Illumination: Equity strategy and market outlook

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Global perspectives: Top-of-cycle investing

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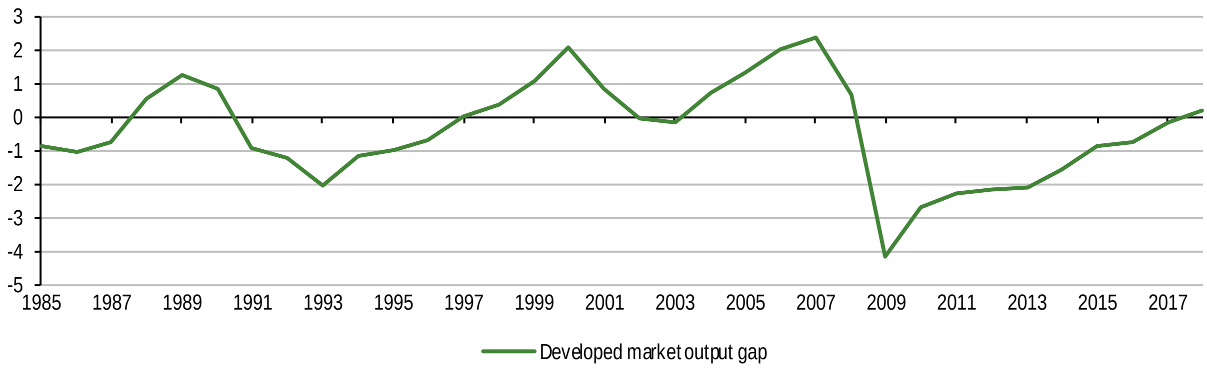
- **2018 is likely to be a year of two halves for global equity markets.** Initially, strong economic momentum and investor sentiment is likely to prevail over the negatives of high valuations and continued monetary tightening. However, the delayed impact of tighter policy in 2017 and further tightening in 2018 appears in our view to be a strong headwind to further equity performance from mid-year.
- **Output gaps in developed markets have now closed, in aggregate, for the first time since 2009**. This is a structural change from the slack environment which persisted following the financial crisis of 2008-09. Investors should therefore consider sector allocations carefully. Our analysis of sector performance over the previous three cycles indicates that lower-risk and less cyclical sectors may offer the better risk/reward even if cyclicals for now have the whip hand.
- **The closing of global output gaps has eliminated much of the room for manoeuvre in terms of monetary policy**. We view developed market monetary policy as being in a steady transition from accommodative to restrictive, a process which started in H216. In our view, investors should be cognisant of the long 18- to 24-month lag of the effect of monetary policy on economic variables such as inflation and growth. The current record strength of the eurozone economy for example is likely to prove the exception rather than the rule.
- **Ultra-low long-term government bond yields remain at odds with our base case of continued growth.** Price insensitive buyers – the world's major central banks – are either actively winding down balance sheets (US Fed), tapering QE (ECB), or becoming more sensitive to economic distortions (Bank of Japan). Though the level of debt in major economies means that future long-term rates are likely to be lower than historical averages, we see little diversification benefit in owning bonds at current yields. Investors should remain underweight duration risk in our view.
- **Equity valuations remain unappealing in general.** Price/book multiples for developed markets are now well above historical averages, except for the bubble period of the late 1990s. However, in an environment of such positive economic surprise, valuation data are unlikely to represent an impediment to further market progress but remain a real risk factor when the cycle turns.
- **Top-of-cycle investing is an uncomfortable proposition.** What performs most strongly up to the peak in activity often performs the worst immediately after. We believe the time for maximum equity market exposure was much earlier in this cycle when valuations discounted all but the worst economic outcomes. At present, equity portfolios should be tilted towards sectors which have offered a degree of resilience and a better risk/reward in the past. Specific growth or event-driven situations should also be favoured over broad market exposure, in our view.

