Illumination: Equity strategy and market outlook

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Equity market overview and strategy

Strong earnings momentum and increasing investor confidence have helped drive the UK stock market up 6.6% year-to-date with the FTSE currently standing at a 21-month high. We still have our concerns – primarily over the risks relating to debt levels, public sector spending cuts, unemployment and potentially slower economic growth – but at present, it is hard to disagree with the prevailing sentiment of optimistic opinion. Against this background, we have become more confident on the outlook for basic materials, industrials and the oil & gas sector, but also continue to favour keeping some exposure to more defensive sectors in the event of any pull-back. Overall, we maintain a bottom-up approach, preferring stocks with high global diversification that offer undervalued growth potential.

One quarter through 2010, and (some more) reasons for optimism

More than three months of 2010 have now elapsed providing us with an opportunity both to look back and to look forward. The statistics paint an encouraging picture – indeed, one better than we had foreseen at the start of the year: the FTSE continues to make new highs (currently at levels last seen in July 2008) and the VIX index of volatility stands at its lowest since May 2008. Year-to-date, both the FTSE 100 and the FTSE All-Share have added more than 6%. Notably, March's performance (gains of greater than 2.5% for both indices, and only five down days) is a notably stronger performance than that recorded in February, when markets showed a significant lack of direction. Meanwhile, in the US, the S&P's first quarter gain was its best since 1998.

Exhibit 1: Relative performance of major UK indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	6.1	2.6	4.0	14.3	42.6
FTSE 250	10.8	5.5	7.9	14.8	48.9
FTSE Small Cap	4.0	0.9	2.6	1.9	54.4
FTSE All-Share	6.6	2.9	4.5	14.4	43.5
Relative UK performance					
FTSE 100 vs FTSE 250	(4.7)	(2.9)	(3.9)	(0.5)	(6.3)
FTSE 250 vs FTSE All-Share	4.2	2.6	3.4	0.4	5.4
FTSE Small Cap vs FTSE All-Share	(2.6)	(2.0)	(1.9)	(12.5)	10.9

Source: Datastream, Edison Investment Research

While a plethora of factors have helped power markets to a series of new 2010 highs, key for us – and more important than the macro data points that have become available since our last strategy piece – is the strong earnings momentum that has been demonstrated across a range of sectors. Almost a fifth of the FTSE 100's constituents reported (either full-year results for those companies with December year-ends, or trading statements) during March and the majority delivered results ahead of consensus expectations and/or raised guidance for the year ahead. Companies appear to be benefiting from stringent cost-cutting undertaken over the last 12 months as well as a stable low interest rate environment that has not only helped debt servicing, but has also (albeit gradually) helped stoke end-market demand.

Going forward, the key question relates to whether such momentum can be sustained. Optimists point to the fact that the full impact of operating leverage is yet to come through, while several lead macro indicators (particularly purchasing managers' surveys) also point to an encouraging picture. Further grist for the mill is provided by valuation – at 15.7x 2010 P/E we see the UK market as being no more than fairly valued – and by increasing M&A activity in both the primary and the secondary markets. Bears, however, make equally valid arguments in asserting that exceeded results performances have been driven more by bottom than top-line trends – clearly an unsustainable phenomenon – while the outlook may also become more difficult with impending spending cuts and still high unemployment.

At the least, we feel it is important to reiterate that concerns of a local nature need to be seen in a global context. In other words, some commentators highlight risks relating to the impending UK general election (scheduled for 6 May) and the fact that the UK's budget deficit (currently at 12.7% of GDP) is higher than Greece's and the impact that these factors could have on equity market sentiment. While it would be foolish to deny such concerns, our contention is that the FTSE's constituents are increasingly globally diversified in their nature; for us, the key statistic is that over 50% of the FTSE's forecast earnings momentum will be driven by the mining and oil & gas sectors, responsible for 30% of the All-Share's weighting (source: Thomson Reuters). These sectors are inherently international in nature. As another indicator of positive global sentiment, it is also worth noting that the oil price currently stands at an 18-month high at over $80/barrel.

Against this background, our stock and sector strategy favours global diversification, bottom-up analysis and undervalued growth. We retain our core overweight in basic materials (which has remained one of our two favoured sectors since Q409), but have become more confident on the industrials and oil & gas sectors, where we see strong momentum, which we anticipate being sustained. Given valuation, relative underperformance and also as a hedge against a near-term market correction, we also favour the more defensive sectors (telecoms, healthcare and utilities). We have ongoing caution over the financials sector as well as towards consumer-related plays, given risks to the outlook, and their typically UK-centric bias. Additionally, we see poor forecast earnings momentum in a number of consumer-facing sectors.

Overview and outlook: It's all about momentum

The key lesson learned from the first quarter is that earnings momentum has mattered more than macro data points. This has driven relative sector performance year-to-date and hence informs our sector strategy going forward. Year-to-date, the UK market has gained 6.6%, but notable outperforming sectors have been technology (up 16.2%), basic materials (14.8%) and industrials (11.9%), while healthcare (down 1.1%) and utilities (up just 0.8%) have lagged considerably. What unites the former sectors are two factors – their global nature and their favourable exposure to the economic cycle. By contrast, both healthcare and utilities have defensive characteristics, and the latter in particular has a heavy bias towards the UK economy.

Exhibit 2: Best and worst performing UK sectors (ranked in descending order)

YTD	Last month	Last three months	Last six months	Last 12 months
Technology	Basic materials	Technology	Basic materials	Basic materials
Basic materials	Industrials	Industrials	Technology	Technology
Industrials	Consumer services	Basic materials	Industrials	Financials
Consumer services	Technology	Consumer goods	Consumer goods	Consumer goods
Consumer goods	Telecoms	Consumer services	Consumer services	Industrials
Financials	Oil & gas	Telecoms	Oil & gas	Consumer services
Oil & gas	Financials	Financials	Utilities	Oil & gas
Telecoms	Utilities	Oil & gas	Telecoms	Healthcare
Utilities	Consumer goods	Utilities	Healthcare	Telecoms
Healthcare	Healthcare	Healthcare	Financials	Utilities

Source: Datastream, Edison Investment Research

We started 2010 with considerable caution, favouring only basic materials (our top pick in January's Edison Insight) among the three best performing sectors year-to-date, but feel that there is now a good case to move to a more overweight view on industrials and oil & gas, particularly given momentum. Our other overweight positions at the start of the year (telecoms, healthcare and utility) have delivered a disappointing performance, but we continue to believe the investment case for these sectors remains supportive, even if not quite as compelling as at the start of the year.

Several factors explain our adoption of a more optimistic stance. Most importantly, the economy seems to be reaping the benefits from the combination of lower interest rates and stimulus measures adopted last year. Investors should take comfort from the fact that the Monetary Policy Committee was unanimous in its decision to keep UK rates unchanged at 0.5%, while a similar message was echoed by the Federal Reserve, with Ben Bernanke stating that US rates would stay "exceptionally low ... for an extended period."

Such a scenario has a number of positive ramifications that have manifested themselves over the last month. Industrial production in the UK rose at its fastest level in 15 years according to the latest PMI survey (1 April), while the most recent CIPS survey (also 1 April) shows that UK new order growth is close to a six-year high. Consumer confidence also reached a two-year high in March, double levels recorded 12 months ago. Meanwhile, retail spend increased 3.5% year-on-year in February (no March figures are available yet), despite January's reversal in VAT. Evidence of these trends already having a positive impact corporate performance was provided in the recent reporting season. Positive statements that have subsequently resulted in improved consensus expectations were provided by 18 of the FTSE's 100 leading members in the month of March, a remarkably strong performance. Importantly, as Exhibit 3 shows below, companies from a range of industries were responsible for providing the positive surprises.

Exhibit 3: FTSE-100 constituents reporting a better outlook in March

Basic materials	Consumer goods	Consumer services	Financials	Healthcare	Industrials	Oil & gas	Technology	Telecoms	Utilities
Rio Tinto	Home Retail	Carnival	Aviva		Aggreko			Vodafone	
	Kingfisher	Pearson	L&G		BAE				
	Morisson	WPP	Lloyds		Rolls Royce				
	Next		RBS		Wolsely				
	Reckitt								

Source: Edison Investment Research

A virtuous circle effect also appears to be at work, since broadly improving macro stability and better corporate performances have contributed to a reduction in overall risk levels and hence growing confidence, evidenced by increasing corporate activity levels. As mentioned earlier, the VIX volatility index is back to levels last seen in May 2008, and has fallen 20% in the last year. Several potential concerns (Greek debt levels, the status of Obama's healthcare reforms in the US) appear to have been resolved for now, while there have also been some encouraging positive macro surprises (a $9.5bn restructuring of Dubai World's debt, World Bank upgrades to Chinese GDP estimates).

Against this background, corporates have recommenced deal-making, further spurring equities. During the last month, Prudential announced plans to acquire AIG's Asian assets, both UK-listed oil majors announced acquisitions abroad, Babcock secured rival VT in a £1.3bn transaction and Arriva confirmed that it had received a take-over approach from Deutsche Bahn. BSkyB, Liberty International and Wellstream have all also been subject to bid speculation in recent weeks.

Meanwhile, the UK IPO market opened up, with Promethean (interactive whiteboards) and Supergroup (clothing and accessories) both raising £400m and other companies such as CPP and EMIS also coming to market. Other major companies mooted to be considering listings include New Look and Ocado. Bond issuance has also been robust, both in the UK and continental Europe. In what clearly appears to be a reversal of 2009 trends, investors are putting cash to work (in equities and bonds), while anecdotal evidence also suggests that fund inflows are increasing.

If the outlook appears as rosy as described above, then why are we not more positive? The answer is provided by several members of the Bank of England's Monetary Policy Committee: its 17 March Minutes talk of "considerable uncertainties", while Deputy Governor Charles Bean said in a speech on 19 March that "the road ahead is still bumpy" with the risk of "further adverse shocks". Furthermore, committee member Andrew Sentance even highlighted in a separate 19 March interview with CNBC that there was still "some risk of a double-dip" recession in the UK.

Investors, however, appear to have looked through these comments, with the UK stock market gaining on both days when these speeches were made, and having risen by 2.0% since 17 March. Nonetheless, the Bank's comments do have some validity in our opinion. The government was forced to cut its forecasts for UK GDP growth in March's Budget, down from 1.5% to 1.25% for 2010 and from 3.5% to 3.0% for 2010, and both the CBI as well as the Ernst & Young ITEM Club have described economic prospects as "sluggish" in recent reports (both released on 22 March).

While the government has stated clearly that it intends to reduce the UK's budget deficit significantly in coming years (from 11.8% of GDP by the end of 2010 to 5.2% by 2014), few details on exactly how the deficit will be cut have been provided. Even if there is a change in political administration (and another Budget) later this year, we do not expect the Conservatives to be meaningfully more forthcoming in their reduction plans. The key risk is that public sector spending cuts impact both unemployment and consumer confidence levels, resulting in the virtuous circle alluded to earlier becoming significantly more vicious.

UK unemployment did fall 33,000 in March, but 2.45m people (equivalent to a rate of 7.8%) remain unemployed. More worryingly, the number of people registered as being long-term unemployed rose by over 10% to 687,000 in the last reported period. Moreover, despite improving confidence levels among consumers, we note that mortgage lending is still "subdued" (according to the British Bankers' Association, 23 March), and several large UK bellwethers (including Kingfisher and Next) have been reluctant to provide guidance on likely future spending intentions. Sainsbury even went further in describing the consumer outlook as being "particularly challenging."

Our strategy: Look beyond the UK

What appears obvious is often that which is most important, hence the following observation: what drives the UK stock market is *not* the UK economy. The FTSE's (major) constituents are increasingly internationally diversified in their nature and indeed one of the criteria we use for screening companies in our *Illuminator* stock-picking product is international competitiveness. While we appreciate that many investors will look at more than just the UK stock market, we believe the observations we make below have validity across a range of different markets.

