EDISON

Illumination: Equity strategy and market outlook

December 2016

Published by Edison Investment Research

EDISON

Global perspectives: 2016 greatest hits

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **There have been few changes in the investment outlook since our last update and instead, in this final note for 2016 we review our calls for the year.** This is an important exercise for discovering any potential bias in our strategy forecasts. We were pleased to discover that the hits clearly outnumbered the misses. However our 'buy' ideas were much better timed than our 'sells' and the bias towards caution was unhelpful in a market where the equity risk premium appears to have contracted further during 2016.
- **Our key concern at present is that investors are underestimating the impact of tighter US dollar funding conditions on financial markets.** The first tentative signs of a "Trump tantrum" – higher dollar, higher bond yields and lower equities values – were in evidence this week following the Fed's revised forecasts for US interest rates. With FOMC Chair Yellen suggesting that fiscal stimulus is not obviously needed to support growth at this juncture, the potential for conflict between the Fed's views and those of the incoming US administration should be watched carefully.
- **We therefore continue to believe US government bond yields are on a rising trajectory and maintain a cautious view on global equities, primarily on valuation concerns.** Furthermore, a rising US dollar is likely to be negative for emerging markets and corporate profits forecasts globally. A period of underperformance for global equities cannot be ruled out for Q117, or at least until the uncertainty in respect of the interaction between US monetary and fiscal policy has been resolved.

2016 Edison strategy greatest hits (and misses)

For this final note of the year, and at a time when our strategic outlook is little changed from November, we have taken the opportunity to review our calls for the last 12 months. There have been some very successful calls, but also some notable misses and a general bias to caution, which despite the political volatility has in fact proved unrewarded this year. We have extracted our key recommendations from our full notes which remain available on the strategy section of the Edison website.

17 December 2015 – Global equities (hit)

"... global equities remain fully priced, in our view and we would not be surprised if major equity indices finished 2016 at levels similar to today."

"...we believe US interest rates could end the year rather lower than Fed policymakers' current projections..."

Exhibit 1 shows this view proved correct right up to the end of November, when a continuation of the Trump rally pushed developed markets to +5% for the year in US dollar terms. Similarly, the median Fed projection for US rates was 1.4% last December and it is likely US rates will end the year at 0.75%.

Exhibit 1: Developed market equities +5% YTD (US$)

Source: Thomson Reuters Datastream

28 January 2016 – Ebbing market volatility (hit)

"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... "

Although we perhaps should have become less cautious at this point in a note entitled Bounce perhaps, boom no, this was close to the low for markets in 2016.

25 February 2016 – High yield bonds (hit), energy markets (hit)

"After years of trading at very tight spreads to similar duration government bonds, junk bonds are now trading at yields close to 10%. With a yield advantage over 8% above those available on government bonds, junk is now trading at a risk premium not seen since just before the 2008 financial crisis."

"Recent comments from OPEC's secretary-general reconfirm that the oil price has declined by much more than was originally envisaged at the outset of Saudi Arabia's strategy to regain market share... oil producers are recognising that it is in their interest to cooperate despite differences in foreign policy objectives. Talks are the first step in that direction. By the time agreement has been reached, it will be time to take profits from any oil price rally."

Exhibit 2 shows that from the lows of earlier in the year, high yield bonds have delivered some of their best returns in the last two decades. This was arguably our best call of the year on a risk-adjusted basis. At the time of these comments oil was trading at US$30; today, we would reiterate our earlier view that following the OPEC agreement it is time to take profits in oil at over US$50.

Exhibit 2: US High yield bond spreads return to post-crisis lows during 2016

Source: Thomson Reuters Datastream

24 March 2016 – Hawkish monetary policy (miss)

"We expect global equity markets to be range-bound during April. The next incremental shift in US monetary policy is likely to be (modestly) hawkish, possibly coming as soon as June. In addition, the recovery in commodities such as oil and iron ore has been rapid and progress is likely to be slower from here..."

This was much too early to be thinking cautiously as in hindsight the commodity recovery was still in its infancy and there was in fact no rate increase in June. A pick-up in credit growth in China may have caught commodity sector short-sellers by surprise in H1 but the Trump effect continued the rally into the autumn.

