EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: Profits trump politics

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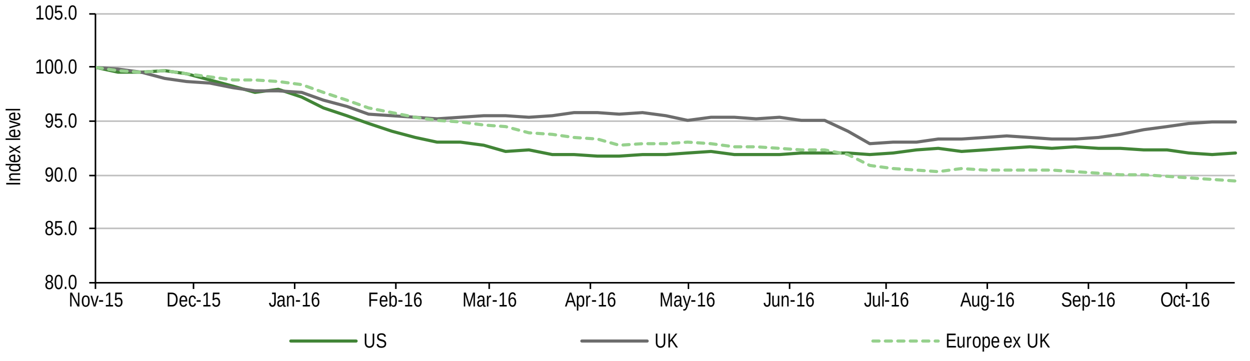
- **In an environment of increasing political turbulence, markets have sought comfort in relatively stable earnings estimates.** We believe longer-term investors should consider trading earnings revisions to their advantage by leaning against the prevailing positive sentiment. Overweight exposures to commodities, commodity equities and energy are no longer contrarian and should be reduced, in our view.
- **The decline in sterling is much less surprising in the context of its significant prior overvaluation and Brexit has merely acted as a catalyst.** In our view, sterling has already declined sufficiently to factor in the known risks of the UK's departure from the EU but is likely to remain volatile and relatively weak for some time. We believe investors should be screening for UK companies which are likely to benefit from weaker sterling with share prices that have underperformed international peers.
- **The economic risks feared by investors at the start of 2016 have failed to materialise to date and the market rally since Q1 has been significant.** We believe investors are ignoring growing political risks due to the difficulties in quantifying the impact on portfolios. Even if earnings estimates are stable, extended equity valuations should not be ignored and our overall outlook remains cautious.

US and European earnings: Better to travel than to arrive

Even if international political risks have increased, consensus profits forecasts have remained on a stable trend over the second half of 2016, Exhibit 1. In the UK, 2017 forecasts have now recovered their modest post-Brexit drop, in part due the positive impact of the decline in sterling. US estimates for 2017 have also only fluctuated in a very narrow range over the last six months. Interestingly, in continental Europe the post-Brexit declines have stuck and there has been an additional modest decline in forecasts during October. However, the overall picture of stability is in sharp contrast to the significant downgrade cycle which spooked investors during 2015 and Q116.

