# Illumination: Equity strategy and market outlook

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# Global perspectives: All that glitters is not gold

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- **2017 to date has been the year of broadening sector performance.** The standout was the global technology sector which is up 40% in US dollar terms. We have also been surprised by the weakness of the US dollar on a trade-weighted basis, given that the US Fed is further along the track in normalising monetary policy and that Trump's proposed fiscal policy initiatives, theoretically at least, should be dollar positive.
- **The changing nature of the digital economy means that relatively high valuations for certain leading franchises may be increasingly sustainable**. From being a free-for-all in the 1990s the digital economy has matured and consolidated around a number of global leaders in each major market segment. But it is only where dominant market shares have been achieved – for example in search or premium devices – that the 'defensive moat' is wide and a premium rating justified.
- **Crypto networks have become too large to ignore.** The value of major cryptocurrencies in circulation is already 20% that of US dollar notes and coins, indicating just how much this once niche ecosystem has grown. But we make no specific call on the bitcoin price which is clearly highly speculative in nature. What is more important in our view is the enormous disruptive potential of distributed digital investor networks for conventional finance over the medium-term.
- **We continue to believe a cautious outlook is warranted** on the basis of valuations that indicate very low expected returns in both equities and credit in developed markets. However, recent economic surprise is increasingly positive and therefore a major fracture in markets in the near term still remains unlikely. To deliver, investors still need to combine a relatively modest level of market exposure with carefully selected exposure to specific company- or event-driven situations, in our view.

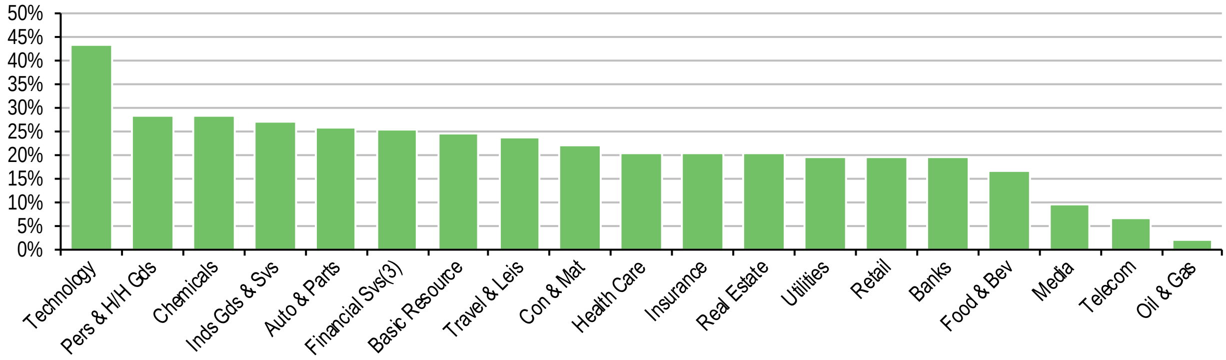
## 2017: All that glitters is not gold – but digital

### *Broadening recovery in world economy drove strong returns in 2017*

2017 was the year in which an initial recovery in commodity-related equities broadened into a strong performance for nearly all sectors. The standout performer was the global technology sector which is up over 40% year to date.

The US$ denominated figures in Exhibit 1 are also flattered by an 8% decline in the trade-weighted value of the dollar over the period. It has been a remarkable outturn for the US dollar given that the US Fed is so much further ahead in tightening policy compared to the ECB or Bank of Japan. Furthermore, Trump's policy agenda which comprises fiscal stimulus, corporate tax reform and elements of protectionism is in theory a dollar positive. That it is still a theoretical positive speaks volumes in terms of the difficulties of getting it through the US political system.

**Exhibit 1: World sector index performance in 2017 to date**




Source: Thomson Reuters Datastream. Note: Total return in US$ to 27 November 2017.