1: Earnings momentum

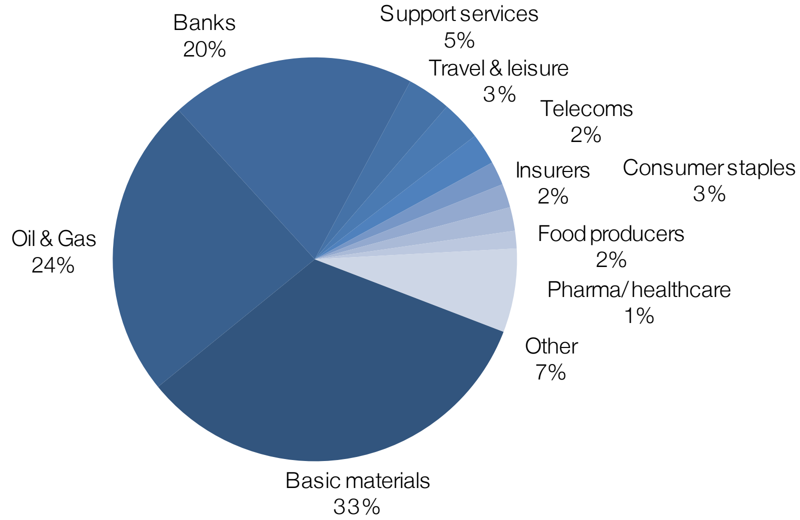
Exhibit 4 highlights that based on consensus earnings expectations, two sectors – basic materials and oil & gas – are forecast to provide over half of the FTSE's earnings growth for 2010. The major listed constituents of these two sectors derive a significant proportion of their earnings from outside the UK and so are not beholden to the performance of the domestic economy.

More importantly, as we have highlighted for some time, the thesis of global industrialisation will continue to drive momentum in these two sectors, and basic materials in particular. Our contention remains simply that as the (emerging) world industrialises, demand for resources will endure and consensus is potentially being too cautious in estimating growth prospects. Notably, the World Bank recently revised upwards its estimates for Chinese GDP in 2010 (from 9.0% to 9.5%) while Rio Tinto said on 16 March that demand in China for iron ore, copper, coal and aluminium will "increase dramatically" over the next 15 years. The IEA also reported that oil demand in China rose by an "astonishing" 26% year-on-year in January (the last month for which data is available).

Looking ahead, we see significant potential for China still to build out its infrastructure, especially in more rural areas. Over 200 cities in China have more than 1m inhabitants, but fewer than 40% of these have airports or roads that extend more than 20 miles beyond the urban boundary. Demand for basic materials and demand for oil are inextricably interlinked in our view.

Importantly, the basic materials and oil & gas sectors constitute over 30% of the FTSE's weight (12.9% and 18.0% respectively – see Exhibit 7 below), and so if earnings momentum in these sectors does endure, then this should help drive the UK market higher. It is also noteworthy that despite the healthcare sector constituting 7.3% of the FTSE's weight, it is responsible for just 1.4% of its 2010 earnings momentum and a similar argument also applies for telecoms (5.7% weight, 1.9% momentum).

Exhibit 4: FTSE earnings growth breakdown for 2010 (in percentage points)



Source: Thomson Reuters Datastream, Edison Investment Research

2: Relative macro stability

Bears should take comfort that concerns levelled towards the UK economy (unsustainable state debt levels, rising unemployment, mixed consumer signals) also prevail elsewhere. Furthermore, as Exhibit 5 highlights, the major UK indices have outperformed their European peers by over five percentage points both year-to-date and over the last 12 months. Two factors are responsible for this performance in our opinion: first, the UK stock market has a heavy preponderance to internationally diversified companies (the point enunciated above); second, even if current UK debt levels mirror those of Greece, the UK benefits from a flexible currency and a lower percentage of GDP weighted to domestic consumption.

Concerns over Greek debt default and potential contagion effects have had a significant impact on the performance of equities, with the resolution of the Greek situation (via a combination of Eurozone and IMF support) providing a helpful fillip for equity markets globally. Nonetheless, those countries with major debt burdens and fewer tools at their disposal for managing the situation have seen their stock markets notably underperform. Spain's benchmark IBEX index has dropped 7.3% year-to-date, while Italy's MIBTEL also finds itself in negative territory.

Macro trends in the UK also appear *relatively less bad* than in the Eurozone. Eurozone unemployment is still rising and is notably higher than in the UK (10.0% vs 7.8%, based on last reported figures), and while Eurozone inflation continues to rise (up to 1.5% in March vs 0.9% in February), consensus opinion suggests that the rate of UK inflation may now have begun to slow. Moreover, despite recently positive purchasing manager surveys from both Germany and France, Eurostat's 25 March press release showed that industrial new orders had fallen 2.0% in January, a deterioration on the previous month, where a 0.9% rise was recorded.

