



EDISON



Illumination: Equity strategy and market outlook

January 2018

Published by Edison Investment Research

Global perspectives: A January mini-cycle

- **The first few weeks of trading in January have highlighted the themes for the remainder of 2018.** Strong economic sentiment and earnings upgrades resulting from US tax reform initially pushed equity markets higher. However, the same factors are now pushing the entire yield curve upwards, creating competing demands for investors' capital. We continue to believe that in the short term, the still-strong growth dynamic will have the upper hand and risk assets will continue to perform. Over the longer term, however, the re-normalisation of monetary policy may bring stretched equity valuations into sharper relief.
- **The weakness of the dollar is a puzzle unless considered in the context of declining growth fears in Europe and China.** Over the past three years, both of these regions have been subject to speculation that excessive debt burdens carried the risk, at its most extreme, of a further financial crisis. As these fears have melted away and speculative positions unwound, the euro and renminbi have been in greater demand. The strength of sterling has also been remarkable and, in our view, is more reflective of a Brexit being easier in a supportive global economic environment, rather than any positive surprise in the political process.
- **US corporate tax reform has boosted 2018 US EPS estimates by approximately 4% during January.** On our estimates, this represents the majority of the benefit of the lowering of US corporate tax rates. In continental Europe and the UK, 2018 earnings forecasts have been stable year-to-date.
- **The implementation of tax reform and a lower dollar keeps the US Fed on track to raise rates in 2018.** We note that US short-term interest rates have been rising at an accelerating pace over recent weeks and market-implied inflation expectations have also been increasing.
- **We continue to believe this is a top-of-cycle investing environment where for cyclical sectors the risk/reward is less attractive.** While recognising the growth dynamic is strong for the moment, we continue to believe equity portfolios should now be tilted towards sectors that have offered a degree of resilience. Specific growth or event-driven situations should still be favoured over broad market exposure, in our view.

Analyst

Alastair George

+44 (0)20 3077 5700

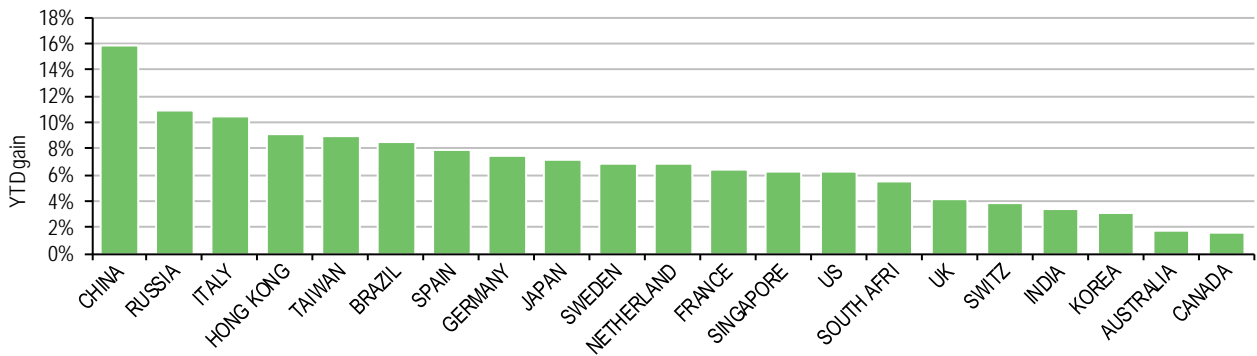
institutional@edisongroup.com

A January mini-cycle

Rally in equities and rising bond yields highlight themes for 2018

Since the beginning of 2018, global equities have enjoyed strong returns as positive economic momentum has continued to support investor sentiment. In US dollar terms, China's equity market is now up over 15% in just three weeks, with Russia and Italy also delivering returns in excess of 10%. This is, in our view, the nature of top-of-cycle investing, whereby the most cyclical or high beta sectors deliver the strongest returns, but also carry the greatest risk once the cycle turns.

Exhibit 1: Strong gains in global equities during January



Source: Thomson Reuters Datastream. Returns calculated in USD from 31/12/17 to 23/01/18.