Top-of-cycle investing

Strong near-term economic momentum supportive of markets

Finally, the developed market output gap between trend and actual output has closed, a decade after the financial crisis of 2008. The recovery has been slow but of a long duration. The nature of the economic cycle, such as it has existed in the past, is that long periods of expansion are followed by short, but sharp, contractions. Therefore, while the output gap may have closed only recently, it is likely that developed market economies are closer to the top of the cycle.

Exhibit 1: Developed market output gap closes



Source: IMF, Edison weights and calculations

Investing at the top of the cycle requires a different approach, in our view. There is something of an analogy with musical chairs as no one wants to be caught out when the music stops – or the cycle turns. Just as in the game, hovering near a safe chair may be the best strategy. With developed market equity valuations as high as they are now, in our view there is relatively little balance sheet or asset value support, in the event of a hiccup in growth momentum.

Although we continue to have concerns over the medium term (and we will outline how best to navigate the conflict between our short and medium-term views) in the short-run there has been remarkably positive economic momentum across all regions in the latter part of 2017. We fully expect this to follow through into the first half of 2018 and a round of profits upgrades is increasingly likely as analysts return from the seasonal vacation, given the continued economic surprise.

Commodity markets highlight the positive momentum in the global economy. Oil prices are now well above the marginal cost of shale, only recently regarded as a ceiling for prices, indicating the demand-led nature of the current market. Industrial commodities such as iron ore and copper are also trading close to new highs in recent weeks. The crash in the commodity sector in early 2016 is now a long-distant memory as the forecast collapse in demand from China failed to materialise.

Many of the risks associated with the excesses of the past will naturally diminish in the event of a period of above-trend growth. These include the productivity puzzle, as increased investment by the corporate sector should in theory improve the labour output per hour by increasing capital intensity. The corporate sector now has an increased incentive to improve labour productivity as labour becomes increasingly scarce.

Furthermore, improved levels of GDP add scope to either reduce deficits or increase government spending in otherwise fiscally constrained nations. A recovery which eases the fiscal pressure in the periphery of Europe would be welcomed by the ECB as it comes closer to the scenario of escape velocity, which the central bank has been trying hard to achieve.

The extended period of strong profitability in the corporate sector also goes some way to accommodating the rather large levels of non-financial corporate debt by enabling corporations to deleverage and improve credit metrics through operating cash generation. Benign deratings of currently high price/book valuations can also be realised by a continued strong return on equity, which allows for more rapid growth in book values.

However, it is important to recognise that despite the comforting psychological narratives that an economic expansion provides, investing has over the last 30 years been much riskier at the top of the cycle compared to during periods with a negative output gap or recessionary conditions.

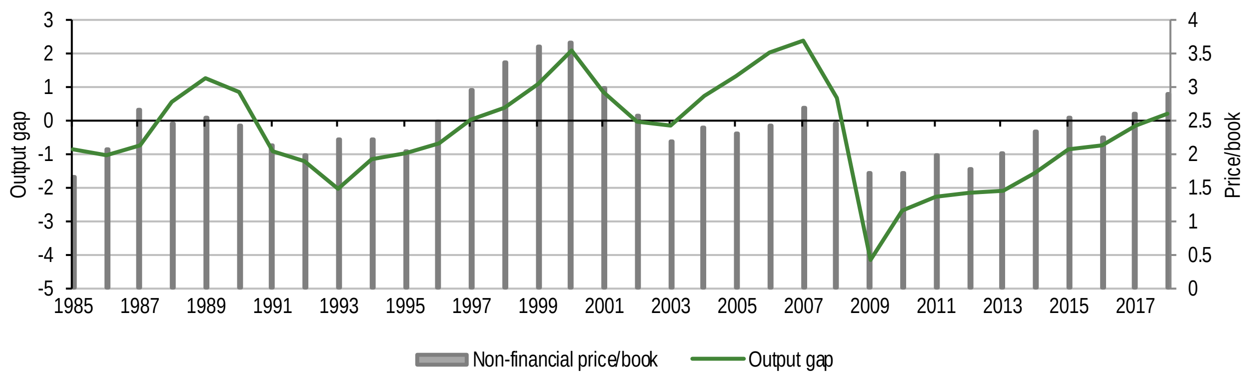
The reason for this is not that markets do not perform less strongly when the output gap has been closed – in fact the average annualised return until the peak in economic activity is modestly higher at 14%, compared to 12% during periods when the output gap is negative.

