Illumination: Equity strategy and market outlook

February 2015

Published by Edison Investment Research

EDISON

Global perspectives: Valuation – still relevant?

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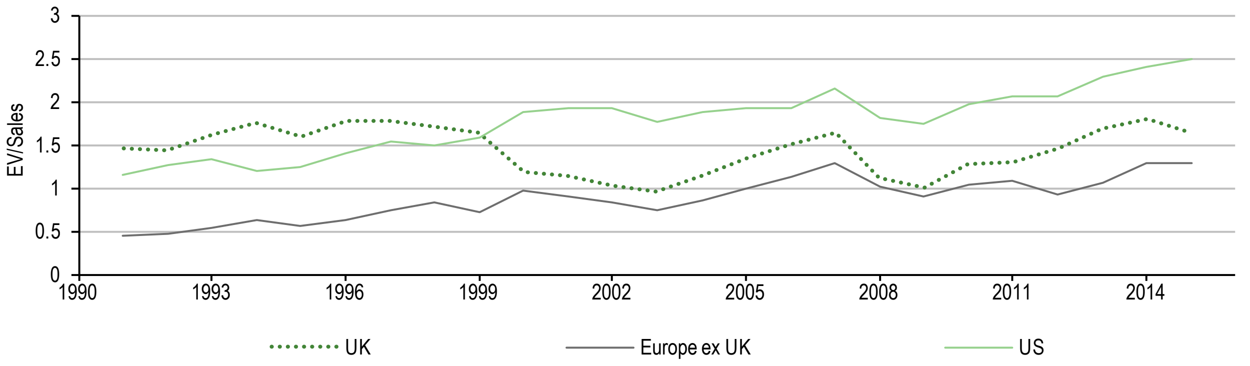
- **For the last two years investors have tolerated high valuations in equity markets.** This is a global phenomenon, in our view driven by the ultra-loose monetary policies of the world's major central banks.
- **We expect that as the US Federal Reserve starts to raise US interest rates this global re-rating is likely to go into reverse.** This statement does not imply a sensational crash is imminent or a sharp decline in equity prices is inevitable, but instead signals that significant headwinds to strong equity returns lie ahead, in an environment where sales and earnings growth on a global basis have slowed to a crawl.
- **Time to look for profit-taking opportunities in equities.** Since the lows in mid-December, the FTSE All World index has risen by 7% in US dollar terms as the introduction of ECB QE has strengthened investor confidence and the benefits of lower oil prices and long-term interest rates have fed through to eurozone activity. We expect the second half of 2015 will be a tougher environment than the first for risk assets and would look to take profits where there has been strong performance.

Is valuation still relevant?

For the last two years, the valuation measures for many of the world's major equity markets have remained stubbornly above long-term averages. This is a sufficient period of time for investors to legitimately consider whether valuation remains relevant in a world where asset prices have been driven by central bank policy to such a large extent.

We have estimated the extent of the overvaluation by sector for the US, UK and eurozone. Exhibit 1 shows the median non-financial EV/Sales multiple for each market, which is in each case at or near a 25-year high.

Exhibit 1: EV/Sales – median multiple for US, UK and eurozone non-financials

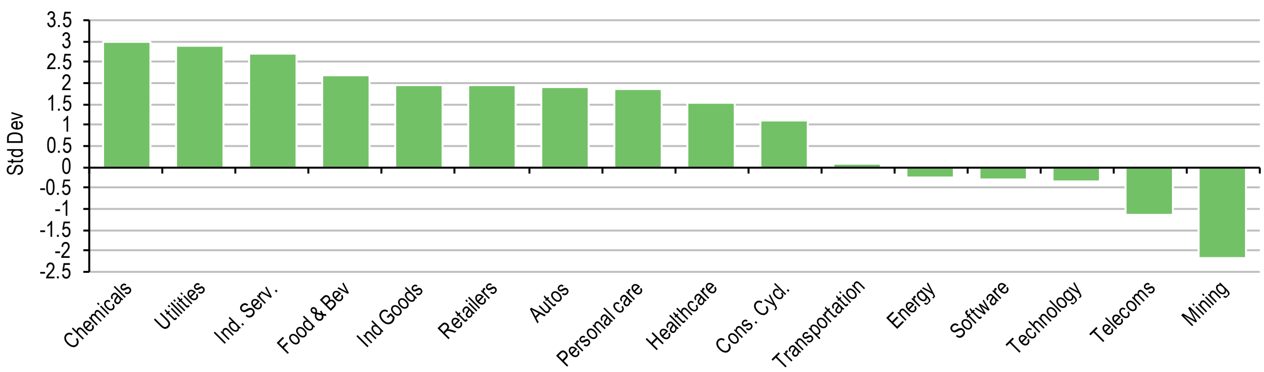


Source: Thomson Reuters Datastream, Edison calculations

In the US, on an EV/Sales basis the median stock is trading at 27% above the average level for the last 25 years (we would be pleased to provide the full range of valuation metrics to readers who are interested, although the conclusions are similar). Exhibit 2 shows this valuation 'stretch' is widely spread across sectors, with some trading two standard deviations above their long-run average levels. It is this spread of overvaluation that is making life difficult for active managers; during 2014, unsurprisingly, 80% of US active managers underperformed the Russell 1000 index.

