EDISON

Illumination: Equity strategy and market outlook

April 2017

Published by Edison Investment Research

EDISON

Global perspectives: Numbers trump narrative

Analyst

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

- **We re-check global equity valuations.** While we undertook the exercise hoping to become more relaxed in respect of equity exposure in what is for now a bull market, we conclude that the valuation picture remains disconcerting. Equity valuations are relatively extended across the UK and Europe and exceptionally high in the US. The combination of high valuations and price momentum accelerating to the upside but concentrated within a narrow range of digital stocks is starting to feel like the 'financial instability' the US Fed has been keen to avoid.
- **We are a little frustrated as we seem to have called the Trump 'no-bump' correctly.** 'Soft' economic data is trending down to meet hard data as we expected and there has been no follow through of post-Trump market optimism in US earnings forecasts. However, declining inflation and growth expectations in the US have been taken as a positive for equities as US interest rate expectations and longer-term yields fall. If sustained over coming quarters, this softening in economic data is likely to impact corporate profits.
- **What to do if the market is overvalued?** An overvalued market does not exclude the possibility of attractive stock-specific or event-driven situations and this is relevant to the debate between passive and active management, if index returns are set to disappoint. In the UK, between the low yields on government bonds and the higher volatility of equity markets reside defensive niches of the property market that continue to offer yields close to long-run averages. We continue to like floating-rate senior debt, which would benefit from any further increase in US rates. Credit spreads on high-yield bonds are too tight, however, and the asset class now appears to offer fixed-income returns with equity-like risk, following the opportunity in 2016.
- **Remaining cautious.** Even as we approach the data with an open mind the numbers trump the narrative. Developed market equity valuations appear to price in a sustained period of strong economic growth, which is at odds with the expectations in the bond market. In such circumstances and notwithstanding the benefits of the improved sentiment in Europe, we believe investors have to look to the active, rather than passive, element of their portfolios to deliver returns.

Numbers trump narrative

It is challenging to be right and wrong at the same time. At the outset of 2017, we believed the market was too complacent in respect of the US Fed's determination to re-normalise interest rates. Trump's policy of corporate tax reform and fiscal stimulus appeared at risk of being blocked by the US Congress and the surge in economic surprises, driven by soft data such as surveys and sentiment, seemed seasonal and likely to mean-revert according to our analysis earlier in the year.

Furthermore, with global equity valuations already extended and the momentum from the commodity reflation trade of 2016 in retreat, a period of sub-par equity performance seemed a distinct possibility.

Indeed, with the continued roll-over of global economic surprise indices, the bond market has in recent weeks re-traced much of the Trump reflation trade with US 10-year yields back to 2.3% from year highs of over 2.6%. Market-implied expectations for US interest rates have also been drifting further beneath the Fed's most recent dot-plot in recent weeks, Exhibit 6. It is becoming clearer that there is only limited likelihood of Trump's campaign promises, in terms of corporate tax cuts and a fiscal stimulus, becoming reality at the scale originally envisaged.

The recent bout of geopolitical tension following the US air strike in Syria and hardening of the US position in terms of North Korea would also normally be unhelpful for risk assets. Rumours of an executive order to withdraw the US from NAFTA this weekend – swiftly denied – add to the policy uncertainty by highlighting the flow of inconsistent signals emanating from Trump's administration in respect of foreign and trade policy.

However, global equities are holding firm at or close to all-time highs in many cases. The very strong relief rally that accompanied the predictable event of a Le Pen/Macron run-off in the French presidential election only demonstrated how well supported equity markets are in the short-term. Our retreat from a bearish strategic outlook in March was largely pragmatic, having seen how easily markets were absorbing bad news on US politics and interest rates; this month's relief rally shows how only a little positive surprise can drive markets higher in the current environment.

We have re-checked the valuation data and note that US equities in particular have entered valuation territory not seen since the late 1990s. The US 12m-forward P/E is currently 18x (Exhibit 1) and higher than at any time outside the dot-com bubble. No matter which way the data are cut – price/book, price/sales, median or weighted average – risk premia or equivalently future expected returns over the medium term appear to be much lower than normal on US equities.

