EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Only one game in town

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- **Markets recover poise as central banks ease policy.** While we felt that October's market declines and increase in volatility were a rational adjustment to the increasing valuation and fundamental risks, other investors disagreed. Declining inflation and growth expectations have driven all of the world's major central banks to a looser verbal or actual policy stance in recent weeks.
- **Outlook for 2015 is for more of the same.** We expect GDP growth in line with long-run trends in 2015. This will highlight the contrast between tolerable growth of 2.5-3% in the UK and US and the much weaker 1-1.5% long-run growth trends of Japan and the eurozone. Continued monetary policy divergence is likely to maintain upward pressure on the US dollar versus the yen and euro, even as the consensus on this view makes FX volatility likely.
- **Bond yields price in a disinflationary environment.** Disinflation confounded those expecting a rotation out of bonds and into equities during 2014. By contrast, safe government bonds were among the best performing asset classes this year. We believe the fair value range for US and UK government bonds lies in the region of 2-2.5% in the US and UK and this year's bond market performance will only be repeated next year if there is a substantial shortfall in economic activity.
- **Equity valuations remain challenging.** The extended period of ultra-low interest rates and the perception of multiple central bank 'puts' has driven the median stock to, or close to, 25-year highs on a price/sales basis in the US, UK, Europe and Japan. In line with shrinking expectations for trend GDP growth, sales growth forecasts have halved from the pre-2008 period. In addition, consensus EBITDA margin forecasts are at record highs, indicative of a this-time-is-different dynamic. We remain cautious on equities.
- **Watch for political risk in Europe.** The astonishing rise in support for alternative political groups in Europe is a natural consequence of high unemployment and slow wage growth. New protest movements have also benefited from the perception that control over the economy has been handed over to central banks, which have in turn followed policies that benefit a wealthy minority. Investors should be alert to the risks of a shifting mood among electorates in Europe.
- **Only one game in town.** Disappointing data from the eurozone, China and Japan and falling commodity prices have contributed to declining growth and inflation expectations. Yet we look towards 2015 with equity valuations at record highs. Were it not for the willingness of central banks to participate in the world's security markets, we sense equity valuations would not be so effervescent. From a top-down perspective, in our view the rationale for a cautious portfolio positioning into 2015 is clear.

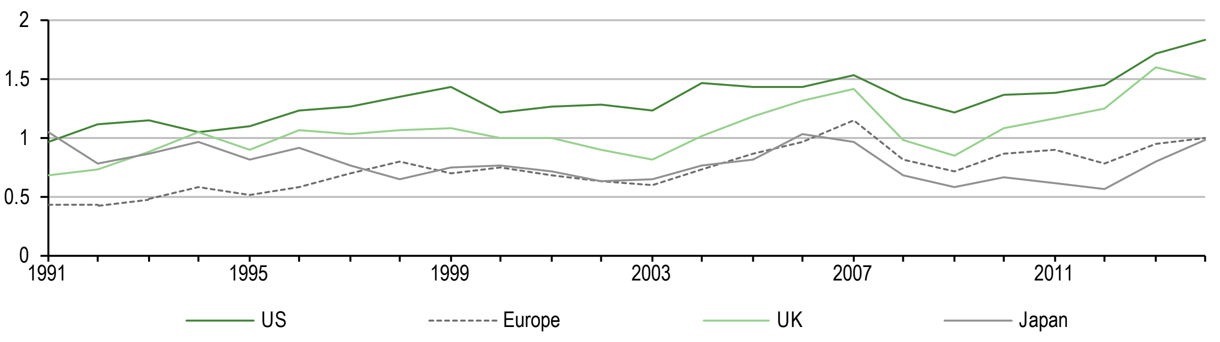
Only one game in town

The last four weeks could not have made the reliance of equity prices on the direction of monetary policy more obvious. Now that US unemployment is closer to target, the Federal Reserve has shifted its focus to below-target inflation, pushing expectations for the lift-off in interest rates to the second half of next year. In the UK, Bank of England Governor Mark Carney emphasised the deflationary risks during his press conference, similarly pushing out expectations for the first UK interest rate increase to H215.

