EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Help to buy?

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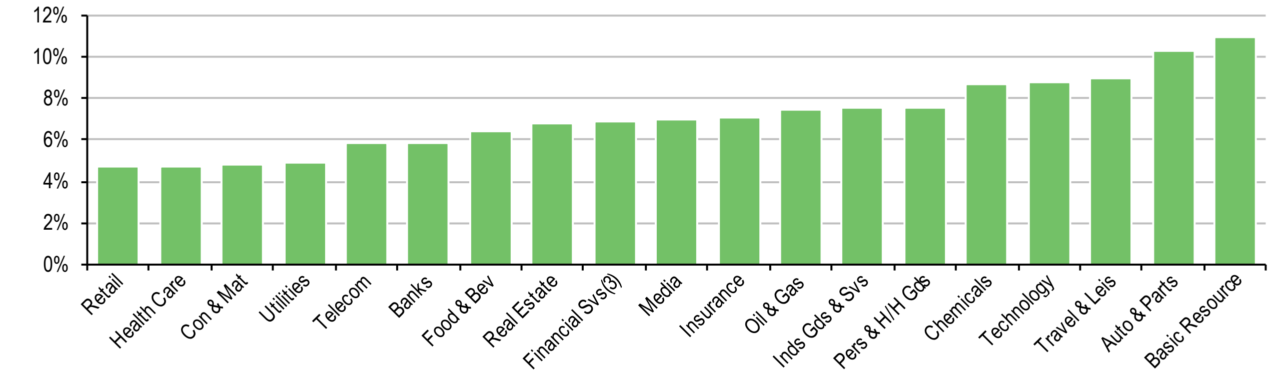
- **Market sentiment has refocused on the scope for central banks to ease policy.** Interest rates have been cut in China, while the ECB has signalled as clearly as it can that more monetary stimulus will be deemed necessary by December. Forward expectations for interest rates have continued to move lower, in both the US and Europe.
- **This central bank 'help-to-buy' dynamic has buoyed equity prices, as we have previously suggested it might.** However, we have misgivings on the sustainability of this risk-on environment. The underlying parameters that dictate the long-run returns on global equity markets, namely valuations and the outlook for profits growth, are discouraging. Equity valuations in general remain extended and, in addition, the recent economic volatility has led to a marked deterioration in earnings momentum in every major economic region.
- **The recent rally in global markets is therefore, in our view, an example of volatility rather than a new uptrend.** While the term volatility and falling prices appear to have become synonymous in global media in recent years, we prefer to use the traditional definition; volatility describes the variability of prices. In this respect we would not be at all surprised to see markets give up some of the recent gains.
- **Yesterday's FOMC statement was more hawkish than we expected.** The rebound in global markets also seems to have rekindled the US Fed's willingness to raise interest rates in December, even as US economic momentum has slowed. It is hard to avoid the impression that the US Fed has become market-and-date rather than data-dependent. In our view, this statement will make investors hesitate before chasing this rally.
- **Conclusion.** Investors have correctly anticipated further easing from the ECB and China's central bank. However, the most recent FOMC statement clearly indicates a much higher probability that the US Fed will raise rates in 2015 than the market appeared to be expecting. While the looser-for-longer global monetary policy outlook may have been a reason to refrain from panic and not exit equities during August, it is not at all clear that October's mini rally will run much further without implicit encouragement from the US Fed.

Help to buy?

Recent weeks have seen a remarkable recovery in global equity prices given the very limited change in the fundamental outlook. But at the same time as this recovery in equity risk appetite, earnings estimates have continued to fall across each of the major economic regions. The downgrades in the basic industry sector were well anticipated and this sector has been the strongest performer in the recent rally, Exhibit 1.

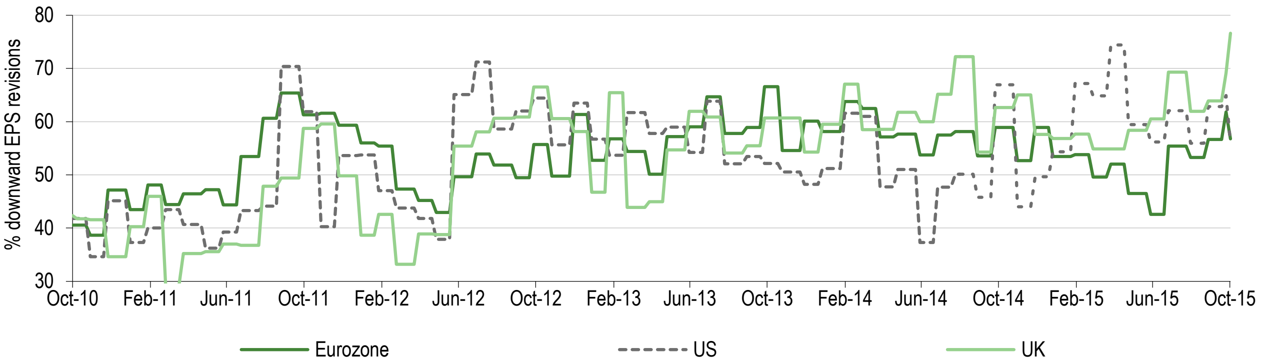
Exhibit 1: Global sector performance end-September to 28 October 2015 (US$)



Source: Thomson Reuters Datastream

However, we would highlight that the knock-on effects of lower commodity and energy prices are still feeding through to downgrades in the industrial sector in the US, UK and eurozone, Exhibit 2. These second-order effects on the supply chain are likely to result in a continued drip-feed of declining profits guidance into the end of the year.

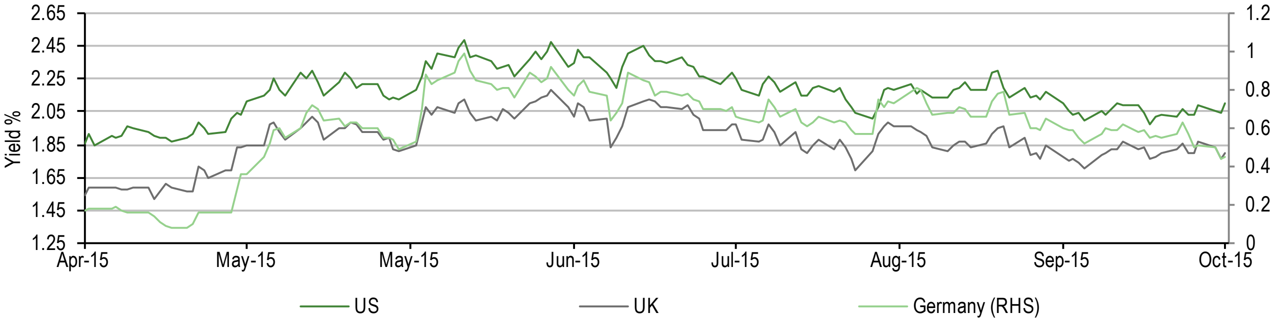
Exhibit 2: Industrials sector – downward earnings revisions as percentage total



Source: Thomson Reuters Datastream, Edison calculations

Despite the recent equity market rally, the bond market remains unconvinced; yields remain significantly lower than at the mid-point of the year, reflecting lower inflation expectations, Exhibit 3.

Exhibit 3: No rebound in 10-year bond yields since highs of June 2015



Source: Thomson Reuters Datastream

In our view, behind these apparently contradictory market moves (with growth-sensitive assets such as equities higher and bond yields lower) lie the still highly visible hands of the world's major central banks. In September, a long-flagged US interest rate increase did not materialise, while in China monetary policy is now being eased. During its October monetary policy press conference, the ECB could not have sent a clearer signal that it believed further monetary easing would be required by December, sending the euro down 3% against the dollar on the day.

The anticipation of this monetary response has helped investors buy into (or at least stop selling into) the recent deterioration in global growth prospects. Furthermore, within the strong rebound in global markets during October, it has been cyclically sensitive sectors such as basic materials, autos and technology that have outperformed, Exhibit 1.

But as a liquidity-driven rally, with very little support from the underlying economic and corporate data, which to date have shown few signs of reaching a turning point, we believe this rally is at risk of at least a partial reversal following the most recent FOMC statement released yesterday.

Is the Fed data-, date- or market-dependent?

October's FOMC statement gives us pause for thought as the statement was widely expected (including by us) to be dovish. The market-implied probability for a December increase in US interest rates had declined to its year low going into the FOMC meeting.

However, the insertion of language that highlights December's meeting as one where a rate increase will be considered appears to be an attempt to focus the market on a calendar date. The more hawkish tone of the statement also contrasts with the FOMC taking note of the slowing pace of US job growth. Commentary referring to the potential for recent economic and financial events to restrain economic activity has been removed.

In the context of a slowing US economy, the most recent FOMC statement leans towards the uncomfortable interpretation that, subject to benign market conditions, the US Fed aims to raise US rates in December with relatively little weight being given to the loss of near-term US economic momentum

Furthermore, as the ECB's thoughts on the need for additional monetary stimulus were published only days earlier, this statement also implies a Fed that is relaxed about the depreciation of the euro, which dropped by a further 2% against the dollar post the FOMC statement. This may help Europe, but will not ease concerns over the strength of the dollar on US corporate profits. An additional implication may be that Fed policymakers' concern has eased in terms of the potential for a destabilising rise in the dollar against emerging market currencies, an outcome that many investors continue to fear following the market declines during August.

Therefore, despite the initially positive US equity market reaction to the statement, we believe investors should reserve judgment; this looks more like a statement of intent to raise US interest rates in December, rather than to delay into 2016. It was only a few weeks ago that some commentators believed further US QE was just around the corner; that prospect now seems remote.

Conclusion

Incoming data during October continu to indicate that profits momentum is slowing on a global basis, and yet markets have rebounded strongly from the lows of September. Given the strong hints that the ECB will be loosening monetary policy further during December, yesterday's hawkish FOMC statement strikes a somewhat discordant note in this risk-on period for the markets.

The initially positive US equity market reaction to the statement may well prove unsustainable in our view. To us, subject to stable market conditions, the Fed appears much less dovish than we thought one month ago. While the looser-for-longer global monetary policy outlook may have been a reason not to panic and exit equities during August, it is not at all clear that October's mini rally will run much further without implicit encouragement from the US Fed.

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