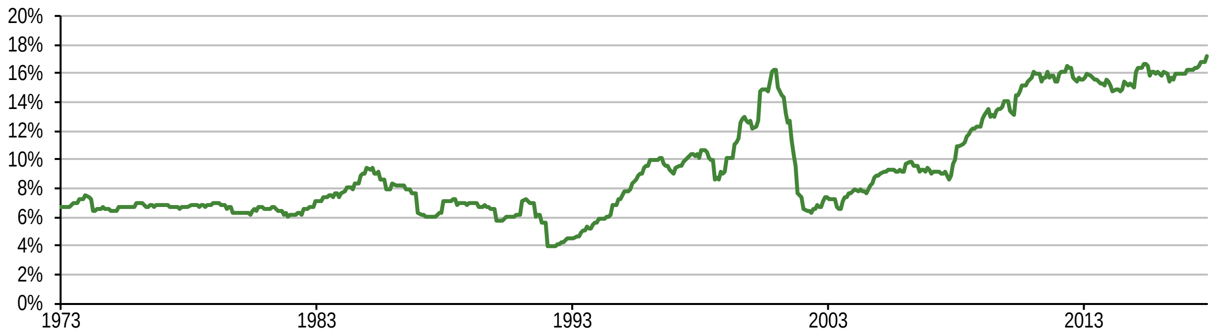
For technology, the stand-out premium to historic valuations requires further thought. It is true the extent of the overvaluation today does not match that of the original technology bubble of the 1990s. It is also true however that current multiples for the US technology sector – a trailing P/E of 27x compared to the long-term average of 21x – suggests more modest returns may lie ahead.

Investors should also consider the changing nature of the digital landscape. It is no longer a competitive free-for-all as a large share of digital activity has become embedded around only a few large players in each market segment. For example, Alphabet (Google) enjoys a >70% share of search in many developed markets. This exceptionally strong market position is not only highly cash generative in the short term, it also offers critical leverage in terms of obtaining the data sets required for the development of the most competitive artificial intelligence networks in future. Consumers appear to have little idea of the aggregate value of their digital breadcrumbs in terms of search history, websites visited, email contacts, click-through behaviour and location tracking employed by Google and its smaller competitors.

It is therefore becoming increasingly difficult to see the investment case for a new scale competitor in conventional online search or retail which would challenge the position of the incumbent. Similarly strong market positions are visible in the social media, smartphone, desktop/enterprise and semiconductor segments. While cognisant of 'Blackberry' or 'Nokia' risk it is becoming increasingly clear that 'Big Tech' has now established a pervasive permanence not dissimilar to 'Big Oil' in the 20th century – and it is still only early in the 21st.

Based on current valuations, the ongoing growth in digitalisation of the world economy, and the strategic position and financial flexibility of Big Tech, even after the gains of this year it is difficult to recommend a long-term underweight position for companies in such a commanding position. We do think however that gains are likely to be closer to normal than supercharged from current valuation levels. US P/E ratios for the sector of 27x would appear to discount the long-term sector EPS growth rate of 15% for example. In addition, as these companies have grown cyclical risks such as advertising spend or overall retail sales will become more important. That US tech sector earnings are well above the long-term trend of 8-10% of S&P 500 earnings is also clearly a risk factor, Exhibit 2.

**Exhibit 2: US tech sector earnings as % of S&P 500 earnings**




Source: Thomson Reuters Datastream

However, our point is that where dominance has been achieved there may be a structural reason for a permanently higher valuation. The strong performance of the global technology sector has been much broader than a few global leaders, however; in our view, it is not the time in the cycle to throw darts at the dartboard in the hope of exceptional gains. We would, for example, be wary of richly valued companies which have not established dominance in their sectors and therefore do not benefit from a virtuous circle of strong cashflows being reinvested into product development to maintain that dominance or growth through M&A.

## Crypto networks gaining acceptance – industry disruption ahead?

In hindsight, the trade of 2017 was to buy bitcoin. Following a tenfold increase in the price this year, the value of all bitcoins in existence now exceeds $180bn. A further $120bn of current market value from other blockchain tokens such as Ethereum means that the digital token market now exceeds US$300bn. This is no longer a small niche phenomenon. While data is hard to find, the possibility of a significant number of new accounts being funded by credit cards cannot be ruled out and a crash may have meaningful economic implications if consumers have borrowed to buy tokens.

