Illumination: Equity strategy and market outlook

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Global perspectives: If the facts don't change

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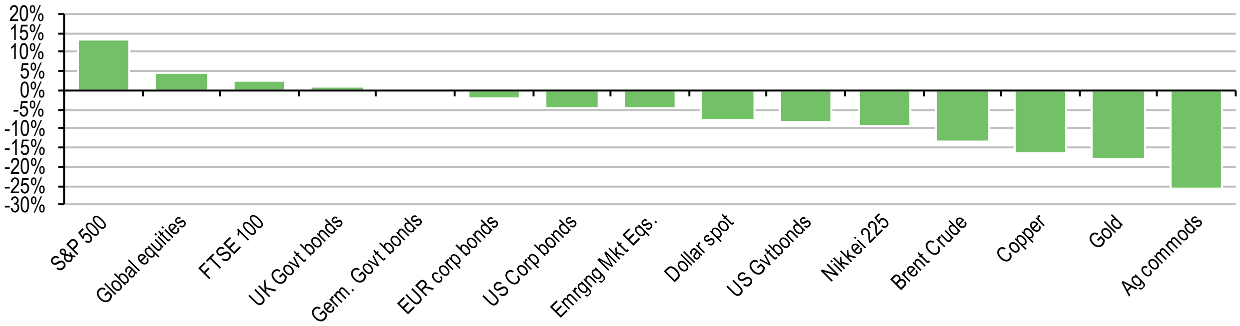
- **So far this year we have highlighted government bonds over equities, large caps over small caps and defence stocks over cyclicals, all within a cautious overall outlook.** While each of those calls have proved correct, the unusually small trading ranges of major asset classes have made large gains difficult to come by.
- **After a period of inactivity, the urge to 'do something' can be strong but should be resisted.** If the facts – and market prices – do not change there seems to be no rationale for changing the view. The last time we were enthusiastic about the prospects for equity markets was June 2012, shifting progressively to a more a cautious stance by early 2013. With the notable exception of the US, most equity markets have effectively moved sideways for over 18m. This lack of movement in both the strategic outlook and markets is frustrating but action should only be taken for the right reasons.
- **We have re-checked our readings.** Valuations remain high in developed market equities and corporate credit; the structural low-growth thesis remains intact with the eurozone under near-term pressure; global corporate sales growth has shown an alarming decline since pre-2008; geopolitical tensions could yet escalate and the ongoing slowdown in China should not be forgotten. Given this data, we choose once again to stick with a cautious positioning.
- **It can pay to wait.** While US individual investors may be more bullish than at almost any point in the last six years, each of the IMF, BIS, US Fed and G20 have all clearly stated that markets have run ahead of fundamentals in many cases. The facts have not changed and we have not changed our mind. We believe portfolios should remain cautiously positioned and skewed to larger-cap equities with event or restructuring potential. Returns to these more specific factors are likely in our view to be higher than returns from continued exposure to the economic cycle. Our recent suggestion to reduce government bond exposure last month has worked well as yields have moved sharply higher since.

If the facts don't change...

In local currencies, returns across the spectrum of liquid assets have now been modest for the last 18 months, with the notable exception of the US equity market, which has moved into relatively unusual valuation territory. For investors based in regions with appreciating currencies, performance has been more difficult to achieve; for example, in sterling terms many asset classes have delivered negative returns, Exhibit 1.

