Illumination: Equity strategy and market outlook

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Global perspectives: Equity headwinds

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- **Despite the modest declines over the last three months developed market equities remain expensive compared to historical averages and notably so in the US.** While above-average profit margins, low market volatility and ultra-low interest rates may have provided some justification for high valuations previously, we believe these assumptions are now being challenged by markets.
- **Developed market EBITDA margins remain extraordinarily high.** Two long-term drivers of this record run of corporate profitability, globalisation and weak wage growth, may now be fading. We believe that the prospect of a reversal of globalisation represents a further risk to large-cap corporate profit margins. Furthermore, wage growth is accelerating as unemployment falls on both sides of the Atlantic.
- **Widening divergence between US Fed and ECB likely to place further pressure on the euro, in our view.** US two-year interest rates have continued to climb as Fed policymakers maintain a hawkish outlook due to the resilience of the US economy and extra boost from tax reform. US 10-year yields have in recent days broken through the 3% level. In Europe however, economic momentum has faded quickly during Q118 and the ECB has turned hesitant.
- **With output gaps closed we believe future monetary and wage growth developments offer only headwinds for markets.** This remains a top-of-cycle environment in our view. Record forecast profit margins face risks from developments in US trade policy and tightening labour markets. With Fed monetary policy clearly remaining on a tightening track and offering for the first time in a decade real returns above zero, we stick with our cautious stance on global equity markets.

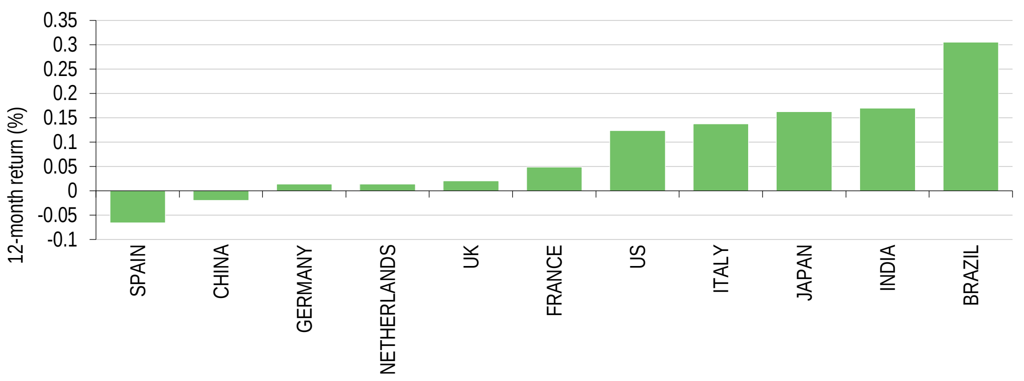
High equity valuations face macro headwinds

Drivers of record run of corporate profitability may be fading

We have had a cautious view on global equities for longer than has been comfortable. In truth, over the last 12 months this view has been 50% right at best. European markets, including the UK, have delivered relatively little capital growth. However, the US and emerging markets have moved significantly higher.

When the headlines are focused on geopolitical events, it is also easy to lose sight of the anchor of equity valuations. We have updated our equity valuation measures and find that the US market in particular remains notably expensive while European markets still appear overvalued. We recognise that this has in part been justified by the record run of corporate profitability but the factors driving this phenomenon may now be going into reverse.

Exhibit 1: 12-month equity market performance in local currency



Source: Thomson Reuters Datastream, as of 25 April 2018

Our cautious view on global equity markets has been in part stymied by the eventual agreement on US tax reform and the surprising weakness of the US dollar over the last 12 months. These factors, combined with persistent commodity strength, created a more benign environment for asset prices than we anticipated originally. The components of our original argument for caution were the relatively high level of equity valuations, the likelihood of mean-reversion in terms of corporate profitability and rising global interest rates. We now reconsider each factor in turn.

Exhibit 2: Median valuation measures for global equities

	Current 12-month trailing (x)			Premium/(discount) to average (%)			Average (%)
Region	P/E	P/book	P/sales	P/E	P/book	P/sales	
Europe (ex UK)	17.1	2.2	1.7	11%	9%	47%	22%
Japan	18.4	1.6	1.2	(23%)	(1%)	45%	7%
UK	15.5	2.1	1.7	9%	(4%)	29%	11%
US	20.4	3.1	2.6	18%	18%	46%	27%
Emerging	14.6	1.7	1.6	16%	(2%)	18%	11%

