



Illumination: Equity strategy and market outlook

May 2015

Global perspectives: Range bound

- **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.

Analyst

Alastair George

+44 (0)20 3077 5700

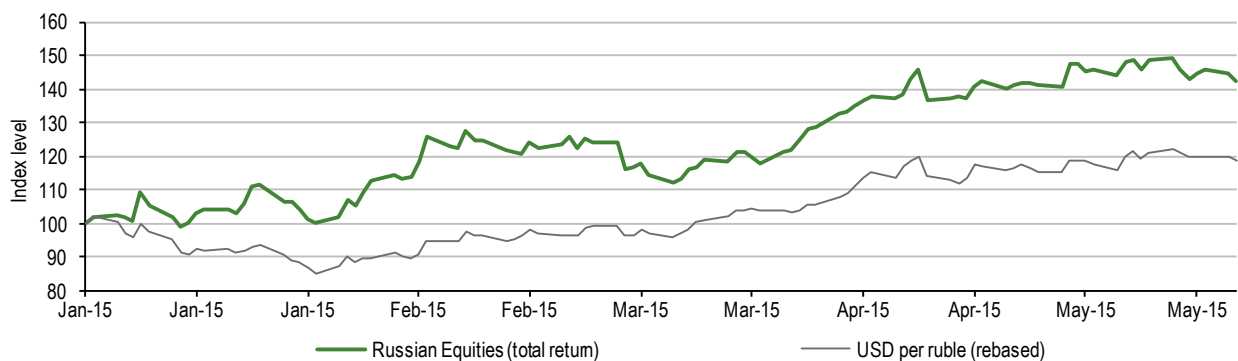
institutional@edisongroup.com

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.

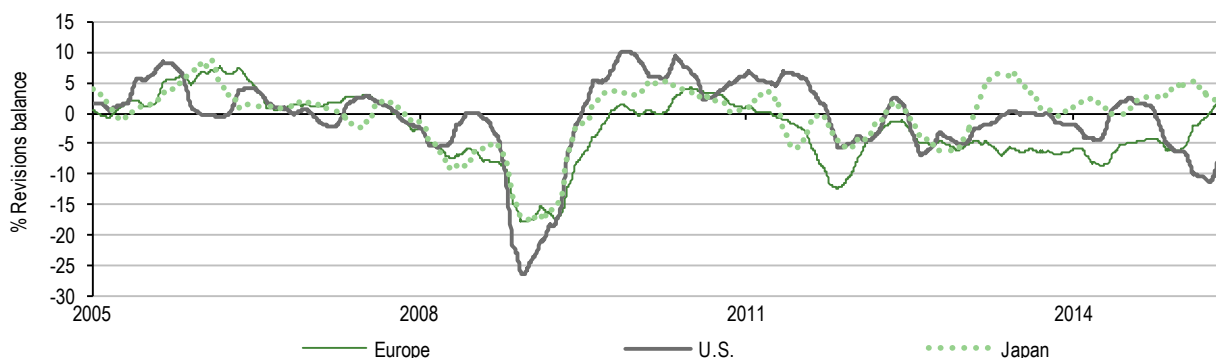
Exhibit 1: Russian equities USD performance year to date and USD/RUB



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



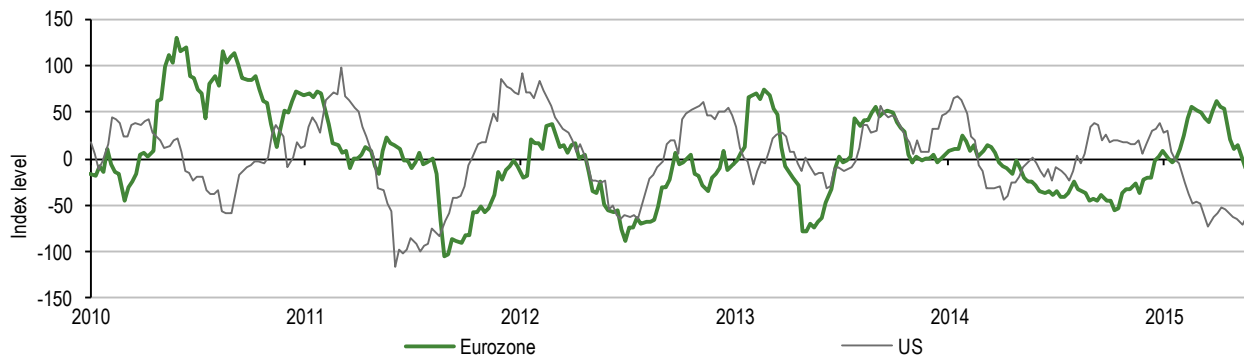
Source: Thomson Reuters Datastream

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

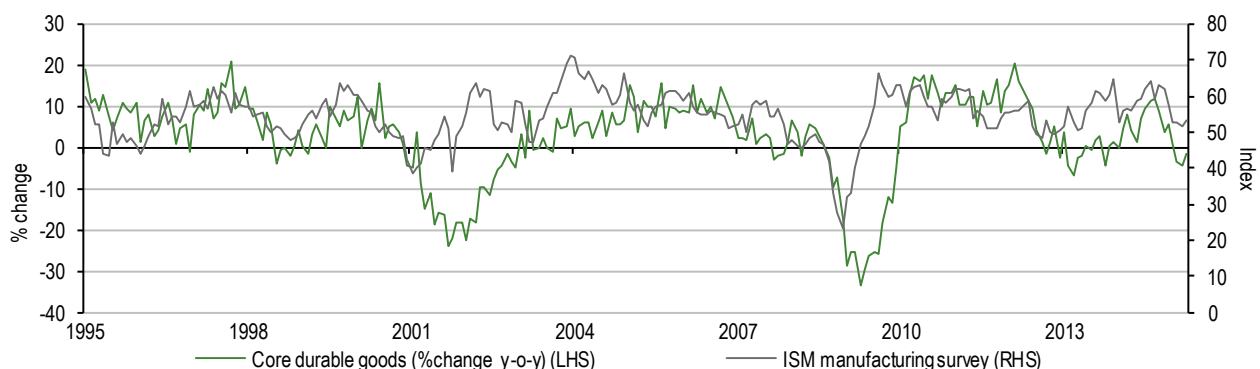
Last month, we highlighted the slowdown in US economic momentum which had pushed out market expectations for the first US interest rate increase from June to September. We are becoming more relaxed about this totemic change in US monetary policy for global markets as the danger for asset prices was a 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 manufacturing 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.

Edison, the investment intelligence firm, is the future of investor interaction with corporates. Our team of over 100 analysts and investment professionals work with leading companies, fund managers and investment banks worldwide to support their capital markets activity. We provide services to more than 400 retained corporate and investor clients from our offices in London, New York, Frankfurt, Sydney and Wellington. Edison is authorised and regulated by the Financial Conduct Authority (www.fsa.gov.uk/register/firmBasicDetails.do?sid=181584). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison and is not regulated by the Australian Securities and Investment Commission. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

DISCLAIMER

Copyright 2015 Edison Investment Research Limited. All rights reserved. This report has been prepared and issued by Edison for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. This research is issued in Australia by Edison Aus and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. The Investment Research is distributed in the United States by Edison US to major US institutional investors only. Edison US is registered as an investment adviser with the Securities and Exchange Commission. Edison US relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. As such, Edison does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). It is not intended for retail clients. This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison has a restrictive policy relating to personal dealing. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report. Edison or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Edison, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication. FTSE International Limited ("FTSE") © FTSE [2015]. "FTSE" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
United States

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place
88 Phillip Street, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand