

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

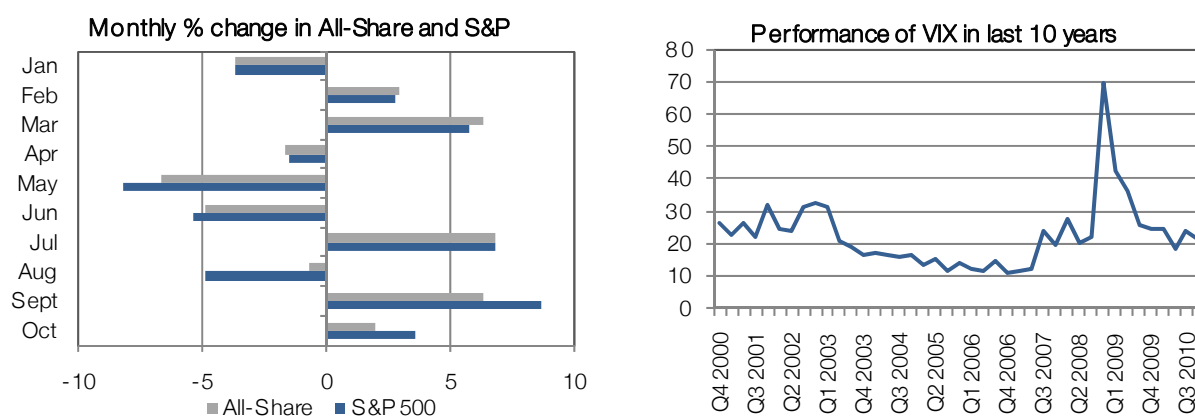
Stock markets edge higher, but we do not feel that recent gains will prove sustainable. In particular, we believe excessive faith has been placed in the potentially restorative powers attached to a further round of quantitative easing. Such a policy may not help correct underlying issues and could only serve to stoke already nascent inflation. The current Q3 reporting season may be as good as it gets in the near term; benefits from cost savings have mostly come through and future revenue growth (even with more QE) will become harder to detect. We also see relatively limited valuation support at present. Against this background, we retain our current equity strategy, favouring diversified growth (basic materials) and high cash returns (telcos, utilities) principally at the expense of the consumer sectors.

Living in the land of delusion

Equity markets have reached six-month highs in recent weeks, with gains from July's lows now totalling more than 18% in the UK and 16% in the US. While investors may feel that they can take some comfort from these moves, we feel it is more than justified to question their sustainability. In brief, our primary concern relates to the fact that we believe investors are at risk of discounting an overly optimistic scenario about future market prospects.

Recent gains may be encouraging, but have to be set against a context of equity indices around the globe that have witnessed violent reversals with alarming regularity since the start of 2010. The All-Share has, for example, seen five months year-to-date of gains and also five months of losses, a pattern repeated for the S&P. There have also been consistent failures for the All-Share to breach 3,000, a symbolic level not passed since June 2008. Similar dynamics have played out in many other equity markets globally. Moreover, volatility – as measured by the VIX Index – remains high by historic standards. While the levels of 70 witnessed at the time of the Lehman collapse seem like the distant past, the current VIX reading of 21.2 is just 2% lower than a year ago, while it should not be forgotten that for most of the mid-2000s (2005-07), it averaged much closer to 10 – half of today's level.

Exhibit 1: Equities have been volatile year-to-date; the VIX is high by historic standards