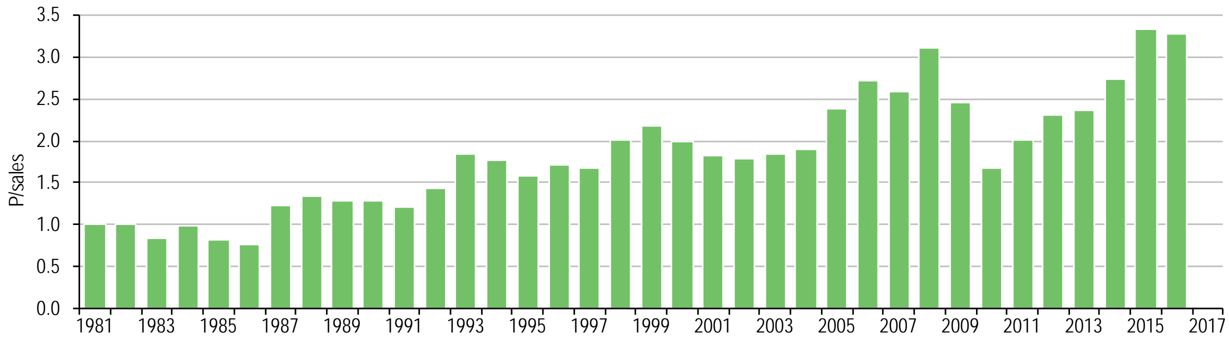
Exhibit 1: S&P 500 12m-forward P/E at record levels except for 1990s bubble

Source: Thomson Reuters Datastream

In case the data might be distorted by the inclusion of digital economy companies, which have especially high ratings, we have also calculated the valuation statistics for a universe of US companies that have been listed since 1987. The conclusions remain the same (Exhibit 2) with

long-standing US businesses also trading close to record-high valuations. This is in spite of the exceptional growth in profitability and cash flow of large cap technology companies, which is at times at the expense of traditional sectors such as retail.

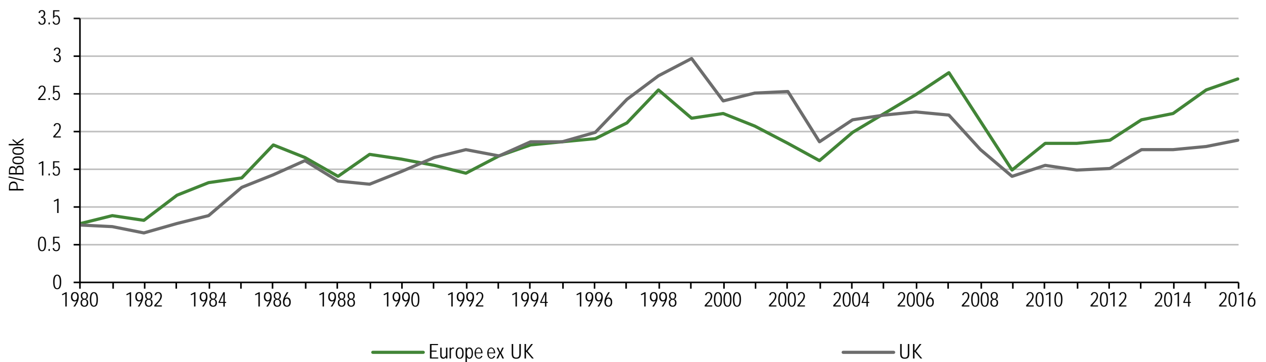
Exhibit 2: US 'Old economy' stocks – median price/sales multiple also well above average



Source: Thomson Reuters Datastream. Universe is stocks with trading history dating from 1987.

In other markets, such as the UK and Europe ex-UK, the valuation data are not quite as unequivocal, although valuations remain well above historical averages (Exhibit 3). We acknowledge that within the eurozone unemployment remains at cyclically high levels, suggestive of a much larger output gap than in the US currently (Exhibit 4). Eurozone policy rates are therefore likely to remain at very low levels for the foreseeable future and the lack of alternatives to equities rather than absolute returns prospects seems to be driving performance.

Exhibit 3: UK and Europe P/book



Source: Thomson Reuters Datastream, Edison calculations

In a benign market environment, valuation statistics can appear rather dry and academic. Furthermore, if valuations were only moderately above historical averages we believe they could be safely ignored in an environment of moderate but stable growth. However, in the US for example, a move to merely average price/book multiples would represent a decline of close to 25% from current levels and it is difficult to rationalise further multiple expansion. The risk/reward does not appear in the investor's favour at present.

