

Illumination: Equity strategy and market outlook

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Alex Gunz
Analyst, institutional product
020 3077 5746
institutional@edisoninvestmentresearch.co.uk

Equity market overview and strategy

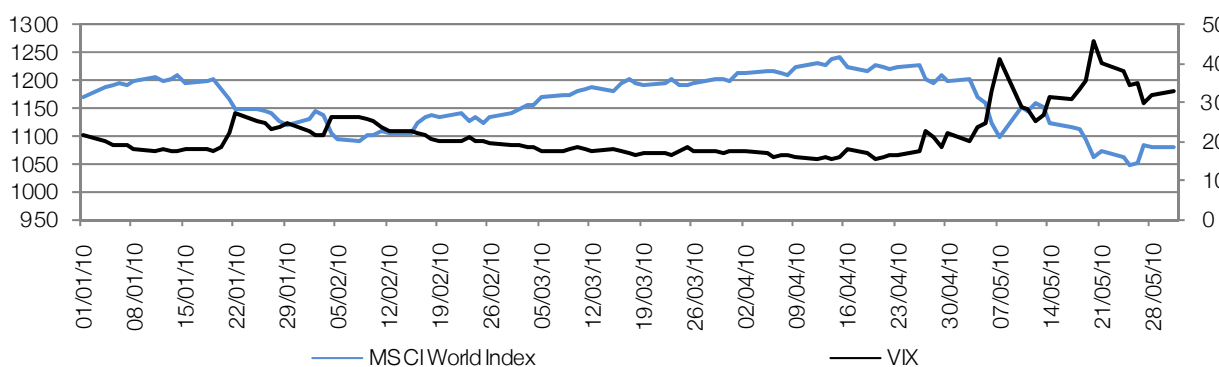
Volatility and uncertainty have been the key themes for equity investors over the past month, and we see little reason for this to change over the summer. There remains an unappetising cocktail of substantial state debt burdens, rising inflation and growing unemployment. Added to this, earnings momentum is showing some signs of slowing and we do not see valuation levels for equities as being overly compelling. Our strategy for sector and stock allocation relates to adopting a longer-term focus, preferring positions that offer high global diversification and undervalued growth potential. Near-term, high yielding plays are likely to find most favour. On the negative side, we retain our high conviction underweight in consumer cyclicals.

The bumpy road ahead

Amid the usual plethora of statistics that have been released since the last edition of the *Edison Insight*, the one that stands out most for us has been the move in the VIX: after hitting a 52-week low of 15.6 on 12 April, the volatility index moved to make a 52-week high of 45.8 just 27 trading day later, on 20 May. To put this level of investor nervousness into context, although the VIX peaked at over 80 during the nadir of the Lehman crisis, the *only* other time that the volatility index crossed 45 during the last decade was after the 9/11 attacks in America. Although the index has now moved back to around 30, it is notable that the 50- and 100-day moving average levels are continuing to trend steeply up. Such moves as have been witnessed in recent weeks are indicative to us of ongoing investor nervousness.

This has also been played out in a stock market context, with global indices enduring their worst month in performance terms since February 2009 (the month before equities began their recovery from 12-year lows). The 10 May bounce of 5.2% in the All-Share post the Eurozone's co-ordinated bail-out of Greece seems long-forgotten, replaced with the FTSE-100 dipping below 5,000 (although this level has now been regained) and the All-Share breaching its crucial 2,600 resistance level. Elsewhere, the Dow experienced an intra-day drop of 9% on 6 May and its fall of 3.6% on 20 May was its biggest one-day decline since February 2009.

Exhibit 1: Equities and volatility closely correlated: both are also showing increasingly volatile movements



Source: Datastream, Edison Investment Research

We have discussed in previous editions investors' preference for the 'risk trade' (in March) and how fears over sovereign debt default have undermined signs of burgeoning earnings momentum (in May). Both of these issues have clearly come to the fore in recent weeks, with the risk trade being decidedly taken off – evidenced by gold reaching new highs – and investors focusing primarily on a potentially deteriorating macro environment.

