EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Bounce perhaps, boom no

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- **Central banks in the early stages of soothing markets.** Comments from Bank of England Governor Carney (19 January) and ECB president Draghi (25 January) may have helped stabilise markets, but the key player is the US Fed. The FOMC statement on 27 January indicates the Fed's views are now also converging on the lower market expectations for US interest rates. While a bounce in global markets is a distinct possibility in the short term, if profits forecasts do not improve such a rally would be unsustainable in our view, given still-high valuations.
- **Away from today's focus on central bank influence, the subdued performance of equities is closely correlated to declining earnings forecasts.** In the UK, profits forecasts during 2015 fell at the sharpest pace in the last 10 years, including 2008. Plotting market performance against a profits forecast index shows a remarkably close correlation in each of the US, UK and continental Europe. We would also highlight that while Oil and Mining have been the focus for downgrades over the last year, there is little upward momentum in any sector.
- **At current valuations, equities are still not priced for downgrades.** Price/book and price/sales valuations remain well above average in developed markets, so it is too early to argue that equities are so cheap near-term earnings do not matter. In fact, the correlation between negative sector performance and negative earnings momentum remains high at present.
- **In 2016 markets have moved fast, but insufficiently far for us to change our cautious strategic view (much as we would like to!).** As we expected, the yield curve has flattened to correctly reflect a slowing pace of economic activity. Equity markets have fallen, but they have not de-rated and do not offer sufficient value to be immune to further downgrades. To become more positive on equities we would need to see still lower valuations or have increased confidence that the US dollar has peaked, in addition to some evidence that the pace of earnings downgrades has slowed.

Bounce perhaps, boom no

As markets fell in the first part of January, a bull market in bearish analysis started to develop. We are not unfamiliar with the bear case having consistently highlighted the overvaluation of developed market indices in recent years. The risk of a correction has been increasing since the US Fed in particular stepped back from policies which pushed global indices higher. Former Fed policymaker Richard Fisher's comments on CNBC (6 January) on how he was part of a group that "*frontloaded a tremendous market rally*" still have the ability to shock, even if it is not exactly groundbreaking news.

"It was the Fed, the Fed, the Fed, the European central bank, the Japanese central bank, and what are the Chinese doing? All quantitative easing driven by central bank activity. That's not the way markets should be working. They should be working on their own animal spirits, but they were juiced up by the central banks, including the Federal Reserve…"

So, with US monetary policy significantly less investor-friendly, it should not be a surprise that 2016 has started out with the same volatile trading conditions seen at the end of 2015. In early January, Fed Vice-Chairman Stanley Fischer's comments appeared to confirm that the US Federal Reserve's view of the US economy remained more upbeat than that of market participants, thus implying a hawkish bias relative to market-implied forward interest rates. Investors perceived limited central bank 'put' protection at the time; but it remained our view that the Fed would change course in the event of either a further major equity market sell-off, or a shortfall in economic activity.

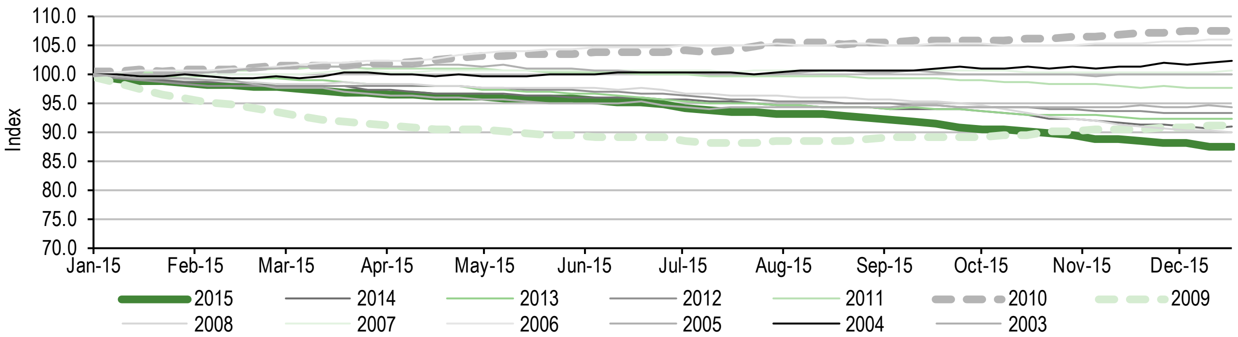
January's FOMC statement contained the tell-tale signs of a softening of December's hawkish rhetoric by referring to a slowdown in US growth at the end of 2015 and as importantly, stating that the FOMC is assessing the implications of global economic and financial developments. Notably, the risks to the outlook are no longer described as balanced. We would highlight that this softening had been fully anticipated by money markets as two-year US yields were unchanged on the news.