Valuation is, however, a dog that does not bark alone, even if the trigger for a move lower in valuation levels is often not obvious ahead of time. It is certainly difficult to find an obvious trigger at present with commodity prices stable and economic activity growing globally, if slowly. Corporate profits expectations have also stabilised Therefore, there is no clear reason to dive wholly into cash, but what is often left unanswered is what is an investor to do, with equities and government bonds as expensive as they are currently?

Time for active management

Much has been said in favour of passively managed investment vehicles, firstly in terms of cost, where the advantage is undeniable, and secondly in the widely reported underperformance of active managers versus benchmark indices in recent years. This second factor is, in our view, highly dependent on the time period chosen. Given the valuation concerns we have highlighted it now appears a good time to consider rotating away from the current fashion for passive index investing.

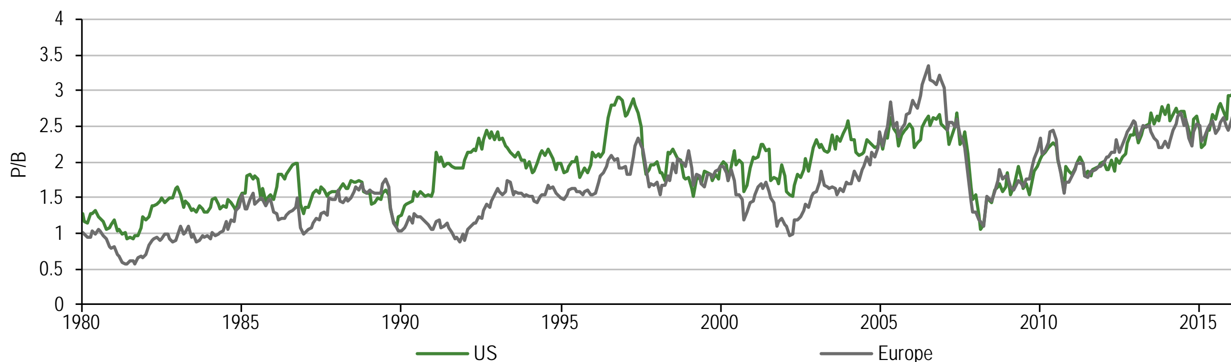
We believe there are several tactics that can be employed to avoid the worst excesses of current equity market valuations and to deliver an acceptable expected return without undue risk. It is not the case that every sector or security is clearly overvalued, even if that is the general trend.

For example, we note that within the real estate sector in the UK there a number of niche sectors exposed to positive demand factors such as logistics and healthcare where initial yields are still within historical ranges and well above 10-year government bonds. Such investments may appeal both to more risk-averse investors seeking greater yield than cash and equity investors looking to deliver real returns forecast at only a little lower than equity markets but with significantly less volatility.

Second, increasing LIBOR rates favour floating rate senior loans, which currently yield close 5%. The default history on this asset class suggests that except in the very worst-case scenarios investors benefit from significantly greater capital protection compared to equities. As a source of diversification, it is also one of the few asset classes which will pay a greater income in the event US interest rates increase faster than the market expects.

Third, we also continue to favour UK and European insurers in view of price/book, ROE and dividend yield measures all in line with historical averages. However, general industrials in each of the UK, Europe and US are all suffering from the valuation malaise discussed previously (Exhibit 4).

Exhibit 4: Industrial sector (price/book) has already benefited from substantial upward re-rating



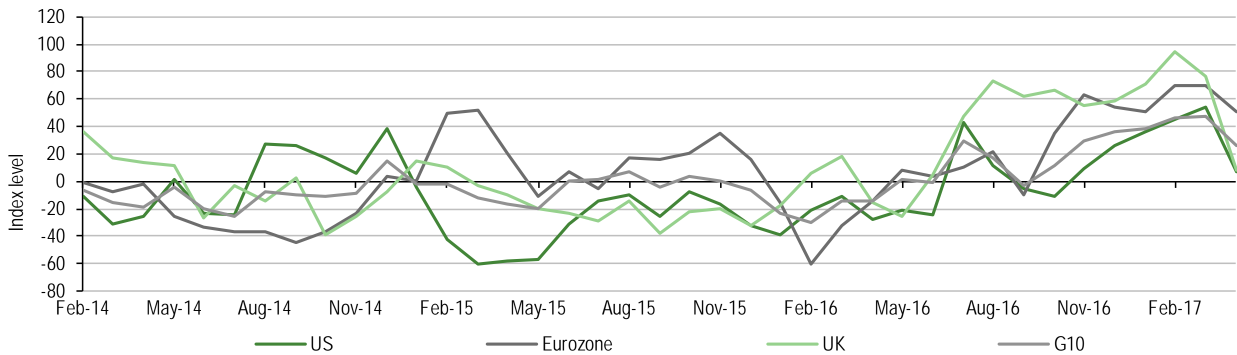
Source: Thomson Reuters Datastream, Edison calculations