Exhibit 1: Sterling denominated asset class returns since May-13



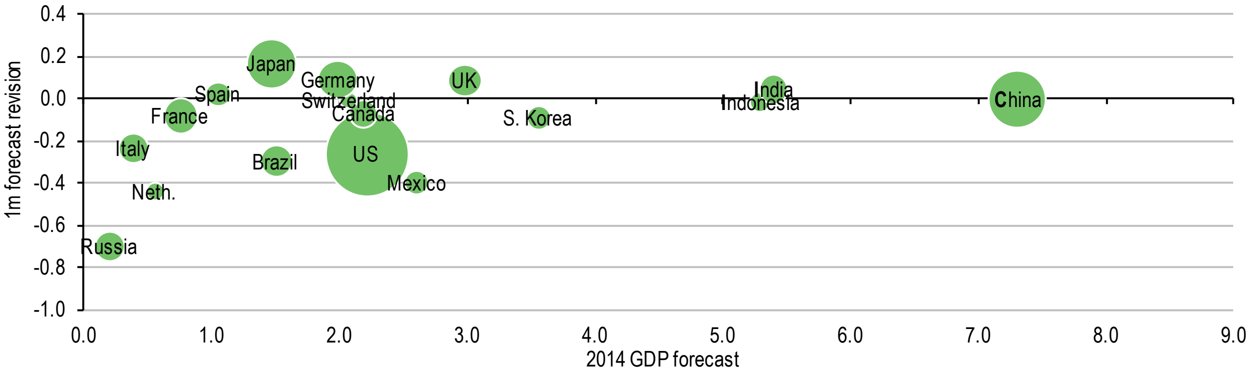
Source: Thomson Reuters Datastream

While not proponents of technical analysis, we sense the momentum that pushed investors to move out on the risk curve has ebbed, almost in parallel with the decline in the rate of expansion of the Fed's balance sheet. On our estimates valuations remain high across equities and corporate credit. We believe investors as a whole are starting to question why they should continue to be overweight risk assets when expected returns are low and momentum is weak – and the era of ultra-cheap dollar funding is drawing to a close, albeit with a long sunset.

Monetary policy still not delivering strong growth

While monetary policy has been used to great effect to fight the fires of stressed and overleveraged financial systems, such as immediately post 2008 and during the eurozone sovereign debt crisis of 2011/12, the path to strong and sustainable growth remains to be found. Investors are told that monetary policy works with a lag and we recognise the upward effect on asset prices has certainly been significant and rather more immediate. But the original premise of these policies was to put developed market economies back on the growth trajectory of the pre-2008 era and on this basis the success of these policies remains moot, Exhibit 2. Developed market growth forecasts remain well below the pre-2008 period, even in the US which pushed earlier and harder with aggressive monetary policy, while also benefiting from unanticipated development of energy reserves and the dominant share of global technology sector profits growth.

Exhibit 2: 2014 Global GDP forecasts

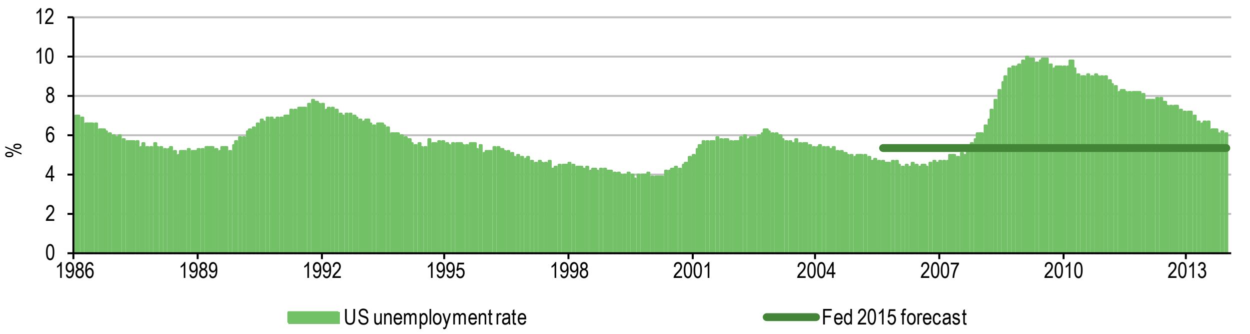


Source: Thomson Reuters Datastream

We see the most recent statements and comments from the US Fed as a shift to a slightly more hawkish position on monetary policy with official unemployment converging towards the Fed's longer-run forecasts. While the Fed's most recent statement retained the "considerable time" language, in reference to the period after the end of quantitative easing before raising US interest rates, it is becoming clear that these words have lost much of their meaning, in terms of providing forward guidance investors can rely on.

At the FOMC press conference Fed Chair Yellen's comments strongly indicated that US interest rate policy is now data rather than time dependent. For 2014, this is unlikely to make significant difference to Fed policy as the incoming unemployment data is still consistent with the Fed's projections of steady declines to 5.4-5.6% by the end of 2015, Exhibit 3. But for 2015 we see a number of well-sourced press articles which suggest Yellen's hints are being ignored by the market.

