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Illumination: Equity strategy and market outlook

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Global perspectives: Path of least resistance

- **Global rally rumbles on.** Beneath the headlines lie two core beliefs supporting equity markets. First, declining inflation fears are leading to falling long-term bond yields and expectations of looser-for-longer global monetary policies. Second, consensus forecasts for 10% earnings growth in each of the US, UK and continental Europe at the start of the year have remained intact into Q2 17 and are proving an irresistible draw for global equity investors.
- **However we continue to believe that investors should maintain valuation discipline.** While this Goldilocks period for equities may continue over the short-term, there is a mutual inconsistency in expecting both robust profits growth and ultra-low bond yields to persist. Equity valuations still point to lower than average returns over the medium-term.
- **Why be disciplined or cautious when there is no trigger in sight for a correction?** While the currently low level of market volatility may be a temptation to increase portfolio risk, this should be resisted in our view. We believe investors should avoid clearly overvalued sectors and focus on stock- or situation-specific ideas. Current conditions are conducive to M&A activity at present and portfolios should be skewed to this factor where possible. In addition to equities, niches of lower-risk assets classes such as property or credit instruments, where the long-run expected return is likely to be only a little lower than equities, remain attractive.

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Path of least resistance

While we may have valuation concerns, the global equity market rally rumbles on. Investors have moved well beyond the “Trump bump”, which has been superseded by expectations for a strong outturn for profits growth in developed markets over 2017, while government bond yields have been falling in line with increasingly muted inflation expectations.

Paradoxically, recent political events in the US have benefited global asset markets by depressing the dollar, Exhibit 1, and therefore easing global financial conditions. This has been an unanticipated benefit of fading expectations for an “America First” Trump stimulus; the scenario of a stronger dollar leading to tighter global financial conditions has been avoided. The lack of market reaction to the more recent political infighting in the US just highlights the low level of confidence investors have in the delivery of Trump’s policy agenda.

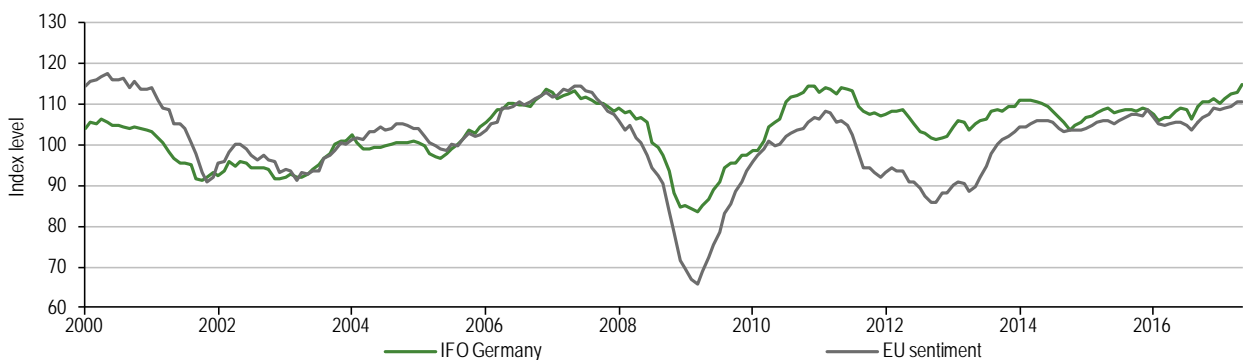
Exhibit 1: Trade-weighted dollar declines as markets discount the Trump effect



Source: US Federal Reserve

Within Europe, talk of further exits from the European Union have practically vanished following the election of Macron as French president. At present there is something of a virtuous circle of declining political and sovereign risk perceptions, improving economic sentiment and actual growth. We note both Germany’s IFO business expectations index and the EU sentiment measure are both close to cyclical highs, Exhibit 2.