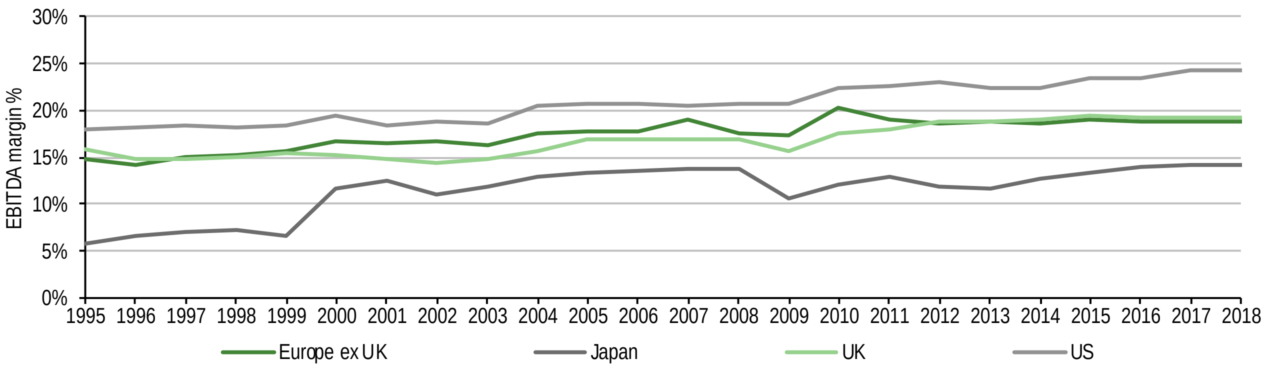
Source: Thomson Reuters Datastream, Edison calculations. Note: Figures >15% highlighted.

US equity valuations remain particularly extended

Exhibit 2 shows the current median market premium versus the 25-year average on a number of traditional valuation measures, with a composite figure in the final column. Unsurprisingly perhaps, following the strong performance and continued run of record-breaking profitability, US equities continue to be highly valued on this composite basis. European and UK equities also remain overvalued but the valuation premium has been shrinking as corporate profits and book values have grown over the past year, with relatively limited capital appreciation over the same period.

It is of course also true that high valuations have not been an impediment to progress in global equities in recent years, thanks to consistently low interest rates at all maturities along the yield curve. Furthermore, any fears of a decline in corporate profitability through mean reversion have also proved firmly wide of the mark in this cycle, at least to date. Median EBITDA margins have remained extraordinarily high across developed market equities, Exhibit 3. This is a continuation of a trend that may have started as early as the mid-1990s.

Exhibit 3: Upward trend in EBITDA margins in developed markets



Source: Thomson Reuters Datastream, Edison calculations

As a result, price/sales multiples are exceptionally elevated but in part due to each dollar of sales producing significantly more EBITDA than in the previous cycle. There are, however, signs the factors behind such above-average profitability are now turning for the worse.

Tariff liberalisation => globalisation => higher margins: Reverse gear now?

For example, over the last 20 years the declining influence of unions, trade liberalisation and consequent globalisation has enabled supply chains to shift to incorporate lower-cost countries. This has the combined benefit of shifting production to lower-cost workers and also to regions where there is greater appetite for capital investment.

Such a shift qualitatively improves EBITDA margins and may also be responsible for a part of the observed weakness in capital investment for companies listed on developed market exchanges. The fixed asset investments made in emerging markets which support this globalised supply chain model are clearly considerable – and are in our view key to the concerns over a trade war, as expressed by international organisations such as the IMF.

Despite these risks and following a long period of increasing globalisation, the US administration has now opened a formal process providing for increased tariffs on international trade with China. The key risk in the short term is corporate investment growth in exporting nations, a significant contributor to the cyclical direction of the global economy. With uncertainty in respect of any ultimate resolution to the US/China trade dispute elevated, corporate investment plans are at risk of being deferred if not cancelled. This is already evident in declining business optimism on both sides of the Atlantic.

Similar effects have been seen in the UK as negotiations to exit the EU continue. The Bank of England has estimated that UK business investment is 3-4% weaker than it might have been, as a result of the uncertainty over Brexit. For equity market prices, investors need nothing more than an expectation of a period of uncertainty to require an additional risk premium and as Exhibit 1 shows the UK equity market has been a relative underperformer over the prior 12 months.

It is still too early to tell how the US administration will ultimately proceed with trade negotiations. The precedent of North Korea shows that the mood within the White House can shift rapidly even if, on the face of it, once opened trade disputes are difficult to resolve quickly. In our view, a meaningful reversal of globalisation through tariffs would risk moving away from the benign environment for large-cap corporate margins. However, despite the tough early rhetoric from Trump, US Treasury secretary Steven Mnuchin is now set to meet his Chinese counterparts. We believe a 1930s-style trade war remains a scenario of very limited probability at present.