However, for all but the most esoteric institutional investors, gaining direct exposure to digital tokens would have been all but impossible due to real-world constraints on investment mandates. Indirect exposure through chip or graphics card manufacturers or venture capital investments in blockchain technologies appear to be the extent of institutional involvement. Even the Chicago Mercantile Exchange (CME) future on bitcoin will not be launched until the end of the year. There is clearly some anticipation that this derivative will open up a new source of demand as the price of one bitcoin moves over $10,000.

It is important, in our view to bypass the earlier and rather polarised arguments as to the merits of cryptocurrencies versus traditional non-bank money such as physical cash or gold. We take no view on the merit of owning digital currency per se, except to observe the high level of historical volatility which suggests buying on credit or margin would be a very risky strategy. Our second observation would be that the value of bitcoin in circulation now is already well over 10% of all US dollars in circulation ($1.5trn) and exceeds that of sterling notes and coins ($100bn). Expectations for further tenfold increase therefore appear challenging, unless real progress is made in transaction usage.

In addition, the rapid bitcoin account growth over the last year (100% since Q416) points to the possibility of a bubble. Internet searches are populated with offers to buy bitcoin with credit cards. The potential for fraudulent internet sales to unsophisticated individuals seems clear. Finally, those who believe there is any limit to digital token issuance should consider the Ethereum coding tutorial at https://www.ethereum.org/greeter. This tutorial moves immediately from a 'Hello World' distributed app to complete code for 'Design and issue your own cryptocurrency'.

What we would not however dismiss is the very powerful network effect demonstrated by the growth of digital tokens and its possible impact on the traditional finance sector. The basis of the traditional financial network is the concentration of capital flows between savers, corporates and the government sector through the lens of a (heavily regulated) banking system.

If however the starting point was the absence of trusted third parties such as banks or clearing houses, blockchain (or distributed ledger) technology solves the resulting problem of authenticating money transfer, proving authenticity of ownership of digital tokens and proof of settlement. Blockchain technology alone however would be of interest only as an academic exercise if merely a white paper; it is the adoption of the technology by active developer groups and significant financial backers which gives it real world relevance.

That digital tokens are now able to (and have) raised meaningful amounts of capital for new digital projects from a distributed range of online and potentially anonymous investors is a very exciting proposition for the 21st century. This is also a development in which regulators and incumbent financial intermediaries are likely to play an aggressive round of catch-up – a reason we deliberately avoided using the word 'equity' in the previous sentence. For example, the US SEC has recently warned potential ICO (initial coin offering) issuers that they may be undertaking security offerings subject to registration. Regulators have therefore taken notice.

Although contingent on continued access to a sufficiently broad network of global investors, the potential for this digital competitor to disrupt traditional stock exchanges as well as traditional payment transfers should be obvious. Due to the growth of these digital financial networks, financial institutions without a strategy to embrace these technologies are at risk of being disintermediated in the long term. For the corporate sector, the technical ability and willingness to raise capital by issuing tokens could also rapidly become a necessary strategy to remain competitive. It is too late to act after a disruptive start-up has already raised ample digital capital to finance its attack on the industry business model.

