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

Last month's rally is encouraging for equity investors and may help restore some much needed optimism. However, it masks neither the fact that equities are only just (<5%) in positive territory year-to-date nor the fact that fundamentals remain highly challenging and indicators broadly inconsistent. We continue to believe that consensus expectations do not fully reflect a scenario of slowing growth for 2011 and that nascent inflation could undermine top-line prospects over coming months. Moreover, headline multiples of c 14x earnings for both the UK and US equity markets clearly do not constitute value territory. Against this background, we have become more defensive in our stock selection and prefer to play undervalued names with either strong global exposure or high cash returns. Basic materials and telco score highly for us; consumer names least so.

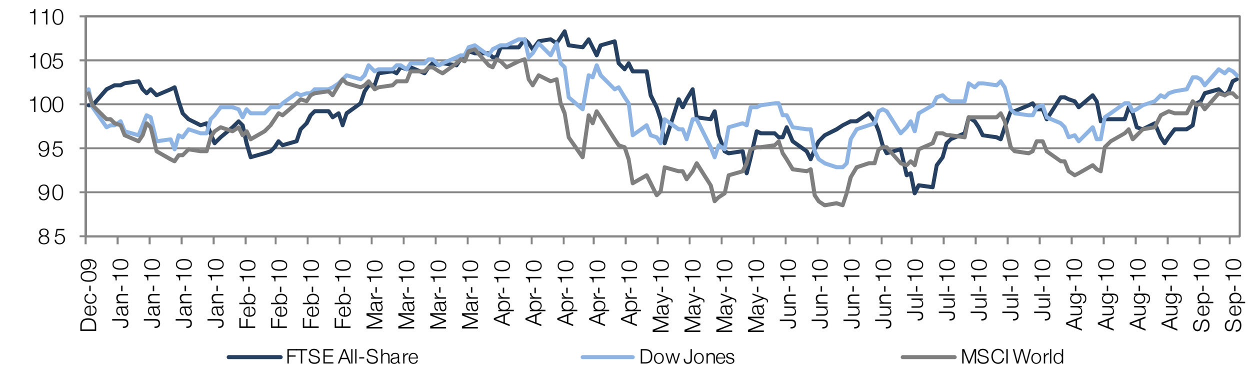
Still on the edge

Although the UK market's 12.7% gain during Q3 represented the best quarterly performance since the third quarter of 2009 (and the second strongest quarter in performance terms over the last decade), the All-Share remains constrained beneath a glass ceiling that it has persistently struggled to break. The main UK market has failed to breach the 3,000 level since June 2008 and, even despite September's rally, it remains 4% below its April high.

Moreover, context is also important: a gain of just 3.8% in the first nine months of the year hardly constitutes an exciting performance or makes a convincing case for equities. In four other years in the past 10 (2003, 2005, 2006 and 2009) UK equities have done better by this stage of the year. 2010's lacklustre performance is all the more disappointing in contrast to previous years, since stocks this time around ought to have received a theoretical boost in from interest rates effectively being at zero. The FTSE's sclerotic performance has been mirrored elsewhere with the year-to-date gains of just 0.9% for the MSCI Global Index, 2.3% for the Euro Stoxx 600 and 3.5% for the Dow.

Exhibit 1: September's gains are encouraging, but equities are still broadly flat year-to-date

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

It is against this background that conviction in our contention that global equity indices (and by proxy, the world economy) remain 'on the edge' is reinforced. We are on the edge, namely still in a zone of uncertainty where trends could tip either positively or negatively, for two principal reasons: first, macro data points remain highly inconsistent; and second, with the rate of growth deteriorating and inflation rising, consensus earnings estimates will begin to look increasingly stretched in our view. Furthermore, prospects for a year-end rally also look limited (as we discuss below); and even if such an event happens, it will fail to disguise deeper underlying issues.

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Despite September's rally (a 6.3% gain for the All-Share, its best month since April 2009), there are many reasons to be concerned, or as the Lex Column in *The Financial Times* puts it, "almost everyone is worrying about uncertainty" (10 September). We also find it interesting to note the recent postponement of what would have constituted America's largest IPO (at US$1.22bn) year-to-date: Liberty Mutual, the insurer, announced on 29 September that it would delay the flotation of its property and casualty business citing "stalled economic recovery" and a "volatile stock market." Problems seem manifest globally.