Exhibit 2: Germany IFO Index and EU sentiment near all-time highs

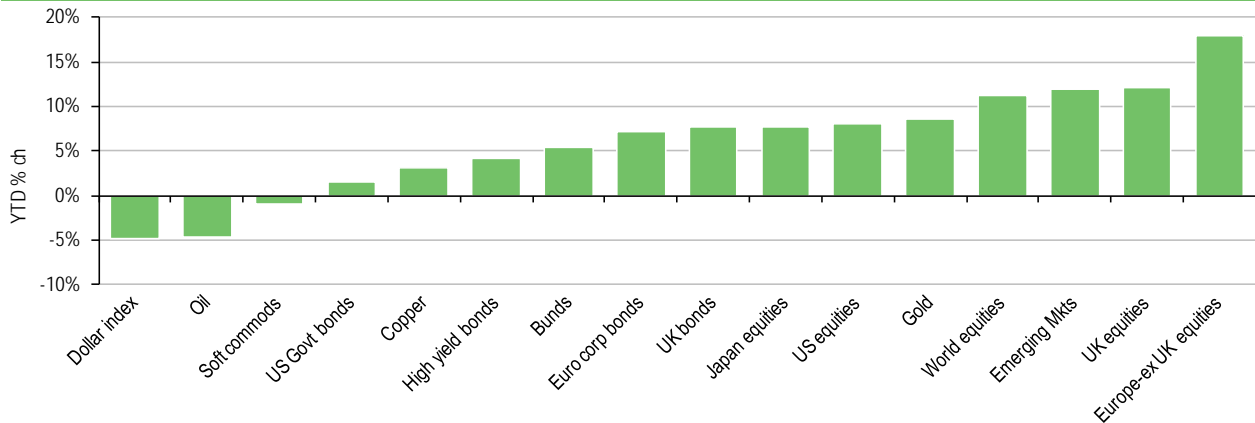


Source: Thomson Reuters Datastream

It is not just sentiment however; the ECB will take heart that credit in both the household and non-financial corporate sector has continued to grow at an increasing pace over the last year. In the short term, there appears no obvious impediment to a continuation of this positive dynamic in continental Europe. Even if later in the year the ultra-loose policies of the ECB may have to be reconsidered, it is clear that nothing is imminent. The ECB’s chief economist only this week emphasised that underlying inflation expectations give scant indications of a convincing upward

trend in inflation as wage growth remains subdued. A stronger eurozone economy also eases policy divergence between the ECB and Fed, a second driver behind US dollar weakness in recent months.

Exhibit 3: Broad rally in assets during 2017 as US dollar declines



Source: Thomson Reuters Datastream. Note: As of 23 May 2017.

Easier than expected financial conditions have resulted in a broad rally across all asset classes during 2017, Exhibit 3. This has been associated with very modest 90-day volatility, Exhibit 4, which shows that realised volatility has fallen to levels not seen since the 1995-97 period when the US was coming out of recession and optimism in respect of the globalising economy (and European integration) was in full flood.

Even if there may be technical effects in play as hedge funds sell volatility to retail investors via ETFs, a decline in volatility is consistent with the absence of any obvious near-term economic instability. In such an environment, the temptation is to increase portfolio exposures to maintain the same level of market risk; this may be the path of least resistance for investors as a whole.

However, for risk management purposes, we would continue to use a long-run average volatility estimate rather than the current depressed level. In our view, a higher return is achieved from dynamic risk management by adding risk when valuations are low and market volatility high, rather than in the current circumstances.

In fact, it has been remarkable just how insensitive markets have become to daily newsflow, at least compared to 2016. We believe the consistently strong expectations for corporate profits growth is key to the equity outlook. In turn, earnings forecast data should be closely monitored for any sign of a break with the upward trend.

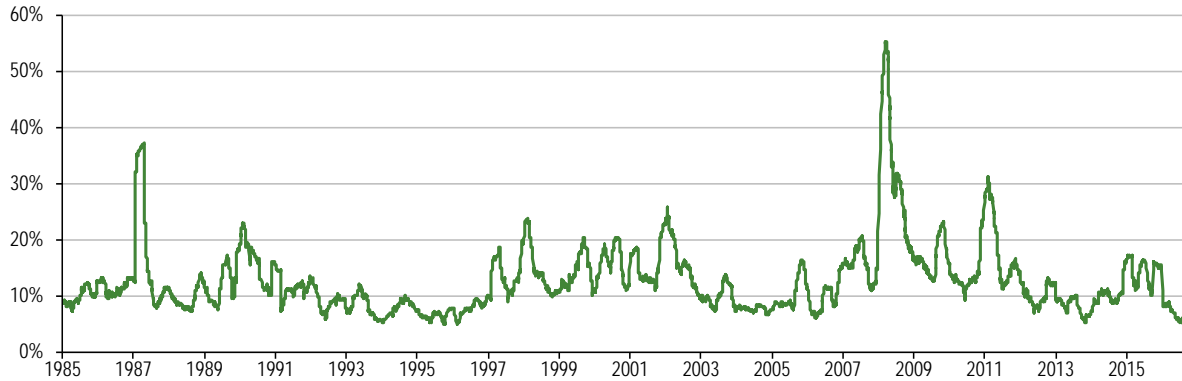
M&A activity to benefit from fall in volatility