The effects of the extended period of unconventional monetary policy have stretched beyond the financial market domain into the real economy. Away from the headline narratives of China's slowdown and the flip/flop switches in policymakers' views on the direction of monetary policy in recent quarters (which appear rather too closely related to the most recent direction of financial markets), investors are faced with rapidly declining profits forecasts.

Earnings revisions moving markets

It is well known that analysts tend to start the calendar year with overly-optimistic profit forecasts that decline as the year progresses. However, we think earnings forecasts are currently being neglected – for example in the UK, 2015 was the worst year for earnings revisions since 2007, Exhibit 1. One could be forgiven for thinking that a global recession was on its way given the pace of the declines.

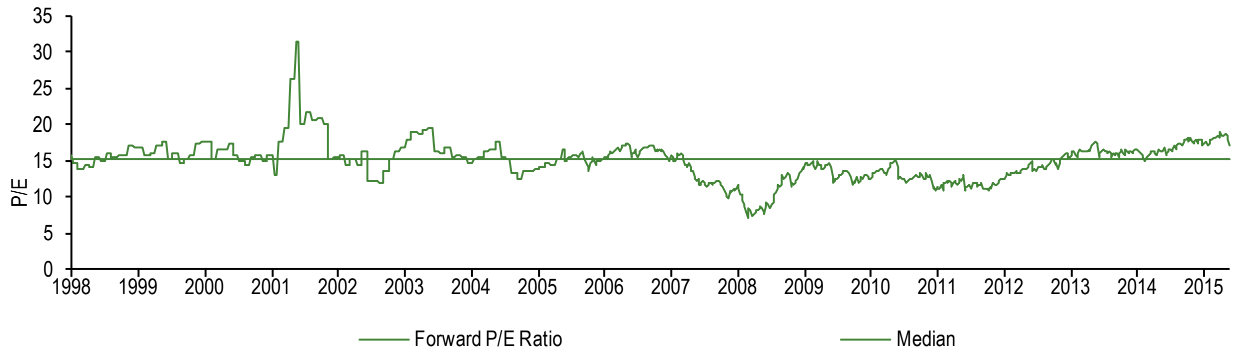
Exhibit 1: UK earnings revisions in 2015 compared to history



Source: Thomson Reuters Datastream, Edison calculations. *Chart shows monthly evolution of consensus FY1 earnings forecasts*

Given these continuous downgrades, the harsh reality for the UK's FTSE 250 – which is supposedly exposed to the growth in the UK's domestic economy – is that all of the gains recorded in 2015 represented P/E multiple expansion. FTSE 250 profits have remained stubbornly unchanged since 2013. As a result, the index is currently trading at one of its highest forward P/E multiples of the last 15 years, Exhibit 2.

