Illumination: Equity strategy and market outlook

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Global perspectives: Range bound

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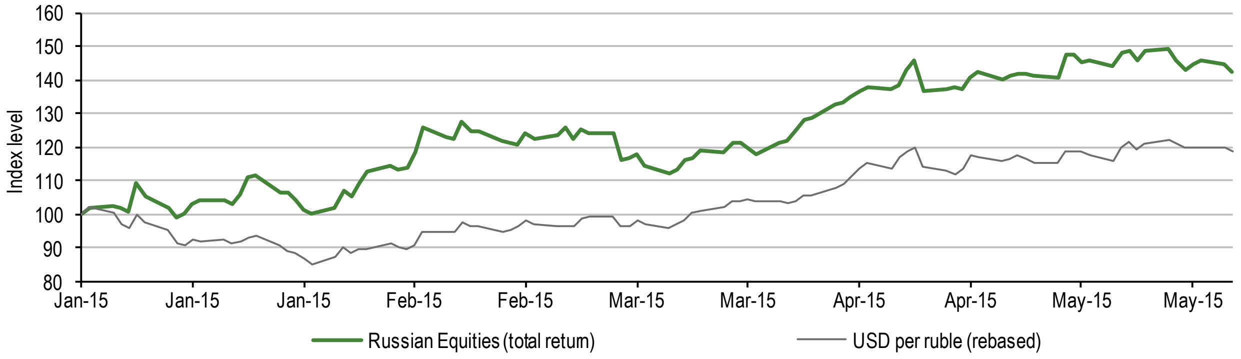
- **We can see no compelling reasons for US and European equities to trade significantly above or below current levels in the short-term.** The positive economic surprise in Europe during H115 may have driven the reflation trade which pushed up energy prices, equity markets and bond yields but expectations have now caught up.
- **Increasing uncertainty in the outlook for the US economy** – incoming data from the US has continued to disappoint in recent weeks. At this point, it is not clear to us that the weakness in growth is temporary; there has been something of a recovery in US earnings estimates in recent weeks but the economic data is still surprising to the downside. Buyback activity may be supporting US equity prices at present in a manner reminiscent of central banks' bids for government bonds but valuations remain stretched and longer-term returns are likely to be modest.
- **And increasing uncertainty regarding US Fed policy** – we are sure US Fed policymakers would have preferred to see US growth clearly demonstrating 'lift-off' before interest rates followed. The current language being used by Fed policymakers indicates a desire to look through the soft patch in the GDP data, but monthly durable goods data has not been encouraging.
- **Running a cautious portfolio position but maintaining exposure to Russia and energy while avoiding bonds has proved the right call.** The 40% gain in US dollar terms in Russian equities during 2015 suggests further gains are likely to prove slower from here. Despite the recent increase in yields, in our view eurozone bond yields remain exceptionally low relative to the ECB's inflation target. Perhaps the only thing that is more dangerous than being bearish for an investment strategist is a suggestion that there may be no short-term themes to play. But we would prefer to say that rather than recommend low-conviction trades.

Range bound

We approach the mid-point of the year with the strong improvement in European economic sentiment behind us. Surging confidence in Europe has eased fears of global deflation and in the process partially reversed the direction of Europe's triple stimulus of lower energy prices, the euro and eurozone government bond yields.

At the same time as fears of a European double-dip recession proved unfounded, tensions between the US and Russia have subsided. This is perhaps more evident from what appears to be a PR ceasefire from both sides as on the ground in Ukraine the truce remains uneasy with continued reports of fighting. Sanctions may remain in place, but both the Russian rouble and equity market have performed strongly this year, Exhibit 1. Russian equities have been among the best performing year to date with gains of 40% in US dollar terms.

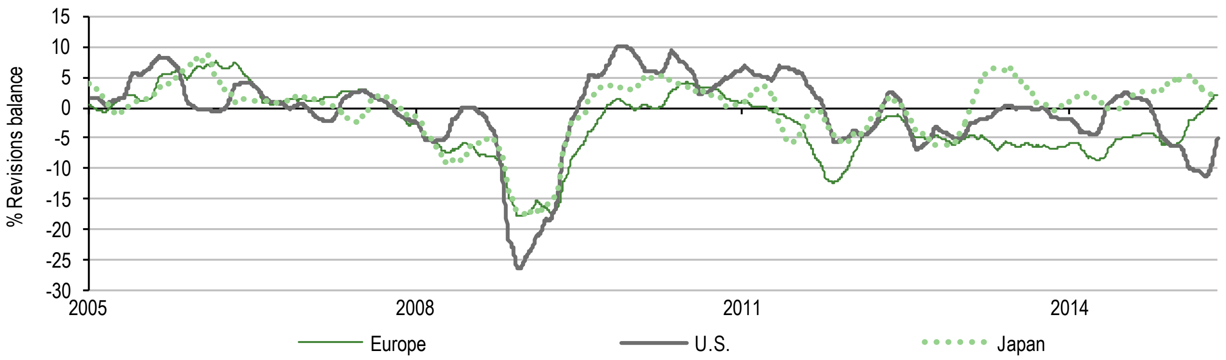
Exhibit 1: Russian equities USD performance year to date and USD/RUB



Source: Thomson Reuters Datastream

Another trade which we favoured earlier in the year was increasing exposure to the energy sector. This has now largely played out as oil prices are now much closer to a level which would incentivise increased onshore US drilling activity and we do not expect the oil price to rise significantly from here. Given the uncertainty over US economic prospects the opportunity to enter this trade appears to have passed.