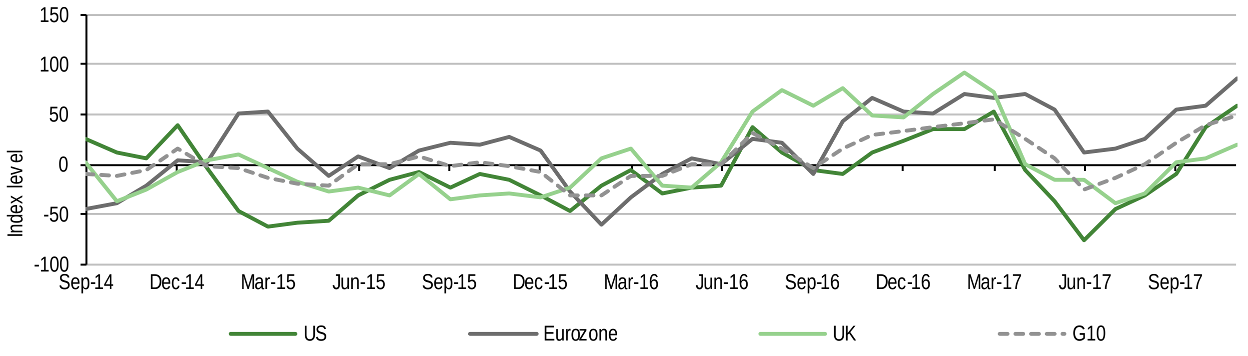
## Economic surprise accelerating

In recent weeks, the positive economic surprises seen over the last quarter continue to strengthen. The data appears to be moving faster than any monetary tightening, leading to a benign environment for risk assets such as equities, Exhibit 3. What is more of a conundrum is the lack of response in global bond yields. This is even as the Bank of Japan is now hinting that it is past peak monetary accommodation, following the Fed, BoE and ECB. Earnings forecasts for 2017 remain robust with median growth close to 10% for developed markets and a similar level of growth forecast for 2018.

Furthermore, based on our estimates the surge in economic surprise is not seasonal and therefore suggests a real improvement in economic conditions. The data series may in fact be supported over the next two months by the strong tendency of December and January to deliver positive economic surprises compared to the rest of the year.

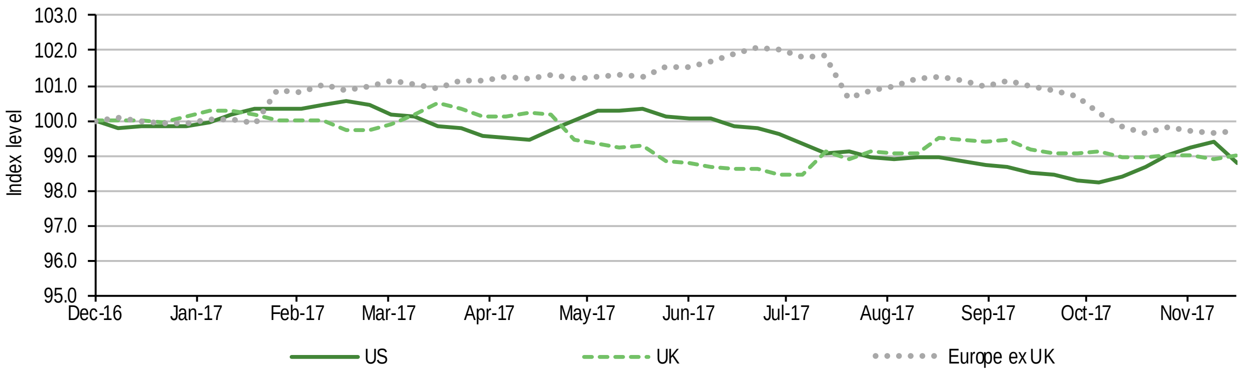
Developed market earnings forecasts for 2017 have remained relatively stable in the second half of 2017, given that the modest declines in Europe ex-UK are largely a result of the appreciating euro, which has risen by 8% on a trade-weighted basis since Q2. The resilience of earnings estimates has in our view been key to the short-term support for markets, Exhibit 4.