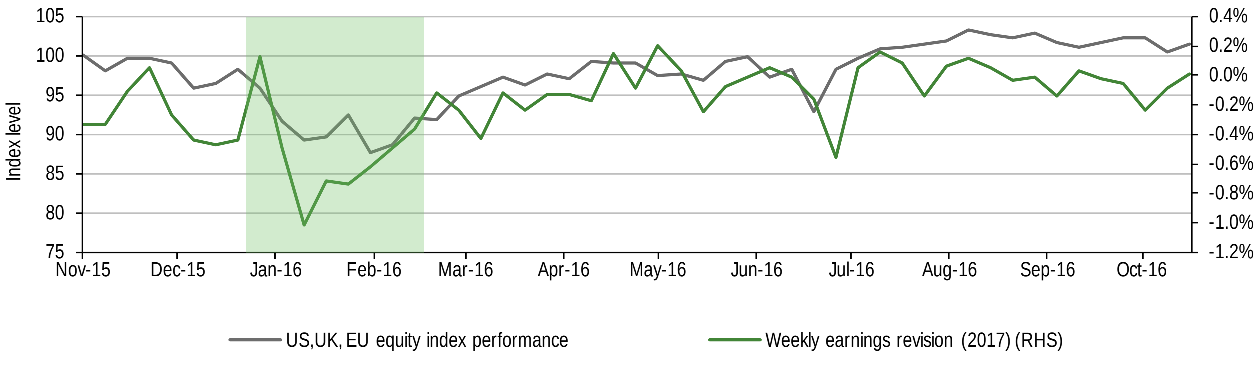
Exhibit 1: 2017 EPS revisions trends



Source: Thomson Reuters Datastream, Edison calculations

Since 2009 there has been relatively strong short-term correlation between sector returns and consensus earnings revisions, which was especially notable during 2015. We believe longer-term investors should consider trading earnings revisions to their advantage by leaning against the prevailing sentiment. The relief rally in equities this year which coincided with the inflection point in earnings forecasts in February 2016, has been significant, Exhibit 2.

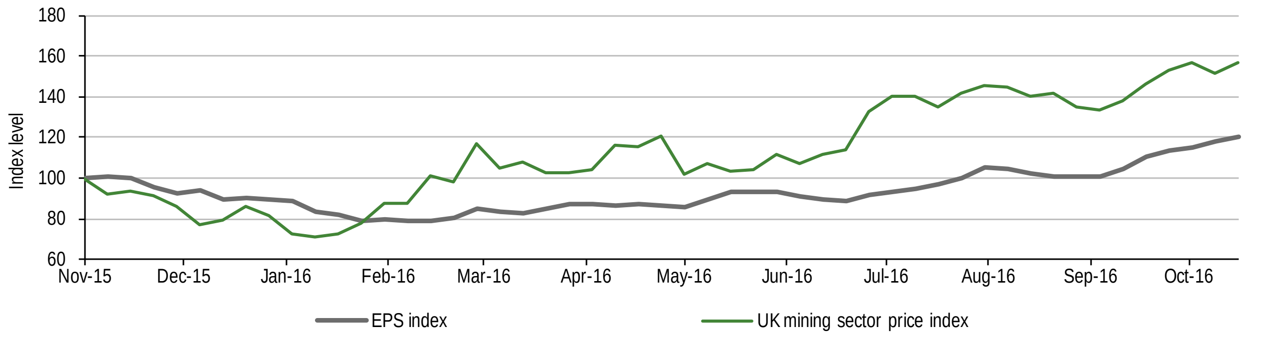
Exhibit 2: Relief rally in equities followed inflection point in earnings estimates



Source: Thomson Reuters Datastream, Edison calculations

In particular, overweight exposures to commodities, commodity equities and energy are no longer contrarian in our view and should be reduced. The improved short-term outlook for the UK mining sector appears to be largely discounted - 2017 forecasts have been revised up by 50% since February while the sector has doubled in price, Exhibit 3.

Exhibit 3: 50% rebound in earnings forecasts discounted by 100% gain in UK mining sector



Source: Thomson Reuters Datastream, Edison calculations

This positive re-appraisal of earnings prospects within the commodity and energy sectors has meant that a number of funds which had become bearish on China have discovered that the market can remain irrational for longer than an underperforming fund can retain its clients. We do in fact concur with much of the medium-term analysis suggesting that the golden era for commodity markets has passed, and we have previously highlighted significant risks to the market outlook which remain in place today.

However in February, when the fears of a commodity collapse were running in full flood, markets moved too quickly to fully discount an imminent hard-landing scenario. In the event, a surprise surge in credit growth in China combined with a recovery in oil prices from oversold levels to foster one of the largest commodity equity rallies since the 1970s, with the exception of the go-go years of mid-2000s.

This rally does not prove the bears 'wrong', nor the bulls 'right'. Rather than searching for absolute truths or intellectual satisfaction, investors should, in our view, remain pragmatic and therefore resist the temptation to overstay their welcome in commodity and energy sectors as the risk/reward balance tilts back to level.

Sterling: Lower for longer as the EU strikes back

The UK's new Prime Minister Theresa May's honeymoon period is clearly over. Days after emphasising the importance of national sovereignty and appearing to lean towards a 'hard' Brexit, a dawn raid on sterling and subsequent weakness has given opponents ammunition to attack the UK's plan to leave the EU. Furthermore, tough talk from the UK government has been reciprocated from EU leaders and European heads of state. President of the European Council Donald Tusk may even have given the game away by linking the concept of a 'hard' Brexit to 'no Brexit'. For sterling, we believe investors should look through the politics and focus on the economics.