Firstly, in the UK we note that the Bank of England's latest statement suggests that "the probability that further action would become necessary to stimulate the economy... has increased" (Monetary Policy Committee Minutes, 22 September). We do not find this surprising given that the CBI is also arguing that the UK economy will now recover more slowly than previously thought, with its 2011 GDP estimate cut from its 2.5% forecast made in June to a more sober 2.0%. It seems that the robust economic growth witnessed in Q2 may just have been a blip. All three UK PMI surveys (for construction, services, manufacturing) fell in the last month with the drop in construction (from 54.1 to 51.2) being especially disappointing given its contribution to Q2's GDP figure. While both unemployment and inflation remained unchanged in September relative to the previous month, they continue to rise on a rolling 12-month basis.

Turning to Europe, the Commission's September upgrade for 2010 GDP (to 1.8%, versus 1.0% made in July) seems not only belated, but also hubristic, given a likely deceleration in growth trends (the Commission forecasts 1.4% for 2011) and also against a backdrop of emerging concerns. In particular, Europe's PMI survey showed its lowest reading in September for seven months (missing consensus expectations) while German industrial orders fell by 2.2% in July relative to June (the last month for which reported data is available), constituting the sharpest fall since February 2009. Even if German business and consumer confidence levels are currently tracking at three-year highs, it appears that German investors disagree: the respected ZEW survey shows investor confidence at its lowest in 19 months, having now fallen for five consecutive months.

In the US, we have now seen four months of declining production statistics over the last five months based on ISM factory data (although the index remains above 50 and September's drop was only slightly worse than consensus had been assuming) and it is hence unsurprising that there is increasing caution from Fed. Its Beige Book highlights that there are "widespread signs of deceleration" in five of the 12 regions analysed (8 September), while its statement of 22 September goes further in suggesting that it can provide "additional accommodation" if required in order to support the (struggling) economic recovery. This may be necessary since confidence among US house builders stands at a one-year low, and among consumers at an eight-month low. Fewer new homes were sold in the US last month than in any since 1963, while the Empire State Survey of manufacturing trends in New York also points to the greatest slowdown in a year.

Even if the jury remains out on the likelihood of a double-dip (we have been in the more negative camp and also note deteriorating economic trends in Ireland and Greece), then future GDP growth will not be as we have known it. The new reality is potentially one of permanently lower growth, and our sense is that it will take a long time (longer than valuation levels currently discount) to return to trend GDP of greater than 2.5% in the western world. It is interesting also to read the OECD's 9 September comment that the global economy was currently slowing at a rate "more pronounced than anticipated."

Three questions therefore need to be asked: first, can current (even lowered) growth levels be sustained; second, what if they can't; and, third how much of this more negative scenario is reflected in current earnings expectations?

On the first question, we would reiterate the theme discussed in last month's strategy piece, namely that of the joyless recovery, or one that has been described by President Obama as being "painfully slow" (10 September). Despite being advocates of globalisation, what happens in the world's largest economy clearly has major ramifications elsewhere. Against this background we note that after four quarters of US economic recovery, output has increased by just 3.0% in contrast to a 7.7% leap in the same period post the 1982 recession and a 6.2% gain in 1977 (data courtesy of *The Economist*, 18 September).

Unemployment also peaked at lower levels in previous recessions than the 10.1% level witnessed in October 2009; almost 12 months on, the rate has moved down marginally, to 9.6% (actually up 0.1pp in August relative to July). Trends are similarly disappointing elsewhere, with Eurozone and UK unemployment flat in the last month, at 10.1% and 7.8% respectively. Impending public sector job cuts in the latter's economy following October's Comprehensive Spending Review may also force unemployment higher. With such a large percentage of the workforce in the developed world still without work, growth may prove hard to sustain.

In a world of deteriorating growth prospects, there remain no shortage of proposals about how to kick-start the economy (again), but some are untested and others have been tried already and will likely suffer diminishing returns from increasing use. We note the recent announcement of Obama's 'new' $50bn stimulus plan and also similar promises of more spend in Japan, while there has been growing talk of a return to quantitative easing in both the US and the UK. As we have written on many previous occasions, debt remains the key issue that refuses to go away and this logically implies that there is more potential fiscal pain to come, potentially squeezing out the benefits of any possible stimuli.

Of potentially greater concern is the fact that not all of such a negative scenario is, we believe, reflected in current valuation levels. Expectations regarding earnings were buoyed post a robust Q2 earnings season (where cost cutting and operating leverage helped drive profits even in an absence of revenue growth) and with both the All-Share and the Dow trading on c 14x 2011 earnings, similar hopes seem to be being priced for the upcoming third quarter earnings season. Even if Q3 results do not disappoint (we expect similar top- and bottom-line trends to Q2), 2011 may be the time when consensus estimates have to start crunching downwards. An interesting potential lead indicator and proxy for emerging trends was also provided by global carrier FedEx when it reported earnings on 16 September: it missed estimates and warned regarding the outlook.

Playing equities therefore remains a challenge and we would reiterate our greater preference for other asset classes (especially gold, where we have been long-standing bulls and note its current 52-week high). Our equity strategy has four strands:

- We emphasise the importance of stock (over sector) selection, hence the value of products such as our *Illuminator* screen;
- We remain keen to play global themes and exposure, particularly since the BRIC economies seem noticeably more robust than their western counterparts;
- We highlight the merits of investing in defensive sectors – current feedback from our investor base suggests their growing preference for cash returns; and,
- We reinforce our conviction levels in our negative sector stances, especially given downside risks we see for markets.

As a result, basic materials remains our core overweight sector. Meanwhile, we have increased our preference for the telco, utility and healthcare sectors, all of which have outperformed since the start of 2010 but still look undervalued to us. As a consequence we have become less positive on industrials (momentum seems to be slowing and those with high UK exposure may be at risk from the spending review), financials (performance has been poor) and oil & gas (valuation levels look challenging). Given the outlook, our most negative sector preferences remain focused on the consumer, both for listed goods and services companies.

Market review: In case you missed it, was there a rally?

As we stated earlier, September's 6.3% bounce in the All-Share constituted its strongest monthly move since April 2009 and this trend was broadly mirrored in all of Europe's main bourses. However, look below the surface and what September shows in the UK is an almost equal number of up and down days for the market (11 up, 10 down and one unchanged) while the story of 2010 so far shows four months of gains for the All-Share against five of declines. Similarly, just as sentiment towards equities *may* have improved in the last month, a record level for gold as well as strong gains for defensive currencies such as the yen and the Swiss franc also show a strong preference for risk aversion.

We square this theoretical dichotomy by suggesting that investors remain deeply ambivalent towards equities. This is certainly what the story of 2010 shows and, as Exhibit 2 highlights, the All-Share has added just 3.8% year-to-date and the Euro Stoxx only 2.3%, while the CAC, IBEX and MIBTEL (in France, Spain and Italy respectively) are still in negative territory, to the tune of at least 5%.

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	(3.5)	(0.6)	0.7	(2.4)	6.4
FTSE All-Share	(2.3)	(0.7)	0.9	(1.5)	7.0
DJ EURO STOXX	(8.6)	(4.0)	0.5	(2.2)	(2.6)
DJ EURO STOXX 50	(11.5)	(4.3)	0.5	(3.9)	(5.5)
France CAC40	(11.3)	(4.2)	(0.5)	(5.9)	(4.5)
Germany DAX30	(0.5)	(3.6)	(0.7)	5.8	8.4
Spain IBEX35	(14.7)	(3.0)	8.8	(1.4)	(10.4)
Italy MIBTEL30	(15.1)	(6.1)	1.0	(6.3)	(12.0)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	8.0	3.7	0.2	1.5	11.9
FTSE All-Share vs EURO STOXX	6.3	3.3	0.4	0.7	9.6

Source: Datastream, Edison Investment Research

Supporting the theme of ambivalence is that of oscillation: investors have constantly shifted between the poles of the 'risk trade' being on and off. September was definitively an on-month with the UK basic materials, technology and industrials sectors reporting gains of over 10%, while the three weakest performers were the utility, telco and healthcare segments, with none moving higher than 2%. This constitutes a reversal of August's trends and we also note that on both a six-month and nine-month view, the basic materials sector has underperformed on a market-relative basis. During these time frames, the three classic defensives have all gained, with the exception of the healthcare sector from a year-to-date perspective.

Given the well-documented challenges facing the Eurozone, it is not surprising that on every time period we analyse (see Exhibit 2 above), the main European indices have underperformed their UK counterparts. Growth on the continent remains slower and unemployment higher, while Eurozone currency and debt issues are also factors that refuse to dissipate. On a one-year view, investing in the UK All-Share relative to the Euro Stoxx 600 would have delivered investors gains of over 10 percentage points.

The one strong point (for now) and exception to European doldrums is Germany, where the DAX Index has outperformed the FTSE both year-to-date and over the last 12 months. Similar to the UK, the major constituents of the German market are international in nature and also heavily export-led. While recent performance from this market has been encouraging and while we continue to advocate the theme of global exposure, we note not only September's decline in German investor confidence (mentioned above), but also the fact that a slowing US economy has clear negative implications for nascent export-led countries such as Germany. Whether September's stock market gains (across Europe) can be sustained is discussed in more detail below.