Rather, as Exhibit 1 shows the data highlights that the period of above-trend output prior to the next recession tends to be rather short. Furthermore, the actual turn of the cycle has recently been associated with substantial equity losses (2000-02 and 2008-09) and modestly negative equity returns over the 1988-1991 period.

Multi-year losses such as these will be a long way from investors' minds in the current environment. Yet this is precisely the pattern which has repeated over the previous three cycles. We believe investors should at least be aware of Exhibit 2, which shows that benign economic conditions can ultimately lead to difficult markets.

Periods of above-trend output are marked by the tendency for valuations to run ahead of long-term averages in such an environment, setting the stage for disappointing performance when the economic cycle turns. It may be different this time – but the historical data suggest it may be prudent to invest with a view to a swift exit, should the need arise.

Exhibit 2: Output gap and non-financial price/book



Source: IMF, Edison weights and calculations, Thomson Reuters Datastream

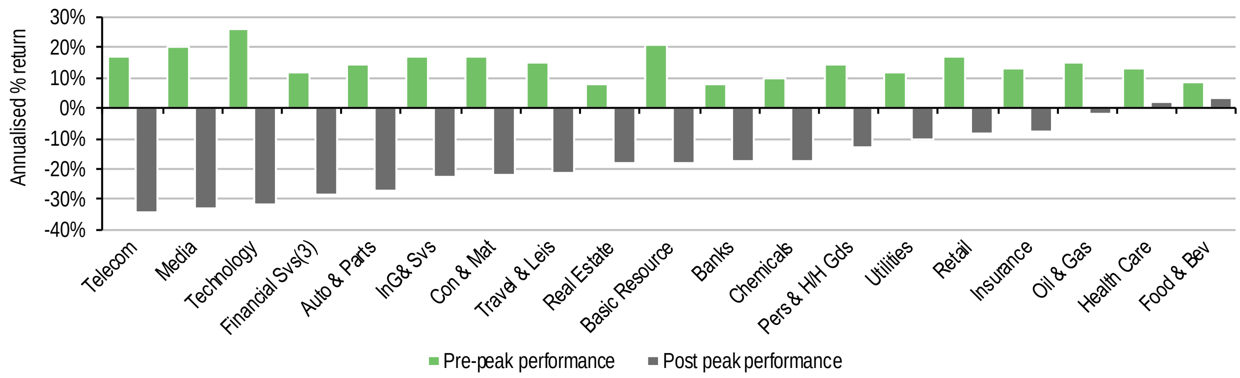
Look for value in defensive rather than cyclicals

Late cycle returns relatively uncorrelated to magnitude of post-peak losses

We have examined the sector performance of developed markets during periods when economic output is above trend since 1980. We have split these periods into an early phase (such as now) and a post-peak phase when the economy is slowing but still above its long-term trend and taken the average annualised return over the prior three cycles.

Exhibit 3 shows that average returns in the early phase of above-trend growth (such as now) are strong at 14% and modestly higher in traditionally cyclical and higher beta sectors such as basic resources, construction and autos. Telecoms, media and technology have also generated similarly strong returns although this is in part due to the influence of the dot-com bubble of the 1998-2002 period which may be an outlier.

Exhibit 3: Sector returns pre- and post- economic peak



Source: IMF, Edison weights and calculations, Thomson Reuters Datastream

What Exhibit 3 also confirms is that stock market returns in the period after the cycle has peaked have on average been very disappointing. Over the last three cycles the average sector has lost 15% in capital value following the peak in activity.

