Illumination: Equity strategy and market outlook

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Equity market overview and strategy

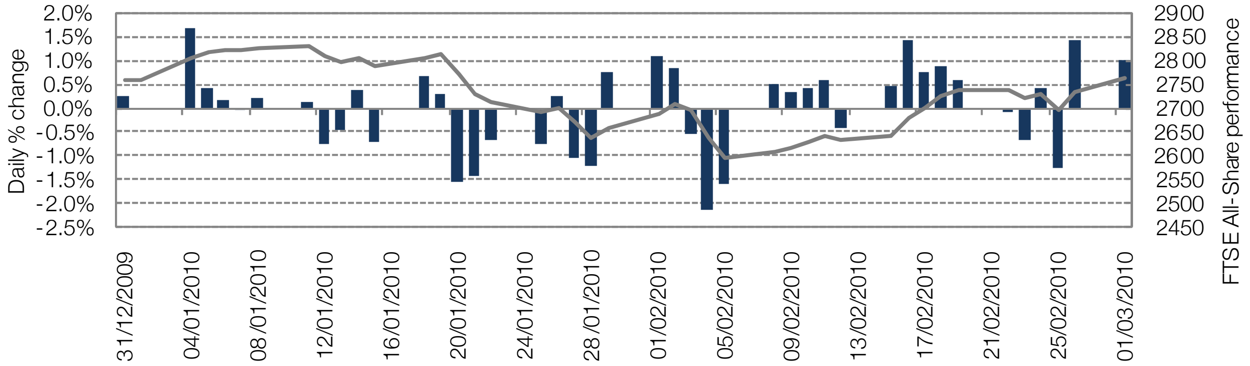
The cloud of uncertainty that hangs over both the UK and global economy as well as its stock markets refuses to dissipate. As we have written previously, the lack of direction in equities – which has played out for the first two months of the year – is indicative of our uncertainty thesis. Macro data points and broad caution from many commentators suggest to us that risk aversion levels continue to rise and, against this background, we see little reason to change our sector allocation strategy. Within equities, we remain overweight utilities and telecoms, but can also find favour for basic materials. Meanwhile our core underweight positions are also unchanged, namely, in financials and consumer (goods and services).

How risky is 'the risk trade'?

The UK stock market has fallen by 0.9% year-to-date and is down by 0.3% in the last three months. The FTSE All-Share finds itself back at a level last seen in November and 4 February's one-day fall of 2.1% was the worst daily drop since 2 July. The question that investors are justifiably allowed to ask is whether these price movements simply represent a minor correction to the bull run which began last March (during which time the UK market has gained 43.3%) or are a lead indicator for further impending market pain and equity dislocation.

The answer to this conundrum has clear implications for asset allocation and uncertainty over it is evidenced by recent swings in equity markets: for February, the FTSE experienced 13 days during which the market rose and seven during which it fell, but turning in a gain of just 1.3%. What seems to be at work in our opinion is a crucial debate by investors over how aggressively to take on board risk. Optimists advocate the 'risk trade', namely favouring cyclicals, industrials and emerging markets, whereas pessimists see merits in defensives, high yielders and 'safe haven' proxies such as gold.

Exhibit 1: Equities market volatility year-to-date: more days of rises than falls – but only just



Source: Datastream, Edison Investment Research

We have argued for some time that recovery scenarios have become increasingly discounted by investors, while visibility on the outlook has been deteriorating. Put another way, the case for moving away from the risk trade has therefore been rising. Macro data points from the last month (regarding government borrowing, retail sales, unemployment and the general health of the economy) only serve to reinforce this thesis and inform our core strategy. However, the volatile inter-day movements witnessed in equities also suggest that there is a clear need for investors to be nimbly positioned, especially for those seeking to exploit short-term price changes.