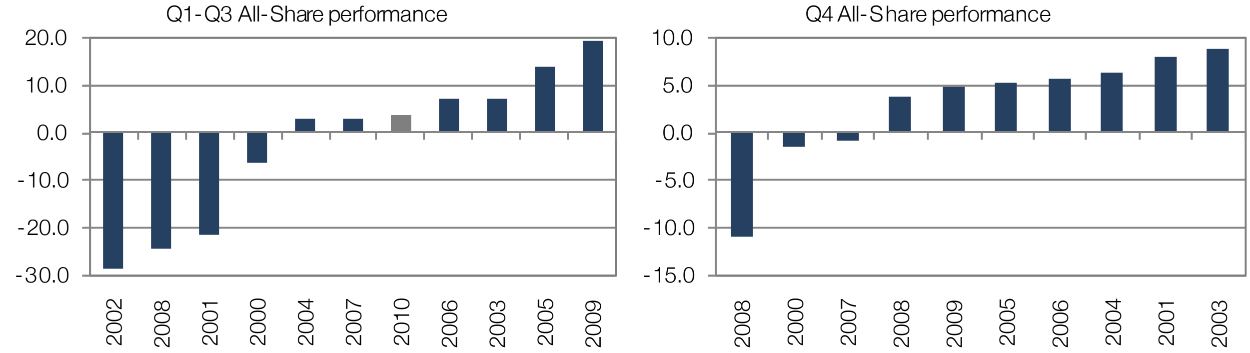
Outlook: Part 2 on the rally theme – what to expect before the year-end

Caveat emptor: even if we do see strong market gains before the end of 2010, these will, in our view, neither fully compensate for the high volatility and limited gains experienced so far this year, nor mask the deeper problems facing the global economy.

History is at least on the side of the market bulls, since the All-Share has risen during the fourth quarter in all but three of the last 10 years (2000, 2007 and 2008), but a more sobering statistic is that the average gain recorded during the October-December period has been just 2.9%, while the biggest (witnessed in 2003) was only 8.8%. Last year was emphatically the best year for equity markets globally in the last decade, as the world bounced back post-Lehman, but of the UK's 25% gain for the All-Share in 2009, less than one-fifth of this rise was actually attributable to positive moves during Q4.

We also note that in the two years during the last decade which most mirror the year-to-date performance of the All-Share (2004 and 2007, where gains of 2.9% had been recorded in each case after nine months against a 3.8% rise in 2010), in one case, there was a healthy fourth quarter rally – when the All-Share posted a 6.2% positive move in 2004 – but in the other, equities ran out of steam as credit crisis concerns emerged. Q407 saw the All-Share lose 0.9%.

Exhibit 3: Q1-Q3 and Q4 trends in UK equities are inconsistent and provide only a limited guide to the future (% change)



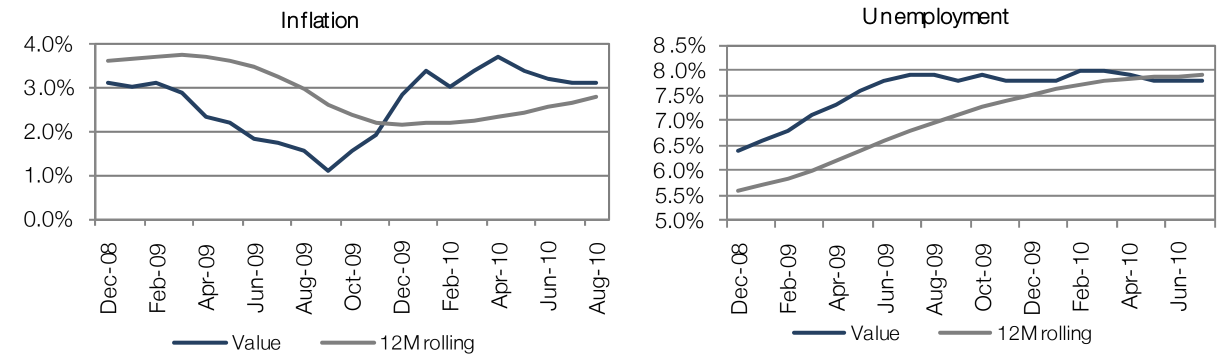
Source: Bloomberg, Edison Investment Research

Analysis of other global equities markets shows similar patterns and so it seems fair to conclude that not only is an end-year rally far from guaranteed, but it also may not be spectacular in performance terms. Given that expecting the unexpected has become the new normal in the last two years, clearly there is scope for history to prove us wrong and for markets to gain strongly through until December. Nonetheless, even should this be the case, we feel it is more constructive to look beyond this and once again focus on the risks ahead. These factors will likely start to undermine equity performance going forward.

Our major concern relates to rising inflation. This is of particular importance since in an environment where growth is slowing and cost cutting/operational leverage can only provide upside for a limited period, the performance of top-line trends matters increasingly. Inflation would undermine any emerging revenue growth and hence risk putting downward pressure on consensus financial earnings estimates.

These problems would be further compounded by still-high unemployment (there are no signs of this falling – as we highlighted above) since companies may find it increasingly hard to rely on organic, consumer-led, revenue demand. Inflation plus unemployment runs the risk of creating the potentially unappealing cocktail of stagflation. The Oxford English Dictionary defines this as “a state of the economy in which stagnant demand is accompanied by severe inflation.”

Exhibit 4: Stagflation is coming – in the UK, both inflation and unemployment continue to rise on a 12-month rolling basis



Source: Office for National Statistics, Edison Investment Research

In terms of data points to support our thesis, the Bank of England writes that the “near-term prospects for inflation remain unusually uncertain” (22 September). This statement also ignores the reality that inflation has been above the Bank’s target in 41 of the last 50 months, and the last nine consecutively. August’s reported figure of 3.1% showed no decline relative to July (consensus had been for a drop to 2.9%) and of greater concern is the fact that an assessment of core inflation – stripping out for food and energy, which show more seasonal volatility – shows that it rose in the last month, from 2.6% to 2.8%. Moreover, the Bank’s latest Inflation Attitudes survey (16 September) shows that average expectations for UK inflation one-year out stand at 3.4%. Meanwhile, in the Eurozone, inflation has also edged higher, adding 0.2 points over August, to 1.8%.

We see two main risks for further future inflation ahead. First, input (raw material) prices are clearly rising. The UN’s latest food report (published at the start of September) highlights that wheat prices stand at two-year highs and global meat prices at levels last seen in 1990. Cotton prices are also at their highest level seen since 1995. Some companies are also already warning of the dangers such movements can pose. Next, one of the UK’s largest retailers, for example, said on 15 September that “for 2011 we are expecting significant product cost price pressure from around the world.”

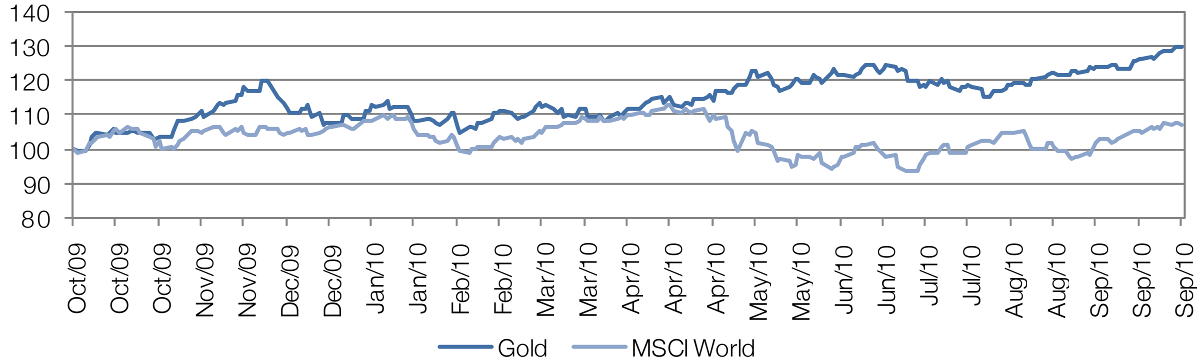
Furthermore, investors should not ignore the fact that the still burgeoning growth economies of the globe – India and China – are also seeing rising price levels and these could risk feeding through to the more developed west. India’s inflation stands at 8.5% (9.5% on an underlying basis had the calculation for the price basket not been changed last month), while the rate in China has edged up from 3.3% to 3.5% in the last month.

Our other concern relates to the risk posed from a possible return to quantitative easing, a topic being actively discussed in both the US and the UK, although its success the first time around remains far from proven. We regard the policy of easing as effectively constituting a form of monetising government debt (which in its own right remains a significant and still inadequately discounted concern). Governments and central banks may simply end up ‘inflating away’ debt as a convenient way of dealing with this problem, only to bring about another.

The ongoing outperformance of gold relative to equities (a 10% gain since the start of the year and more than 25% in the last 12 months, as Exhibit 5 shows) is to our mind indicative of inflation concerns. The flurry of deal-making that we have seen year-to-date (15 FTSE-250 companies alone have seen approaches since the start of 2010, while last Monday, for example, saw both Unilever and Wal-Mart announce large transactions) is also an interesting indicator with regard to the inflation debate. If companies are worried about organic growth prospects – either because the world economy is slowing and/or because inflation is eating revenues away – then they might logically seek to 'buy' growth through deal-making. Should this trend of M&A continue, then it may be encouraging for owners of the bid targets but does not constitute a panacea for equities, particularly should the outlook be becoming more difficult.

Exhibit 5: Gold has been a significantly better investment than equities in the last 12 months

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

Towards a sector ranking: Key considerations

Edison's equity strategy was outlined earlier and relates to stock selection (axiomatic amid market volatility), global exposure, defensive positioning and avoidance of high risk sectors, particularly relating to the consumer. Bottom-up analysis has inevitably had to take precedence over a more sector-based approach during 2010, but we nonetheless feel it remains constructive to provide a conceptual framework for considering those sectors where we have the strongest positive and negative views.

Our sector rankings are reviewed monthly and for October we have made several changes relative to the previous month. Basic materials remains our most preferred place to play and we are encouraged not just by fundamentals but also by last month's 12% gain as well as a 30% rise in the last year. Similarly, our negative stance on the consumer space (services and goods) remains intact. While the sector performed broadly in line with the market in the last month, on a one-year view, it has gained (providing a reason for correction) while valuation provides limited support.

Changes have taken place elsewhere within our list, with our preference for telecoms, utilities and healthcare rising somewhat, at the expense of industrials, financials and oil & gas. Our broader macro concerns and volatile markets year-to-date suggest that there is a good chance for an imminent move back towards risk aversion and hence defensives, while valuation levels and cash returns are also highly supportive. By contrast, we see risks rising for the industrials segment (particularly for UK exposed names ahead of the Spending Review) while the recent performance from the financials sector has been disappointing and perceived sentiment towards the sector may move more negative owing to re-emerging concerns over sovereign debt, especially given current record bond yield spreads in Ireland and Portugal.

Exhibit 8 shows our preferred sector strategy, which we caution is strictly illustrative since it only relates to hypothetical positioning across UK equities whereas, in reality, investors will likely take into consideration a much broader range of factors. We also highlight (in Exhibit 6) how our sector preferences have changed in the last month and also how they have shifted over the last four quarters (see Exhibit 7).

On a three-month view, our overweight call on basic materials has been vindicated with it being the best performing sector in the UK, up 19.5%. Both consumer goods and services also lagged the market (by 4.4 and 2.5 points respectively), supporting our negative stance. We did, however, not call financials entirely correctly (the sector gained 12.7%) nor did we fully see the oil & gas bounce post BP's woes (up 19.4% in the last quarter) coming. Over the last year, being overweight basic materials and underweight financials was the right call (delivering a positive spread between the two sectors of 31.2 points in favour of basic materials) although telcos did not deliver quite the gains we had expected.

Exhibit 6: Edison sector rankings for October and how they compare to September

Position	Oct-10	Rationale	Sep-10
Best	Basic materials	M-term fundamentals, global exposure, valuation	Basic materials
	Telecoms	Valuation, cash returns; some global exposure, M&A potential	Industrials
	Utilities	Valuation, cash returns; some global exposure, M&A potential	Financials
	Healthcare	Defensive profile supported by value and yield	Telecoms
	Industrials	Earnings momentum posiitve but slowing; risks emerging	Healthcare
	Financials	Performance has been disappointing; sector risk aversion rising	Utilities
	Technology	M&A potential, but valuation demanding	Oil & gas
	Oil & gas	Sector has underperformed but remains expensive; n-term risks	Technology
	Consumer services	Structural concerns given outlook; heavy domestic bias	Consumer services
Worst	Consumer goods	Structural concerns given outlook; heavy domestic bias	Consumer goods

Source: Edison Investment Research

Exhibit 7: Edison sector rankings for Q4 and how they compare to previous quarters

Note: Ranking refers to the view at the start of each quarter.