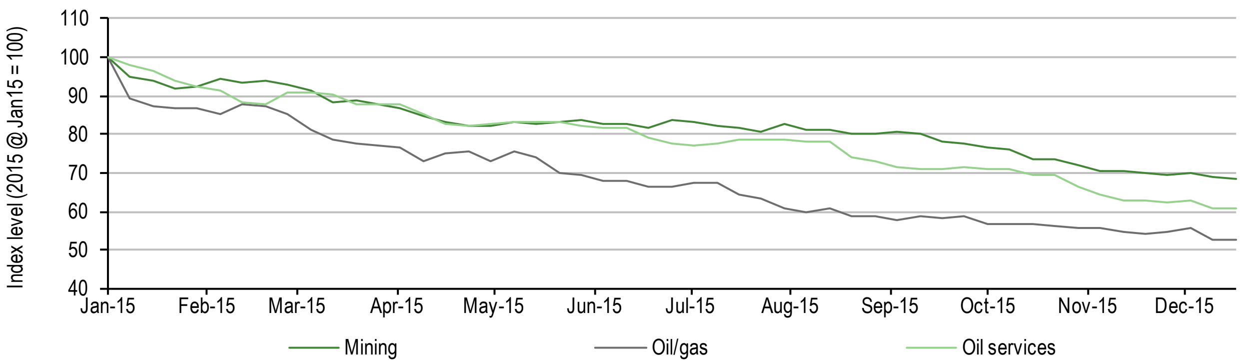
Exhibit 2: FTSE 250 1-year forward P/E multiple



Source: Thomson Reuters Datastream

From a sector earnings perspective, the impact of the weakness in the global outlook and China in particular could not be clearer. Basic industry earnings forecasts fell by 50% during 2015 and still do not show any sign of recovery. In the energy sector, the second leg down in energy prices is still feeding into estimates, Exhibit 3.

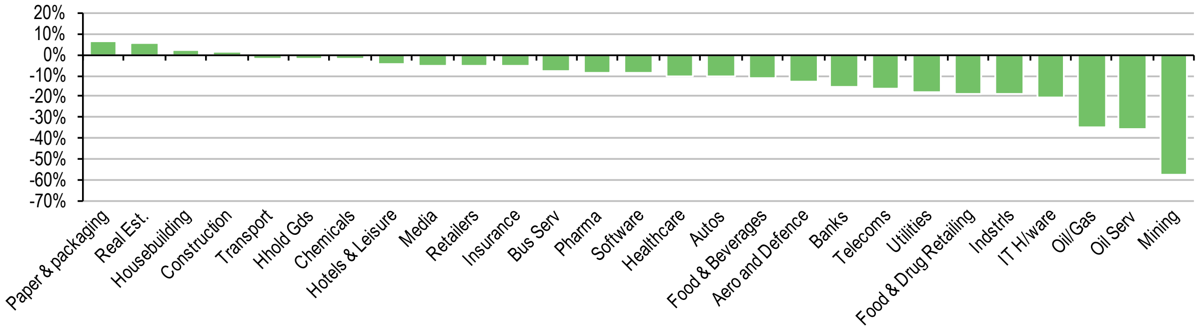
Exhibit 3: Oil and basic industry 2015 earnings forecasts



Source: Thomson Reuters Datastream, Edison calculations

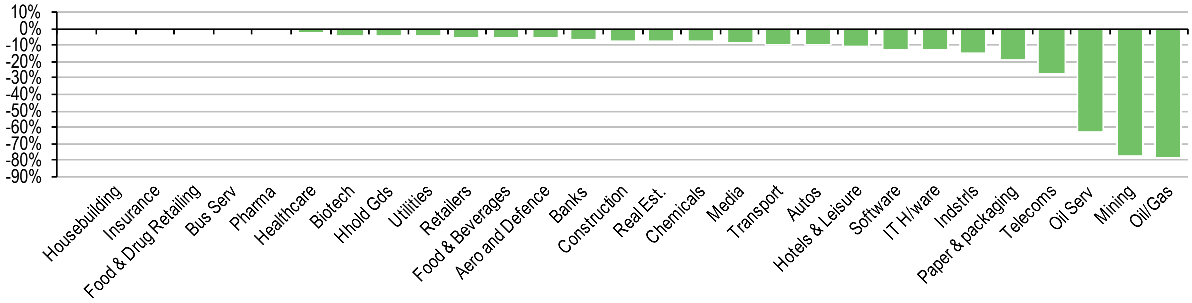
During 2015, the correlation between UK earnings revisions and UK sector performance was a much higher than average 70% as investors focused on the sustainability of profits and profits growth. Extreme deflation in the commodity and energy sectors may be the obvious culprit, but when we split out earnings momentum by sector there are few positives and many negatives elsewhere, Exhibits 4-6.