In order to maximise potential returns, we advocate the following strategy: in broad terms, we favour high quality growth stocks on modest valuations, and especially those with diversified global exposure. Since we see little merit in advocating the risk trade based on the current macro outlook, our core preference is for stocks in late cycle defensive sectors and those offering high yields, especially telecoms, utilities and healthcare. We have also favoured gold for some time (Edison has published three in-depth reports on the topic since April 2009) and see it as being the optimal hedge against most economic eventualities.

Nonetheless, we do not feel it is constructive to be wholly bearish on the outlook and continue also to favour basic materials. This provides us with some hedge, particularly on scenarios where the risk trade gains credence. More fundamentally, we believe that demand for basic resources will endure and consensus is potentially being too cautious in estimating growth prospects. Valuation for the sector is also compelling. Moreover, when considering what would allow us to become more positive on equities generally, we would need not only to see greater coherence in macro data points, but also a more substantial valuation case. With the UK market on 15.6x 2010 P/E, we do not see equities as being overwhelmingly cheap, more fairly valued, particularly given the outlook.

Overview and outlook: Equities positive (only just); economy negative

Even if the UK market limped to a 1.3% gain in February and the UK's GDP growth for the quarter was slightly revised upwards (from 0.1% to 0.3%, and so still hardly an overwhelming endorsement of a return to growth, especially since analysts had originally been forecasting growth of at least 0.4%), it would be fair to say that macro data and news flow in the last month has been predominantly negative. This has not been just a UK phenomenon, with statistics from both Europe and the US casting a similarly gloomy cloud, while concerns over sovereign debt default also remain substantial.

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

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	(0.1)	1.1	1.5	12.2	49.1
FTSE 250	1.9	1.5	3.3	10.0	61.8
FTSE Small Cap	0.1	1.4	1.5	5.5	50.5
FTSE All-Share	(0.9)	1.3	(0.3)	11.8	50.9
Relative UK performance					
FTSE 100 vs FTSE 250	(2.0)	(0.4)	(1.8)	2.2	(12.7)
FTSE 250 vs FTSE All-Share	2.8	0.2	3.6	(1.8)	10.9
FTSE Small Cap vs FTSE All-Share	1.0	0.1	1.8	(6.3)	(0.4)

Source: Datastream, Edison Investment Research

Although the Bank of England announced on 4 February that its programme of quantitative easing (QE) would be withdrawn (as we had foreseen), the Bank clearly remains concerned about the health of the UK economy, describing it as "sluggish" and the outlook as "fragile." A subsequent speech by Governor Mervyn King, on 23 February, also seemed to suggest that a return to QE may occur sooner rather than later, while a separate speech by Deputy Governor Paul Tucker on the same day saw him raise the risk of potential stagflation in the UK. Unsurprisingly, sterling fell on this news and is currently at a 10 month low relative to the US dollar. Sterling weakness is obviously positive for exporters, but also somewhat plays to our thesis favouring globally diversified (and preferably defensive) businesses such as Vodafone.

The Bank has every reason to be cautious about the outlook for the economy and we are inclined to concur with its 'sluggish and fragile' analysis, which also does not appear to dismiss the possibility of a double-dip recession. Several factors provide testament to this perspective:

- Unemployment stood at 2.46m for the three-month period to December (the last time frame available) and while the absolute number of unemployed did drop by 3,000 relative to the previous period, not only is this a very small number that could easily reverse, but also, more importantly, those out of work for more than a year rose 37,000 to 663,000. Long-term unemployment is now at the highest level since April 1997, notably the month before the current government assumed power.

- UK retail sales fell by 1.8% in January relative to December, more than three times worse than analysts had anticipated, and the steepest drop in 18 months. Meanwhile, a separate survey by the British Retail Consortium showed that the UK witnessed the worst retail growth trend in January 2010 for 15 years. While snow in early January may have had some impact, the return to VAT at 17.5%, concerns over unemployment and declining consumer confidence are likely to have been bigger contributory factors.
- In addition to weaker retail trends, the housing market is also showing some signs of stagnation. According to the Department for Communities and Local Government, house prices only rose 2.9% in 2009, less than that asserted by the major lenders, Halifax and Nationwide (closer to 6%). February's figures from Nationwide also show UK house prices down for the first time in 10 months, although the building society believes this may have been partially the result of poor weather. Meanwhile, figures released by the British Bankers Association also show that mortgage lending fell sharply in the last month, to its lowest level since 2002.
- Inflation also reached 3.5% in January, its fastest pace in 14 months despite poor retail spend and a sluggish housing market. This rate of inflation compares to 2.9% reported in the previous month, and both figures are substantially ahead of the Bank's target of 2.0%.