On an EV/Sales basis the overvaluation would appear to be at its most extreme in the chemicals, utilities and industrial services sectors. By contrast, mining and telecoms are the only sectors trading significantly below their long-run average valuations. We would however caution that for both technology and telecoms the long-run average EV/Sales multiple is somewhat distorted by the 1998-2000 dot-com episode. But for less volatile sectors, we may be reaching the point where the perception of safety may be creating its own investment risks.

Exhibit 2: US EV/Sales – standard deviations above 25-year average by sector

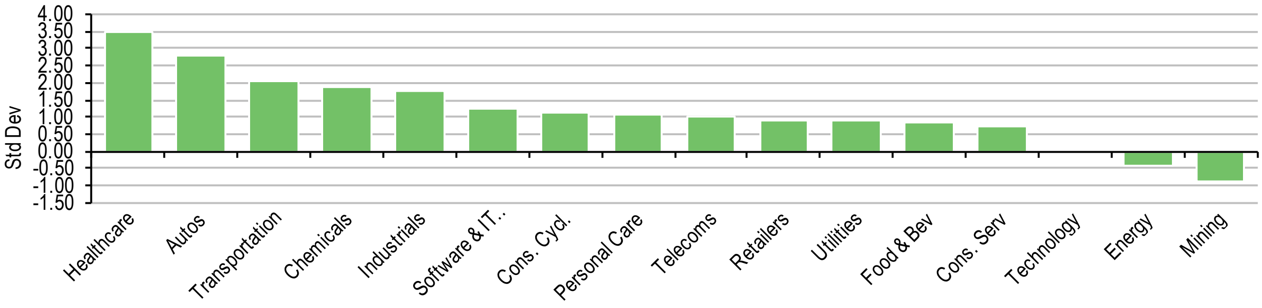


Source: Thomson Reuters Datastream, Edison calculations

In the UK, the pattern is similar with only mining and energy trading below long-run valuation averages. We believe that the combination of low valuations and a significant change in corporate behaviour, namely favouring returns to shareholders over capex, is supportive of share prices in the large-cap mining sector despite a difficult trading environment. The energy sector is likely to continue to recover as the oil price stabilises at a level that more closely matches supply and incremental demand.

However, for the remainder of the market, valuations are above or well above average with healthcare, autos and transportation trading at more than two standard deviations above long-term levels.

Exhibit 3: EV/Sales – median multiple for UK by sector

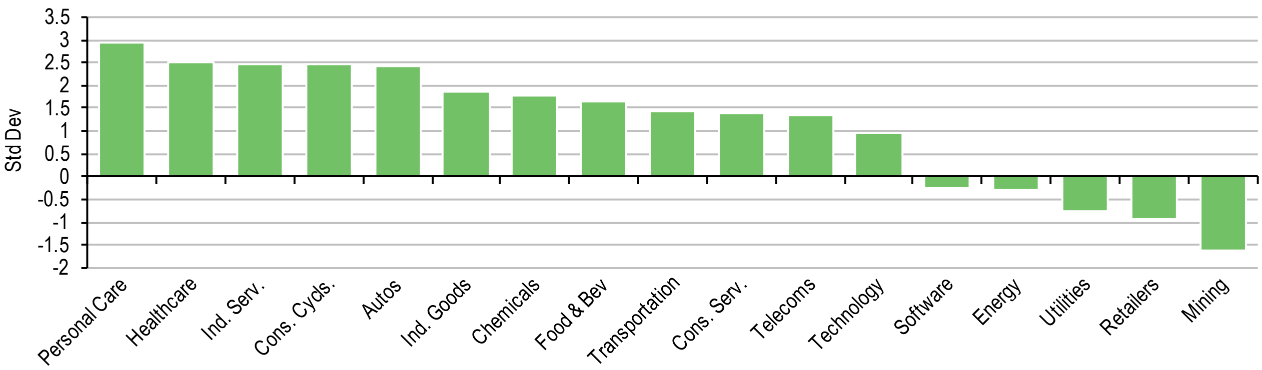


Source: Thomson Reuters Datastream, Edison calculations

For the eurozone, one could be forgiven for thinking that all was well in the region as a whole, if high valuations can be taken as a proxy for investor confidence in future prospects. Eurozone EV/Sales multiples are currently at their highest levels over the 25-year period of the data and, as in the UK and the US, the rich valuation levels are also broadly spread over a large number of sectors. It is unclear why we should expect strong price performance in future, unless the region's economy confounds supply-side factors, which indicate that growth will be modest for some years to come.

