Illumination: Equity strategy and market outlook

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Global perspectives: Volatility returns

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- **Volatility returns to global markets during October.** While the proximate triggers for the recent market mini panic remain unclear, the risk factors of high equity and credit valuations were clearly in place. Slowing price momentum and some weak data points out of Europe may have been enough to trigger a mini avalanche of sell orders. While equities drew the headlines, the flash crash in sovereign bond yields and surge in volumes pointed to panic buying, discrediting the thesis of a "great rotation" out of bonds and into equities.
- **Central banks saved the day – again.** Dovish comments from St Louis Fed President James Bullard coincided neatly with the turn higher in market sentiment, while in the UK Andrew Haldane of the Bank of England (BoE) was on hand to brief the press with his softer stance on future policy, preempting the scheduled release of BoE minutes. In Europe, anonymous sources close to the ECB disclosed the limitations of the current asset purchase policy and teased markets with the prospect of corporate bond purchases and even full-blown QE in 2015.
- **Fundamental outlook downgraded.** Investors can be forgiven for sitting on their hands as policymakers try to jawbone markets higher while economic and earnings forecasts continue to decline. It is becoming increasingly difficult to avoid the suspicion that risk premia across the entire market spectrum have become a policy objective; many investors may be wishing for a return to times when security pricing was based on company or credit fundamentals.
- **We expected this rise in volatility at the end of US QE and do not see a buying opportunity.** US equity markets have completely recovered from their mid-month 7% dip. The recovery may have been dramatic, but in our view investors should consider whether this is another example of volatility rather than a restoration of the previous calm. In Europe, where the DAX sold off by nearly 15%, valuations are closer to (but still above) historical averages. However, investors are now having to deal with a number of high-profile earnings misses and downgraded growth expectations following the slowdown in eurozone economic activity.
- **There is no change to our cautious strategic view.** The so-called great rotation that was forecast to be the theme for 2014 has not happened as sovereign bonds have outperformed equities year to date. We cannot ignore slowing economic momentum, high-profile profit warnings and slow aggregate corporate revenue growth and believe that global equities will continue to tread water while the fundamental outlook remains uncertain.

Volatility returns

In June we highlighted the unusually low levels of market volatility and low risk premia across asset classes. In the absence of volatility, we felt that investors had become accepting of a slow growth, low volatility and a low return environment. In such an environment, some investors may have been encouraged to move out on the risk curve to maintain expected returns.

It is not at all clear to us precisely what shattered this uneasy positioning during October. Possible reasons include the continuing geopolitical risks in Ukraine, Syria and Iraq; the recent substantial losses incurred by some large funds in a number of event-driven situations; the weakening economic momentum in the Eurozone; or even the uncertainties surrounding the spread of Ebola.

We view the recent market turbulence as a step along the road to normality and therefore see this recent heightened volatility as reflective of a regime shift. Equity and credit valuations remain in general too high in developed markets, in our view, given a global growth outlook that remains challenging. We believe that the ‘flash surge’ in government bond prices during October on a dramatic surge in volumes, Exhibit 1, is indicative of fixed income investors being caught on the wrong side of declining growth and inflation expectations.

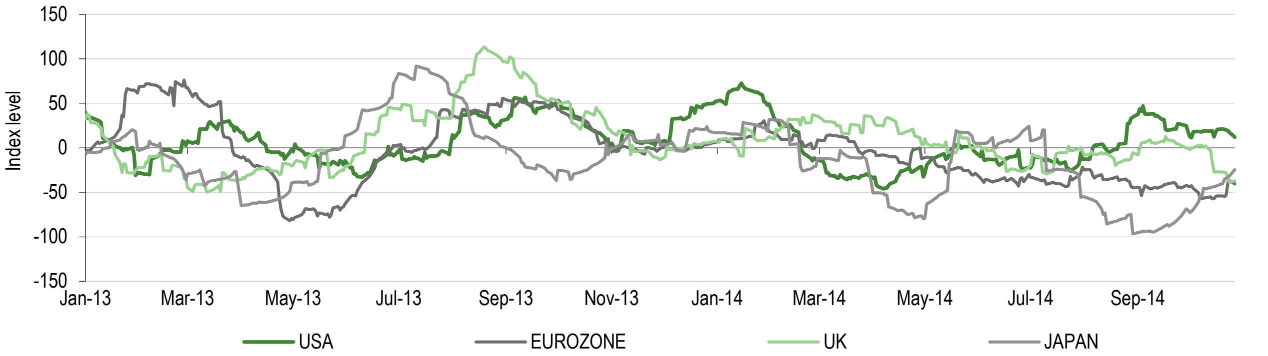
Exhibit 1: US 10-year Treasury Futures ‘flash surge’

Source: Bloomberg

Central banks saved the day – again

By a remarkable coincidence, policymakers from the St Louis Fed, BoE and ECB saw fit to make comments reflecting a softer line on monetary policy at precisely the point when the market decline was starting to look like a rout. Comments from James Bullard of the St Louis Fed backed an extension of US QE and, judging from the immediate turn in prices that followed, appeared to put a floor under markets. In times past, single-digit variations in equity indices used to be the hallmark of a normally functioning market rather than cause for alarm. However, if the intention of this flurry of comments was to stabilise markets it was certainly effective.