Debt is the main issue that simply seems to refuse to go away. In our opinion, had free markets been left to function efficiently, then banks would have been allowed to fail in 2008. As a consequence of state intervention, there was an effective transfer of moral hazard from the private sector to the public sector, and investors are now paying the price for this. The ramifications of such a move will also be felt for some time to

come, not just from a stock market perspective, but also as the 'price' now being paid is a scaling back of the welfare state and its associated provisions, as evidenced by the austerity measures being introduced by most European nations and especially the UK.

Moreover, investors should not forget that with global inflation and unemployment on the rise, there is a clear danger posed by too many countries attempting fiscal and monetary tightening at the same time. It is also not clear whether such attempts will work. With the benefit of hindsight, the sheer scale of Greece's bail-out (€750bn) seems not to be an act of harmonious coordination, but more one of panic. Crucially, it also potentially fails to address Greece's key issue, which was not one of insolvency, but of illiquidity; and, insolvency cannot be rectified by piling on more debt. A more logical plan would have been to seek to restructure Greece's debt.

We see the move in the LIBOR-OIS spread (a key measure of how likely institutions are to default, which relates to the cost of insuring debt) of more than 30 basis points during the last month as being indicative of investor scepticism. More worryingly, for the first time since September 2008 and the collapse of Lehman Brothers, even triple-A rated Germany was unable to complete an auction of Bunds, with its sale on 26 May of five-year bonds raising just €6.1bn relative to a target of €7.0bn.

If investors did not have enough to contemplate on the negative side (notwithstanding the formal enactment of the biggest financial reform in the US since the 1930s), we also see the gloss coming off the improving earnings momentum story, which had been one of the key positive trend indicators emerging in recent months. Some 20% of the FTSE-100's constituents that reported during the last month missed consensus estimates and/or gave cautious guidance over the outlook. This phenomenon has not just been restricted to one sector, with trends weakening in both the consumer space (eg Diageo, Next) and the industrial space (eg Rolls Royce, Smiths). Fiscal austerity, rising unemployment and accelerating inflation could all compound matters. Moreover, at 14.0x 2010 P/E we do not see the All-Share as constituting evidently good value.

Against this background, sector and stock selection is clearly challenging. We have higher conviction in our underweight positions (especially regarding consumer services) than we do elsewhere. For investors willing and able to adopt slightly longer-term perspectives, there is a good case for focusing on fundamentals and identifying key themes. Over time, we remain convinced about the trends of emerging market growth and industrialisation as well as increasing globalisation. Although volatility will remain the watchword for coming months, implying likely further downward market corrections, we are happy to use weakness to build positions in basic materials. High yielding defensives may offer less risk, but have less scope for medium-term outperformance and indeed healthcare, telcos and utilities have all lagged the market year-to-date.

Market review: Sell in May...

The UK market dropped 6.6% in May, its worst monthly performance since February 2009. Europe fared even worse, falling by 7.2% over the last month. The sell-off was indiscriminate to the extent that every UK sector declined in absolute terms, and since the start of the year, only three sectors (technology, industrials and consumer services) remain in positive territory. If the old adage about selling in May has any truth, then investors should take note that there remain over 70 trading days until the St Leger horse race is held in September.

Recent sectoral performance suggests an increasing adoption of risk-averse positions, although trends are far from uniform or consistent. Over the last month, the healthcare and telecoms sectors have outperformed the UK market, by 3.8 and 2.4 percentage points respectively. By contrast, the utility sector dropped 6.8% although its performance was not as bad as that witnessed in the oil sector (down 10.6%, compounded by BP's Gulf of Mexico spill woes) or the consumer services sector (a 7.6% fall). The move in this latter sector

supports our negative stance and was driven by several companies reporting disappointing results and outlook commentary. On the more positive side, the All-Share has gained 18.7% over the last year, with every sector returning gains with the exception of the utility space (down 1.0%).