It is unfortunately not, in our view, easy to pinpoint a peak in economic activity in real time. Economic data are reported with significant lags and can be revised years later. Therefore, we believe from a strategic perspective it is better to be prepared ahead of time and be at least in part guided by the typical length of the period of above-trend output and the lags inherent in monetary policy. The average duration of the pre-peak period has ranged between 18 and 48 months over the last three cycles. For the present cycle, we may have been operating in an above-trend environment since the beginning of 2017. On past data the peak in activity could be as close as six months or as far as three years away.

Fortunately what the data also suggest to us is that a precautionary approach only sacrifices a modest degree of performance. Defensive sectors such as food, personal goods, insurance, large-cap oil & gas and pharma have delivered double-digit annualised returns at the top of the cycle but also offered substantially better capital preservation after the peak in activity, thus offering a better risk/reward and long-term return.

It is clearly tempting to keep running profits when commodity prices continue to climb and profits momentum is strong. But this is precisely the time to take profits in cyclical sectors and rotate into more defensive and less cyclical investments. There is also something intrinsically more exciting about trying to pick the top of the market rather than aim for a steadier but ultimately better long-term performance and it requires a degree of humility to accept that the end of this period of expansion is likely to be difficult to predict.

Over-confidence comes in many forms; one is a subconscious belief that it will be possible to time the market in this way. This bias runs the risk of dashing for cash too early or exiting the market too late. The data show that a pre-emptive move closer to the exit by rotating into more defensive investments may be a more rational step, foregoing relatively little return while at the same time substantially reducing risk to capital.

Closing of output gaps points to tighter monetary policy

Central banks have much less room for manoeuvre in 2018

Positive economic momentum and the elimination of slack in developed markets clearly support the policy stance of the US Federal Reserve of gradually removing monetary accommodation. Money markets originally tried to call policymakers' bluff but short-term interest rate markets have now shifted to discount Fed guidance for three rate increases in 2018. This would take market US interest rates close to 2% - a level unseen for well over a decade.

In the eurozone, the ECB is also well past peak monetary accommodation and is in the process of winding down QE. Should the record strong momentum evident in PMI data continue over the coming quarter, we believe the ECB may even have to guide to a more hawkish stance, couched in the terms of the unanticipated success of their prior policy initiatives. Such a development is already being priced into the euro which has continued to strengthen against the US dollar over the last few weeks.

While gradualism in returning monetary policy to more normal levels has been clearly emphasised by policymakers, the closure of global output gaps and the remarkable decline of unemployment in the US, UK and Germany highlights the challenge of attempting to run supportive monetary policy at the same time as factoring in the traditional lags between policy changes, inflation and growth. The current debate in the US about the advisability of raising rates while inflation is below target and falling is an example of the communication challenge – the Fed is not targeting current inflation but inflation in 12 to 24 months' time.

There is also policy uncertainty driven by questions over the lack of wage growth in developed markets to date, despite declining unemployment. The value of even implicit use of the Phillips curve model, which links labour market slack to forecast wage growth and inflation is even being called into question by the US Fed's own policymakers. We believe this is a difficult question and the data required to resolve this academic debate will not be available until after policy for the next 12 months at least will have been set. Minutes for the Federal Open Market Committee (FOMC) December 2017 meeting show there is an active debate on whether the currently low levels of US official unemployment will in fact lead to an acceleration in wage growth in future.

In terms of the Fed's current thinking, also taken from the December 2017 meeting minutes, there is certainly a range of views. While the consensus was still in favour of gradual rate increases over the next 12 months, a few participants were not comfortable with the current median projection for the Fed Funds interest rate at the end of 2018 of 2.1%, as they believed this may prevent inflation rising sustainably to 2%. On the other hand, a few other participants highlighted the lack of tightening of financial conditions even as interest rates have increased and the diminishing slack in the labour market.

