EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Bonds trump equities

- **2014 has proved to be the year of the bond market.** Declining growth and inflation expectations confounded the consensus and yields have moved steadily lower. By contrast, major equity markets, outside the US have underperformed initially high consensus expectations.
- **Keep focused on the bigger picture.** The collapse in the oil price and the Russian rouble are currently in the headlines, but a combination of factors is driving increased risk aversion. Purchasing manager's indices outside the US show a significant slowing of growth during H214. A strongly rising dollar hints at tighter US monetary policy next year and more difficult conditions for those dependent on US dollar-denominated debt funding. Much will depend on the US Federal Reserve's willingness to emphasise or downplay international factors when setting US interest rate policy.
- **Oil price declines likely to support economic activity – in the medium term.** Studies of previous oil shocks indicate that a modest growth stimulus is likely to result from the recent decline in the oil price. If one of the economic weaknesses of the current decade is a lack of wage growth, declining energy prices for consumers should be welcomed over the medium term. However, in the short term investors should factor in a significant reduction in energy sector capex, surging credit spreads in energy-related bonds and fewer petrodollars to be recycled into global asset markets.
- **Too soon to move on equities in general.** In the space of only a few days, European equity markets have completely given up November's "central bank bounce". Comforting press leaks from monetary policymakers have been conspicuous by their absence during December. While the FTSE 100 may have recorded its second sharp reversal this quarter, once again we do not believe there is a buying opportunity as valuations remain too high for equities in general.
- **Bond yields price in a disinflationary environment.** Bond investors have been the big winners of 2014. It remains in our view a time to take profits; the Bank of Japan has reminded us that central banks always have it in their power to generate inflation, even if real growth is harder to achieve. Bond yields are now effectively pricing in the failure of central banks to achieve their inflation targets.
- **Few attractive options for investors**. Those who bought into the central bank narrative in recent weeks will have been left nursing losses. Even as European equities return to the lows for 2014 we struggle to see the buying opportunity, with valuations still substantially above long-run averages. For professional portfolio managers, holding cash can be an uncomfortable proposition. However, unless the US Federal Reserve is prepared to keep monetary policy looser than warranted by US domestic conditions to ward off potential external risks, continued global volatility is likely to lie ahead.

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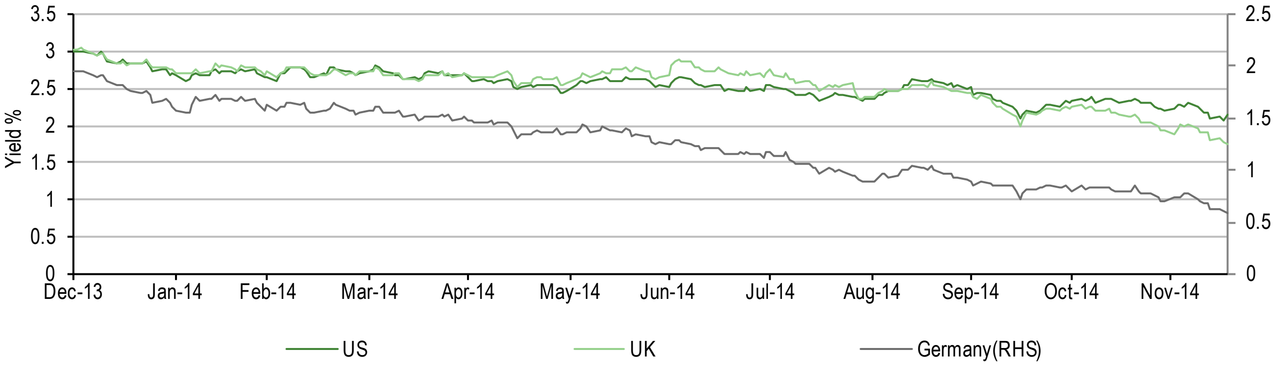
2014: Bonds trump equities

Declining growth and inflation expectations and a prevailing consensus at the start of the year that yields were set to rise has meant that 2014 has been the year of the bond market. For 10-year maturities, yields have declined by 80bp to 2.1% to and 120bp to 1.8% in the US and UK respectively, while in the eurozone investors in German bunds have benefited from yields declining by 130bp to record lows of only 0.6%.