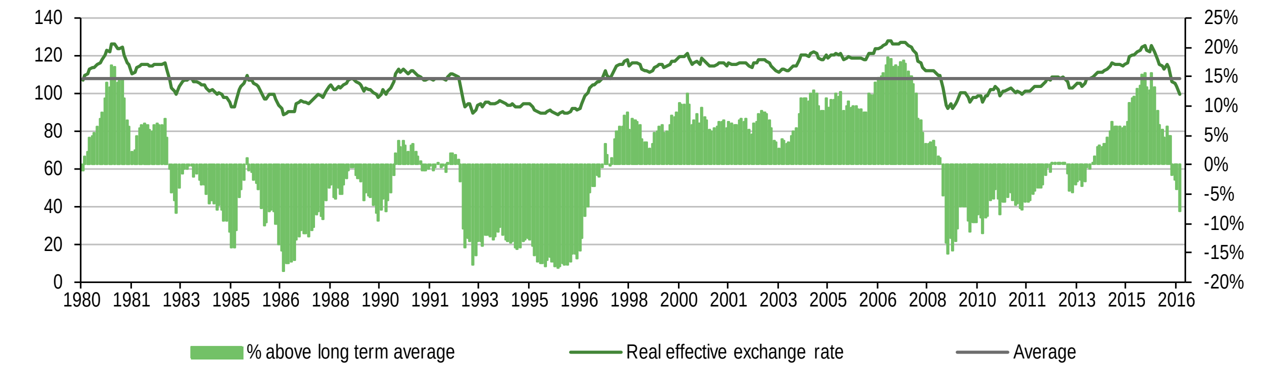
In our view, it remains highly unlikely that the UK will suffer the fate of North Korea for having the audacity to exit the EU. There is too much at stake, especially for Germany which has the largest goods surplus with the UK. A strict Chinese wall around the EU's financial services market would represent a move towards the protectionism that the EU claims to abhor. Such a development would effectively force the UK's hand in terms of closing the trade deficit by substituting UK produced goods for imports. We believe this very adverse 'no agreement' scenario should be weighted in investors' minds with its modest probability.

We also recognise the problem the EU faces in keeping other member states on board. The weakened status of the EU project in other – and not just peripheral - European nations is clearly a concern. This is why the EU has to play tough with the UK in our view, as the reasons for UK voters rejecting the EU – loss of sovereignty, concerns over immigration and a sense of dissatisfaction with the lack of economic growth are being felt across the region.

Political uncertainty in Europe is likely to remain elevated at least until the UK's Article 50 negotiations converge towards a reasonable exit strategy for both sides. We do not believe the recent formal constitutional or legal challenges will ultimately derail the process of the Article 50 notification but at the same time note the divergence of views in respect of Brexit within the UK Parliament. There also appears to be a non-trivial residual corporate interest in delaying, blocking or softening any Brexit; very public challenges to the leadership at various points in the process should therefore be expected and another reason to expect heightened FX volatility.

The risks to sterling, which we highlighted prior to the Brexit vote, have clearly materialised, Exhibit 4. Sterling had been supported by perceptions of relatively faster UK growth, expectations for interest rate increases as recently as last year and significant capital inflows which supported the UK's fiscal deficit. As a result, the currency had risen in value on a real effective (inflation adjusted and trade-weighted) basis to as high as at any time in the last 30 years by mid-2015. Since the UK's EU referendum and a double-digit decline against other major currencies, the question now is whether this has further to run.