In Europe, ECB President Mario Draghi has become increasingly vocal about the need to urgently address declining inflation expectations. If investors do not get full-blown QE in the eurozone by early next year they may feel let down. In Japan, a substantial increase in the pace of QE last month was deemed necessary as the original rate of easing has proved ineffective in raising inflation expectations and stimulating growth. We would emphasise that much hinges on whether the Bank of Japan's policies are ineffective or merely insufficient. The People's Bank of China, where the impact of the devaluation of the yen against the US dollar is most acutely felt, finally lowered interest rates in response to declining Chinese economic momentum.

Equity prices have responded to this further loosening of global monetary policy by rising sharply. The S&P 500 is now making new highs, while European markets are close to their highs for the year.

Exhibit 1: Median price/sales for global equities



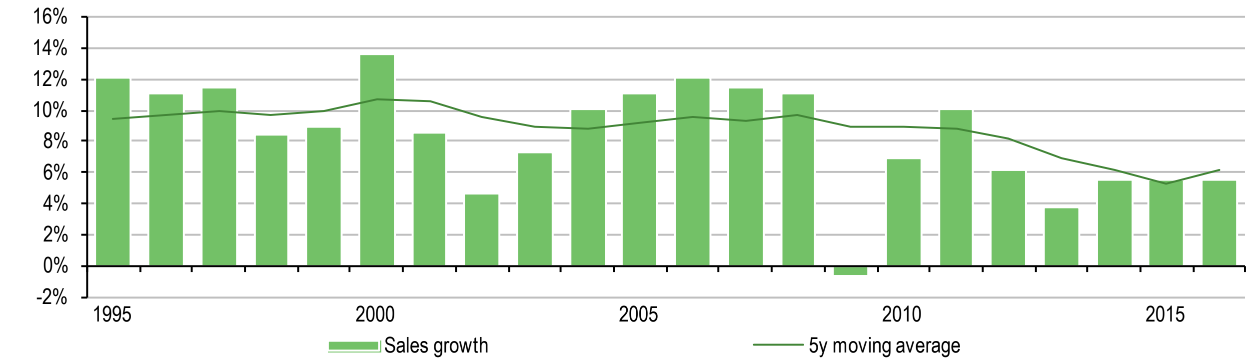
Source: Thomson Reuters Datastream, Edison calculations

In our view, this pattern of declining growth and inflation expectations being matched with ever more aggressive monetary policy to the benefit of risk assets is now the only game in town. It is also becoming a dangerous game to play. Median price/sales valuations of equities in the US are making new records, exceeding those seen in 2007, but even in the more growth-challenged areas such as Japan and Europe valuations are also close to 25-year record price/sales levels, Exhibit 1.

For some investors, the decline in yields across global bond markets is a rationale for higher equity market valuations. By contrast, we believe the signal from bond markets is that growth is likely to be slower as the era of negative working age population growth moves closer. Slower growth is clearly evident in corporate revenue trends, when comparing the pre-2008 period with more recent years; the growth rate of revenues for the non-financial sector has halved on a global basis from 10% to 5%, Exhibit 2.

In the US, unconventional monetary policy is associated with a recovery, albeit the slowest recovery of the post-war period and which even now is performing only in line with what is implied by productivity and working age population growth of 3% pa. There has been only limited catch-up to previous trends, even after the unanticipated benefits of the sharp increase in US energy production.

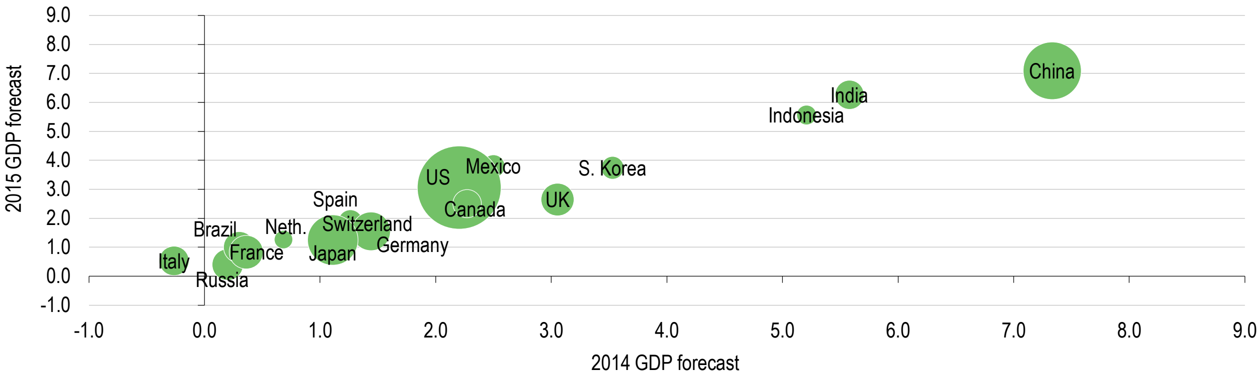
Exhibit 2: Global declines in corporate revenue growth



Source: Thomson Reuters Datastream, Edison calculations

We believe that consensus economic forecasts for 2015 are now realistic for the major economic regions, Exhibit 3, as the central expectation is for growth no higher than long-run trends. In terms of the impact of the ECB's likely QE programme in the first half of 2015, we see the benefits as limited.