The decline in market volatility is however conducive to an increase in M&A activity. Financing conditions appear generous to issuers with interest rates still low and credit spreads significantly tighter than 18 months ago. Company boards are likely to be encouraged by the relative stability in equity markets and the real economy. The corporate sector remains highly profitable with median forecast EBIT margins still very strong in the US and UK and picking up in Europe, Exhibit 5. There has been a notable uptick in Europe in M&A announcements in recent weeks, a trend which is likely to continue in our view.

It has been something of a golden age for corporate profitability in recent years, a corollary of the subdued wage growth observed by central banks. We have to acknowledge this period of elevated margins has continued for rather longer than we originally expected and also in some respects reflects new (often digital) business models which combine technical innovation with rapid market domination. The traditional battle between antitrust enforcers and the technology sector also

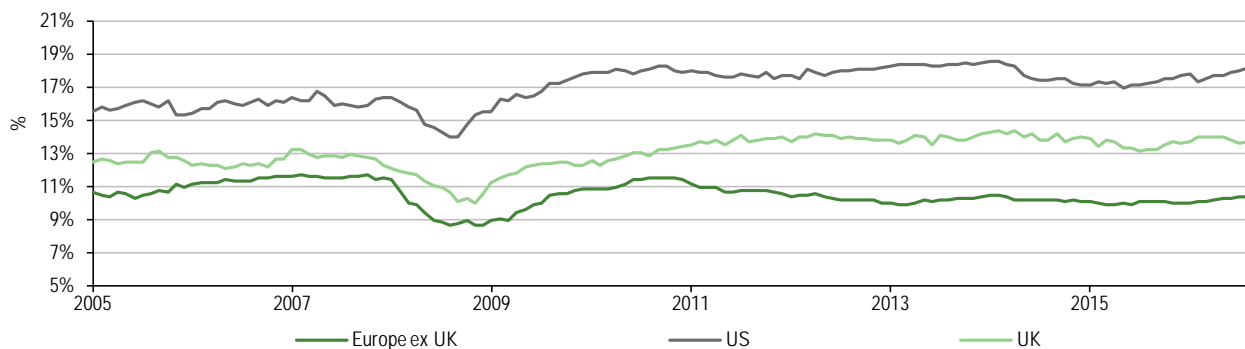
appears to have eased somewhat. We believe the increased probability of getting large and complex deals through antitrust regulators during extended reviews in this cycle is also likely to give greater confidence to companies contemplating further industry consolidation.

Exhibit 4: Realised 90-day volatility for global equities



Source: Thomson Reuters Datastream, Edison calculations

Exhibit 5: 12m-forward forecast EBIT margins for US, UK and continental Europe



Source: Thomson Reuters Datastream

Earnings forecasts: A short-term support for markets

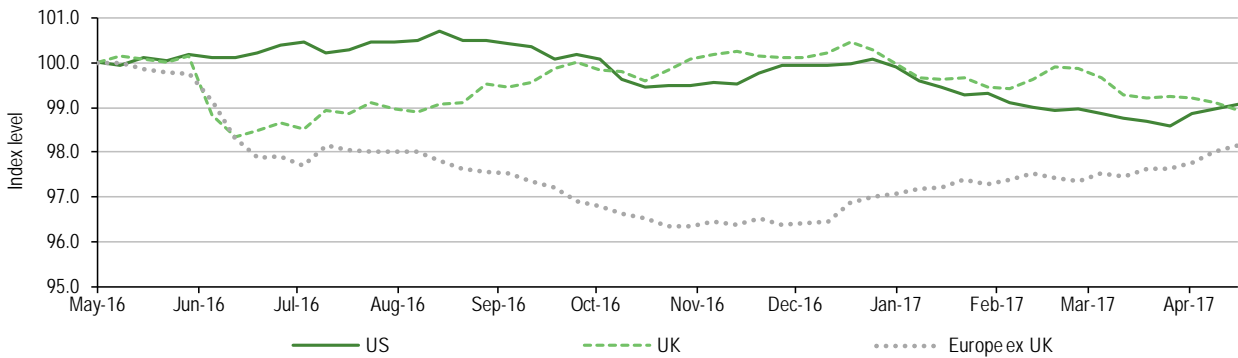
Rising estimates confirm the recovery in continental Europe