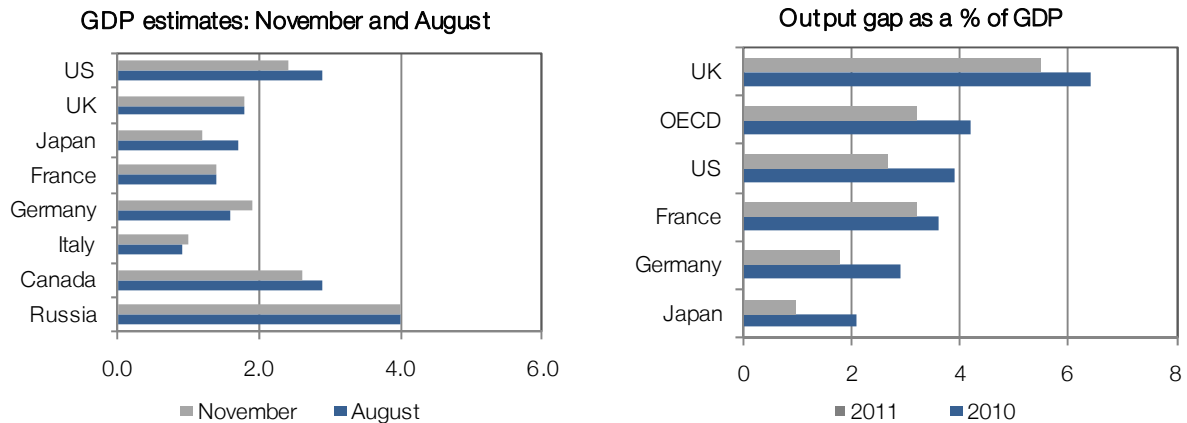
Source: Bloomberg, Edison Investment Research

The reality is, despite recently more positive moves in equities, that the same old problems remain, driven by the ongoing process of painful deleveraging compounded by insufficient liquidity in the financial system.

Growth is clearly slowing down. The IMF's estimate for 2011 GDP growth within the G8 was trimmed from 2.4% to 2.2% in October and, as Exhibit 2 illustrates, forecasts have been markedly scaled back in some countries over the last three months, particularly the US. Q3 US GDP of 2.0% may have been better than the rate witnessed in Q2 (1.7%), but stands a long way down on consensus expectations for 3.0% held six months

previously. In addition, although the US economy has now grown for the last five quarters, it is still well below the level of output recorded at the start of the last recession, and a similar picture can be seen in most other developed economies. Furthermore, initial conclusions from the Q3 reporting season around the world make for highly inconsistent reading: better bottom-line performance (more than 75% of companies have beaten relative to expectations) masks a deteriorating top-line.

Exhibit 2: 2011 G8 GDP estimates have been scaled back; the output gap remains significant



Source: IMF, OECD, *The Economist*, Edison Investment Research

Against a backdrop of these well-documented problems, we worry that excessive hope (hence the 'delusion' of our title) seems to be being placed in the potential benefits that a second round of quantitative easing may be able to deliver. We note with interest that the most recent Merrill Lynch fund manager survey (for October) suggests that levels of risk appetite stand at their highest since April 2009. Such optimism – or perhaps even hubris – implies to us that the scope for potential disappointment is high.

Rhetoric suggests that a second round of quantitative easing ('QE II') is looking increasingly likely. Fed Chairman Ben Bernanke made the obvious point on 7 October that "the task of economic recovery and repair remains far from complete" and then used the phrase "a case for further action" in speeches on both 15 and 20 October. The Fed may make its decision at November's meeting. Elsewhere, QE could also be on the agenda. Based on Governor Mervyn King's language – there is a "key role" for the Bank to provide stimulus when "the economy is in need" (speech of 20 October) – the UK may also be edging towards such a stance, although just one of the nine-member Monetary Policy Committee voted in favour of such a policy in October.

Our concerns relate not only to how much of the stimulating potential of QE is already reflected in investor expectations (and valuation levels – both the S&P and the All-Share on c 13.5x P/E, for 2011), but also what may happen if the US/ UK announcements regarding QE do not match near-term hopes. Last time around ('QE I' policies came to an end in March), over 10% of GDP was bought back by central banks in the form of treasury and mortgage bonds, equivalent to \$1.7 trillion in the US. More fundamentally, we feel it important to ask the question, 'what if it does not work?' There may be no way of answering this, but it is valid to highlight that policies such as QE inevitably suffer from diminishing returns – the more times they are used, the less successful they become, particularly in a market that currently seems to be driven more by investor psychology than fundamentals.

Given the fiscal constraints faced by most developed economies (clearly evidenced by the announcement of the recent Comprehensive Spending Review in the UK), the trouble is that monetary policy perhaps represents the only tool left for winning the war. However, it is not clear whether QE (and correspondingly lower yields) will help stimulate an economy where banks do not want to lend and consumers do not want to borrow.