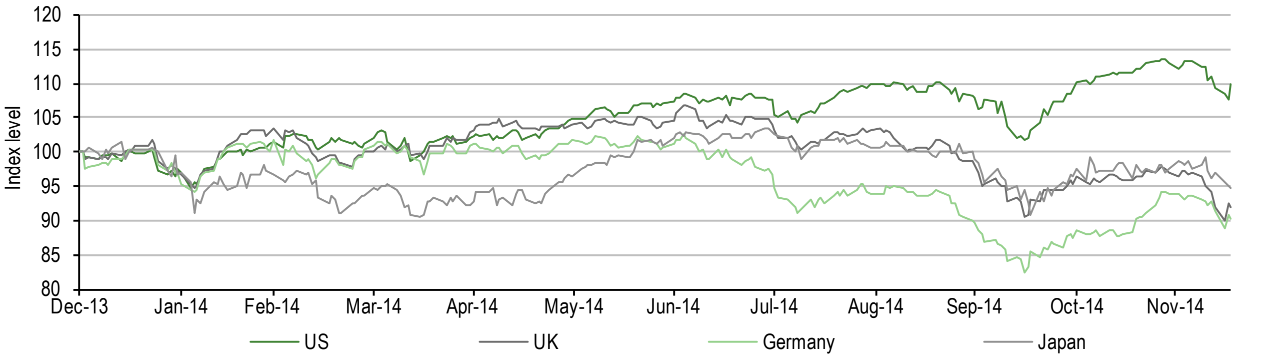
Exhibit 1: Year-to-date global bond yields



Source: Thomson Reuters Datastream to 17 December 2014

In equities the outturn for 2014 is very close to our predictions at the start of the year; initially high valuations have proved to be a significant headwind for many markets, with the notable exception of the US. In Europe and the UK markets have struggled to break through levels recorded as long as 18 months ago, Exhibit 2.

Exhibit 2: Year-to-date global equity market returns (US$)



Source: Thomson Reuters Datastream to 17 December 2014

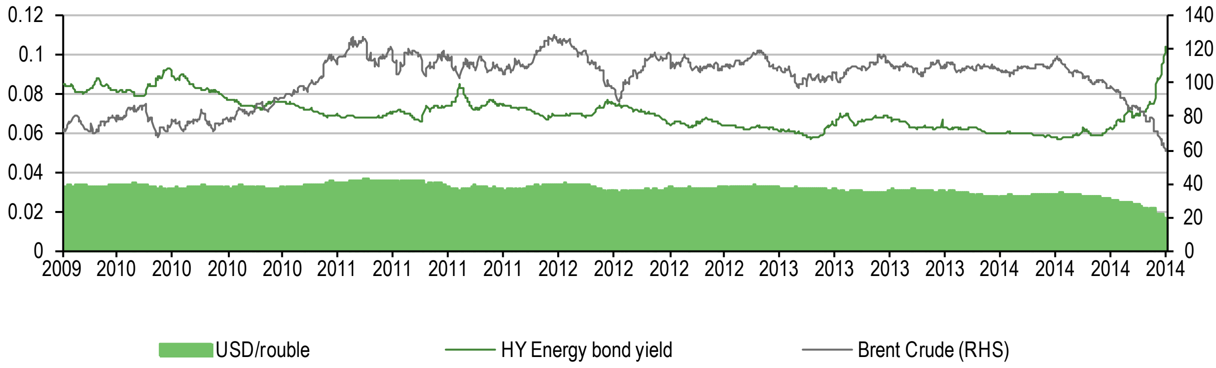
These year-to-date investment results are not a surprise to us; in addition to our valuation concerns, we have in a number of recent notes highlighted slowing revenue growth and what appear to us to be unsustainably high corporate profit margins. We also believe the very low interest rate environment has led to a misplaced reliance on relative value measures such as the comparison between yields on bonds and the (higher) dividend yields available on equities.

