Illumination: Equity strategy and market outlook

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Global perspectives: Policy divergence

- **US and UK make progress while the eurozone stalls.** Diverging economic prospects mean the US Federal Reserve and Bank of England will be tightening monetary policy while the ECB grapples with disappointing growth and declining inflation expectations. This is likely to continue to pressure the euro against both the US dollar and sterling.
- **Did Draghi announce eurozone QE at Jackson Hole?** Judging by the bounce in European equities following Draghi's comments at least some investors believe eurozone QE is on the way. Draghi's speech indicated that the ECB has become significantly more concerned about declining inflation expectations in recent weeks. But investors should not expect a 2012 Nikkei-style reaction to any ECB policy moves. Due to political constraints and differences within the eurozone, any policy changes are likely to be measured in our view.
- **Mind the gap between bonds and equities.** Outside the eurozone inflation expectations have been stable. Steady declines in bond yields during 2014 therefore imply bond market investors are pricing in lower medium-term growth. In this case, equity investors should take care; theoretically there is no change in fair market values or dividend yields if the real interest rate and growth rate decline in equal measure.
- **Why are bond yields in decline?** Having recommended overweight positions in UK and US government bonds at the start of the year at yields of over 3%, yields have compressed by 60bps and we believe gains will be tougher from here, absent another crisis. In our view it is time to take profits with prices supported by geopolitical fears.
- **Maintaining cautious position.** While central banks are in uncharted territory, having engaged in numerous experimental and extreme monetary policies in recent years, investors are under no compulsion to conduct similarly aggressive experiments with their portfolios. Global equity valuations remain above historical averages and we have seen no convincing reasoning for a permanently high plateau in market multiples. Within equities, we believe investors should continue to focus on large-cap and M&A-related investment ideas.

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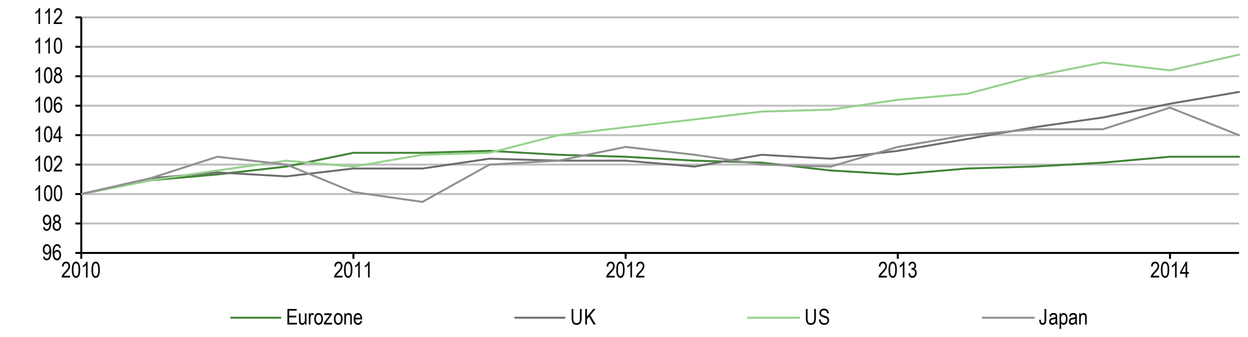
Monetary policy diverges

US and UK economic growth is now clearly pulling away from the eurozone, Exhibit 1. This is naturally leading to different trajectories for monetary policy and as a result the euro is likely to continue to remain under pressure, against both the US dollar and sterling.