A combination of the above factors suggests a somewhat gloomy outlook for the UK economy and it is also possible to see how concerns over stagflation (ie inflation combined with economic stagnation) can gain some credence. As mentioned previously, weak sterling has provided a fillip for exporters and trends in UK manufacturing provide one of the very few current economic bright spots. According to the latest Purchasing Managers' Index, manufacturing activity grew at its fastest pace in 15 years in January, while new orders for the month stood at their highest level since 2004. Sterling could remain weak for some time in our view, particularly if – as seems likely – there is a hung parliament in the UK post the country's impending election. Indeed, the Conservatives' lead over Labour has shrunk from 13 points to six points in the last month.

However, it remains self-evident that the sustainability of exports (and hence manufacturing) is contingent on the health of other economies and, here, the evidence suggests additional cause for concern. That UK business investment fell 5.8% quarter-on-quarter in Q4, a deterioration relative to the previous three-month period, is also a worrying trend. Turning to Europe – the UK's biggest trading partner – Jean-Claude Juncker, prime minister of Luxembourg and previous president of the European Council, echoed Mervyn King's exact words on 16 February when he described Europe's economy as "fragile". At 10%, Eurozone unemployment stands at its highest level since August 1998, while inflation has also edged up and the volume of retail trade has disappointed relative to expectations (0.1%, relative to 0.4% estimated for January). The closely watched ZEW and IFO confidence indexes in Germany have also tracked downwards recently, with the ZEW now having fallen for five consecutive months.

The picture in the United States appears little better. Despite the Federal Reserve raising its economic growth forecast range from 2.5-3.0% to 2.8-3.5% for 2010, it retained its estimate for unemployment at 9.5-9.7%. January's figure was 9.7%. Similar to trends in other developed markets, consumer confidence also seems to be waning, reaching a 10-month low in January, with Americans increasing their savings ratios and major retailers such as Macy's and Home Depot reporting slower sales. US new home sales in January were also at their lowest level on record.

Above and beyond the deteriorating trends described above, sovereign debt default remains an additional and very prominent concern. The implications of such a scenario matter not just for the real economy, but also profoundly for investors in the stock market. The collapse of Dubai World in December served as a clear warning (indeed, creditors will only receive 60 cents on the dollar) and it is currently far from clear how the current Greek crisis will resolve itself.

Time is a factor for the Greeks, particularly given S&P's recent debt downgrade to BBB- (one level above junk) and given that €25bn of debt needs to be refinanced by May. Moody's is also reported (by the *Financial Times*) to be considering a two-notch downgrade to Greece's debt. At least until there is a coherent Greek resolution, investors have some justification in fearing a contagion effect and it should also not be forgotten that the UK is set to end 2010 with £180bn of debt (according to the ONS), equivalent to 12.8% of GDP. As a point of concerning reference, Greece's deficit currently stands at 11.8% of GDP.

If further evidence were required to support a move *away* from the risk-trade then it would be the following: in the last three months, the SOV-X iTraxx index, which measures credit default swaps (the cost of insuring against debt default) has more than doubled. This sends a very clear message to investors that both debt and equity are asset classes with high risks. Even if investors in equities are somewhat better placed than those in debt, equity markets can still fall in a scenario where risk aversion levels continue to rise. This again provides credence for our stance of defensive positioning. It is also worth noting that one of the criteria employed by our stock picking tool (*The Illuminator*) is balance sheet strength, and investors should logically consider avoiding highly geared stocks for now.