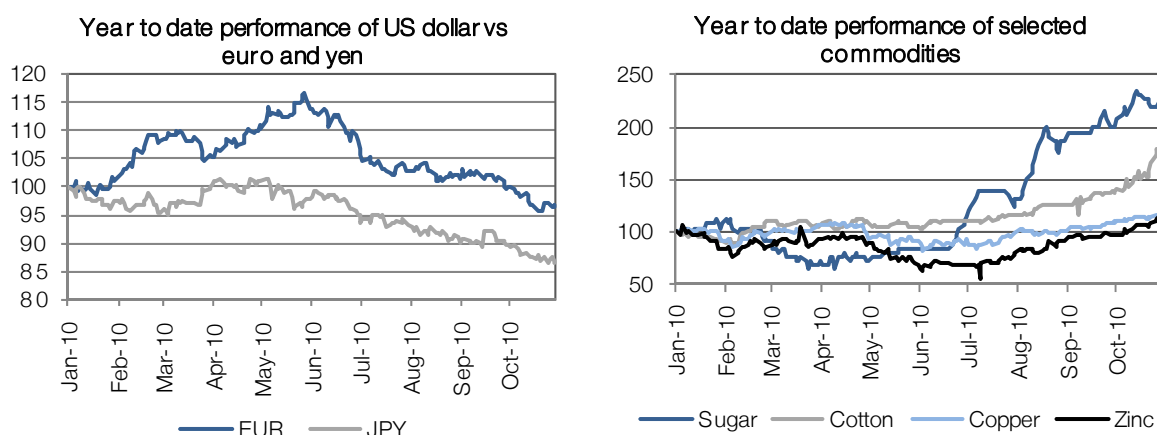
Impatience may also get the better of investors not willing to take into account the time required for structural deleveraging, but neither inflation nor default (the likely concomitants of QE) represents an appealing option.

Meanwhile, other problems are also building up. Despite the hopes being placed in QE, the weakness of the US dollar (at a 15-year low versus the yen and an eight-month nadir against the euro) hints at the potential failure of both fiscal *and* monetary policy. If neither of these strategies works, what could perhaps be more logical than resorting to what *The Economist* dubbed “currency wars” (16 October) as a way of driving the economy? A ‘race to the bottom’ to drive growth via exports risks creating a dangerous dynamic of competitive non-appreciation.

Beyond the potentially destabilising geopolitical risks that such strategies may induce, we also worry that depreciating currencies combined with more monetary stimulus may stoke inflation. This is of particular concern since rising input processes would undermine slowing growth and eat into companies’ already diminishing top-line performance. The indicators are not encouraging: we note recent highs in coffee, sugar (at a 30-year peak) and cotton, as well as in copper (now higher than it was pre-Lehman) and zinc. Elsewhere, reported inflation in China stood at its highest in two years in September, while it is currently rising in 20 of the EU’s 27 member states. In the UK, inflation has been above the Bank of England’s target in 42 of the last 50 months and the chairman of Marks & Spencer, the country’s largest retailer, warned in a recent (26 October) speech that he sees risks of more inflation “coming through.”

Exhibit 3: The dollar weakens; and commodity prices rise

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

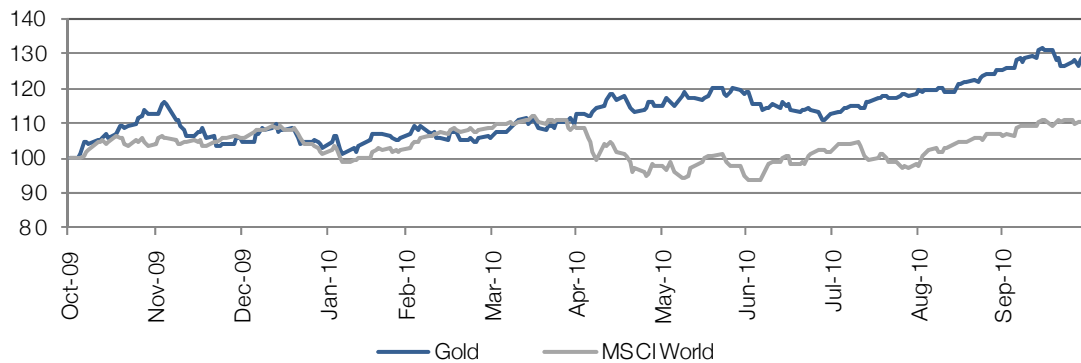
From all the confusion, one conclusion seems abundantly clear to us: against a backdrop of QE, currency and inflation uncertainty, gold represents a logical safe haven. This has been a well-documented theme of Edison’s, but we reiterate our view that this remains an attractive asset class with no counterparty risk, inherent scarcity value and a hedge against either inflationary or deflationary scenarios. The precious metal hit a 52-week high on 14 October while it has outperformed the MSCI Global equity index by 18.8% on a year-to-date basis. On a three-year view, Edison believes it could reach \$2,000/oz, some 45% above current levels.