While economic surprise indices may be rolling over, US earnings forecasts for 2017 are effectively unchanged since January. In the UK and continental Europe forecasts have risen relatively sharply since the start of the year; in the UK reflecting a continued tailwind from sterling weakness and in continental Europe the long-awaited improvement in economic activity.

In the short-term earnings momentum is a key driver of sector performance, as demonstrated in 2015 when basic resources and energy estimates fell consistently, leading in turn to considerable sector volatility. While we still have concerns in terms of equity valuations in general, thus justifying a cautious overall outlook for global equity markets, there is in our view likely to be near-term support around current levels, for as long as earnings forecasts remain stable.

However, we would inject a note of caution when interpreting the weighted average earnings revision indices for 2017. As shown in Exhibit 6, on a median basis, continental Europe has continued to deliver positive surprise while the median US and UK 2017 earnings estimate has fallen, albeit modestly, in recent months. The consistency between the weighted average and median measure in continental Europe suggests that a broader upgrade cycle may be underway.

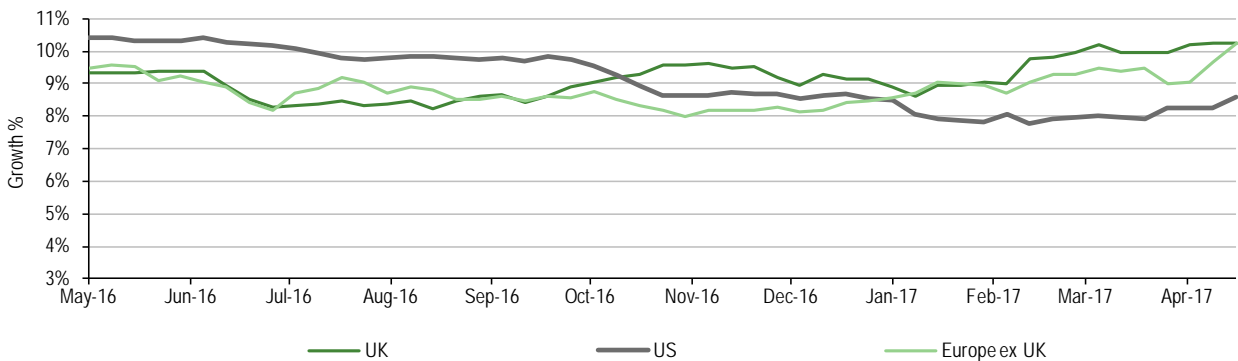
Exhibit 6: Equal-weighted revisions index suggests broader momentum in continental Europe



Source: Thomson Reuters Datastream, Edison calculations. Note: Unweighted average.

Furthermore, the equal-weighted earnings growth forecast for 2017 remains in the region of 9-10% in each of the US, UK and continental Europe, Exhibit 7. As in prior years, the actual outturn is likely to be somewhat lower, but even so this forecast is well ahead of 2016, where at the same point in the year forecasts were for earnings growth of 7% in the US and UK - and a mere 4% in continental Europe.

Exhibit 7: Forecast 2017 earnings growth stable and still close to 10%



Source: Thomson Reuters Datastream, Edison calculations. Note: Unweighted average.

Therefore, while there is a coherent case for investment caution due to current relatively high equity market valuations (particularly in the US – where the 12m forward P/E is at levels not seen since the dotcom bubble), not all the data point in the same direction. Stable earnings forecasts are likely to reassure P/E-based investors relying on a 2017 earnings growth figure in the region of +10%.