28 April 2016 – Brexit probability (miss), Sterling (hit), London real estate (hit)

"For investment purposes we would suggest the Brexit probability in the next five years is currently 10-15% (c 33% chance of vote to leave and a 30-50% probability of Brexit if so). For comparison, we would put similar odds of the EU breaking apart for another reason over the same period."

"The key risk is the UK's current reliance on foreign inflows of capital and as a result the likely pressure on sterling in the circumstances."

"With a question mark over UK/EU trade in services, we conclude that larger financial services firms would also be likely to suffer, in addition to London real estate and related sectors."

"The decline in sterling would however benefit exporters focused on international markets outside the EU. The uncertainty has perhaps already led to a valuation gap in this segment of the stock market and investors should stay aware of the potential for M&A."

The Brexit vote was one of our worse predictions for 2016. However, while we called the wrong result for the referendum, even now there remains significant uncertainty and legal complexity over the timing of Brexit. Questions in terms of the structure and composition of the EU clearly remain relevant for investors and as recently as the Italian referendum earlier in December.

Sterling has however fallen as we anticipated and we would also highlight a number of recent bids for UK-listed companies with overseas exposure, including ARM, Premier Farnell, e2v, Lavendon and Brammer.

26 May 2016 – Beware of buy and hold (jury out)

"The combination of slow growth and high valuations points to a period of low returns for US, UK and European equities over the medium term. The latter years of the 20th century appear to have been an exceptional period for equities where buy and hold or "time in the market" strategies fitted the then prevailing investment parameters."

"Beware of buy and hold: In our view, investors should consider taking the opportunity presented by the recovery in equity markets to diversify by reducing equity exposure and allocating capital to segments of the property and credit markets which currently offer similar levels of return but at significantly less risk."

While global markets have continued to move higher since this was written we still hold onto this view and look with some concern to rising US government bond yields. Should yields push closer to 3%, investors starved for yield and overweight equities may start to shift back towards fixed income; this remains a very live topic for 2017, especially following this week's shift in Fed forecasts for three rather than two US rate increases during the year.

We continue to believe that as equity valuations remain relatively high, investors suffer little opportunity cost from lower-risk investments which offer similar returns at substantially lower volatility. However, it remains the case that this diversification strategy can only be pushed up to the limits of required portfolio liquidity.

26 June 2016 – Brexit vote analysis (hit)

"In terms of Brexit there is real uncertainty over the leadership, timing and process. No option can be fully discounted, including a no-Brexit... The referendum was advisory and Leave supporters need to secure a majority of MPs in parliament to enact legislation to exit the EU... Mutually assured economic destruction is clearly a negotiating tactic and not a strategy..."

Even today there remains significant uncertainty over the Brexit process with legal challenges underway. Suggesting investors remain cautiously positioned however was the wrong call in hindsight as the UK market proved resilient in the months following the vote. Our confidence in a mutually beneficial post-Brexit arrangement has also been eroded somewhat and the process is looking even more protracted than we originally anticipated.

28 July 2016 – Monetary policy (miss)

"In terms of monetary policy, we believe the Bank of England will match market expectations but at this stage is unlikely to exceed them..."

"Tighter US monetary policy and its resulting impact on market sentiment, commodities and emerging markets is something that could be high on the agenda by September."

"Following the rebound in market prices, median UK equity valuations remain expensive in aggregate and growth prospects for sales and profits remain weak. We believe investors' portfolios should remain cautiously positioned."

The BOE surprised us by so quickly re-introducing QE, even if later this year the MPC has had a change of heart as inflation has picked up. In part as a result, but also because we perhaps underestimated the impact of bearish investor positioning ahead of the Brexit vote, we were too cautious on UK equities. For US monetary policy, once again we were too early – the next rate increase would prove to be December.

25 August 2016 – Short-term equity stability (hit), bond proxies (hit), bonds (hit)

"Over the last six months, markets have been driven higher by easier than expected monetary policy in the US and UK. In the UK at least the anticipated economic slowdown has so far failed to

materialise, leading to a short-term win-win for equity investors. Therefore, despite very high valuations, with global earnings estimates being revised upwards equity markets are likely to remain well supported... equity investors should maintain discipline and look to take profits on positions in overvalued sectors, which may represent bond proxies."

"...as central banks question the benefits of negative interest rates and the focus turns to fiscal policy, we believe investors may wish to start taking take profits in government bonds."