With such a dismal assessment and future prognosis, it is fair to ask why equities have not fallen further year-to-date. Notwithstanding our own caution, we provide three possible reasons: first, the macro environment is notably more robust than a year ago; second, despite concerns in the developed world, the BRIC economies continue to power ahead and drive much of global demand as well as capital inflows; third, corporate management teams do not seem quite as downbeat as their economist counterparts.

Exhibit 3: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
DJ EURO STOXX	(1.0)	0.5	(2.3)	3.2	48.0
DJ EURO STOXX 50	(0.7)	(0.1)	(3.4)	2.1	47.3
France CAC40	0.2	(1.0)	(0.2)	5.2	46.0
Germany DAX30	1.0	(2.4)	(1.1)	7.3	54.0
Spain IBEX35	(5.1)	(4.2)	(12.0)	(6.6)	43.5
Italy MIBTEL30	(3.1)	(4.1)	(5.5)	(2.9)	48.5
FTSE 100	(0.1)	1.1	1.5	12.2	49.1
FTSE All-Share	(0.9)	1.3	(0.3)	11.8	50.9
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	0.6	1.2	4.9	10.1	1.8
FTSE All-Share vs EURO STOXX	0.1	0.8	2.0	8.6	2.9

Source: Datastream, Edison Investment Research

Investors should note the relative decline in importance of America, Japan and the UK, which now constitute 59% of the Global MSCI by value, down from 73% in 2003 (according to *The Economist*, 9 January 2010). Much of the slack has been taken up by emerging economies, all of which are on track to grow comfortably ahead of the developed world in 2010 (and likely beyond). This again plays to our thesis in seeking global diversity in stock selection.

Finally, the current reporting season provides some insights into corporate confidence. While there has been a mixed picture in the UK and Europe so far, profit warnings are down on last year's levels and management teams (perhaps given their vested interest in seeing share price appreciation) have typically sounded notes of cautious optimism. Deal-making also remains on the agenda: in the UK, Prudential recently announced plans to acquire the Asian assets of AIG in a £23bn transaction, while Babcock has had two offers for VT Group rebuffed. In the US, Schlumberger has announced its intention to complete an $11.3bn all-share acquisition of Smith International. The IPO market is also showing a few signs of life, with African Barrick Gold set to list imminently in London and companies including New Look and Ocado also keen to move ahead with their own flotations (even if Travelport and Merlin Entertainment have decided to put their listings on hold for now). These trends are encouraging but far from consistent and reinforce our belief in the importance of rigorous stock selection.

Our strategy: Defensiveness to the fore; asset allocation unchanged

Based on the evidence available, we see a somewhat uncertain outlook for equities, even if they potentially represent a more attractive asset class than bonds. At the least, we believe that risk appetite has receded, suggesting that there are limited merits in the adoption of the much vaunted 'risk trade' strategy. Much of the optimism that characterised sentiment towards the end of last year seems to have dissipated, while near-term visibility seems poor. We also anticipate that the current UK/European reporting season could send a range of potentially conflicting signals to investors.

A case for equities can be constructed premised on valuation (equities are trading on just 1.5x book value, a level last seen after the bubble had burst at the end of the dotcom era) and operating leverage (rising revenues on low cost bases), while further M&A activity would boost sentiment. However, the sceptics have on their side concerns over sovereign debt and rising CDS spreads combined with a spike in volatility, as well as a series of macro trends that potentially point towards a deteriorating outlook.

Against this background, we make three key assertions that have constituted our stance on equities for some time, namely:

- We advocate adopting a broadly defensive portfolio bias.
- We are more confident on global growth prospects than UK growth prospects.
- We believe that bottom-up analysis and stock-picking will matter more than sector allocation.

Exhibit 4 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 major revisions to our preferred sector allocation relative to the previous month. We provide additional explanation and justification below:

- Our core underweight sectors remain unchanged (financials and consumer). We are also somewhat cautious on the oil & gas sector, given recent volatile moves in the oil price and disappointing results from the UK majors (BP and Shell) at the start of February.
- Our preferred overweight sectors are primarily defensive, based on yield and value (utilities, telecoms, healthcare). We also favour basic materials, based on valuation and global diversity grounds.

