 money supply growth falling to new lows, Exhibit 8. These official data are supported by anecdotal evidence of a sharp tightening in credit conditions in sectors such as real estate, where previously funds were easy to obtain. Bank balance sheets have barely expanded in the past 12 months after years of double-digit increases.

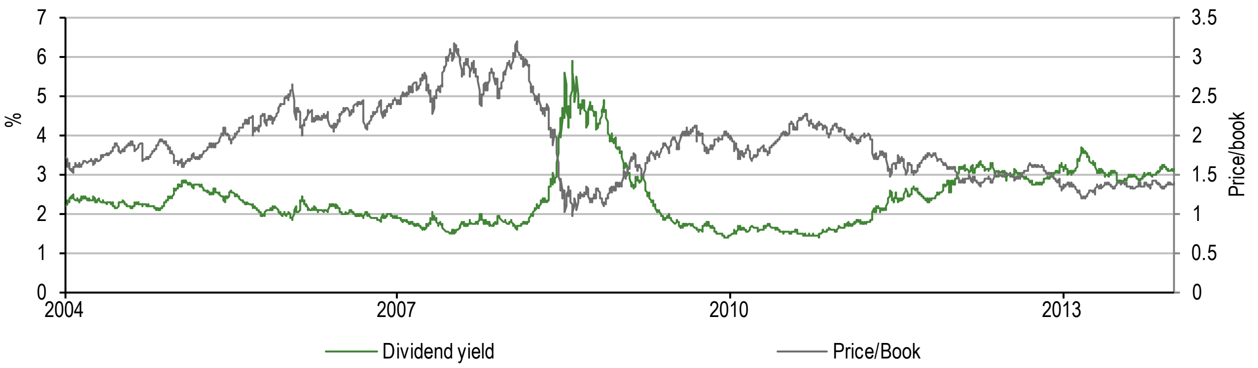
Exhibit 8: 12-month growth in China's listed bank balance sheets and M2 money supply



Source: Thomson Reuters Datastream, Edison estimates

One sector that has effectively discounted the impact of a slowdown in China is global basic resources. Despite the overall market rally this sector has fallen in value by close to 50% from the most recent peak of May 2011, Exhibit 9. Dividend yields for the sector are now close to 10-year highs, excluding 2008, while price/book values are currently modest. BHP is rumoured to have had an approach for its thermal coal assets and recently confirmed the rumours of a portfolio review. While there will be volatility as China slows, valuations indicate all but the worst outcomes for this sector may be in the price.

Exhibit 9: Global basic resources sector at valuation lows (ex-2008)



Source: Thomson Reuters Datastream

Conclusion

We believe markets are entering a new phase as profits growth slows and the prospect of the 'lift-off' in US interest rates moves closer. Recent M&A activity in the large-cap segment of the market has driven outperformance, modestly narrowing the valuation gap to mid-caps.

However, overall our portfolio strategy is still cautiously positioned. For markets in general we can only see low-risk premia across equities and credit markets. In equities, we are concerned investors may have not priced in the full extent of the declines expected in organic revenue growth in the corporate sector. For credit, the buoyancy of credit markets is certainly supportive of M&A, but we would prefer to own potential takeover or restructuring targets rather than the low-coupon debt being used to finance the deals.

Geopolitical risks are rising in Ukraine with continued escalation and no end in sight to the dispute, either between the US and Russia or at a national level. In China growth continues to slow, something that has been well understood by basic resources investors, but in our view has been crowded out of the headlines by events in Eastern Europe.

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