The reduction in risk premia for higher beta equity markets is also reflected in foreign exchange markets as the US dollar has fallen significantly against other major currencies. The decline in the US dollar is down to external factors, in our view. Domestic US politics has only recently delivered substantial corporate tax reform likely to support US growth over the next 18 months and lead to incrementally higher interest rates. We believe investors have taken note of the very strong rebound in eurozone economic activity and increasingly realised the ECB is now on a parallel track to the US Fed, in terms of scaling back unconventional monetary policy.

While plausibly deniable, US Treasury Secretary Mnuchin's recent Davos comments suggest that the US no longer feels the need to maintain even a token commitment to its "strong dollar" policy of the past 30 years. The relaxed attitude of a key policymaker to the fall in the dollar has only accelerated its decline. It is much too early for any firm conclusions on whether this represents a meaningful shift in US policy. However, speculation is already developing in terms of the use of the US dollar as a bargaining chip in US trade negotiations. This could potentially be an unanticipated source of significant FX volatility in 2018.

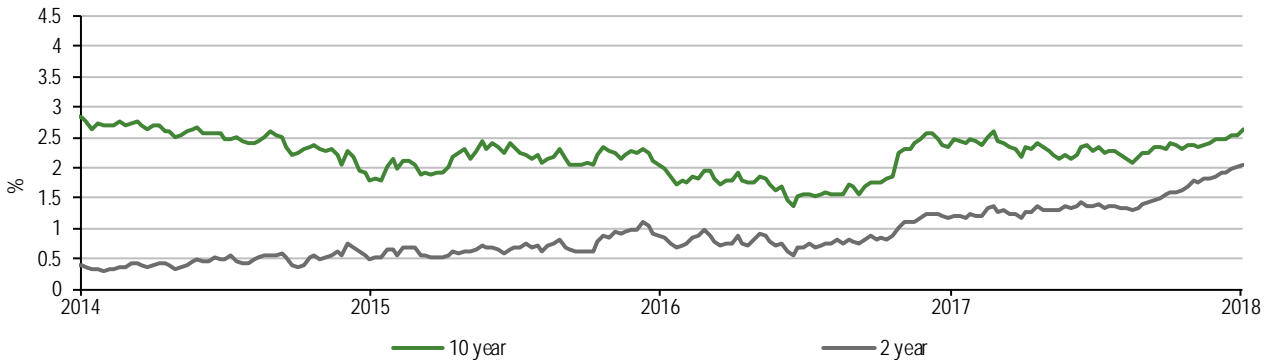
Exhibit 2: Declining trade-weighted US dollar contributing to easier global financial conditions



Source: Thomson Reuters Datastream

Improving economic sentiment has also led to rising global bond yields and rising market-implied inflation expectations in the US, which has given developed equity markets something of a brief pause in mid-January. We believe the themes of strong short-term growth, which is positive for risk assets and rising bond yields and interest rates, but negative for risk assets, are likely to bounce back and forth in investors' consciousness during 2018. The growth dynamic for now, however, clearly appears to have the upper hand. Bond yields have risen sharply (Exhibit 3), yet equity performance remains robust.

Exhibit 3: Rising US bond yields and interest rates



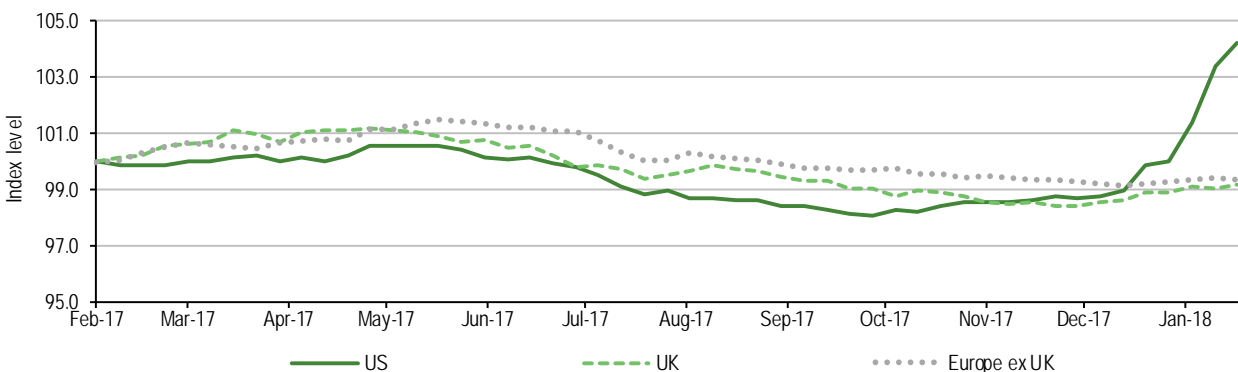
Source: IMF, Edison weights and calculations