Exhibit 3: US unemployment and Fed forecast

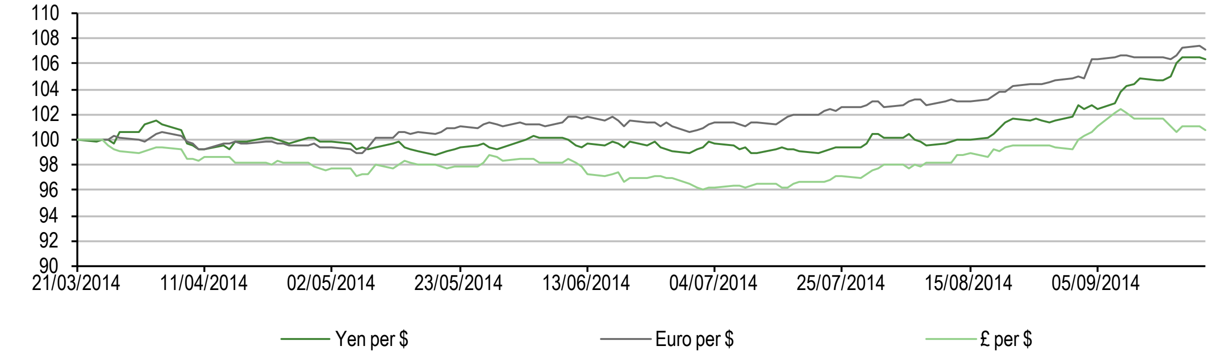


Source: Thomson Reuters Datastream

The Fed also cut its 2015 GDP forecast by 30bps to 2.8% but maintained the same formal outlook for monetary policy, confirming a fractionally more hawkish policy stance. We would draw reader's attention to Yellen's fondness of talking in terms of optimal control in respect of monetary policy. Conceptually the control input – the stance of monetary policy – under a Yellen Fed might be expected to move back to neutral more rapidly as unemployment comes back to target, having been looser than other models (such as the Taylor Rule) when unemployment was further away from target.

This may be the reason why Yellen is trying to create sufficient policy room for manoeuvre without surprising the market. Certainly as we have discussed previously, the diverging stance of monetary policy between the US on the one hand and Japan and the eurozone on the other is having a predictable effect on FX markets. Recent moves are arguably reaching a point where they could be described as disorderly, Exhibit 4.

Exhibit 4: US dollar against the yen, sterling and euro



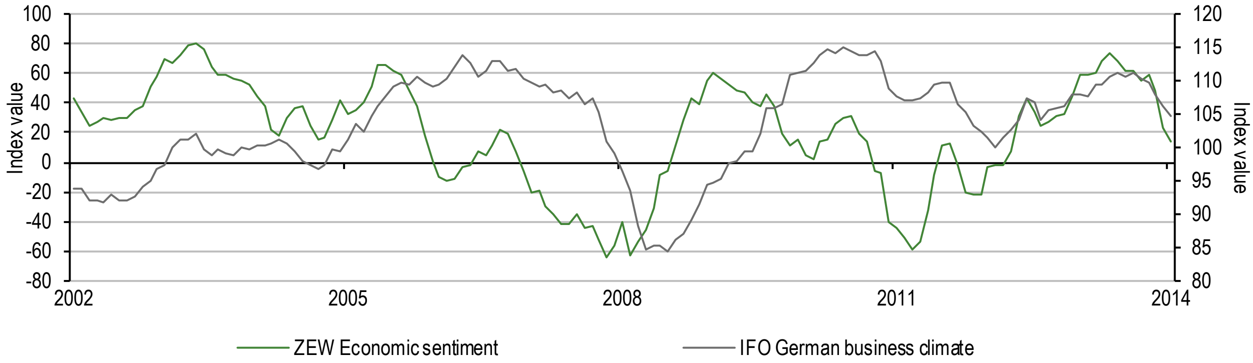
Source: Thomson Reuters Datastream

Eurozone losing momentum

In the eurozone, Draghi's recent comments are shifting in emphasis to highlight the necessity of structural reforms and possibly a loosening of fiscal policy, in order to revive the eurozone's growth dynamic. This is clearly difficult to argue with, and was the mantra of the European project for many years before 2008. However, the political difficulties of implementing these structural reforms within eurozone nations are still significant and in our view it would be premature for investors to price in progress at this stage. However to the ECB's credit, after efforts spanning a number of years, banking sector regulation at least is finally being centralised at the ECB.

In terms of economic momentum in recent months the decline in Europe, whether due to tensions in Ukraine or not, is becoming more evident with sharp falls in both eurozone and German business sentiment, Exhibit 5. We also note that the slowing growth in China is very much in accordance with the script as the transition from an investment-led to consumer-led economy is encouraged. The combined effect of a loss of near-term momentum in China and Europe (which account for 30% of world GDP) has contributed to significant declines in commodity prices this year, as shown in Exhibit 1.