Gold therefore remains our investment of choice, and within the equity sphere, we have made few changes to our current strategy. Given market volatility – which we expect to continue – we see the logic in adopting a ‘bar-bell’ approach, combining some sectors/stocks that would benefit from any move towards the risk trade, while also continuing to keep a high focus on defensives. Put simply, we favour emerging over domestic growth and place a high emphasis on free cashflow/dividend generation. As we discuss in more detail below,

this leads us to an overweight stance in basic materials, telcos, utilities and healthcare, balanced with underweights in the consumer and financial space.

Exhibit 4: Gold has been a significantly better investment than equities in the last 12 months

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

Market review: Still stuck beneath a glass ceiling

The All-Share limped 2.0% higher in October but not without several setbacks along the way. The UK's leading market saw an equal number (10) of up and down trading days during the past month and the All-Share has drifted down 1.4% from its month high achieved on 25 October. More importantly, the symbolic 3,000 threshold for the All-Share has singularly been failed to be breached, not just in October (or in April, when the market made superior highs to those seen in the past month), but not since the summer of 2008. Inconsistent market gains are the corollary of inconsistent economic and corporate data, and, against this background, the threshold may remain a hard one to cross.

Such a thesis also appears to have been borne out by an analysis of the best and worst performing sectors over the last month and on a year-to-date basis. During October, telcos delivered the most impressive gains in the UK market (up 6.4%) followed by basic materials (5.9%) and utilities (5.4%). Meanwhile, the UK's worst performers were the technology (down 3.7%) and utilities (a 2.3% drop). This suggests an ongoing dialectic between investors favouring 'risk on' and 'risk off' trades. Similarly, since 1 January, both telco (defensiveness) and industrials (growth) have led the way in performance terms, while healthcare has been one of two notable laggard sectors, still in negative territory (the other being oil, the result of BP's woes earlier this year).

While the All-Share's year-to-date gain of 6.4% can hardly be described as impressive, the UK market's returns have been bettered in Europe by only the German DAX among the indices we track. Indeed, the Euro Stoxx 500 remains in slightly negative territory (down 0.1%) since 1 January. Meanwhile, both the Spanish and Italian bourses have dropped by more than 7% since the start of the year. UK underperformance relative to continental European indices during October (see Exhibit 5) may partially be explained by the fact that non-domestic exchanges are playing 'catch-up' against the All-Share.

Despite another strong performance from the German market during October (with a gain of 5.7% recorded), we see some signs that the gloss may be coming off the story here too. While Q3 releases from large and diversified German businesses have impressed, we note that economic sentiment in Germany weakened during the last month (down from -4 to -7 according to the most recent ZEW survey), while exports have now declined for two consecutive months. In addition, German retail sales fell in September at their biggest rate since March 2008. Whether 10%+ year-to-date market gains in Frankfurt can be sustained through until the end of the year remains to be seen. We expect bourses to continue to see-saw over the remaining two months of 2010, and also more-than-likely into early 2011.