**Exhibit 3: Global economic surprise indices accelerating in Q417**




Source: Thomson Reuters Datastream

**Exhibit 4: Earnings estimates for 2017 remain stable in Q4 for US, Europe ex UK and UK**




Source: Thomson Reuters Datastream, Edison calculations, unweighted average

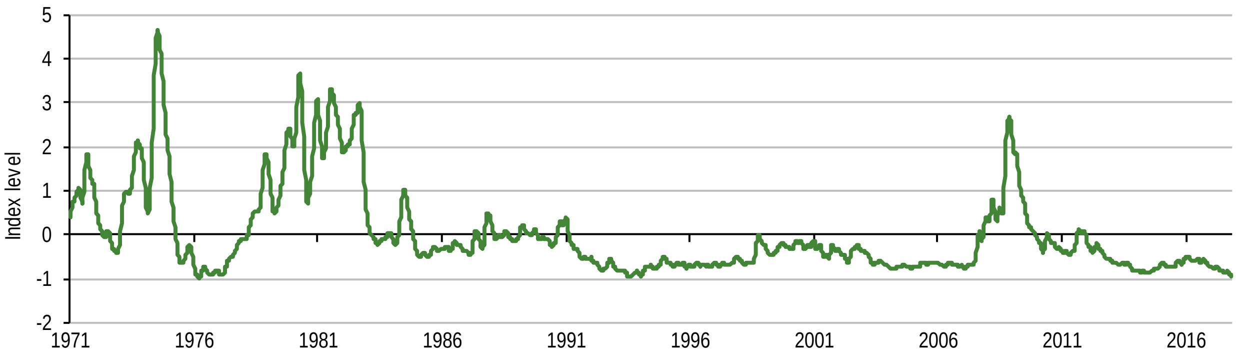
## Financial conditions loosen as Fed tightens policy

US two-year yields and three-month LIBOR rates are now rising to discount the Fed's policy of three rate increases in 2018. However, as shown in Exhibit 5, overall US financial conditions as measured by the Chicago Fed Financial Conditions Index are in fact still loosening, Exhibit 5. This is clearly at odds with the intended direction of US monetary policy, as it would appear from this data that the monetary taps remain wide open. Given the Fed's concerns earlier in the year in terms of the risks to financial stability, a further market-driven loosening of financial conditions is becoming worrisome as it may encourage the US Fed to quicken the pace of monetary tightening.

We view the prospect of three rate increases in 2018 as a meaningful amount of monetary tightening given the current level of debt/GDP within the US and other developed markets. US rate increases were so easily absorbed by the market in 2017 that a degree of complacency may have set in and we are mindful of the typical 12- to 18-month lags between monetary policy changes and real economic activity. Monetary policy has been likened to pushing on a string in the depths of a recession – and it seems to be taking time for the US Fed to pick up the slack as policy tightens.

In addition, and contrary to our earlier expectations, longer-term bond yields have remained very low in recent months, thus flattening the US yield curve. The shape of the US yield curve is now also clearly at odds with buoyant equity and credit markets. This is also something of a conundrum and we continue to believe that the pressure on bond yields is to the upside, recently reinforced by positive economic data.

**Exhibit 5: Chicago Fed financial conditions index now close to record low**




Source: Thomson Reuters Datastream. Lower = easier US financial conditions, based on measures of risk, credit costs and leverage

## Conclusion

In hindsight we have been over-cautious in our strategic views during 2017 as the performance of both Europe ex-UK and US markets has been relatively strong, despite the starting point of extended valuation multiples and progressively tighter monetary policy in the US at least. However even a cautious strategy would have generated returns significantly above cash during the year.

It is has also become increasingly evident that the digital economy is consolidating around a handful of global leaders which has led to an exceptional and not wholly unwarranted performance of the US technology sector during 2017.

While we take no view on the outlook for the bitcoin price due to its speculative nature we do see the coalescing of a significant amount of capital and infrastructure around blockchain technologies as a very important development with potentially disruptive implications for the conventional finance sector. Such digital disruption is not driven by any relative academic merit of distributed ledger technologies but more simply by the now established network effect within the digital finance community. In particular, it would in our view be a mistake to overlay the outlook for bitcoin with the outlook for digital investing. For the traditional finance industry, the risk is the genie is already out of the bottle.

There is no change to our strategic view as we continue to believe a cautious outlook is warranted for developed markets over the medium term on the basis of valuations that indicate very low expected returns in both equities and credit. However, recent economic surprise is increasingly positive and credit conditions loose. Therefore, a major fracture in markets in the near term remains unlikely in our view. We continue to believe that as we may be late in the cycle investors should combine a relatively modest level of market exposure with carefully selected exposure to specific company- or event-driven situations.

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