Exhibit 3: GDP growth forecasts



Source: Thomson Reuters Datastream

For example, unconventional central bank policy in the US (which includes the decisions taken to stop bank runs during the latter stages of 2008) had a clear cost/benefit proposition. For example, there was an obvious economic benefit in reducing excess risk premia in markets, which had left many large participants in the financial sector undercapitalised and unable to extend credit. Later purchases of government bonds were more controversial, but have played a part in easing credit conditions by moving the yield curve closer to the ultimate outturn for inflation, even if this was not the stated aim.

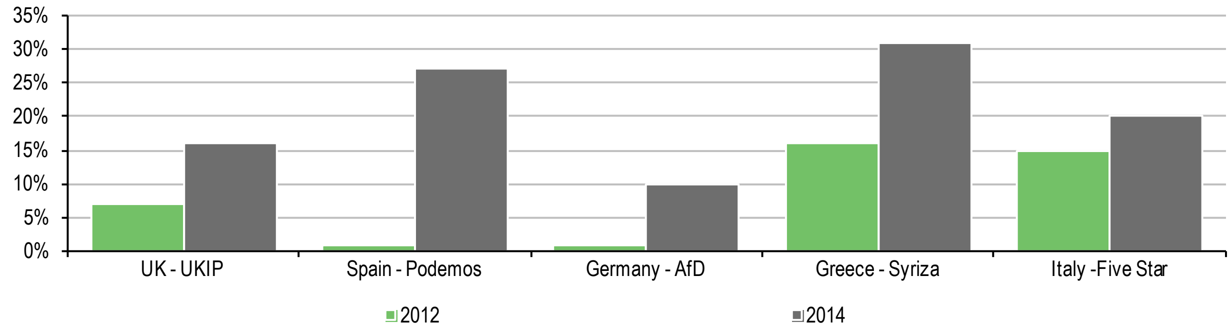
By contrast, in the eurozone the acute phase of the sovereign debt crisis has passed. Risk premia in sovereign debt markets have in fact fallen so far that yields on Spanish 10-year debt are within 150bp of German bunds, which may yet prove to be an underestimate of the underlying credit risk. The ECB has spoken of targeting corporate bonds, yet these are also trading at record low yields.

For these reasons, we believe the largest impact on the eurozone of a full QE programme will be on the exchange rate rather than the real economy, similar to the Japanese experience over the last 24 months. This will of course be highly beneficial to corporates exporting out of the eurozone, many of which are located in Germany.

Political risk rising in Europe

Some market participants are of the view that as a potentially ineffective policy, the scale and duration of any eurozone QE will be underestimated (as was the case with the US), leading to a much larger medium-term positive impact on asset prices than appears likely in the short run. This logic worked so well in the US that it is tempting to believe a repeat performance is likely in Europe.

Exhibit 4: Growth in support for alternative political parties in Europe



Source: Thomson Reuters Datastream, Edison calculations

However, we must caution that the political dynamics are moving so quickly in Europe that they are no longer possible to ignore as minor investment risks over anything but the shortest time horizon. Support for new political movements has been growing strongly in recent years across Europe and has become a very real threat to incumbent parties. For example, the new far-left Podemos party is currently the most popular in Spain following a standing start only 15 months ago. Similar dynamics are being played out in other nations, Exhibit 4.