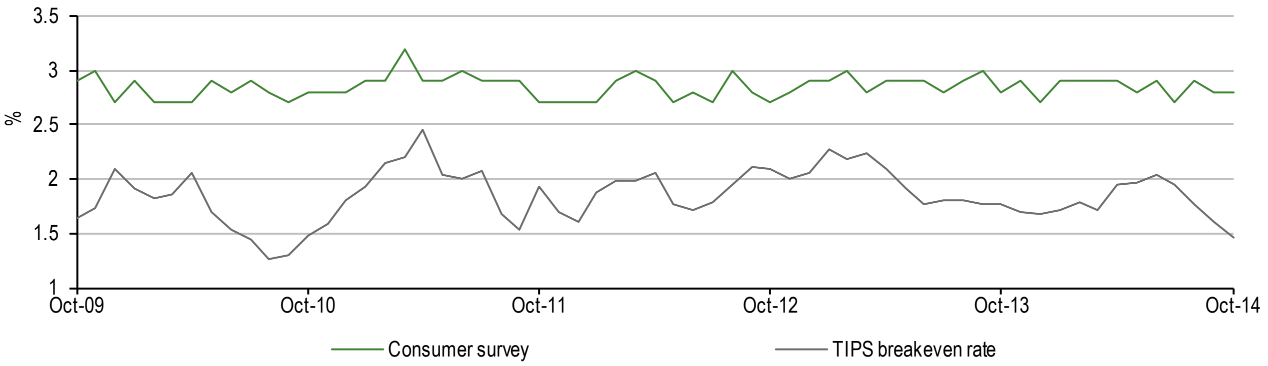
Exhibit 2: Regional economic surprise indices



Source: Thomson Reuters Datastream

While economic momentum has been declining recently in the eurozone, this is not news, nor would it be a reason to change the trajectory of US monetary policy, in our view. In contrast to the eurozone, to date US economic surprises remain positive, Exhibit 2. In addition, US official unemployment is converging towards target levels and the recent decline in US inflation expectations would appear to be insufficient, Exhibit 3, to motivate such a significant change in policy as an extension of US QE.

Exhibit 3: Market-implied and survey-based US inflation expectations



Source: Thomson Reuters Datastream

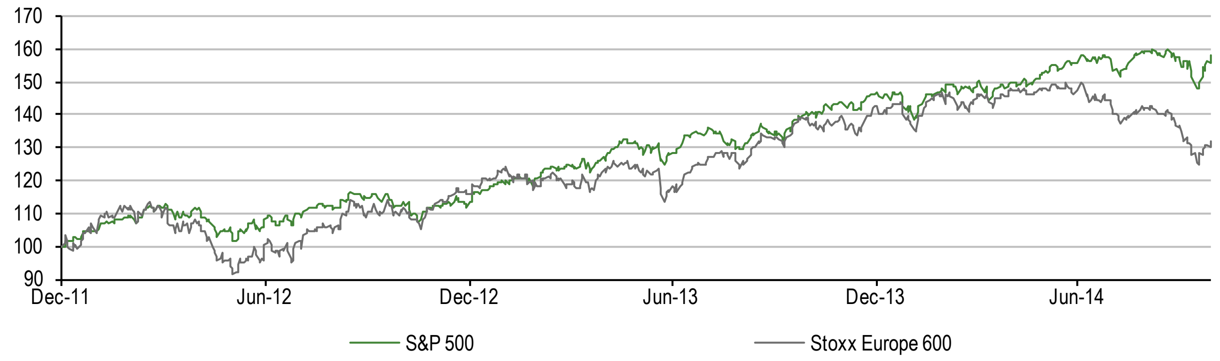
Where the Fed has given itself ample room is in delaying the first increase of US interest rates, should the incoming data warrant it. We were therefore unsurprised to find that the most recent FOMC meeting resolved to end US QE on schedule this month. In the FOMC statement, the data-dependent nature of the first increase in US interest rates was re-emphasised by refocusing attention on still too-low levels of inflation. However, unless the economic slowdown affecting the eurozone has a significant impact on US economic momentum, we view a restart of the US QE programme as unlikely.

In Europe there have been a number of strategic leaks to the media in respect of the ECB's future plans for expanding its balance sheet beyond the limited amount implied by the size of the asset-backed securities market. One such proposal was to buy corporate bonds. With eurozone investment-grade corporate bonds at record low yields of under 2%, it is not at all clear how this will benefit economic growth, even if there will be a modest windfall to existing bond investors and a marginal subsidy to corporate borrowers. Although markets continue to speculate, full-blown QE requires Germany to overcome its objections to monetary financing and to accept credit risk for the indebted regions of the eurozone. With the rise of the eurosceptic Alternative for Germany (AfD) party, the political difficulties of supporting such a policy are only increasing.