Exhibit 4: Sterling real effective exchange rate – from over- to under-valued



Source: Thomson Reuters Datastream

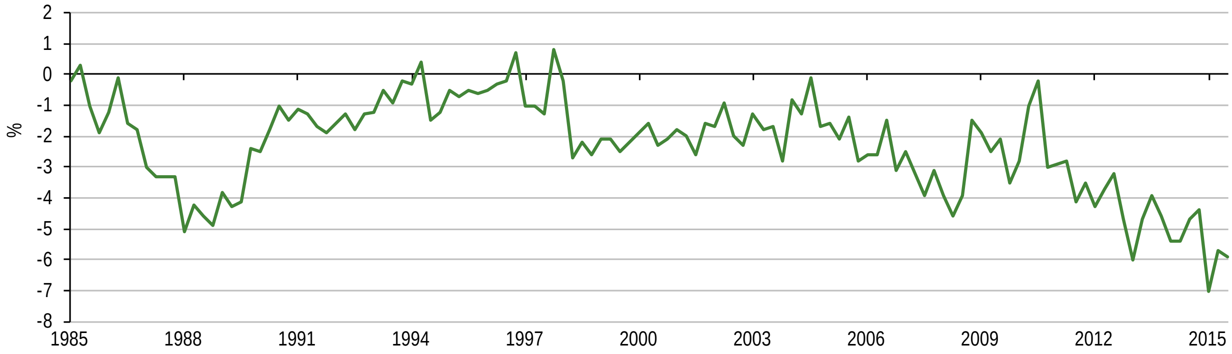
As Exhibit 4 shows, a move in the real effective sterling exchange rate of nearly 20% since the start of the year is large in a historical context. This represents a move which takes the currency from 1.5 standard deviations above its long-run REER average to 1 standard deviation below.

While the swing may be second-largest on record since the 1980s, we note that both after 2008 and after sterling's exit from the ERM, the currency traded at an even greater discount to its long-run average for a number of years after the triggering event. Sterling is therefore not strictly in uncharted territory as a result of higher long-term inflation rates compared to other regions such as the Eurozone, despite the all-time lows reached against the dollar in recent weeks.

Furthermore, Bank of England governor Mark Carney has recently reaffirmed the Bank's view that an overshoot in inflation is preferred to a tightening of monetary policy in response to the decline in sterling. This is in our view the correct strategy and over the longer-term will be supportive of the currency if successful. However, in the short term, sterling short-sellers appear to face little risk from a hawkish switch at the BOE.

It is also easy to point to the vulnerabilities within the UK economy, which have arguably been exacerbated by promoting domestic demand in recent years while ignoring a steady rise in the real effective exchange rate and the resulting loss of competitiveness. In addition to the fiscal deficit, household savings rates have also been falling sharply, creating incremental demand in the short-term but also exacerbating the current account deficit.

Exhibit 5: UK current account deficit



Source: Thomson Reuters Datastream

We believe investors have now started to focus on both the widening current account deficit and its composition, Exhibit 5. The UK's current account deficit has reached a record share of GDP in recent years, although led by a sharp shift in the contribution from the net international investment position (NIIP) component rather than a deterioration in trade. Due to the decline in sterling the weakness in NIIP is likely to partly reverse in coming quarters, which may be supportive of sterling at current levels.

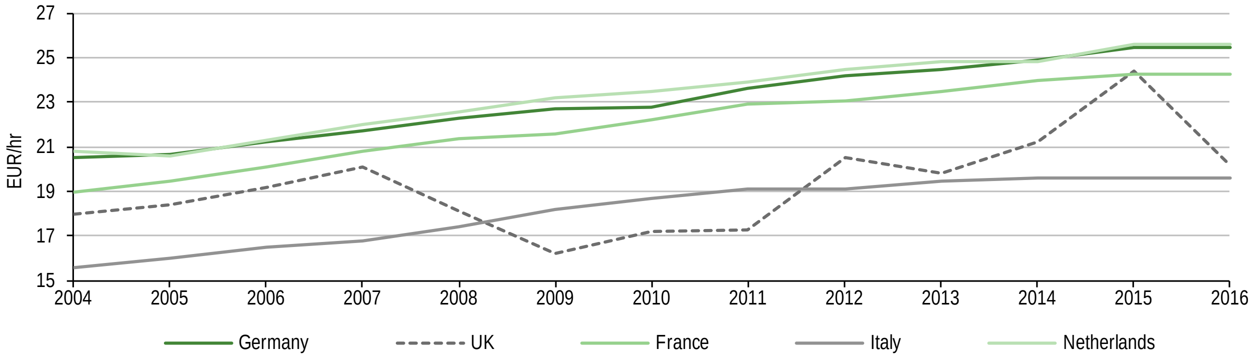
However, the UK's key pressure point is its large surplus in the provision of international services such as banking, law and insurance, and how this might be affected by Brexit. The UK has a £18bn surplus in the provision of services with the EU alone; any diminution of London's role with the EU would be likely to have a significant knock-on effect on London's role in other international financial markets. However, the 'Chinese wall' option – a failure to reach a post-EU agreement on services – is likely to be sufficiently unpalatable to all sides as to be unlikely, in our view.