Rank	Q4 10	Q3 10	Q2 10	Q1 10	Q4 09
1	Basic materials	Basic materials	Basic materials	Basic materials	Telecoms
2	Telecoms	Industrials	Industrials	Telecoms	Basic Materials
2	Utilities	Telecoms	Oil & gas	Healthcare	Healthcare
4	Healthcare	Healthcare	Telecoms	Utilities	Utilities
3	Industrials	Utilities	Healthcare	Industrials	Industrials
6	Financials	Financials	Utilities	Technology	Technology
4	Technology	Oil & gas	Consumer services	Oil & gas	Oil & gas
8	Oil & gas	Technology	Consumer goods	Consumer services	Consumer services
5	Consumer services	Consumer services	Technology	Consumer goods	Consumer goods
10	Consumer goods	Consumer goods	Financials	Financials	Financials

Source: Edison Investment Research

Exhibit 8: 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	12.0%	10.0	1.5%	5.5%	12.0%	19.5%	(5.7%)	30.0%
	Telecoms	6.1%	8.5	5.0%	7.6%	0.8%	10.6%	3.2%	11.0%
	Utilities	3.8%	10.8	5.1%	4.2%	(0.6%)	8.8%	4.4%	12.4%
	Healthcare	7.6%	12.4	4.4%	1.6%	1.9%	5.6%	2.5%	8.0%
	Industrials	7.3%	18.0	2.6%	16.2%	10.7%	11.4%	5.3%	20.6%
	Financials	24.2%	16.2	2.9%	4.4%	3.9%	12.3%	0.1%	(1.2%)
	Technology	1.7%	22.8	1.2%	28.8%	10.9%	18.0%	12.3%	31.2%
	Oil & gas	16.1%	17.2	3.7%	(8.2%)	9.6%	19.4%	(10.8%)	(2.5%)
	Consumer services	9.9%	13.5	2.8%	6.9%	5.9%	10.2%	(0.5%)	11.7%
Worst	Consumer goods	11.3%	15.0	3.4%	7.2%	6.9%	8.3%	1.1%	15.9%
Average		100.0%	14.4	3.2%	3.8%	6.3%	12.7%	(1.5%)	8.8%

Source: Datastream, Edison Investment Research

We provide additional explanation and justification for our sector rankings below:

Basic materials: Momentum, growth and value

We have been encouraged by positive recent and more medium-term (one year) performance and believe there is substantially more to go for given structural long-term growth trends and also currently supportive (10x 2011 P/E) valuation. We favour this sector owing to its global characteristics, and particularly its exposure to the BRIC economies. The prospects for these economies are well known and recent data points re-emphasise the strength of current demand. China alone is responsible for consuming a third of the world's base metals and we note an increase in industrial production levels in September (to the highest level seen since May), while retail sales also moved higher. Meanwhile, in India, factory output rose 13.8% in the last month, reflecting still-strong underlying momentum.

Telco, utilities and pharma: Attractive on yield and other factors

The appeals of defensive sectors are broadly understood, in particular, their combination of attractive dividend yield and value, combined with relatively low economic risk. Although the sector has lagged in the last month as risk appetite has returned to vogue, we see substantial valuation attractions and also upside potential from possible M&A. All three sectors currently trade on sub-market multiples with above-average dividend yields. Some of the larger sector names also offer global exposure (especially in the form of Vodafone, GSK and Astra), while deal-making could improve sector sentiment. Vodafone is in the process of disposing of assets and unlocking value while Cable & Wireless, United Utilities and Northumbrian Water have all attracted recent bid speculation.

Our relative preference for telco over utility and pharma is a function of valuation (8.5x 2011 P/E), and cash returns (5.0% sector yield, higher at Vodafone). Healthcare looks relatively the most expensive of the three defensive sectors and also offers less scope for near-term M&A potential.

Industrials: Risks rising, no longer cheap

While the sector has been a robust performer year-to-date, we believe that this is broadly reflected in current valuation levels, with UK industrials trading on a headline 2011 P/E multiple of 18.0x. The sector is clearly heterogeneous in nature and so therefore we continue to see upside potential for those stocks with global, and particularly emerging market exposure, but we have concerns over potentially deteriorating earnings momentum, some of which may even come through in the impending Q3 reporting season. Cost-cutting and operating leverage benefits may have begun to run their course and the negative impact from the UK's 20 October Comprehensive Spending Review may knock not only sentiment but also 2011 estimates. As a potential lead indicator, Smith Industries last week showed a noticeable note of caution at the time of its preliminary results.

Financials: Performance disappointing, upside uncertain

UK financials did rally from May through to August (recording 3.4 points of market relative underperformance), but lagged notably (by 2.4 points) in September. We feel much of the good news from post stress test relief and favourable Basel III regulations has been reflected in share price moves, particularly for UK banks. A headline multiple for the financials sector of 16.2x 2011 P/E implies limited room for disappointment, just as sector risks are potentially beginning to rise again. Three factors provide some cause for concern and may raise sector uncertainty levels: whether new capital needs to be raised given Basel requirements (Deutsche Bank has already done so, but there may only be limited future investor appetite); the extent financials may be exposed to Ireland's burgeoning debt crisis (while Portugal and Greece – possibly others too – are far from being out of the woods); and, how some of the major institutions (HSBC, Lloyds) cope with current senior management transition.