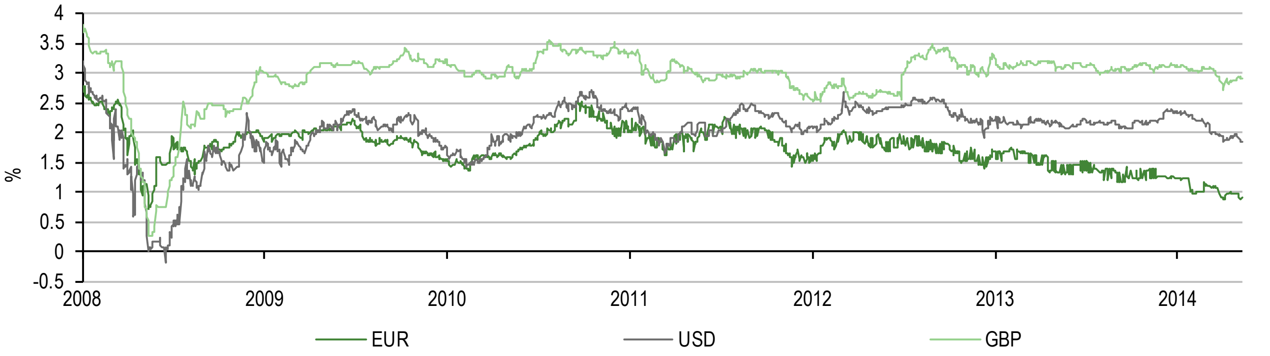
While it remains unlikely that any of these unconventional parties will seize outright power, political ideas are porous between parties. The draw of popular support for views such as votes on membership of the euro, membership of the European Union and restructuring of sovereign debt will be influencing politicians across the political spectrum. With a fiscal straightjacket imposed by current debt burdens (as much as any political ideology on running balanced budgets), we believe there is a significant probability that the eurozone will face further challenges and volatility in the years ahead.

To pay peak valuation multiples for equities requires a considered judgement that the growth prospects for revenues and earnings are significantly above average or that risks to the outlook are lower than usual. We believe many investors are of the view that the fundamental outlook has become less relevant as a global central bank 'put' will insulate portfolios from harm, even if growth disappoints. In our view, with valuations high and growth weak, we believe loose monetary policy is the only game in town – and it remains to be seen what happens when the central banks fold their cards.

Global equities a conundrum

In our view, investors currently face an equity conundrum. 2014 was supposed to be the year of the 'great rotation' as investors switched out of defensive portfolios and added to equity allocations. Bond yields were expected to rise as growth returned. In reality, growth expectations have been consistently scaled back, while government bonds have performed strongly with yields for the highest-quality government debt falling by 75-100bp during the year. Inflation expectations have been falling alongside commodity prices, Exhibit 5.

Exhibit 5:Inflation expectations declining

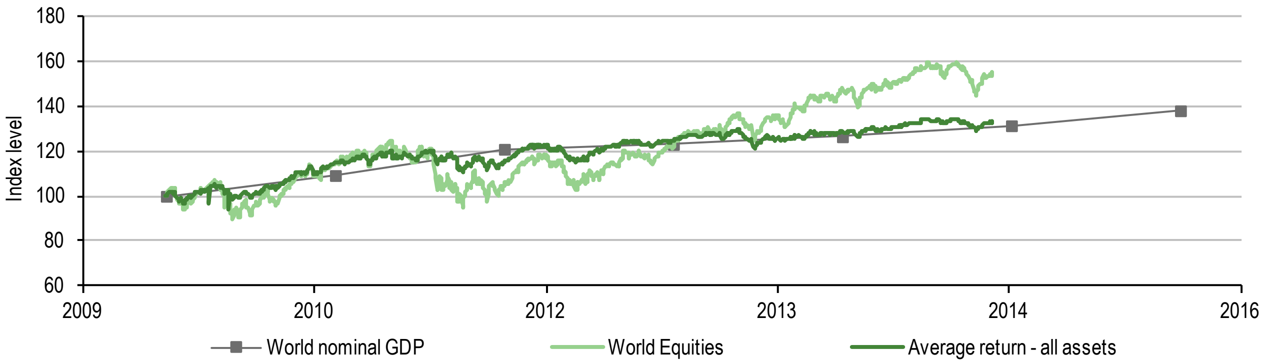


Source: Bloomberg

One may be forgiven for thinking that in this environment, equities would struggle, but the reverse has been the case. On a global basis, equity markets have notably outperformed other asset classes and nominal GDP, Exhibit 6. In our view, this has come about as earlier this decade there was a high degree of unwarranted pessimism on the outlook for profit margins, which failed to take into account the weak negotiating power of the labour force on a global basis.