Exhibit 1: GDP index level since 2010

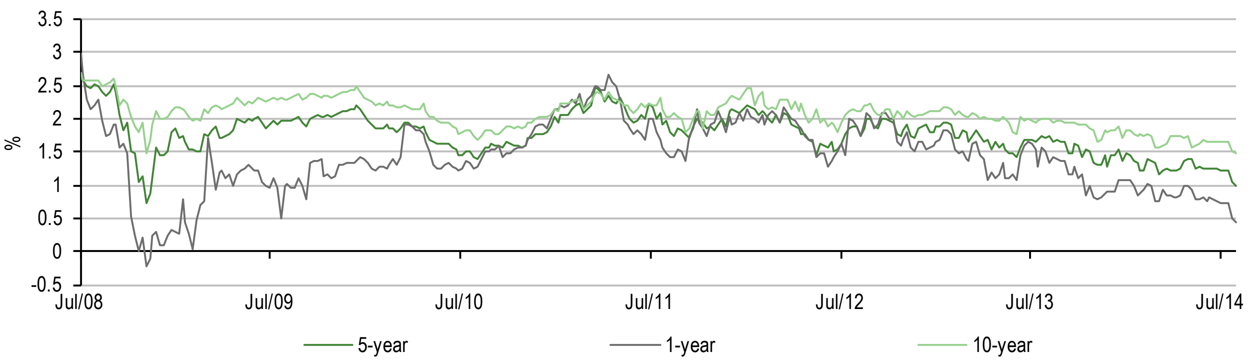


Source: Thomson Reuters Datastream

With stable inflation expectations and steadily declining unemployment the Bank of England is moving closer to its first interest increase in over 5 years, as the first disagreements evident in the recent seven to two vote to hold interest rates at their current low level make clear. While Mark Carney may be criticised for sending confusing signals on the timing of the first increase in rates, creating a degree of uncertainty allows markets to gradually reposition, lowering the risk of sudden shocks later.

In the US, Janet Yellen's speech at Jackson Hole was unremarkable and confirmed the glide path for the end of the current US QE programme in October. But by highlighting the uncertainties in the outlook for wage inflation due to the extraordinary depth of the most recent economic cycle, she has also attempted to prevent the build-up of overly strong expectations on the timing of the first increase in rates. However, the direction of policy to a tightening bias remains clear.

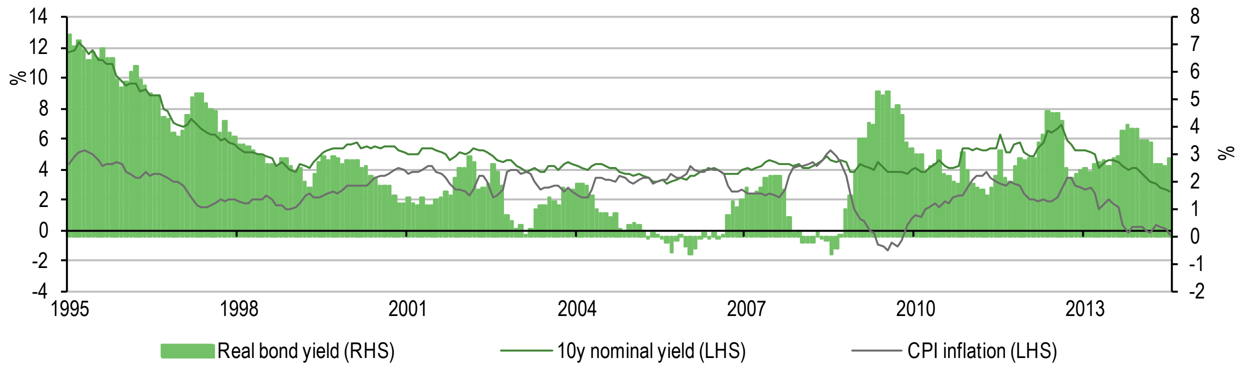
Exhibit 2: Eurozone inflation expectations



Source: Thomson Reuters Datastream

In the eurozone the situation is very different. The eurozone economy has lagged the US significantly since 2008, suffering from the additional impact of the sovereign debt crisis of 2011. The ECB is now concerned that inflation expectations have declined sufficiently sharply that additional policy action will be required to prevent real interest rates rising. This is especially important in nations such as Spain, where deflation is present, unemployment is high and relatively high real interest rates are unhelpful, Exhibit 3.