There would appear to be no discount for the possibility of further volatility in the eurozone. In this respect, we regard the recent bailout extension for Greece as another policy manoeuvre that buys more time but is unlikely to prevent the growth of political pressure for change in the periphery of Europe.

Exhibit 4: EV/Sales – median multiple for eurozone by sector



Source: Thomson Reuters Datastream, Edison calculations

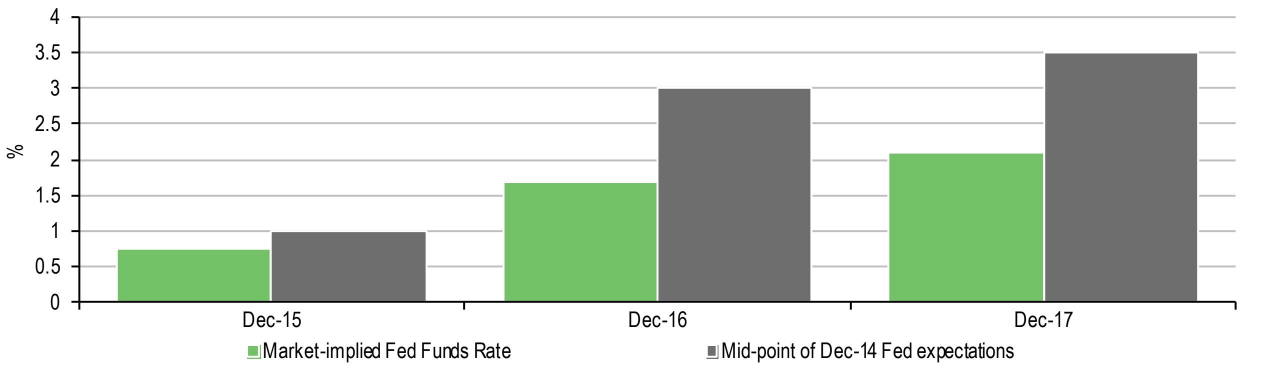
On a global basis we struggle to rationalise high equity valuations with slowing expectations for growth as forecast sales growth rates remain stubbornly below long-term averages; globally forecast revenue growth has fallen to around 6% post-2008 from 10-12% in earlier periods. As we have highlighted previously, the more likely cause of high valuations is the ultra-loose monetary policy pursued by all the world's major central banks in recent years, but most notably the US Federal Reserve.

The danger of this low volatility and slow drift of equity valuations away from fundamentals is reminiscent of the energy markets in 2014; it took a single policy change (Saudi Arabia's refusal to cut production) to trigger a 40% decline in the oil price. However, a decline of this magnitude in global equity markets would be regarded as a policy error by central bankers that have targeted asset prices as a means to boost confidence and bank solvency. Therefore, while a calamitous decline in equity values is certainly not our base case, with valuations significantly above long-term averages, a continued period of subdued performance seems likely.

There is in our view increasing risk in both fixed income and equity markets as the divergence between US market-implied rates and policymakers' expectations grows, Exhibit 5. The precise lift-off date for US interest rates is in our view less important than the policymakers' expectations for an increase in the Fed funds rate to close to 3% over the next 36 months. We are fully aware that similar expectations have proved to be wide of the mark in the past, but this time is different; unemployment is close to the Fed's long-term equilibrium levels and US wage growth has shown some tentative signs of picking up. There is a long walk back towards conventional US monetary policy and in our view traditional equity valuation remains as relevant as ever.

Some commentators believe that the Fed will once again delay increasing interest rates until 2016. This remains a possibility, but for now US inflation appears sufficiently close to target to justify starting the process of removing the extraordinary policy accommodation that has been in place since 2008. Furthermore, the risks to delay are increasing as US equity prices continue to rise from what even the Fed admits are elevated levels.

Exhibit 5: Divergence between market-implied and Fed policymakers' forecasts for US interest rates



Source: Thomson Reuters Datastream

Conclusion

Although world equity markets are nudging the levels last seen before the 2008 financial crisis, Exhibit 6, this is no cause for celebration in our view. An equity market that makes no progress for seven years will hardly set pulses racing. In addition, the FTSE 100 is only now breaking through levels seen as long ago as 1999. Recent performance has been achieved through an expansion of valuation multiples rather than increased profits and prospects for revenue growth, which leads us towards the view that equity returns are unlikely to surprise to the upside in future.

Exhibit 6: Global equity performance (US$)

Source: Thomson Reuters Datastream World Index

The pace may be glacial, but we believe the US Fed will embark on the long process of returning US monetary policy to a neutral stance in the second half of the year as US unemployment continues to decline, wage growth improves and the one-off impact of the decline in the oil price comes out of the annualised inflation rate by Q315. The correlation between medium-term equity returns and valuation measures is relatively strong. Investing at high valuations has historically often resulted in either periods of subdued performance or losses. With the data at hand, investors have been warned – valuation is still relevant.

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