Exhibit 5: Eurozone economy losing momentum



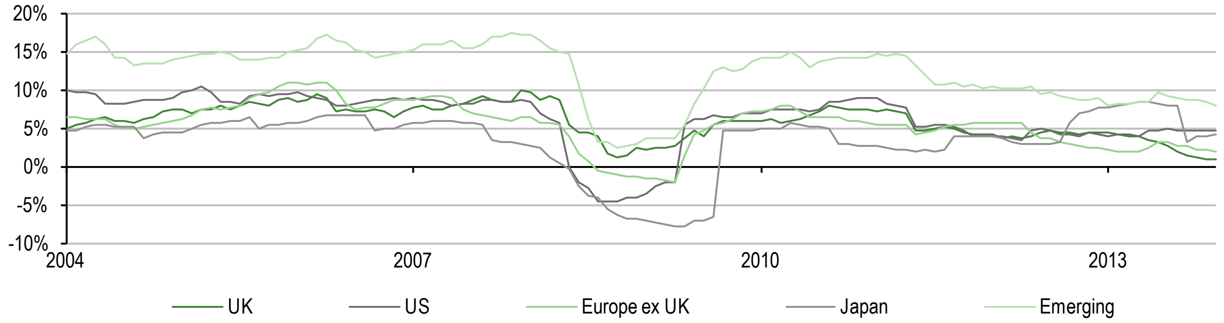
Source: Thomson Reuters Datastream

Global equities – weak revenue growth sharpens the value debate

It was clear to us during 2012 that investors would be well served by moving out of bonds and into equities. For example, the dividend yield of the DAX was close to record territory and at the same time safe government bond yields had declined to historic lows. However, this positive view on equities would have been valid even under the assumption of a more modest level of GDP and profits growth than seen in the past. At present, we believe the combination of relatively high valuations and slow profits growth is something which could come back to haunt many investors encouraged to take more risk to enhance returns.

Many investors may not appreciate that sales growth forecasts across the globe have declined to one-half or less of those prevailing prior to 2008. This is a broad-based phenomenon which can be seen in both developed and emerging markets but is more severe in the UK and Europe, Exhibit 6. While this chart shows 12m-forward sales growth we also note there is no 'catch-up' in the 24-month estimates, which leads us to question whether these too will be cut with incoming data in future.

Exhibit 6: Global 12-month forward sales growth forecasts

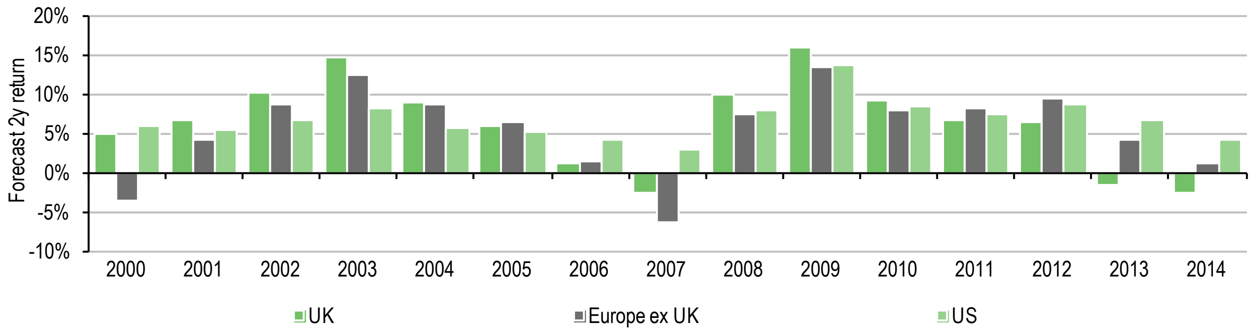


Source: Thomson Reuters Datastream

Sales (and by implication medium-term profits) growth in the low single-digits implies a relatively high dividend yield to meet the long-run rate of return on equities of 8% expected by many institutional investors such as pension funds. We are clearly some way from those levels and continue to struggle to find a compelling valuation argument to be overweight global equities in general.

By estimating expected returns at a stock level we see that on the basis of our models equities are as highly valued as 2007, Exhibit 7. High valuations are broadly spread across sectors but we would highlight that large-cap equity valuations (outside the technology sector) are not so far from longer-term averages.

Exhibit 7: Median stock returns – Edison strategy model



Source: Thomson Reuters Datastream

Conclusion

We see few reasons to change our cautious outlook in the face of high valuations, slow corporate revenue growth and tighter US monetary policy. For as long as the ECB continues to explore ways of loosening monetary policy further and the US remains on a tightening track, the dollar is likely to face upward pressure against the euro.

While the relatively highly valued nature of global equity markets may be a consensus view, investors should also keep in mind the sharp decline in forecast revenue growth rates which is a global phenomenon. We believe portfolios should remain cautiously positioned and skewed to larger cap equities with event or restructuring potential. Returns to these specific factors are likely in our view to be higher than returns from continued exposure to the economic cycle. Our suggestion to reduce government bond exposure last month proved correct as yields have quickly shifted closer to fair value in the circumstances.

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