Exhibit 3: Spain and the zero-lower bound - high real rates as inflation falls



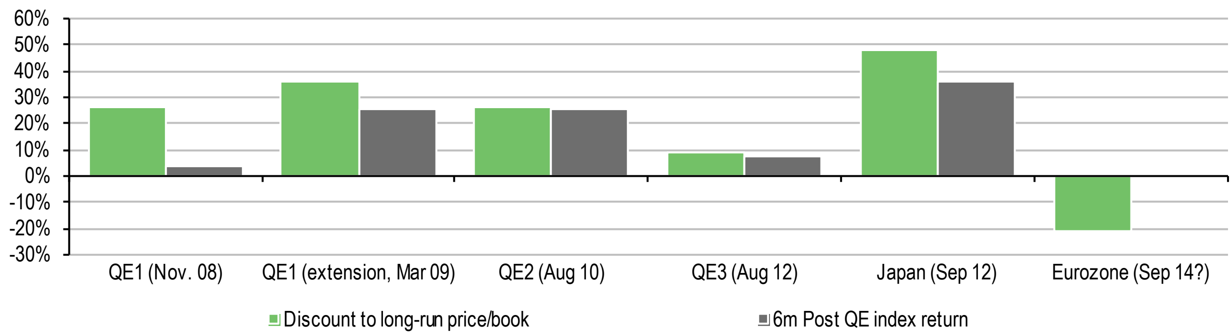
Source: Thomson Reuters Datastream

The recent bounce in European equity markets that followed Draghi's comments is unlikely to develop into a substantial leg-up in prices in our view. Unlike the US and UK, the ECB still has to contend with a large number of constituencies and explicit QE would seem to remain some way off. However, Draghi's suggestion that there scope within the existing Stability and Growth Pact for less constrictive fiscal policy shows the ECB's current willingness to facilitate an easing back on austerity in favour of growth. Having brought calm to sovereign debt markets, the ECB is now prepared to consider a slower rate of deficit reduction to support growth.

In terms of equities, the decline in domestic eurozone growth and pressure on the euro is likely to benefit exporters over those companies exposed only to Europe. This is where equity investors should focus in our view and may benefit Germany's Dax index after a period of sideways trading, geopolitical concerns notwithstanding.

However we do not believe further policy accommodation by the ECB will have anything like the impact on asset prices seen in the US and Japan in recent years. Firstly, massive direct purchases of peripheral European bonds (especially when debt levels remain high) seem politically difficult and therefore unlikely. Secondly, European markets are not as cheap as either Japanese or US stocks prior to QE, Exhibit 4. Easing of ECB policy may be necessary economically in Europe but in our view is insufficient to drive European equities significantly higher.