Economic surprise ebbs – 2017 profits expectations unchanged

As we indicated in March, there was a strong likelihood that the positive economic surprises seen earlier in the year were likely to be seasonal and mean-reverting. Thus far, for each of the UK, US and Eurozone, this has proved to be the case with significant reductions in the surprise indices over the past month (Exhibit 5).

This decline in momentum has had a much more significant impact on the bond and interest rate markets rather than equities. Since just after the Fed's most recent decision to raise US interest rates, the gap has once again increased between the Fed's dot plots and the market-implied trajectory for US interest rates in futures markets (Exhibit 6).

Exhibit 5: Economic surprise indices declining as expected

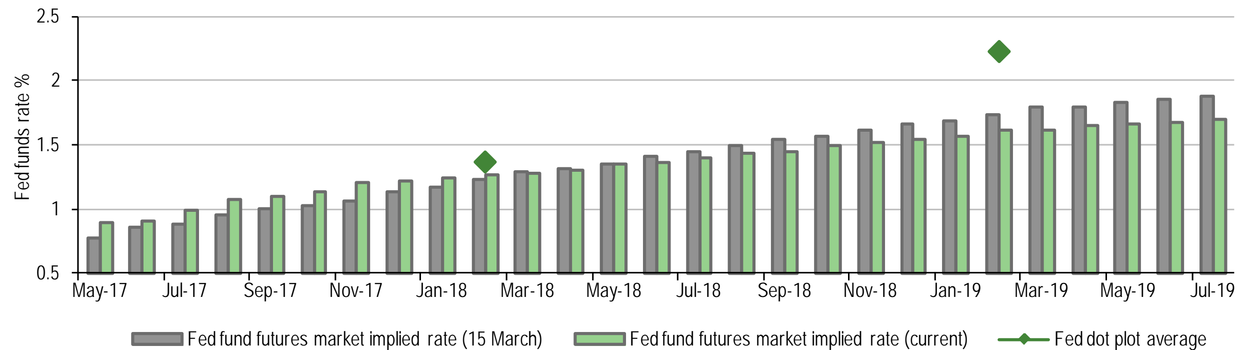


Source: Thomson Reuters Datastream

We believe part of this is rational as it becomes clearer that Trump's stimulus agenda, whether corporate tax reform or deficit spending, will have real difficulties passing through the US Congress.

However, it is not so clear to us in the context of very benign financial markets and close to target inflation that the Fed will hold back in any meaningful way from its gradual path of interest rate increases over the next two years. Given the problems in recent years of seasonal adjustments, which have tended to understate Q1 GDP growth, Fed policymakers are likely to look through any weakness in Q1, at least until it is confirmed in later data.

Exhibit 6: Market-implied expectations drift away from Fed dot plot (again)



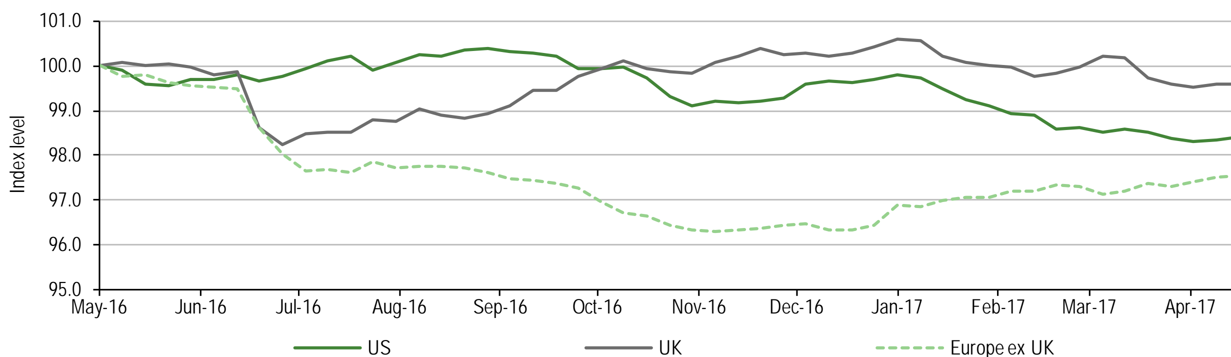
Source: Thomson Reuters Datastream

Furthermore, with both credit and equity risk premia declining and the US dollar falling somewhat on a trade-weighted basis, there is an argument that financial conditions in aggregate have loosened since the previous increase in March. Given the data, in our view the Fed will remain on its current course, close to the dot plot.