Though effectively a note of capitulation on our caution on equities, we acknowledged that looser-for-longer monetary policy was easing upward pressure on the dollar and rising commodity prices were feeding into upgrades for corporate profits, so the short-term outlook was more constructive.

However, the suggestion of taking profits on bond proxies was prescient. Globally, cyclical sectors have outperformed defensive sectors by 19% during H216, Exhibit 3, with the rally picking up steam shortly after the note was published.

Exhibit 3: Global cyclical surged versus non-cyclicals during H2 16

Source: Thomson Reuters Datastream

But the bigger call was on government bonds which appeared unsustainably low in an environment of rising commodity prices and the possibility of a switch of emphasis from ultra-loose monetary policy to fiscal policy. US 10-year bond yields have risen by 100bp since this note.

29 September 2016 – The fiscal tide (hit)

"Central banks appear to be running out of options... If the monetary tide is going out, investors should remain cautious as any transition to a new regime is likely to lead to volatility."

"...the modest easing of global fiscal conditions currently expected is far from radical. Previous historical episodes suggest a crisis may be needed to trigger more aggressive fiscal responses."

"Investors should focus on equity situations where the outcome is highly company or security specific... [and] maintain higher tactical allocations to shorter duration investments, cash and precious metals."

By highlighting the ebbing monetary tide, we remained ahead of the market in terms of the declining value of government bonds. However, the Trump administration is clearly willing to deliver an aggressive fiscal stimulus in the US even as the US is close to full employment - so our view that a crisis was a prerequisite was clearly wrong.

27 October 2016 – Take profits in cyclicals (miss)

"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..."

Regular readers will be aware that we closely track earnings revisions and the recession-level prevalence of downgrades during 2015 was a key contributor to the very muted equity market performance that year.

Despite the political noise, the inflection point for earnings estimates was February of this year and this has been a key support for equity markets. While clearly too early with this recommendation, we remain of the view it is better to travel than to arrive; the recent resurgence in the US dollar is suggestive of weaker earnings momentum during 2017.

24 November 2016 – Whatever it takes vs Make America Great (jury out)

"We have asked the question whether "Make America Great Again" could be compared to ECB President Draghi's "whatever it takes" OMT announcement. A key difference is that in 2012 many asset markets in Europe were trading at distressed levels..."

"Rising inflation expectations and Trump's fiscal policies provide further reasons for the Fed to step back from ultra-loose monetary policy."

"We believe investors should continue to focus on valuations and the direction of monetary policy. Investors should resist the temptation to become fixated by rapidly changing market-implied expectations towards higher growth and inflation. Expectations are volatile and it was only earlier this year that investors feared a worldwide deflationary bust emanating from China."

We continue to believe that portfolios should be constructed soberly from expected returns rooted in equity valuations and expected actual policies rather than buying equities at any price and extrapolating from campaign promises.

Investors currently seem to be placing greater weight on the most easily available information from these campaign promises, rather than weighing up the likely US fiscal and monetary policy trajectories over the medium term. We would highlight that in the early part of the Reagan administration, US stocks also rallied strongly initially, only to fall back as bond yields rose in later years.

Conclusion

Despite the political challenges, a very conventional approach to portfolio management would have paid dividends during 2016. Being prepared to invest where the valuation parameters indicated the best scope for returns for the medium-term would have led investors to cyclical sectors such as mining and energy earlier in the year. The high-yield opportunity was significant and avoiding government bonds and bond proxies has been key to performance in the second half.

Reviewing our notes from earlier in the year has also been at times an uncomfortable, if necessary, exercise. We clearly have been too cautious and in hindsight over-emphasised our valuation concerns. In addition, while our calls to enter trades such as high-yield or energy have been well-timed, our suggestions for reducing exposure have been at best too early. There are lessons to be learnt even if the overall hit rate has been encouraging.

For 2017, we see a continuation of the themes seen in the second half of 2016. Tighter US monetary policy, in part due to rising inflation expectations but also due to anticipated expansionary US fiscal policy is likely to lead to higher US bond yields, which may mute the performance of global equities. We are also yet to see any meaningful earnings upgrades as a result of Trump's policies; on the contrary, we view the rise in the dollar and its correlation with global earnings forecasts with some concern.

EDISON

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 2016 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 [2016]. "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

Edison Investment Research Limited is registered in England. Registered office: 280 High Holborn, London, WC1V 7EE. Company number 4794244. www.edisongroup.com