As we look towards 2015, we have not changed our cautious outlook. Firstly, equity valuations remain expensive, even if there has been some moderation in valuations in recent weeks. Secondly, growth momentum outside the US remains weak. Thirdly, we may be entering a period where US monetary policy fails to reflect increasing external risks to the US economy.

Oil shock to benefit world economy – eventually

The acceleration of the decline in oil prices in the second half of 2014 is a further indication of an unanticipated slowing of global growth, but also represents a wealth transfer from oil-producing sectors to consumers. Markets are currently focused on the damage to the oil-producing sector, as evidenced by the exchange rate volatility in Russia and the widening credit spreads of high-yield bonds issued to finance shale oil production in the US, Exhibit 3. We would also highlight that oil-based sovereign wealth funds, which account for approximately $5tn of worldwide assets, are likely to see a substantial slowing in asset accumulation and consequently may reduce investment flows into developed market bonds and equities.

Exhibit 3: Oil, Russian rouble and high-yield energy bonds



Source: Thomson Reuters Datastream

For consumers, in an environment where the lack of income growth is seen to be an impediment to achieving a sustainable economic recovery, a reduction in energy costs should be beneficial. However, this positive effect on consumers is not likely to be immediate as behaviour is only likely to change once the reduction in energy costs is perceived to be permanent. In addition, it remains to be seen how much incremental spending results, as the preference for saving over spending remains an unknown.

In Europe, the beneficial effect of lower oil prices may be augmented by the prospect of greater urgency in terms of outright QE (unsterilised sovereign bond purchases) in Europe. An ECB consensus on outright QE is proving difficult to reach as Germany continues to fear implicit fiscal transfers, but declining oil prices will only push headline inflation even further below target.

Keep focused on the bigger picture – policy/growth divergence

Investors should in our view avoid the temptation to become sucked into specific narratives such as events in the oil market or the related volatility in Russia. Taken together, a stronger dollar, more volatile equity markets, declining commodity prices and routs in emerging market currencies are hallmarks of periods of tightening US monetary policy.

The anomaly in the context of an improving US economy is declining US inflation expectations; if interest rates were not already at the lower bound the yield curve might have been at some risk of inversion. In our view US bond markets are being driven by declining growth expectations outside the US. With the US dollar still the pre-eminent global funding currency, the divergence between a monetary policy suitable for the US and one suitable for the rest of the world is likely to be an acute pressure point for global markets during 2015.

Conclusion

Those who bought into the central bank narrative in recent weeks will have been left nursing losses. For the second time this quarter, even with European equities close to their lows for 2014, we struggle to see the buying opportunity with valuations still substantially above long-run averages and doubts over global growth proving increasingly valid as commodity prices decline. We remain of the view that outright QE by the ECB is one of the few potential positives for eurozone equities.

For energy markets, the decline in the oil price is consistent with moves in other commodities and in addition there are sector-specific concerns in terms of rapid supply growth. In time, energy consumers will benefit from lower energy costs and that should improve the sustainability of global growth. However, the short-term impact may be negative as a significant number of new oil developments are cancelled and the flow of petrodollars into developed market assets is diminished.

Having been 2014's star performer, highly rated government bonds now have yields that imply economic outcomes strongly at odds with central bank targets for inflation and, by implication, economic growth. We do not expect such a strong performance from bonds in 2015.

A key risk for global markets is the ongoing divergence in growth prospects between the US and the rest of the world. We fear that unless the US Federal Reserve is prepared to keep monetary policy looser than warranted by US domestic conditions to ward off potential external risks, continued volatility, as recently seen in Russia, is likely to lie ahead.