Exhibit 5: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
DJ EURO STOXX	2.4	3.8	0.4	7.5	38.2
DJ EURO STOXX 50	0.5	3.5	(1.1)	6.7	35.5
France CAC40	2.5	3.2	0.5	9.8	36.4
Germany DAX30	4.7	6.1	3.4	13.2	42.2
Spain IBEX35	(7.3)	0.4	(9.3)	(4.2)	33.0
Italy MIBTEL30	(0.2)	4.2	(1.5)	1.7	37.3
FTSE 100	6.1	2.6	4.0	14.3	42.6
FTSE All-Share	6.6	2.9	4.5	14.4	43.5
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	5.6	(0.9)	5.1	7.6	7.1
FTSE All-Share vs EURO STOXX	4.2	(0.9)	4.1	6.9	5.3

Source: Datastream, Edison Investment Research

Towards a sector ranking: Key considerations

We believe that a robust case can be made for equities, but also one that it is not without its risks. On the positive side, recent performance and improving earnings momentum increases our confidence, but we would need to see at least another quarter of results in order to believe that the recovery in earnings is sustainable. Several factors could derail this, particularly were either industrial or consumer confidence to deteriorate markedly. Moreover, recent events such as the Dubai World and Greek debt crises serve as a reminder that exogenous events can destabilise (still fragile) global sentiment – and also take time to resolve. Against this background, we are no more than cautiously optimistic on the outlook for equities and consider it inappropriate to move away from continuing some holdings in more defensive sectors. Key factors that inform our sector and stock stance are the following:

- We favour high global diversity by end-market and particularly emerging market exposure; this factor is primarily driving earnings momentum in our view.
- We are believers in GARP-style investing (growth at the right price), but find merit currently in undervalued sectors that have underperformed. Defensives may come to the fore if there is a market correction.
- We feel that bottom-up analysis and stock-picking will continue to matter more than sector allocation.

Exhibit 6 shows our preferred sector strategy, which we caution is strictly illustrative since it relates just to hypothetical positioning across UK equities whereas, in reality, investors will likely take into consideration a much broader range of factors. Based on the commentary above, we have made some revisions to our preferred sector allocation relative both to the previous month and to the start of the year. We provide additional explanation and justification below:

- The basic materials sector remains a core overweight, and is now joined by industrials and oil & gas, based on their potential to surprise positively with regard to earnings, and the corresponding impact that this move would have on the FTSE’s performance, given their weighting within the index.
- Given recent underperformance (and an increase in risk appetite relative to the previous month), we have become somewhat less positive on the telecoms, healthcare and utility sectors, but find merit based on yield and value.
- We remain concerned about the consumer sectors (goods and services), particularly based on the likely near-term consumer outlook. Both sectors also trade at a premium to the UK market.

- We have become less positive on the technology sector. We note this constitutes the smallest sector within the UK market in weighting terms (just 1.6%), but have concerns given valuation (>25x P/E on a 2010 headline basis) and recent strong outperformance.

Exhibit 6: Edison sector rankings, how and why they have changed

Position	Apr-10	Rationale	Mar-10	Jan-10
Best	Basic materials	Momentum/ global exposure	Utilities	Basic materials
	Industrials	Momentum/ improving sentiment	Basic materials	Telecoms
	Oil & gas	Momentum/ global exposure	Telecoms	Healthcare
	Telecoms	Valuation/ recent underperformance	Healthcare	Utilities
	Healthcare	Valuation/ recent underperformance	Technology	Industrials
	Utilities	Valuation/ recent underperformance	Industrials	Technology
	Consumer services	Near-term outlook/ valuation	Oil & gas	Oil & gas
	Consumer goods	Near-term outlook/ valuation	Consumer services	Consumer services
	Technology	Valuation/ recent outperformance	Consumer goods	Consumer goods
Worst	Financials	Fundamental risks	Financials	Financials

Source: Edison Investment Research

Exhibit 7: Edison sector rankings, key valuation and performance data

Note: * All Share benchmark weight.

Position	Sector	Weight*	P/E	Yield	YTD	Last month	Last three months	Last six months	Last 12 months
Best	Basic materials	12.9%	14.8	1.5%	14.8%	7.5%	9.8%	46.5%	94.4%
	Industrials	7.2%	15.5	2.6%	11.9%	5.0%	10.3%	18.8%	47.0%
	Oil & gas	18.0%	14.1	4.3%	4.2%	2.6%	0.8%	13.8%	28.8%
	Telecoms	5.7%	9.7	4.9%	4.3%	2.9%	3.9%	7.8%	24.6%
	Healthcare	7.3%	12.7	4.3%	(1.1%)	(0.4%)	(0.7%)	6.0%	25.0%
	Utilities	3.3%	15.3	5.1%	0.8%	0.9%	0.1%	10.3%	20.6%
	Consumer services	9.9%	15.9	2.7%	8.5%	4.3%	7.8%	14.7%	34.6%
	Consumer goods	11.2%	18.9	3.1%	7.1%	0.9%	8.1%	16.7%	47.5%
	Technology	1.6%	25.1	1.2%	16.2%	3.2%	13.9%	22.4%	72.3%
Worst	Financials	22.9%	25.2	2.8%	5.2%	1.8%	1.6%	2.6%	53.2%
Average		100.0%	15.7	3.1%	6.6%	2.9%	4.5%	14.4%	43.5%