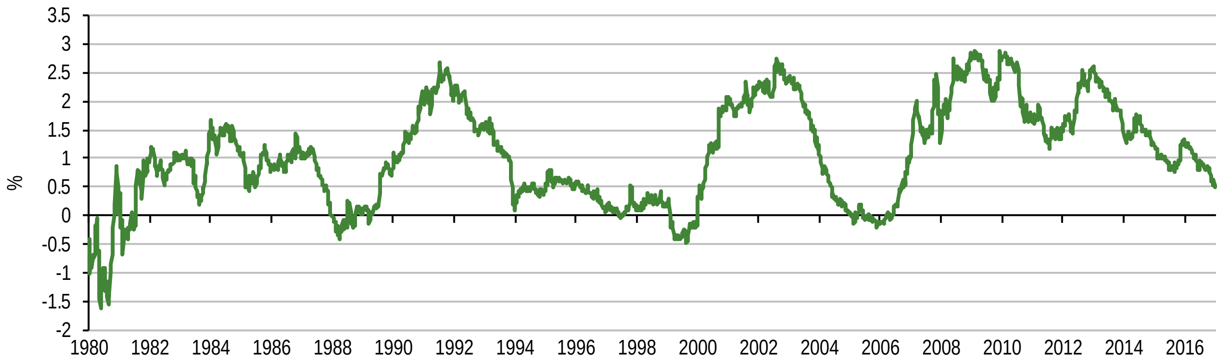
In the absence of definitive data to the contrary, we believe the bias for the FOMC will be to stick with traditional relationships between economic variables. This means that unless there is a significant market hiccup, the Fed will continue with its policy for increasing rates gradually over the course of 2018.

While the US interest rate increases of 2017 have been easily absorbed by the equity market, which at the fringes is showing signs of speculative behaviour, at least in the realm of blockchain-related technologies, there is in our view no guarantee that 2018's rate increases will be so easily absorbed.

We can see a risk scenario where the first round of monetary tightening (2017) starts to impact the economy by mid-year, slowing the current growth momentum while the limited slack in the economy and rising inflation pressure validates a monetary policy stance which may be inconsistent with currently rich equity and bond market pricing.

For bond markets, the flattening of the US yield curve, Exhibit 4, has already caught the attention of Fed policymakers. A reduction in the term premium was attributed to the large holdings of bonds by central banks combined with substantial global private demand for long duration assets. In some respects policymakers may believe this is a desirable crowding-out of the private sector, forcing investors to look elsewhere for returns and lowering financing costs in the process. To date, the flat yield curve was not regarded by Fed policymakers as unusual by historical standards with a divergence of opinion on whether it may foreshadow a recession or is a natural consequence of rising short-term interest rates – in which case inversion was said to carry no signal in respect of the outlook.

Exhibit 4: Flattening US yield curve – too early to claim a harbinger of recession



Source: Thomson Reuters Datastream

Based on the current trajectory of economic momentum and central bank policy, our base case is that global bond yields will gradually move higher as investors realise US interest rates are likely to stick at higher levels for a period of time and the ECB and Bank of England are likely to follow from 2019. In a benign economic scenario, which is the most likely outcome in our view at present, it is no longer unthinkable to consider US 10-year rates of over 3% by the end of 2018 in such circumstances.

We would also suggest that German bunds continue to appear exposed at ECB-depressed yields of just 0.44% when German unemployment is close to 15-year lows and inflation is running close to the ECB's target of below but close to 2%. To win the mandate to resolve the problems of the periphery of Europe, policymakers within the ECB had to overcome stubborn German resistance. Nevertheless, Germany remains the dominant economic and political force within the eurozone and tolerance of above-target inflation at the Bundesbank is limited. We believe bund yields are likely to move higher during 2018.