Exhibit 4: Eurozone QE? A very different starting point for equity valuations

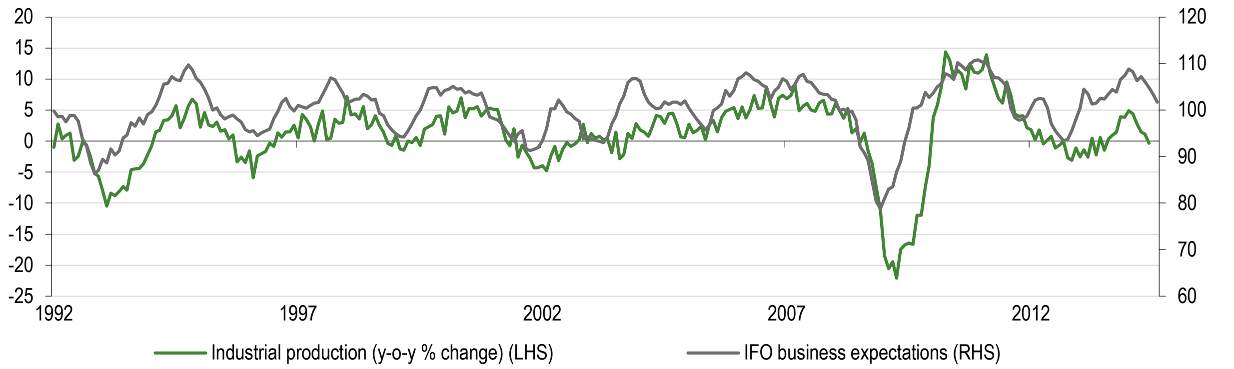


Source: Thomson Reuters Datastream

Mind the gap between bonds and equities

In contrast to the eurozone, inflation expectations have been relatively stable during 2014 in both the US and UK. Steady declines in bond yields during 2014, Exhibit 5, therefore imply bond market investors are pricing in lower medium-term growth through a flatter yield curve or alternatively geopolitical concerns are leading to a subtle flight to safety. In either case, equity investors should take care; theoretically there is no change in fair market values or dividend yields if the real interest rate and growth rate decline in equal measure (ie dividend yield = risk free rate + equity risk premium – dividend growth rate). Events in Ukraine and the Middle East are now known unknowns and it is impossible to predict if they will remain regional, while potentially drawn-out, conflicts with limited global economic repercussions or if they will become more significant. The recent dip in German business confidence and industrial production may be at least in part due to Russian sanctions, Exhibit 5.

Exhibit 5: Russia sanctions bite – on German business confidence



Source: Thomson Reuters Datastream

Conclusion

Once again, global markets are buoyed by the prospect of a significant monetary easing and this time it is the turn of the ECB to not fall short of raised expectations. Though aggressive monetary policy has been highly successful in raising asset prices in the past, we would highlight a very different starting point in terms of equity valuations this time. Furthermore, the ECB is unlikely to be able to engage in direct and substantial purchases of eurozone government bonds, at least in 2014.

Over the medium term monetary policy is not a substitute for real growth. To be a sustainable fix, monetary policy would have to deliver sufficient growth to facilitate a substantial reduction in aggregate debt/GDP. In contrast, aggregate debt levels remain exceptionally high and significantly higher than prior to the 2008 financial crisis in all major developed markets.

In this context, we believe the developed market economic outlook remains one of at best modest growth in, for example, the US and UK, but with a continuing risk of stagnation in Europe. Given the exceptionally high levels of overall indebtedness there is no reason to think that real economic volatility will be any lower than in the past, even if policy actions can smooth over market volatility in the short term.

Investors have been conditioned by recent experience to think that zero interest rate policy and aggressive intervention in lending markets across the maturity and risk spectrum is normal. In fact these policies have been introduced on an ad-hoc and experimental basis. We believe investors do have a choice over whether to conduct similarly aggressive experiments with their own portfolios.

When markets were cheap on conventional measures, ultra-loose monetary policy was at least likely to do no harm. But during the last three years, market valuations have moved to extended levels. We believe investors should remain focused on conventional investment principles. Quality companies with competent management at reasonable valuations in attractive market segments are likely to provide the best insurance against the volatility we do expect in future.

A key risk for us is that crisis-fighting monetary tools are becoming used on a daily basis, leaving little in reserve to respond to an exogenous shock. For example, what could central banks offer should there be a significant and unanticipated shock in future? These types of events, such as

2008 or 1997, are often difficult to forecast. We remain concerned about the rise of geopolitical instability and note Russian sanctions – an event that few would have predicted at the end of 2013 - have already had a significant impact on German business confidence.

Our investment strategy maintains its cautious positioning, even if the temptation to experiment with the linkages between monetary policy and asset prices will remain strong for some. For the medium term we believe investors are better served by sticking to investment principles that have stood the test of many business cycles, even if this period of low expected returns is proving frustrating.

Within a cautious overall positioning, our estimates indicate large caps still offer better value than mid caps. Absent a significant crisis, the strong performance of government bonds year to date (where in Europe total returns have outstripped many local equity markets) leaves less upside on the table and we would now be reducing overweight positions.

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