Exhibit 4: UK 12-month sector revisions, 2015



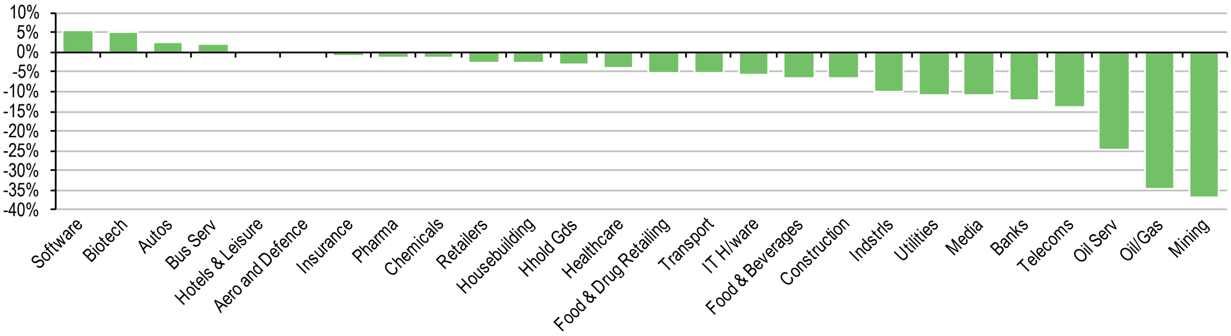
Source: Thomson Reuters Datastream,Edison calculations

Exhibit 5: US 12-month sector revisions, 2015



Source: Thomson Reuters Datastream,Edison calculations

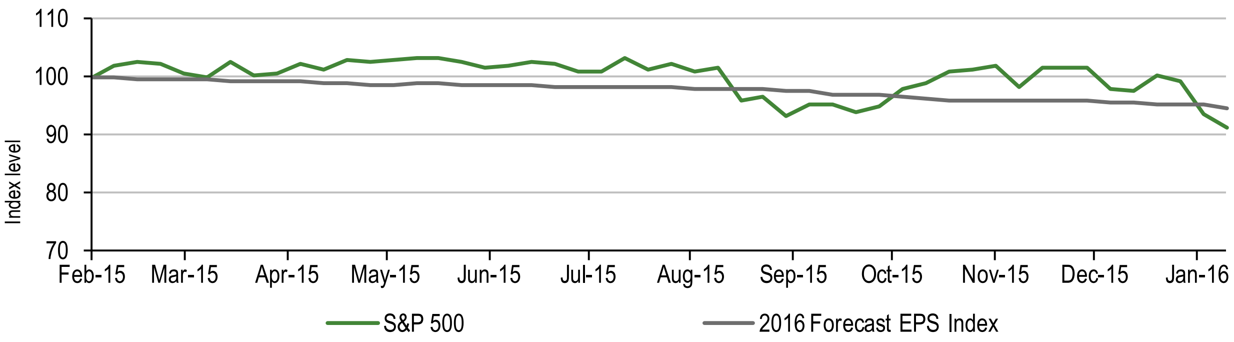
Exhibit 6: Europe ex-UK 12-month sector revisions, 2015



Source: Thomson Reuters Datastream,Edison calculations

We would normally expect market indices to derate in response to these declines in earnings expectations over the past 12 months, but they did not, even given the recent relatively sharp price declines. For example, the US equity market merely tracked earnings revisions lower, Exhibit 7, similarly to UK and continental European markets. In our view, investors are just becoming more realistic rather than pessimistic – valuations remain high outside the commodity/energy sectors and earnings forecasts continue to fall into 2016.