US earnings revisions turn lower; Europe stays lower

While European earnings revisions have remained negative for some time, which may account for much of the underperformance of European equities against ever more highly valued US peers, Exhibit 4, we note there has been a significant decline in US earnings revisions in recent weeks, Exhibit 5.

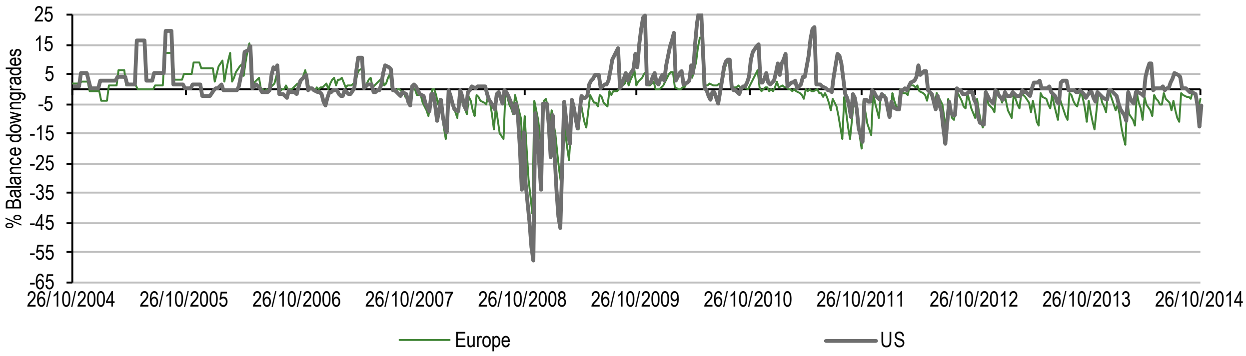
Exhibit 4: Europe and US relative price performance



Source: Thomson Reuters Datastream

This is something of a surprise as the recent earnings season, apart from some high-profile exceptions such as IBM and Walmart, has otherwise been solid with 75% of earnings and 60% of reported revenues beating consensus, which is above historical averages. One data point does not make a trend, but in our view the uptick in downgrades is consistent with declining prospects for earnings from overseas and disappointing durable goods orders over the summer.

Exhibit 5: US and Europe earnings revisions

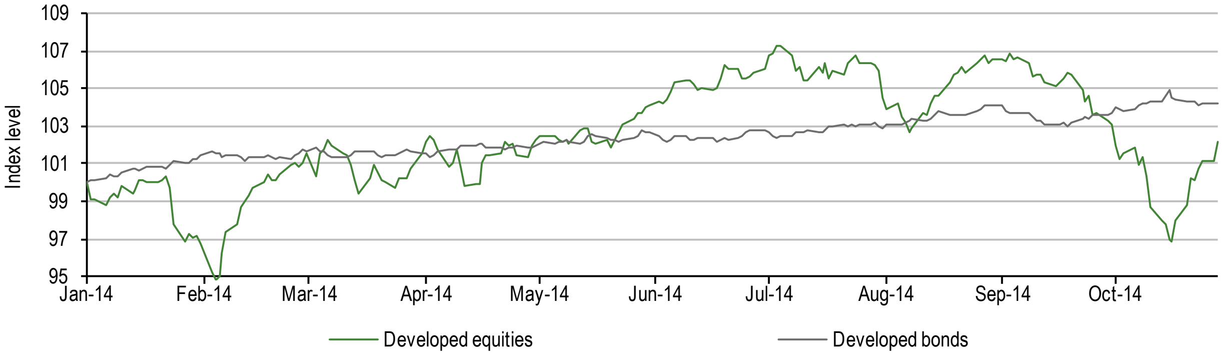


Source: Thomson Reuters Datastream

Conclusion

Investors are welcome to question our cautious positioning. However, we would highlight that so far in 2014, globally, bond indices have outperformed equities and with substantially less volatility, Exhibit 6. In both the US and Europe a five-year period of ultra-loose monetary policy has delivered only a weak recovery to date and the extent of the forward guidance still required to keep even this low level of economic growth on track is telling. In the circumstances, corporate revenue growth forecasts that are so much lower compared to the pre-2008 period should not be a surprise, nor should the corporate sector's continued preference for share buybacks over capital expenditure.

Exhibit 6: Government bonds outperform equities during 2014



Source: Thomson Reuters Datastream

In this context, our enthusiasm to recommend equities when markets continue to trade well above long-run valuation averages is significantly curtailed. Furthermore, the recent decline in oil and industrial commodity prices is indicative of a shortfall in demand in the short term, even if perhaps stabilising in the medium term. With the end of US QE now upon us and increased evidence of a secular slowdown in developed markets, we believe a period of increased volatility lies ahead.

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