Technology: Priced for M&A, not fundamentals

The best performing UK sector year-to-date and over the last 12 months trades on an eye-watering headline P/E for 2011 of 22.8x. In weighting terms, however, it should not be forgotten that UK tech constitutes just 1.7% of the All-Share, with ARM and Autonomy representing the bulk of the sector by market cap. As our tech team has written previously, M&A may continue to buoy the sector further and benefit candidates across the market cap spectrum.

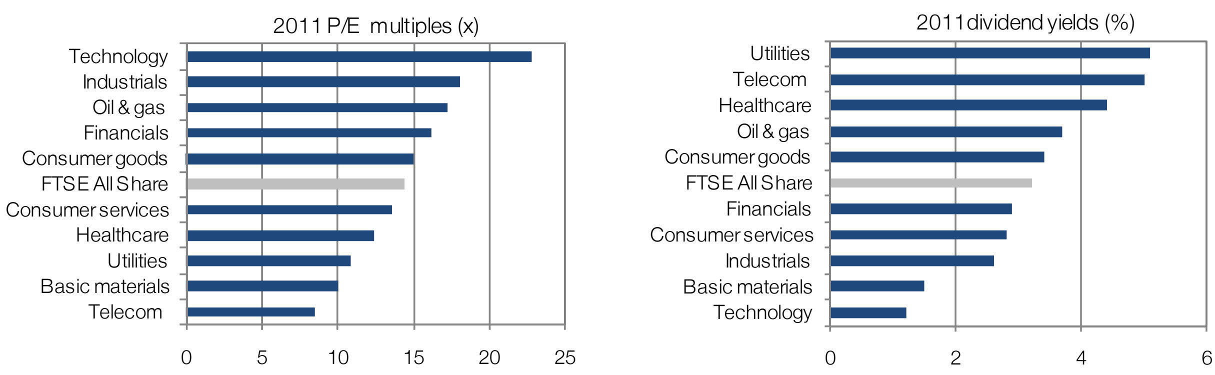
Oil and gas: Hard to be excited at current levels

At just under 5% of the All-Share's weighting, BP's moves this year have had a bigger impact on the UK's market performance, and hence the sub-sector's performance, than almost any other stock. The oil & gas sector has lagged notably year-to-date, but has been the market's second best performer on a three-month view. Much of this is reflected in headline valuation levels (17.2x 2011 P/E) and while we do not deny that there is scope for sentiment to become more positive near-term, we find the sector harder to justify on fundamentals. Crude oil and refined product markets are in significant current surplus which sets the scene for near-term price weakness. Moreover, a lacklustre price trend is also expected to extend into 2011 reflecting the likely persistence of well-supplied markets and high inventories.

Underweight consumer goods and services

We see potentially greater risk to earnings estimates within the consumer space than elsewhere in the market. This view is driven from a deteriorating backdrop where retail sales are falling (August saw sales drop 0.5% relative to July, while year-on-year growth has been a sclerotic 0.4% according to the ONS), consumer confidence is tracking over 20 points below its long-term average (61 vs 83 according to the Nationwide) and large corporates are sounding increasing notes of caution. Within the last month, Kingfisher has characterised the outlook for UK consumer spending as "fragile" while Next expects "very little in the way of growth for the foreseeable future." ABF (owners of Primark), Debenhams, Home Retail and WM Morrison have also joined the chorus of cautious voices. The impending UK spending review may not only dent confidence – and hence spending – further, but also bring about the risk of higher unemployment. Even if sales do receive a temporary fillip in the run-up to Christmas and ahead of January's VAT increase, 2011 looks set to be a considerably more difficult year, an outcome not fully reflected in current valuation levels in our view.

Exhibit 9: Screening for value and growth in UK equity sectors



Source: Datastream, Edison Investment Research

Conclusions

September's rally is encouraging for equity investors and may help restore some much needed optimism. However, it masks neither the fact that equities are only just (<5%) in positive territory year-to-date nor the fact that fundamentals remain highly challenging and indicators broadly inconsistent. We continue to believe that consensus expectations do not fully reflect a scenario of slowing growth for 2011 and that nascent inflation could undermine top-line prospects over coming months. Moreover, headline multiples of around 14x earnings for both the UK and US equity markets clearly do not constitute value territory.

Against this background, we have become more defensive in our stock selection and prefer to play undervalued names with either strong global exposure or high cash returns. Basic materials and telco score highly for us; consumer names least so.

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