On the longer end of the yield curve we do not have a strong view at present; the combination of rising interest rates, modest US GDP growth in 2017 is balanced by stable commodity prices and declining enthusiasm for the Trump trade.

In terms of corporate profits, earnings forecasts for 2017 are effectively unchanged on a weighted average basis for each of the UK, US and Europe, although the unweighted measure highlights a degree of positive momentum within Europe (Exhibit 7). Over short periods, equity markets are very responsive to even modest earnings momentum and this goes some way to explaining the robust performance of European equities in 2017, which are up 8.5% year to date, after a flat performance in 2016.

Exhibit 7: Unweighted earnings revisions show positive momentum in Europe ex-UK



Source: Edison calculations. Index created from median estimate revision.

French Election: Is populism already passé?

Relief across asset classes following first-round vote

2016 may have been the year investors were caught out by misleading polls, but the relief rally following the first round of the French presidential election suggests that investors are being caught out by mistrusting them. A collapse in near-term euro volatility, sharply higher equity markets and a compression in the spread between French and German government bonds suggested significant speculative interest in the possibility of a run-off vote between Le Pen and a far-left candidate.

From here, a victory for Le Pen appears just a remote possibility, deliverable only perhaps in the event of an unanticipated development or scandal as centrist support coalesces around Macron. Investors' focus is likely to move towards German federal elections at the end of September. However, both leading candidates for the German chancellorship are pro-EU and there appears relatively little to attract international speculators in a contest likely to be of greater relevance for Germany's domestic policy agenda.

Compared to only six months ago, political uncertainty in Europe has diminished significantly. The political impasse in Spain has been broken in favour of a pro-EU administration, while in the Netherlands the anti-EU Geert Wilders is not even at the negotiating table as the new Dutch coalition government is assembled.

Notwithstanding the still-high level of support for populist parties in Europe, if Macron becomes French president, the UK's Brexit vote may start to look like an anomaly rather than the beginning of a trend of EU disintegration. We also note that in the US, Trump's first 100 days have pivoted in a direction investors are quite familiar with – a blocked healthcare bill, sabre-rattling foreign policy and lowered expectations in respect of the timing and extent of any US fiscal stimulus or tax reform.

Furthermore, the recent improvement in economic momentum in Europe clearly works against political protest movements. If Europe's nascent economic recovery endures, the loss of momentum in terms of the popular desire for radical change could become permanent.

While the political influence of populism will certainly still be felt as centrist politicians steal the best ideas of the new political contenders, the probability of abrupt change within the EU or eurozone is for now in decline. Market expectations in government bond and FX markets have adjusted accordingly.

But as we highlighted in our earlier analysis of the French presidential election, aside from politics there remains a significant divergence in economic performance and indebtedness between France and Germany. The EU and its member states will have to demonstrate continued economic

performance, spread widely across the region – and not just a short-term cyclical lift – to break away from the structural question marks raised over the last decade.

Conclusion

An overvalued market does not exclude the possibility of attractive stock-specific or event-driven situations and is relevant to the debate between passive and active management, if index returns are set to disappoint in coming periods.

In the UK, between the low yields on government bonds and the higher volatility of equity markets reside defensive niches of the property market that continue to offer yields close to long-run averages. We continue to like floating-rate senior debt, which would benefit from any further increase in US rates. Credit spreads on high-yield bonds are too tight, however, and the asset class now appears to offer fixed-income returns with equity-like risk, following the opportunity in 2016.

However, we remain cautious on equities. We approach the data with an open mind but the numbers trump the market narrative. Developed market equity valuations appear to price in a sustained period of strong, rather than stable, economic growth, which is at odds with the expectations in the bond market. In such circumstances and notwithstanding the benefits of the improved sentiment in Europe, we believe investors have to look to the active, rather than passive, element of their portfolios to deliver returns.

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 and Sydney. 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 2017 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 [2017]. "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 8076960
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 8249 8342
Level 12, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia

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