Investors in the UK also have more cause for relative cheer than do their European counterparts with the Eurostoxx having gained just 9.8% over the last year and having notably underperformed the All-Share over every time period analysed (see Exhibit 2 below). The reasons for such weakness have been well documented and revolve primarily around sovereign debt refinancing. Among the indices we track regularly, it is also interesting – and unsurprising – to note that those countries with the most pressing debt issues have seen their stock markets perform most disappointingly. The IBEX35 in Spain and the MIB index in Italy have both lost more than 9% during the last month, with Madrid's exchange plummeting further following the state-orchestrated bail-out of the Cajasur bank.

An additional reason why we feel UK investors have perhaps fared somewhat better relates to the fact that the UK stock market has increasingly become a play on global macro trends rather than purely domestic factors. Moreover, this 'global effect' is proportionately higher in the UK than elsewhere in Europe. A recent report in the *Financial Times* (27 May) highlighted that a number of Eurozone-listed companies performed significantly worse than expected during the Q1 earnings season as problems with state finances and a general lack of competitiveness took their toll on corporate profitability. This effect has been most pronounced in Portugal and Italy. By contrast, from a UK perspective, as we have discussed previously (see April's edition of *Insight*), basic materials and oil & gas sectors constitute around 30% of the FTSE's weight, but, more importantly, are responsible for over 50% of the market's earnings momentum.

Exhibit 2: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	(4.2)	(6.6)	(3.1)	0.0	17.4
FTSE All-Share	(3.2)	(6.6)	(2.3)	0.9	18.7
DJ EURO STOXX	(9.1)	(7.2)	(2.7)	(4.0)	9.8
DJ EURO STOXX 50	(12.0)	(7.3)	(4.3)	(6.7)	6.5
France CAC40	(10.9)	(8.1)	(4.7)	(4.7)	7.0
Germany DAX30	0.1	(2.8)	6.0	6.0	20.7
Spain IBEX35	(21.6)	(10.8)	(19.6)	(19.6)	(0.7)
Italy MIBTEL30	(15.9)	(9.4)	(10.9)	(10.9)	(1.7)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	7.8	0.7	1.2	6.7	10.9
FTSE All-Share vs EURO STOXX	5.9	0.6	0.4	4.9	8.9

Source: Datastream, Edison Investment Research

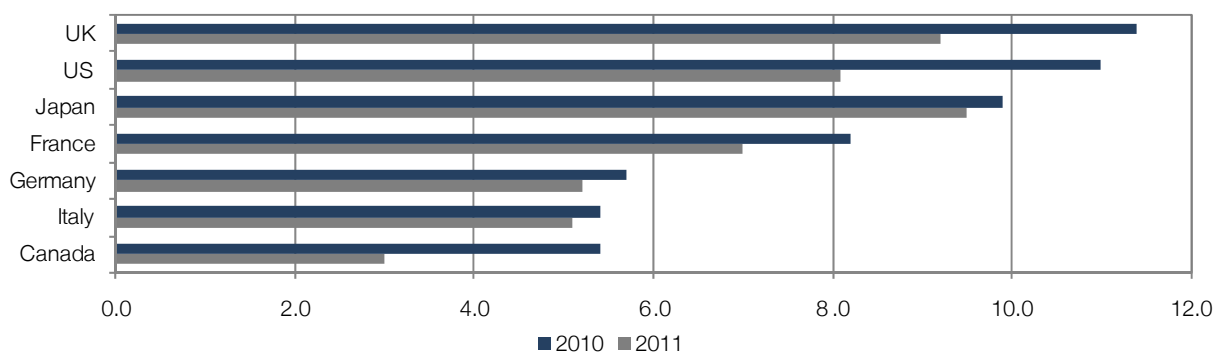
Outlook: How likely is a 'double-dip'?

When Tesco, the UK's largest retailer, released results on 20 April, Chief Executive Sir Terry Leahy joined a growing chorus of voices in stating that "there won't be a double-dip recession." The jury, however, remains out on this issue and indeed data from the last month combined with unravelling global macro events call such a positive assertion increasingly into question.

Despite the very minor upgrade to the UK's Q1 GDP estimate (from 0.2% to 0.3%, but still below the 0.4% reported for Q4), the government's budget deficit remains the key issue that refuses to go away. Importantly, this is a challenge facing not just the UK, but much of the global economy. In unusually florid language, the IMF sounded a warning note on 16 May that developed nations face an "urgent" need to cut their budget deficits; if not, major questions over fiscal sustainability will be raised. The IMF also noted, however, that the UK is on

course for one of the biggest increases in debt over the next 20 years among any of the world's rich economies. In the near term, as Exhibit 3 shows, the UK's debt to GDP ratio is set to reach 11.4% in 2010 (higher than any other G7 nation), and only retreat slightly in 2011.

Exhibit 3: Government debt as a percentage of GDP



Source: IMF, Edison Investment Research

The challenge facing the UK is compounded by the fact that policy-making is still in a state of flux following the recent formation of the new coalition government. Plans announced on 24 May to cut £6.2bn of state spending fail to address meaningfully the country's debt burden of £154bn (albeit revised down slightly by the ONS from its previous estimate of £162bn). Chancellor Osborne's 'emergency budget' on 22 June may hopefully provide some further clues on future direction.

The choices facing the UK and other nations with similar issues are unappealing, and made more challenging by the fact that signs are emerging of deteriorating earnings momentum and hence stalling economic growth. We believe there is a general (and also hitherto untested) danger of too many countries attempting fiscal and monetary tightening at the same time; similarly, risks would also arise were there to be a simultaneous withdrawal of state support for the economy.

The issuance of more debt (at higher interest rates) fails to address the key issue in hand and is also clearly negative for bond markets that already appear to be suffering from issuance indigestion. If public spending is cut, this risks not only raising unemployment levels further, but also impacting demand negatively. Meanwhile, higher taxes (such as VAT) may risk fuelling inflation and also decrease future investment incentives. It may also become increasingly hard to rely on emerging markets in the very near term: India and Brazil (soon likely to be joined by China) have all recently sought to cool their economies by making money more expensive and therefore less attractive to borrow.

Against this background, the double-dip scenario risks becoming increasingly likely. Below, we discuss in more detail three crucial indicators, all of which appear to be trending more negatively at present and support our stance of increasing near-term caution.

1) Inflation

April's inflation statistics (released in May and the last available) paint a sobering picture, with the UK's headline CPI rate increasing 0.3 percentage points to 3.7% and the RPI rate to 5.3%, a gain of 0.9 points relative to the previous month. The increase in the latter marks the steepest gain since 1991. The governor of the Bank of England argues that such rises are temporary and driven primarily by one-off factors, although we note that May represented the seventh occasion in the last two years when Mervyn King has been forced to write to the Chancellor explaining why inflation has breached the Bank's targets.

The Bank of England faces two challenges. First, factors beyond the Bank's control could force inflation higher. Notwithstanding global issues (Chinese inflation accelerated in April to its fastest pace in 18 months), a likely

increase in VAT – imposed by the government – would not only net the Exchequer an extra £11bn a year, but also push CPI inflation up to at least 5% according to a consensus of economists (source: *The Financial Times*, 18 May – and assuming a rise from 15% to 20% in VAT).

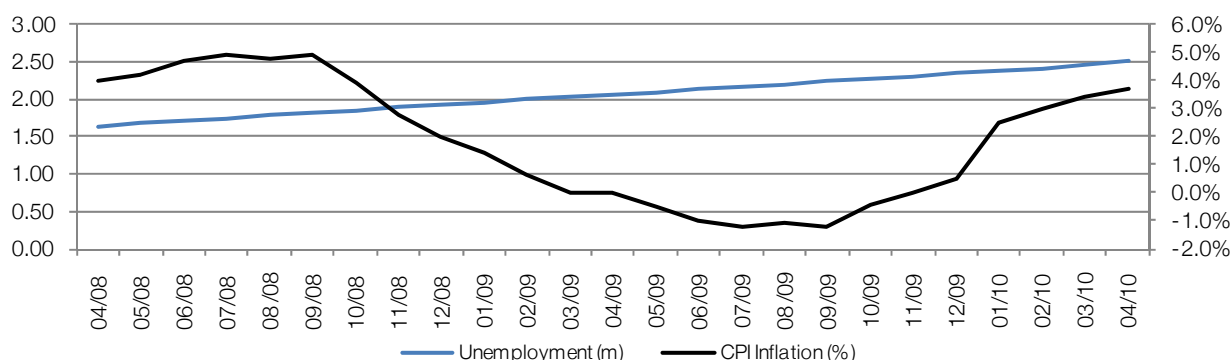
The second issue is that countering inflation via interest rate rises clearly risks undermining nascent economic confidence. It is worth noting the recent case of Australia, which has imposed six rate hikes since last October and saw as a consequence its biggest monthly drop in consumer confidence during May since 1998. Worryingly for investors, the OECD has urged the Bank of England to start its rate rising cycle “no later” than Q4 this year, and suggests that rates should reach 3.5% by 2011 if “further market turmoil” is to be avoided.

2) Unemployment

As sobering as the inflation statistics are those pertaining to UK unemployment. According to the ONS, 53,000 more people became unemployed during the month of March, taking the total number of people out of work to 2.51m, the highest level since December 1994. It is also worth noting that those people classed as economically inactive reached a record level during the last month of released figures, as did youth unemployment levels.

Unemployment constitutes a key cost for the economy and risks are weighted towards further rises in the near term. It is worth noting that although the US emerged from recession earlier than the UK and is currently growing more quickly, unemployment continues to rise. During April, the US rate rose from 9.7% to 9.9% despite impressive levels of new job creation. Returning to the UK, Chancellor George Osborne has already said that a minimum of 30,000 public sector jobs will be lost as a result of his recently announced spending cuts. With more scaling back of the civil service likely, and sentiment in the private sector still fragile, we expect no near-term respite in the UK unemployment rate.

Exhibit 4: A worst case scenario? UK inflation and unemployment both rising



Source: Office for National Statistics, Edison Investment Research

3) Earnings momentum

Inflation and unemployment trends provide limited cause for optimism and we also note an emerging tone of caution from a growing number of UK corporates. Earnings momentum has been generally strong (80% of S&P companies that reported in the US for Q1 exceeded expectations), but appears to be tailing off somewhat, creating an additional challenge for investors – since one of the key arguments for owning equities over other asset classes has been premised on an improving corporate outlook.

Within the UK, there have been a growing number of consumer related companies expressing caution on the outlook (Tesco's above comments notwithstanding). During the last month, Diageo, Next, SAB Miller and WM Morrison among others posted results that were disappointing relative to consensus expectations. While we have been less than surprised by this trend given our caution on the sector, it is also interesting to observe that companies in other sectors now appear to be adopting a more pessimistic tone. In particular, within the industrial segment, both Smiths and Ricardo highlighted in their most recent statements that orders were

slowing and decision-making was being pushed back within certain divisions, while Keller issued a profit warning. These reports are perhaps an indicator of worse to come elsewhere.

Towards a sector ranking: Key considerations

While current market volatility and a potentially lengthening list of uncertainties would suggest good reason to consider a reallocation of equity holdings, our contention is to remain focused on what we regard as a core set of fundamental views and hence positions. Amid recent turmoil (the FTSE is now down 3.2% year-to-date and 6.6% in the last month), the temptation would perhaps be to focus more on 'defensive' allocations and/or stocks that offer attractive and secure dividend yields. We have been neutral/slightly positive on this sector since the start of 2010 and continue to prefer those sectors that offer potentially greater returns, not just when the market enjoys – hopefully – something of a bounce, but also over the medium term. In particular we continue to favour the basic materials sector, which has underperformed year-to-date, but has held up relatively well in the last month. Moreover, we also see the sector as offering attractive value at present.

As importantly, we continue to have high conviction in our negative stance on the consumer and hence on both the consumer goods and services sector. Beyond our concerns about deteriorating confidence compounded by rising inflation and unemployment, our stance is reinforced by the fact that sectors trade at a premium to the market and have not markedly underperformed year-to-date.

Overall, we feel that bottom-up analysis and stock-picking will continue to matter more than sector allocation. With regard to the UK, we are inclined to adopt a cautious perspective on stocks exposed specifically to the domestic economy given ongoing political uncertainties and the impact future policy may have on growth prospects. Where possible, we continue to favour high global diversity by end-market and particularly emerging market exposure; this factor is primarily driving earnings momentum in our view.

Exhibit 5 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 *no* revisions to our preferred sector allocation relative to the previous month. We provide additional explanation and justification below.

Exhibit 5: 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	11.9%	12.4	1.5%	(3.7%)	(6.0%)	(0.1%)	2.6%	39.9%
	Oil & gas	17.4%	9.9	5.0%	(8.7%)	(10.6%)	(5.5%)	(4.9%)	3.1%
	Industrials	7.5%	15.1	2.7%	7.5%	(4.7%)	4.5%	14.5%	35.4%
	Healthcare	7.6%	10.4	4.7%	(6.2%)	(2.8%)	(2.8%)	(0.8%)	15.1%
	Telecoms	5.8%	7.7	5.8%	(3.5%)	(4.3%)	(0.7%)	0.0%	21.6%
	Utilities	3.7%	11.2	5.2%	(7.9%)	(6.8%)	(7.2%)	(2.7%)	(1.0%)
	Technology	1.6%	22.2	1.3%	9.6%	(5.6%)	3.7%	15.0%	37.8%
	Financials	23.0%	21.3	3.1%	(3.7%)	(7.1%)	(4.2%)	(2.7%)	15.5%
	Consumer services	10.1%	14.2	2.9%	1.5%	(7.6%)	1.6%	4.4%	21.5%
	Consumer goods	11.4%	15.2	3.4%	(1.0%)	(4.1%)	-3.0%	6.2%	27.4%
Worst									
Average		100.0%	14.0	3.5%	(3.2%)	(6.6%)	(2.3%)	0.9%	18.7%

Source: Datastream, Edison Investment Research

Underweight consumer goods and services

While the consumer services sector has been the second worst performing in the UK over the last month, both this sector and its consumer goods counterpart have outperformed the All-Share year-to-date. The two sectors trade at a premium to the UK market and we believe this does not appropriately discount the potentially vicious circle scenario facing these companies.

We are particularly concerned that recent earnings momentum within the sector may not be sustained, and indeed, there appears to be a growing chorus of companies who point towards increasing issues. Next said in its 5 May IMS that it remained “very cautious” in its outlook for the year ahead, and Marks & Spencer used exactly the same word at the time of its 25 May results. Meanwhile Morrison described the UK economic environment as “challenging” at its 6 May results and reported slowing sales trends. Both Diageo and SAB Miller also disappointed in their recent results relative to consensus expectations, while a better set of figures from Compass is less a reflection of the macro backdrop and more of its business model and global diversity. Moreover, according to the British Retail Consortium (BRC), UK retail sales fell in April by 2.3% on a like-for-like basis, with the BRC describing the UK consumer as “nervous” (10 May).

The key problem is that consumer confidence remains moribund and could likely fall further, affecting future spending. While Nationwide reported on 13 May that consumer confidence had recovered by one percentage point in April relative to March, this move has done “little to repair,” in Nationwide’s words, March’s nine percentage point drop, the largest fall since July 2008. The new UK government will likely be forced to implement a series of austere fiscal imperatives, certainly in the form of public sector cuts and also potentially via tax (VAT) rises too. Prevailing consensus opinion from economists is that UK VAT will rise from 15% to 20% by the end of 2011. While this could result in at least £11bn per annum of extra revenues for the Treasury, it could likely result in consumers spending less, a problem that would be compounded by possible rising (or at least, not falling) unemployment.