Source: Datastream, Edison Investment Research

Overweight 'momentum' sectors

As we have explained elsewhere, the biggest driver of recent stock market outperformance has been strong reported results from a range of companies across sectors. However, the area where expectations have been exceeded most consistently has been within the industrial segment, with Aggreko, Bodycote, Tomkins and Wolseley among others delivering better than anticipated figures.

Some of the outperformance has been driven through the implementation of 'self-help' measures such as cost-cutting and the subsequent benefits of operating leverage. However, much of our future confidence is also driven by the fact that end-market demand appears robust, particularly from emerging markets. Domestic trends though are also encouraging as evidenced by recent surveys in the UK as well as other developed markets such as the US (where March's ISM reading was the eighth consecutive gain and showed the fastest rate of growth in six years). Globally, oil demand also appears with robust, with per barrel prices at 18-month highs and up over 60% year-on-year.

Looking forward, we expect demand trends to remain intact (although likely reductions in public spending will clearly have a negative impact on some stocks). Moreover, our confidence in these sectors is reinforced by the fact that basic materials, industrials and oil & gas all continue to trade on sub-market multiples. We also note that the oil & gas sector's dividend yield (4.3%) is noticeably higher than that of the UK market (3.1%).

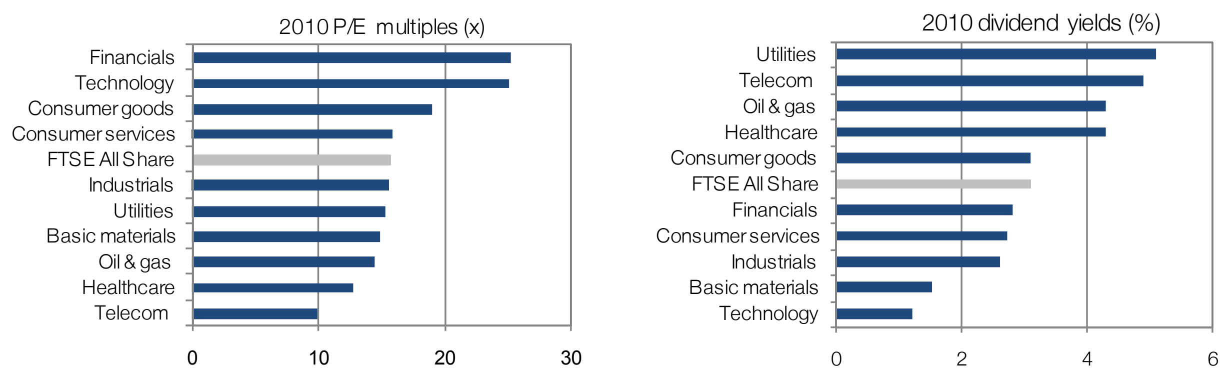
Neutral defensive sectors: Telecoms, healthcare and utilities – attractive on yield and other factors

The appeals of neutral defensive sectors are broadly understood: namely, yield and value, combined with relatively low economic risk. Current dividend yields are 5.1%, 4.9% and 4.6% for the utility, telecoms and healthcare sectors respectively, with all the above sectors also trading on multiples below the UK market average. It is also worth noting the yields described above are still higher than that of the 10-year UK bond (3.9%) and political/currency concerns could suggest that defensively positioned equities constitute bond-like proxies with lower risk. These sectors may come to the fore should there be any pull-back in equities following recent market outperformance.