Exhibit 4: Towards a sector weighting

Note: * Edison View; ** All Share benchmark weight.

Position	Weight*	Sector	Weight**	P/E	Yield	YTD	Last month	Last three months	Last six months	Last 12 months
Best	OW	Utilities	3.6%	19.1	5.4%	0.1%	0.2%	4.5%	12.0%	11.0%
	OW	Basic materials	11.9%	13.4	1.1%	(0.6%)	5.4%	1.6%	35.3%	141.4%
	OW	Telecoms	5.7%	9.9	5.2%	(2.0%)	2.2%	(0.5%)	5.7%	20.4%
	OW	Healthcare	7.8%	12.1	4.3%	(2.0%)	1.8%	1.9%	5.5%	27.1%
	N	Technology	1.5%	23.7	1.3%	7.2%	1.7%	8.7%	20.8%	82.4%
	N	Industrials	7.1%	14.3	2.8%	4.4%	4.0%	7.4%	15.8%	50.1%
	N	Oil & gas	18.2%	13.8	4.5%	(1.0%)	2.0%	(0.9%)	12.2%	34.3%
	UW	Consumer services	9.9%	13.6	2.8%	1.8%	4.8%	2.8%	12.8%	41.5%
	UW	Consumer goods	11.8%	18.5	3.2%	4.7%	2.7%	8.8%	20.0%	42.4%
Worst	UW	Financials	22.5%	25.5	3.0%	(1.9%)	0.6%	(3.0%)	(0.2%)	81.4%
Average (ex-weight, equal to sum)			100.0%	15.6	3.3%	(0.9%)	1.3%	(0.3%)	11.8%	50.8%

Source: Datastream, Edison Investment Research

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. Another major concern is banks' exposure to sovereign debt in countries potentially at risk from sovereign default.

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 likely 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, according to a recent 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 25.5x P/E) remains uncompelling. Nonetheless, recent results from Barclays, RBS and Lloyds do highlight some encouraging trends (particularly lower loss levels), and earnings multiples may begin to compress.

Underweight consumer goods and services

We have been surprised by the 4.7% gain in the consumer goods sector and a 1.8% increase in the consumer services sector year-to-date, ahead of the UK market. While post-Christmas trading statements showed generally strong momentum in December, most retailers suggested that 2010 would be a much more difficult year. We concur with the view that retailers will likely face significant challenges over the coming months and would caution investors attempting to look through these issues, especially since valuation for the sector is not compelling.

The macro data points do not present an attractive picture: according to a recent survey from the CBI, UK high street sales in January fell at their sharpest annual rate for five months. Meanwhile, the British Retail Consortium's last report showed the worst growth trend in the month of January for 15 years. Furthermore, we note that the consumer goods sector trades on 18.5x current P/E and the consumer services sector on 13.5x, with both groups offering sub-market dividend yields.

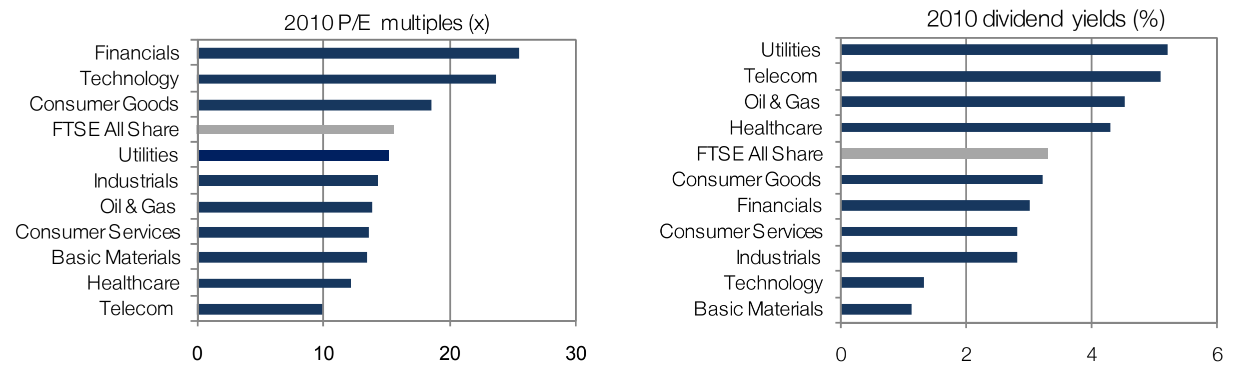
Looking ahead, we see potential scope for disappointment relating to first quarter trading and struggle to see a strong case for outperformance until management teams can sound a noticeable voice of confidence on visibility and the outlook. While some consumer sub-sectors such as pubs & restaurants, 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.

Overweight defensive sectors: Utility, healthcare and telecoms – attractive on yield and other factors

Since the start of the year we have met with approximately 50 institutional investors managing both traditional and alternative funds. The prevailing sense is that if investors have not begun to position themselves short (UK) equities, then there is a clear move towards the adoption of more defensive sectoral biases. As mentioned above, some of this has been borne out in terms of recent relative outperformance in the UK utility sector (2.5 percentage points better than the All-Share in the last three months), although healthcare and telecoms continue to lag somewhat.

The appeals of such sectors are broadly understood: namely, yield and value, combined with relatively low economic risk. Current dividend yields are 5.2%, 5.1% and 4.3% 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 (4.0%) and political/currency concerns could suggest that defensively positioned equities constitute bond-like proxies with lower risk.

Exhibit 5: 2010 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

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 rather than the short-term impact of the recession. Biotech is showing more assurance as evidenced by the tone set at recent conferences such as JP Morgan's in San Francisco. Among the 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 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 outperformance for utilities and telecoms. The UK water sector has long been seen as ripe for consolidation and press coverage at the start of February suggested that Northumbrian Water could be a potential bid target. Within telecoms, both Cable & Wireless and Carphone Warehouse will likely crystallise value for shareholders via impending demergers, while Daisy Group continues to consolidate the smaller end of the market.

Overweight basic materials

Despite notable underperformance in January (when the basic materials sector was the UK market laggard, down 6.7%), persistence in our stance on the sector was rewarded in February, when basic materials gained 6.4%. Bears may highlight the risk of the BRIC economies over-heating and potentially tighter policy stifling growth. Nonetheless, even if further volatile swings in basic resources stocks may be witnessed, we believe a strong case can be made for the sector. Above and beyond fundamentals, valuation (basic materials trade on 13.4x current P/E) and potential scope for M&A also inform our positive sector stance.

Our contention remains simply that as the (emerging) world industrialises, demand for basic resources will endure and consensus is potentially being too cautious in estimating growth prospects. As a reminder, the Chinese economy grew by 10.7% in Q4 (and 8.7% in 2009), and is soon set to overtake Japan as the world's second largest economy. Comparisons between the Japanese economy of the 1980s and China today are both facile and misplaced in our view, with 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. GDP estimates for 2010 assume that the Chinese economy will grow by 9.6% with India close behind (7.3%). Based on analysis by *The Economist*, both these estimates have been upgraded year-to-date, with analysts forecasting growth rates of 8.6% and 6.3% for China and India respectively at the start of the year. While current forecasts are not quite so attractive for Brazil and Russia, both these continue comfortably to outpace their Western peers.

Conclusions

The cloud of uncertainty looming over the economy as well the stock markets refuses to dissipate. The lack of direction in equities – which has played out for the first two months of the year – is indicative of our uncertainty thesis. In light of recent macro data points and broad caution from many commentators, which suggest to us that risk aversion levels continue to rise, we see little reason to change our sector allocation strategy. Within equities, we remain overweight utilities and telecoms, but can also find favour for basic materials. Our core underweight positions are also unchanged, namely, in financials and consumer (goods and services).

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