In continental Europe, the rising trend for earnings forecasts is consistent with the improved economic data for the region over the last nine months. This new step-up in economic growth has the potential for markets to become excited about a virtuous circle of improving economic data and receding financial and political risks.

Certainly this is consistent with the very strong inflows seen into European equity funds in recent weeks. However, in our view this virtuous circle is at least partly factored into continental European equity markets which have enjoyed a robust performance of close to 20% in euro terms over the last six months.

US short-term rates rising as long-term yields decline

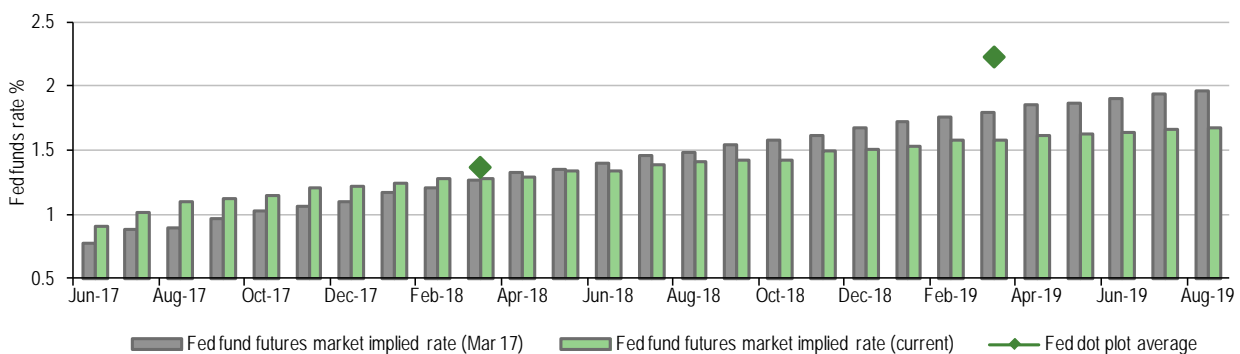
While futures markets are now close to the US Federal Reserve’s dot-plot forecasts through the end of 2017, market expectations have been drifting away from the Fed’s expectations further out, Exhibit 8. Futures markets are now pricing in only a 25bps increase during 2018 while the Fed dot-plot indicates approximately 100bps of tightening. Market expectations for a more relaxed pace of

monetary tightening are also consistent with the decline in US 10-year bond yields, which have fallen to 2.25% from the peak of 2.6% in March.

The most recent set of FOMC minutes highlighted the uncertainties associated with any expansionary fiscal policy. They also highlighted the desire of the US Fed to wait and see whether the recent slowing of activity will be reversed, before once again removing monetary accommodation.

Therefore as of the FOMC meeting in early May, uncertainty in respect of US fiscal policy clearly remains. Markets have become less confident that anything substantive will be deliverable. In this respect, the decline in 2018 interest expectations appears rational. The benefit to global markets is that it eases upward pressure on the dollar and gives the eurozone economies in particular time to catch up, thus narrowing the divergence between the direction of monetary policy in the US and eurozone.

Exhibit 8: Market-implied interest rate expectations diverge from Fed in 2018



Source: Thomson Reuters Datastream

Conclusion

It is never easy to sit on a fence. On the one hand, as we have discussed at length in previous notes, equity market valuations, notably in the US, remain high. On the other, investors appear to have easily priced-in the near-term interest rate increases expected from the US Fed.

Profits growth expectations remain robust. Inflationary pressure remains contained which has kept long-term yields low. Furthermore, Europe's economy has been the surprise performer during 2017, with positive economic surprise continuing for longer than could be predicted from seasonal or mean-reversion factors.

We believe the path of least resistance is for equity markets to drift gradually higher over the summer, at least unless the US Fed adopts a more hawkish tone or starts to address asset prices more directly. However, this would be a low-probability development, in our view.

The currently low level of market volatility may be a temptation to increase portfolio risk exposures, which should be resisted. We believe investors should maintain valuation discipline and avoid clearly overvalued sectors and focus on stock- or situation-specific ideas. Current conditions are conducive to M&A activity at present and portfolios should be skewed to this factor where possible. In addition to equities, niches of lower-risk assets classes such as property or credit instruments, where the long-run expected return is likely to be only a little lower than equities, remain attractive.

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