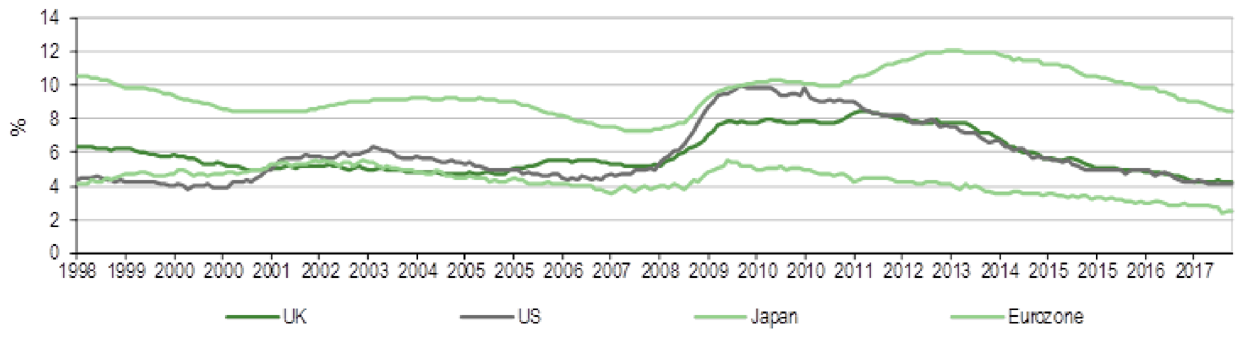
Nevertheless, given the policy volatility exhibited by the current US administration, most recently by raising and dashing days later the prospect of a US return to the Trans Pacific Partnership (TPP), we also believe there is little value in tilting a portfolio to favour a specific outcome on US/China trade. Instead, we expect investors to seek a more cautious portfolio positioning and adopt a wait-and-see approach.

Wage growth accelerating as unemployment declines in the US, UK and Europe

The second factor operating in favour of cyclically high corporate margins has been the long period of very high unemployment in developed markets following the financial crisis. Indeed, the lack of pricing power of labour and increased share of corporate profits in GDP had become something of a political phenomenon contributing to the surge in populism on both sides of the Atlantic.

However, this weakness in wage growth may already be old news. Labour markets have tightened appreciably over the last 18 months and unemployment in many of the world's developed markets is now pushing towards cyclical lows with wage growth moving higher, Exhibit 4.

Exhibit 4: Unemployment has declined to cyclical lows in developed markets



Source: Thomson Reuters Datastream, Edison calculations

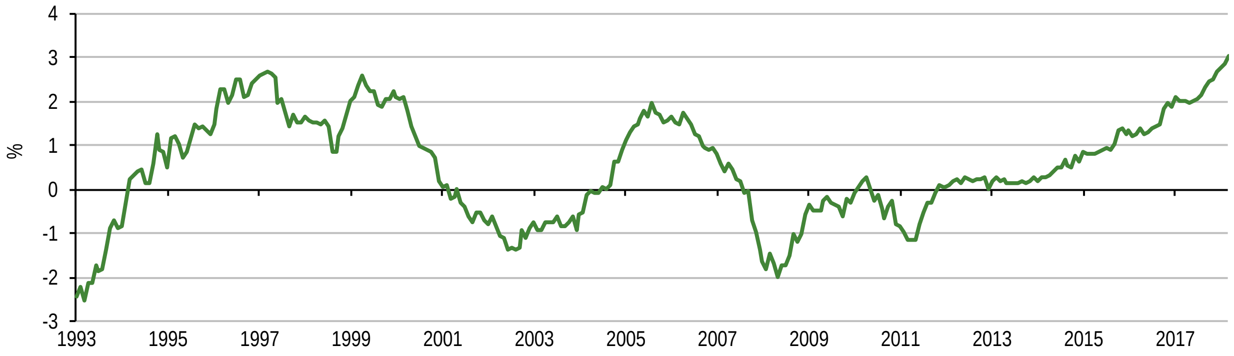
US Fed remains on hawkish track, even as ECB hesitates

The final factor is that ultra-loose monetary policy supported final demand during a period when the pricing power of labour and therefore consumer income growth was very weak, thus maintaining growth in corporates revenues. This was a helpful contributor to the exceptional profit margin performance shown during this cycle. It is however also clear that ultra-loose monetary policy is being gradually withdrawn worldwide, led by the US Federal Reserve.

Despite early signs of a slowing of the global economy, US policymakers have not backed away from guidance of three to four interest rate increases this year, which has finally been embedded in market expectations. We note that William Dudley, the president of the New York Fed, expects US interest rates to become slightly restrictive at as high as 3.4% over the next two years, which in the event would provide significant competition for investors' dollars away from equities.

Furthermore, the two-year interest rate differential between the US and eurozone is already at 300bps, a record level which we expect to place upward pressure on the dollar, propagating tighter financial conditions overseas, and notably in emerging markets. This interest rate differential has only widened as the ECB officials conduct press briefings suggesting increasing concern over the apparent loss of economic momentum in the eurozone in Q118.

Exhibit 5: Two-year US/Germany yield spread at 20-year record



Source: Thomson Reuters Datastream

Conclusion

With output gaps closed we believe future monetary and wage growth developments offer only headwinds, both for markets and levels of corporate profitability over coming quarters. This remains a top-of-cycle environment in our view. Uncertainty in respect of US trade policy risks a chilling of corporate optimism leading to a shortfall in business investment and short-term economic momentum even if the probability of an all-out trade war remains remote.

After the modest falls from the market highs recorded in January global equities remain expensive compared to historical valuation levels, according to our estimates. Record forecast profit margins face risks from developments in trade policy and tightening labour markets. With Fed policy clearly remaining on a tightening track, we stick with our cautious view on global equity markets.

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