Exhibit 7: S&P500 and earnings revisions index



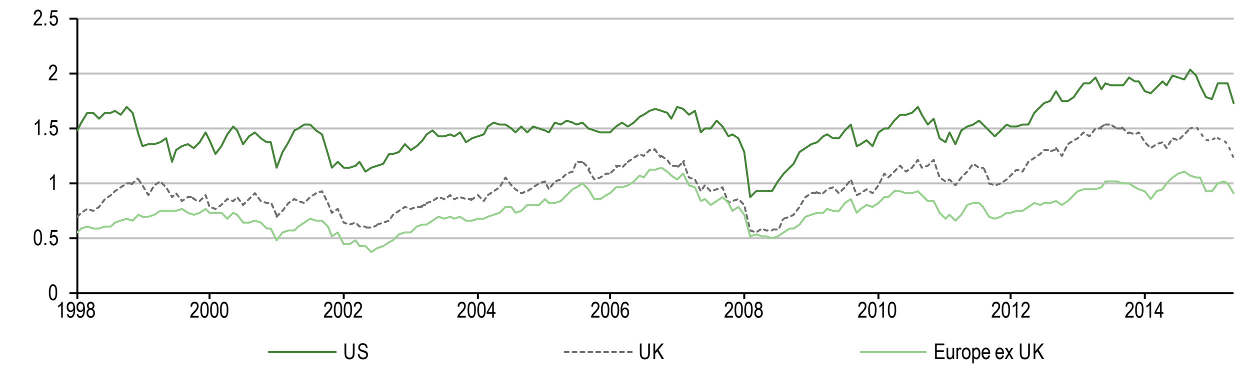
Source: Thomson Reuters Datastream,Edison calculations

Valuations still above average

We can fully accept the rationale for a central bank-inspired bounce from current levels, but we cannot accept the idea of a bounce based on the rationale that markets have become 'cheap'. On a price/book basis, markets may no longer be at the peak levels seen in mid-2015, but they remain well above long-run average multiples, as shown in Exhibit 8. The risk of buying into a sector at even average valuation multiples during a period of negative earnings momentum is also very recent in investors' memories following 2015's experience of the mining sector (down 30% in the last six months), so we doubt investors will be fooled again so soon.

In our view, investors should proceed with caution and wait either for earnings estimates to stabilise or valuation metrics to fall, even at the risk of missing the first part of any upward move and at least until the risk/reward for being early improves. For example, we believe the most recent decline in oil and commodity prices is yet to be fully incorporated in earnings estimates. Incoming economic data is also not so encouraging in this regard with US Q1 GDP estimates falling sharply in recent weeks.

Exhibit 8: Price/Book multiples still above average in the US, UK and continental Europe



Source: Thomson Reuters Datastream

Conclusion

The volatile start to 2016 may give way to calmer conditions now that both the ECB and the US Fed have indicated that they are attentive to market developments. Investors fearing a US monetary policy error such as that seen in the 1936-37 period (which led to calamitous declines in market indices) will now have some reassurance this will not be repeated, while emerging markets should benefit from reduced upward pressure on the US dollar.

However, as we have seen numerous times since 2008 low volatility and loose monetary policy do not necessarily translate into robust growth for economies, corporate profits or equity markets. The wealth effects of lowering risk premia throughout the financial system are difficult to repeat when risk premia are already low (excluding perhaps the notable stress in the US junk bond market). For a sustainable market rally we need to see global earnings forecasts stablise and recover. Our most recent calculations indicate that earnings forecasts are continuing to decline into 2016.

For the longer-term investor, we would also highlight that index valuation multiples remain above average at present. We therefore maintain a cautious overall outlook for now, even if some of the more obvious downside risks are now off the table. It seems only logical to us that as median valuations remain elevated, developed market equities will continue to move sideways at best until earnings forecasts at least stabilise and investors regain confidence in the most fundamental reason – a share of a growing profits stream – to own equities in the first place.

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