From our perspective, the recent decline in sterling to levels well below long-run average real exchange rates has now simply priced in the factors and risks we have discussed above and we see relatively little merit in chasing the currency even lower. In the circumstances, the real mystery was why sterling was trading at such an overvalued level in the first place, hampering the closing of the deficit in traded goods.

We are therefore reluctant to join the crowd, which is predicting parity for sterling against the euro or the dollar – but also do not expect a rapid rebound. In addition, sterling volatility is likely to remain elevated at least until the market perceives that agreement has been reached, in an outline form, on the terms of the UK's exit from the EU.

For stock market investors, sterling depreciation of such a magnitude has already had a meaningful impact on the competitiveness of the UK's industrial base. According to the EU's own databases, UK wages are now materially below those of the Netherlands or Germany, Exhibit 6.

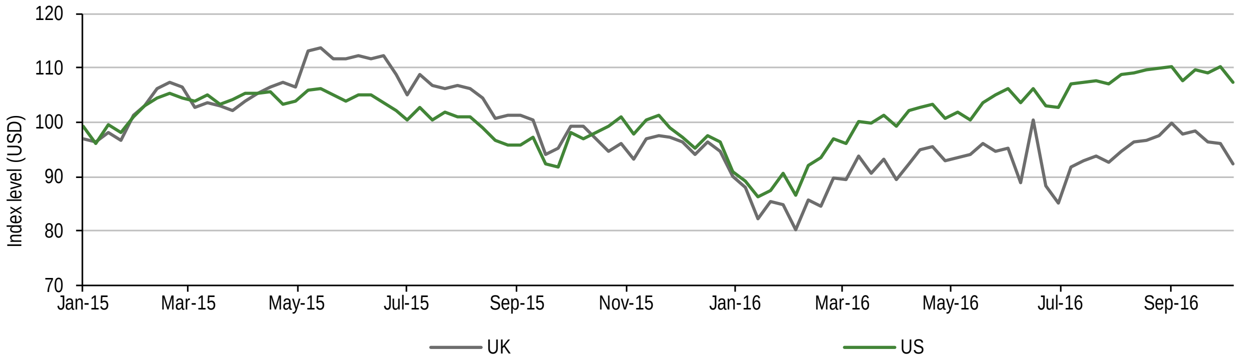
Exhibit 6: UK wages/hour now significantly lower than Germany after sterling decline



Source: Thomson Reuters Datastream

If we are correct that sterling is likely to continue to trade at a lower level for the an extended period of time then UK industrials with overseas sales exposure may benefit from a profitability windfall for longer than investors currently expect. We note that UK industrial companies with over 50% of sales overseas have meaningfully underperformed US peers over the last two years in US dollar terms, despite the robust local currency performance, Exhibit 7. Political uncertainty may result in a reduced appetite for inbound UK M&A in the short term, but investors should still be screening this segment of the market for quality franchises which are beneficiaries of weaker sterling and potential M&A activity in the medium term.

Exhibit 7: Underperformance of UK industrials with international sales vs US peers



Source: Thomson Reuters Datastream

Conclusion

The economic risks feared by investors at the start of 2016 have failed to materialise and the market rally since Q1 has been significant. We believe investors are ignoring growing political risks due to the difficulties in quantifying the impact on portfolios. Even if earnings estimates are stable, extended equity valuations should not be ignored. We highlighted the opportunities in commodities and energy in the context of a broadly overvalued market earlier in the year and believe contrarian overweight positions established then should now be scaled back.

The decline in sterling is much less surprising in the context of the significant overvaluation recorded in recent years and in this context Brexit has merely acted as a trigger. In our view sterling has already declined sufficiently to factor in the known risks of the UK's departure from the EU but is likely to remain volatile and weak for some time. We believe investors should be screening for UK companies which will benefit from weaker sterling where share prices have underperformed international peers.

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