We therefore see potential scope for disappointment relating to future results releases from the UK consumer stocks, and struggle to see a strong case for outperformance until management teams can sound a noticeable voice of confidence on visibility and the outlook. Moreover, valuation – with the consumer goods sector on 15.2x 2010 P/E and the services sector on a multiple of 14.2x – is also not supportive in our view.

Overweight global industrial cyclicals: Buy on weakness

Recent share price movements serve as a reminder that stocks in these sectors offer not just potentially above-average returns, but also increased volatility. The basic materials sector (which has been our core overweight since October 2009) dropped 6.0% in the last month, but has still outperformed on a three-, six- and 12-month view. Indeed, over the last year, basic materials have performed better than any other sector, gaining 21.2 percentage points relative to the UK market. Separately, we continue to be encouraged by the resilience of the industrials sector, being the second best-performing year-to-date.

While potentially deteriorating earnings momentum in certain industrial segments is a trend to monitor closely, our positive stance is driven by two key factors, and also reinforced by valuation considerations. First, companies continue to benefit from the effects of recent cost-cutting exercise, and the subsequent benefits from operating leverage. Second, much of our future confidence is also driven by the fact that end-market demand appears robust, particularly from emerging markets. Even if measures are currently being undertaken to halt near-term growth (and inflation) in markets such as Brazil and India, we expect demand trends to remain robust and endure over the medium term.

In particular, we favour businesses with global diversity, and especially those exposed to the Chinese and Indian markets. We note that 70% of the world’s GDP growth is set to derive from emerging markets, with the latter two contributing 40% of the globe’s growth in 2010 (according to *The Economist*, 17 April). Moreover, China alone is responsible for consuming a third of the world’s base metals, supporting our positive stance on the basic materials sector.

Our confidence in these sectors is reinforced by the fact that the basic materials and oil & gas sectors continue to trade on sub-market multiples, of 12.4x and 9.9x 2010 P/E, respectively. We also note that the oil & gas

sector offers a 5.0% dividend yield – ahead of the UK market – and hence our relative preference for this sector over industrials, given the latter’s valuation premium and dividend discount combined with its recent outperformance.

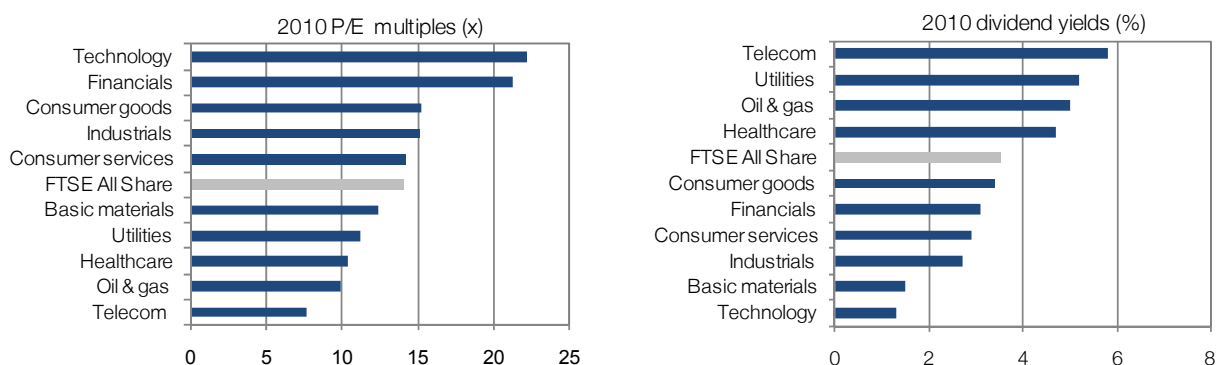
Neutral defensive sectors: Attractive on yield and other factors, healthcare preferred

The appeals of defensive sectors are broadly understood, and have potentially become more pronounced in recent weeks given market volatility. In particular, stocks within these sectors offer investors a combination of attractive dividend yield and value, combined with relatively low economic risk. However, year-to-date, utilities healthcare and telecoms have all lagged the All-Share. We see such underperformance as creating something of an opportunity for investors. We have also been encouraged by recent results from across the three sectors. Our relative preference is for the healthcare sector given that its major listed plays have more global exposure than either the telecoms (ex Vodafone) and utilities sector, which are more dependent on the UK economy and future policy from the country’s new-look government.