Non-financial corporate profit margins have in reality been strong during the post-2008 period, Exhibit 7. However, at present we would highlight a potential risk of disappointment as consensus margin forecasts rise beyond anything seen in the last 25 years. Historically at least, profit margins have reverted to the mean over time.

Exhibit 6: Global asset class performance and nominal GDP



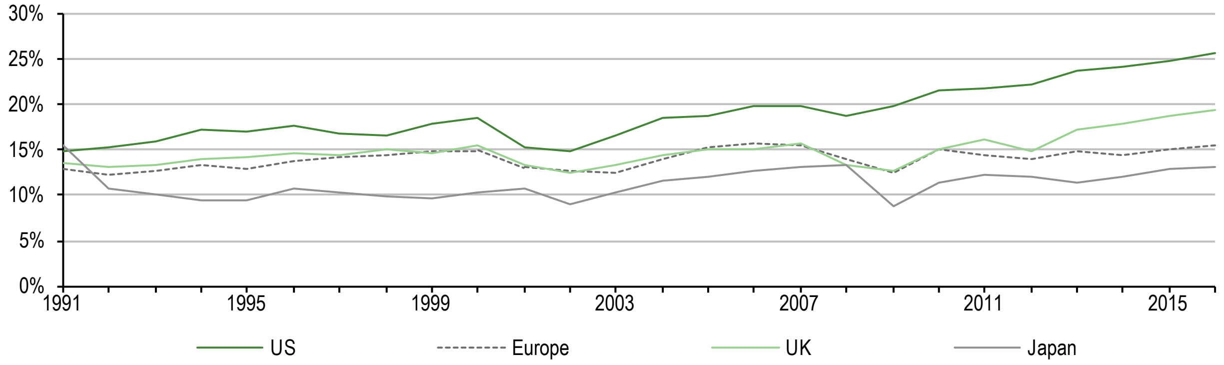
Source: Bloomberg

However, as confidence in corporate profitability has returned we also see the potential for an overshoot in terms of valuations as revenue growth declines. As highlighted in Exhibit 2, on a global basis non-financial revenue growth has slowed to 5% over the last five years, from 10% in earlier periods. This is a global phenomenon seen in both emerging and developed markets outside Japan, where revenue growth has been relatively modest for some time.

For equity investors a silver lining is an associated reduction in capital intensity. Non-financial corporate investment is now closer to 4% of sales rather than the 6% level of the 1990s. In conjunction with higher than expected margins, this has helped the corporate sector to maintain cash returns to shareholders through dividends and share buybacks. Nevertheless, a 2% reduction in capex/sales does not compensate for the 5% reduction in the median sales growth rate.

Therefore, with median price/sales ratios close to record levels, our cautious views on equities remain in place. We note that in Europe at least, bond market returns this year have handsomely outstripped those of equities.

Exhibit 7: Median non-financial EBITDA margins (1991-2013) and consensus forecasts (2014-2016)



Source: Bloomberg

Declining commodity prices will help consumers

The $30/barrel reduction in oil prices since the summer may have a twofold beneficial impact on oil-consuming nations such as Europe. Firstly, lower oil prices will act as a stimulus to consumer spending, acting as an automatic stabiliser in terms of demand. Secondly, it would appear that the ECB in particular is not prepared to look through to core CPI in its fight to ensure inflation expectations remain anchored, thus providing a further reason to engage in QE sooner rather than later.

We also note the recent cut in interest rates in China, which in our view indicates that the People's Bank of China has started to move to limit the pace of the ongoing slowdown. While China’s authorities are carefully trying to avoid incentivising mal-investment in industries with overcapacity, there would appear to be room to soften the stance of monetary policy somewhat, which may be supportive for the global mining sector – currently one of the few sectors trading below long-run valuation levels.

Conclusion

Investors have become increasingly reliant on central banks to drive asset prices as valuations have become stretched and corporate revenue growth has slowed during the post-2008 period, reflecting the sluggish performance of global GDP. For 2015, investors would already appear to be looking forward to further ECB action and we recognise that this is likely to be supportive for equity markets in the short run. However, the valuation signals cannot be ignored; the possibility of central bank intervention is the only reason we are cautiously positioned rather than more negative. In Europe, increasing political risk should be on investors’ agendas.

In bonds, yields have declined sharply since the start of the year and are now at levels that are inconsistent with policymakers' objectives for inflation or growth. While bonds may still have some utility as a hedge against a significant economic slowdown, strong performance this year is likely to lead to only modest returns in most other scenarios.

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