Exhibit 2: Global earnings momentum still favours Europe

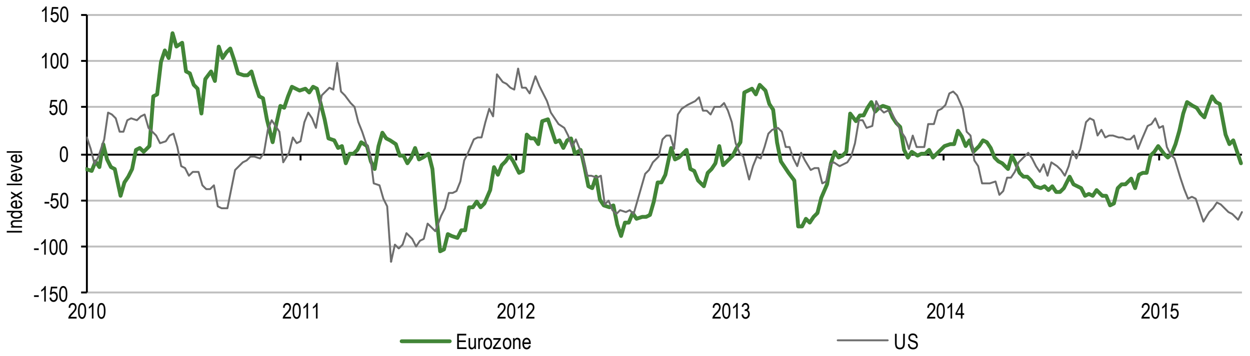


Source: Thomson Reuters Datastream

European and US equity markets have recently been struggling for direction. Earnings momentum still favours Europe over the US, Exhibit 2, but we wonder for how long upgrades will continue, given the catch-up of economic expectations to the improving data, Exhibit 3.

We are certainly struggling to find new themes for investment with so much of the equity universe trading at extended valuation levels and revenue growth weak, even if these are not new observations. The preference of the US corporate sector for buyback activity over investment may be partly related to management incentives to increase earnings per share but is also consistent with our view that growth prospects remain lower than in the pre-2008 period.

Exhibit 3: US and Europe economic surprise indices



Source: Thomson Reuters Datastream

US economic uncertainty – a key risk

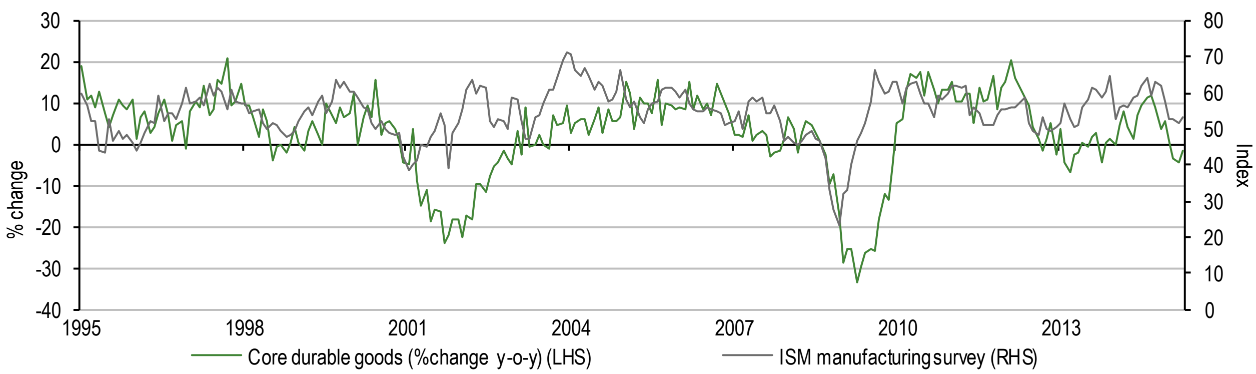
Last month, we highlighted the slowdown in US economic momentum which had pushed out market expectations for the first US interest rate increase from June to September. We are becoming more relaxed about this totemic change in US monetary policy for global markets as the danger for asset prices was a surge in US growth which may have led, from the perspective of the global economy, to an ill-timed tightening of US interest rate policy.

Even if US unemployment and inflation levels indicate that rates should rise, the US Fed may be reluctant to raise rates following two quarters of sub-trend growth, supporting the case for a September move. We believe it is too early to tell if Q1 weakness was a blip; core durable goods orders are now shrinking on a year-on-year basis and ISM manufacting survey has softened sharply in recent months, Exhibit 4.

For these reasons, and unless there is a significant switch in the direction of the data, we believe US policymakers will wait at least until September to raise US rates and with core US inflation close to target at 1.8% US real rates will remain very low for some time.

We are increasingly of the view the first increase in rates will be widely discussed but in contrast to the the 'taper tantrum' of 2013 will ultimately turn out to be a market non-event. Securities markets are supposed to be efficient discounting mechanisms and there are few policy decisions which have been more carefully flagged to the markets.

Exhibit 4: US core durable goods (year on year) and ISM manufacturing survey



Source: Thomson Reuters Datastream

Conclusion

We believe global markets remain highly priced and believe investors should position portfolios with greater weight on the long-term return as there are few obvious value-enhancing tactical opportunities at present.

From a probabilistic perspective, investors should also consider the risks of screening an increased number of potential investments when true opportunities are thin on the ground. Such a process may only increase exposure to investment errors rather than investment opportunities. Patience remains an important investment discipline.

Focusing on the longer-term also brings the risks of the extended and widespread use of unconventional monetary policy into sharper relief; valuation may point to a cautious positioning but the final act of desperation of a central bank under pressure to ensure either private or public debt sustainability, is to create inflation. A portfolio wholly invested in cash therefore carries its own purchasing-power risks. Rather than optimising for returns in a specific scenario, the optimal approach may be to focus on the least-bad portfolio for a variety of outcomes.

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