With regard to the healthcare sector, the mega-cap pharma stocks seem to be finding a renewed degree of confidence, as the M&A cycle seems to have run its course for the time being, while med-tech is now focusing on the opportunities provided by an ageing population demographic. Recent US healthcare reform may also be a positive driver for the sector over the medium term. Among the UK mega cap stocks, our preference is for Astra owing to what we perceive to be misplaced concerns over its 'patent cliff' combined with its strong emerging markets presence (one of our key themes) and balance sheet, which offers the potential for increased share buy-backs.

In contrast to the healthcare sector, the presence of M&A may serve as a potential additional driver for utilities and telecoms. The UK water sector has long been seen as ripe for consolidation and press coverage earlier this year suggested that Northumbrian Water could be a potential bid target. Within telecoms, both Cable & Wireless and Carphone Warehouse have helped crystallise value for their shareholders via recent demergers and may now be involved in further M&A activity, while Daisy Group continues to consolidate the smaller end of the market.

Exhibit 8: 2010 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

Underweight consumer goods and services

Both the consumer goods and services sectors have outperformed relative to the market since the start of the year despite the increasing notes of caution being sounded by corporates. Kingfisher and Next surpassed consensus expectations in their recent results (as did Home Retail Group), but neither company was sufficiently confident to guide positively regarding the outlook, citing uncertainties over future consumer spending intentions. Sainsbury went further in describing the outlook as being "particularly challenging."

We believe that as the remainder of the year develops, risks will grow to the downside for consumer-related plays, particularly if unemployment rises (or even if it does not fall) and this hence impacts spending behaviour. Looking ahead, we see potential scope for disappointment relating to first quarter trading and struggle to see a strong case for outperformance until management teams can sound a noticeable voice of confidence on visibility and the outlook.

Unlike some other sectors, UK-listed retailers are primarily plays on the UK economy (in other words, international assets are not a significant driver of group revenues and profitability, with a few exceptions – eg Tesco, Kingfisher) and while some consumer sub-sectors such as pubs & restaurants, sportswear retailers, bookmakers and advertising agencies may benefit from a football World Cup-related affect in 2010, we do not expect this to be a panacea for the broader industry. Moreover, with the sector trading at a premium to the UK market, we are unable to construct a valuation case at present.

Underweight financials

We have had structural and valuation concerns over the UK financial sector for some time. While it is fair to highlight that risk premiums have begun to reduce as credit has normalised, certain negatives clearly remain. Some of these have been brought to the fore by the Obama/Volcker banking sector review plans, which the Senate now appears to have endorsed. Reforms will likely take time to be implemented and may well be watered down, but it is a clear reminder that the sector remains an obvious (and perhaps justified) political target. Although how proposed reforms are interpreted and subsequently implemented in the UK remains unclear, the country's possible next chancellor, George Osborne of the Conservative Party, has given his endorsement to US reform. At the least, reform has the ability to impact sentiment and increase uncertainty.

More fundamentally, UK-listed banks will have to deal with the challenges imposed by new Basel requirements, increased funding costs, the risk of rising non-performing loans and a generally muted new business environment. The Bank of England also notes that "many banks still have high levels of leverage and unbalanced funding structures" (*Financial Stability Report*, 18 December). On the Bank's own estimates, British banks will need to refinance over £1,000bn in wholesale funding in 2010, which could result in potential volatility in both the debt and equity markets.

It is interesting to note that while we have been negative on financials since Q4 last year, the popularity of the European banking sector among fund managers fell by the biggest margin ever seen in a single month (during February), according to a survey conducted by Bank of America Merrill Lynch. Despite such a stance, and the fact that underweight financials has become increasingly consensual, we believe it is still too early to revise our view, especially given impending uncertainties, and while the valuation (the sector trades on >25x P/E) remains uncompelling. Nonetheless, recent results from Barclays, RBS and Lloyds in particular do highlight some encouraging trends (particularly lower loss levels), and earnings multiples may begin to compress over 2010.

Conclusions

Strong earnings momentum and increasing investor confidence have helped drive the UK stock market up 6.6% year-to-date with the FTSE currently standing at a 21-month high. We still have our concerns – primarily over the risks relating to debt levels, public sector spending cuts, unemployment and potentially slower economic growth – but at present, it is hard to disagree with the prevailing sentiment of optimistic opinion. Against this background, we have become more confident on the outlook for basic materials, industrials and the oil & gas sector, but also continue to favour keeping some exposure to more defensive sectors in the event of any pull-back. Overall, we maintain a bottom-up approach, preferring stocks with high global diversification that offer undervalued growth potential.

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