Equity valuations remain unappealing

Strong performance during 2017 has increased price/book premiums

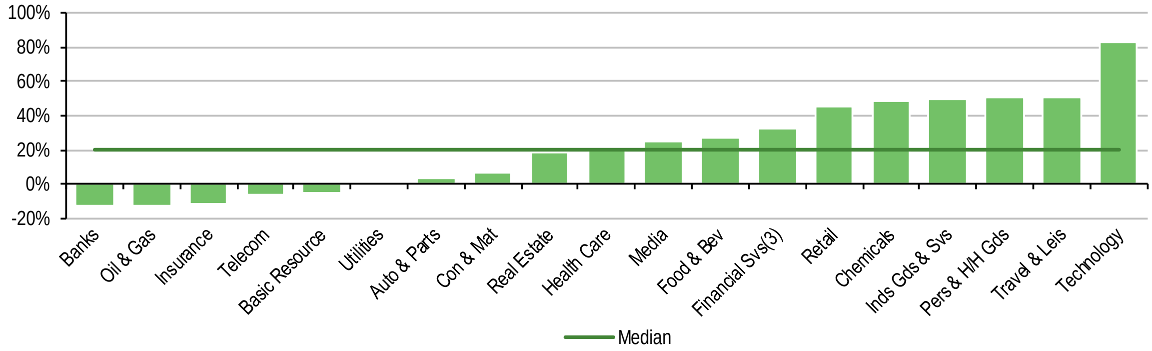
The corporate sector has been the standout beneficiary of the low interest rate and low wage growth rates during this cycle. Low interest rates have substantially lowered financing costs while low wage growth and the ability to source the lowest cost production on a global basis has enabled record-high profit margins to be maintained. This has confounded those who viewed low equity returns as a corollary of slow economic growth.

The doubts over the sustainability of the economic recovery also diverted the corporate sector's strong cash flows into share buybacks and dividends rather than riskier capital investment. In hindsight, it is perhaps clearer that such conditions were going to lead to a substantial re-rating of equities from the depressed levels of 2010-12.

As we have outlined previously, in the short term we do not see any slowdown in corporate profits performance which is currently receiving an additional benefit from rising commodity prices. However, we do have concerns over developed market valuations, which historically have been a reasonable guide to medium-term returns.

Based on currently high developed market valuations, Exhibit 5, we believe markets are fully discounting a continuation of the currently benign economic scenario. This benign scenario may also be our base case for the short term, but not into perpetuity. This is why we believe it is important to be prepared for the possible end of the current expansion. Fortunately, based on our earlier analysis rotating into sectors which have historically offered a degree of capital preservation in a downturn should not sacrifice too much portfolio performance over the near term.

Exhibit 5: Developed market sector price/book multiples remain at a premium to long-run averages



Source: Thomson Reuters Datastream, Edison calculations. Chart shows price/last reported book value for each sector.

It is also the case that following a long market rally the need for active management is increasingly questioned. In our view, with market valuations at current extended levels it is in fact a better time to question the merits of passive management which in traditional form can only offer broad market exposure.

Instead of the broad market exposure which has worked so well in the past, we believe investors should now focus on a limited list of carefully researched ideas, preferably where the outturn depends less on macroeconomic variables but instead on company or situation-specific factors.

Conclusion

For 2018, 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.

Our analysis of sector performance leading up to the peak in economic output and immediately afterwards suggests that while it may be tempting to ride cyclical exposure further the risk/reward is becoming unattractive. Defensive sectors have historically offered only modestly less return during above-trend periods of expansion and markedly greater capital preservation if or when a downturn comes.

For equities in 2018, we believe strong economic momentum and investor sentiment is likely to prevail over the negatives of high valuations and continued monetary tightening at least until mid-year. However, the lagged impact of tighter policy in 2017 and a further tightening in 2018 seems to us to be a strong headwind to further equity performance in the second half of the year. However, we have discussed the difficulties in timing the cycle to perfection and would suggest investors should at least stand close to the exits.

We believe the time for broad equity market exposure was much earlier in this cycle when valuations discounted all but the worst economic outcomes. At present we would prefer focused portfolios based on specific growth or event-driven situations.

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