With regard to the healthcare sector, the mega-cap pharma stocks seem to be finding a renewed degree of confidence, as evidenced by last reported results from both Astra and GSK. Our healthcare team finds favour in both, with Astra providing investors with a pure-play pharma business offering attractive growth but concomitantly higher risk; and, GSK, which represents more of a utility-like play on healthcare with stable future revenue streams. Meanwhile, for the sector generally, 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.

The UK healthcare sector trades on 10.4x P/E for 2010 on a headline basis (although both Astra’s and GSK’s multiples are below this) and offers a 4.7% dividend yield. Yields are higher for the telco and utility sectors (5.8% and 5.2% respectively), although growth prospects in these latter sectors are significantly less compelling. Nonetheless, results in May from BT, Centrica, National Grid, Severn Trent and Scottish & Southern all surpassed consensus expectations.

Exhibit 6: 2010 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

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, a scenario recently advocated by the chief executive of Severn Trent, while 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.

Financials: Becoming gradually more positive

Our decision to move towards a less underweight position within financials last month has yet to be fully rewarded with the sector underperforming by 0.5 percentage points relative to the market. On a year-to-date basis, financials have lagged somewhat, also losing 0.5 points relative to the All-Share.

Although expectations for future revenue growth are still low and the debate over what constitutes 'new normal' earnings has not been resolved, we feel there are a number of indicators that point to a more encouraging outlook. Notwithstanding recent concerns over sovereign debt default risks, we see scope for consensus expectations to become more positive. Recent results from financial services companies around the world have been encouraging and we also note comments from HSBC (which reported since our last edition of *Insight*) highlighting that results would be "comfortably ahead" of the previous quarter and stating that bad debts on its books were at their lowest in two years.

On the positive side, most organisations are placing an increasing focus on cost reduction and synergy delivery, while revenues from a more diversified range of streams (particularly investment banking) seem to be coming through. Moreover, risk premiums have begun to reduce as credit has normalised. While the road ahead will likely continue to be bumpy (given banks' exposure to sovereign risk, new Basel requirements and potential widespread sector reform; the latter is currently being debated in the US Senate), we contend that the industry now finds itself in a period of relative stabilisation, a scenario that should allow investors to begin to form a more constructive stance on the sector. In valuation terms, there remains significant disparity across the sector (whose headline 2010 P/E multiple remains above 20x), and our preference is to favour those businesses with superior – and diversified – business models.

Conclusions

The key themes for the equity investors over the past month have been volatility and uncertainty, and we see little reason for this to change over the summer. There remains an unappetising cocktail of substantial state debt burdens, rising inflation and growing unemployment. Added to this, earnings momentum is showing some signs of slowing and we do not see valuation levels for equities as being overly compelling.

Our strategy for sector and stock allocation relates to adopting a longer-term focus, preferring positions with high global diversification and undervalued growth potential. In the near term, high yielding plays are likely to find most favour. On the negative side, we retain our high conviction underweight in consumer cyclicals.

In order for us to turn more positive on the outlook, we would need to see at least one of the following occur: a concerted and coherent global approach to debt reduction; clear signs of broad-based, sustainable, top-line and bottom-line growth; and, a meaningful valuation opportunity. There seems little imminent likelihood of the first, while results momentum is slowing somewhat at present and the UK market's P/E valuation has retreated only to levels last witnessed in 2006. Between 2006 and 2008, equities became more than 50% cheaper.

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Edison Investment Research

Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
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Edison Investment Research Limited

Lincoln House, 296-302 High Holborn, London, WC1V 7JH
Tel: +44 (0)20 3077 5700 Fax: +44 (0)20 3077 5750

enquiries@edisoninvestmentresearch.co.uk
www.edisoninvestmentresearch.co.uk