Earnings: The real Trump bump

Median per-share earnings growth for S&P 500 upgrade of 4% following tax reform

Analysts' profits forecasts have edged modestly higher in the first month of the year in continental Europe and the UK, as would be expected during a period of above-consensus global economic data. The situation is strikingly different in the US, where tax reform has added to the cyclical economic strength, pushing median 2018 profits forecasts dramatically higher. The increase in 2018 estimates of 4% over the past month already represents two-thirds of our total expected benefit from tax reform.

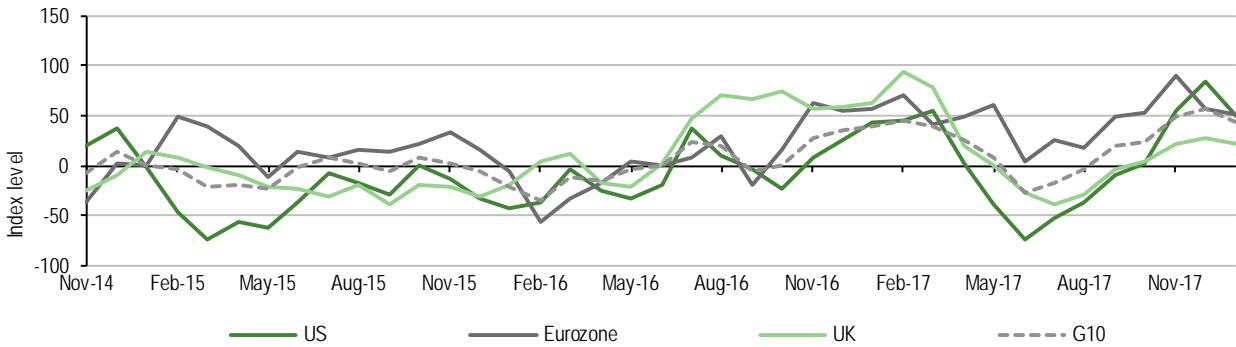
Exhibit 4: Unweighted consensus EPS index for 2018



Source: Thomson Reuters Datastream, Edison calculations

Median consensus earnings growth is now 8% in the UK, 10% for continental Europe and 13% for the US, where the impact of US tax reform is again clear. Though such profit growth expectations are helpful for equities at present, estimates can be volatile and tend to fall modestly over the full calendar year, absent continued positive economic surprise.

Exhibit 5: Global economic surprise indices



Source: Thomson Reuters Datastream

We do note, however, that economic surprise indices (Exhibit 5) show a very modest easing of momentum during January. The key to market performance over the full year will, in our view, be the extent of the lagged effect of monetary tightening of 2017 on the economy during 2018. While there is no reason for panic in respect of the real economy at present, equity valuations remain stretched, in our view, and a period of consolidation to allow earnings to catch up with high market multiples cannot be excluded.

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 holdings in specific company- or event-driven situations. The first few weeks of 2018 have highlighted the competing forces of stronger growth and the renormalisation of monetary policy.

While recognising the growth dynamic is strong for the moment, we continue to believe equity portfolios should now be tilted towards sectors that have offered a degree of resilience.

In terms of bond yields, 10-year yields still seem to us inconsistent with the current pace of economic expansion, particularly in Europe, despite the recent increases. We therefore remain underweight duration risk.

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the [Financial Conduct Authority](#). 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 Pty Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

DISCLAIMER

Copyright 2018 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 Investment Research Pty Ltd (Corporate Authorised Representative (1252501) of Myonlineadvisers Pty Ltd (AFSL: 427484)) and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. 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). 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 2018. "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
295 Madison Avenue, 18th Floor
10017, 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