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

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	4.9	1.9	6.8	1.0	10.5
FTSE All-Share	6.4	2.0	7.0	1.5	11.7
DJ EURO STOXX	(0.1)	3.6	4.4	1.6	4.1
DJ EURO STOXX 50	(4.0)	3.4	3.3	0.6	0.7
France CAC40	(2.6)	2.7	5.0	(0.2)	3.2
Germany DAX30	10.8	5.7	7.6	7.4	18.2
Spain IBEX35	(9.4)	3.1	1.4	3.6	(7.5)
Italy MIBTEL30	(7.7)	5.3	1.7	(1.1)	(5.8)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	8.9	(1.5)	3.5	0.4	9.8
FTSE All-Share vs EURO STOXX	6.5	(1.6)	2.6	(0.1)	7.6

Source: Datastream, Edison Investment Research

Outlook: A letter from America; one that does not make good reading...

An inevitable function of poor growth in the western world is that a rapid shift in the centre of economic gravity is occurring. Whereas 70% of world GDP came from the US, Europe and Japan a decade ago, this figure is now less than 50%. While this has clear longer-term consequences (and hence our preference for equities with high emerging markets exposure), it should not be forgotten that – for now – the US economy remains the world's largest. As such, it represents a proxy for the health of the global economy. Likewise, given the US emerged from recession earlier than its developed peers, its well-being constitutes a valuable lead-indicator for the rest of the world.

The prognosis is not encouraging – and this explains partially the rush towards QE. The Fed's most recent Beige Book (20 October) talks of "modest" economic activity, something we see as disappointing after five quarters of growth. As mentioned earlier, GDP expectations are being scaled back and may fall further. Meanwhile, unemployment remains high, investor sentiment seems cautious and political uncertainty is on the rise. Some combination of these factors seems likely to play out elsewhere in other developed economies, potentially undermining nascent equity market improvements. We feel it worth highlighting the potential parallels that exist and also some other possible concerns:

- *Output figures point to a deteriorating outlook:* Current GDP growth levels may not be sustained and we see a risk of 2011 (and beyond) estimates being further scaled back. US production fell 0.2% year-on-year in September, its first decline since June 2009. This was driven by declining output at mines, factories and utilities, while capacity utilisation also dropped. Durable goods orders remain low by historic levels and much of the recent growth in these figures has been driven by longer-term projects (eg aircraft orders) that may take time or fail to materialise. The UK picture shows a September PMI reading that stands at its lowest in 12 months; an October factory order level at its weakest since April; and the CBI industrial trends order book balance at -28, down from -17 a month earlier and below expectations. European construction output is also barely positive.
- *Unemployment remains a major drag on growth:* Even if US jobless claims fell by 21,000 to 434,000, their lowest level seen since July in the week-ending 23 October, the bigger picture is more concerning. Some 95,000 US jobs were lost in September (versus 57,000 in August and consensus expectations for a loss of just 5,000) and the unemployment rate stands at 9.6%. It has now been over 9.5% for the last 14 months. Europeans should not be complacent: Eurozone unemployment is stuck at over 10% and while the UK rate narrowed slightly (7.8% to 7.7% in the last month), jobless claims in September

rose for the most in eight months. High unemployment highlights a fundamental issue – namely, that the recovery is proving too sluggish to put unused capacity back to work. According to the OECD, current output gaps (see Exhibit 2) may not close until 2015.

- Consumers are unlikely to drive the economy:* Consumption comprises at least 70% of GDP in the US and more than 60% in the UK. Rising unemployment is likely to undermine already poor confidence resulting in consumers potentially spending less even if more money is pumped into the economy via QE. According to the US Commerce Department, purchases increased by just 0.2% year-on-year in October and incomes dropped by 0.1%, their first fall since June 2009. Meanwhile, the latest US Conference Board figures show income expectations at their lowest level since April 2009, while the proportion of people who said jobs were 'plentiful' fell to its lowest level in 2010. In the UK, according to the Nationwide, consumer confidence fell to 53 in September, a drop of nine points relative to the previous month. This compares poorly to the UK long-run average of 83.
- Q3 headline earnings mask concerns and reinforce the deterioration thesis:* While more than 75% of US companies that have reported earnings for Q3 to-date have beaten consensus expectations, this ignores two important facts. First, many companies may still have been benefiting from cost-cutting and operating leverage, but missed on the top-line (eg Apple, Procter & Gamble, US Steel); and second, those that did deliver strong revenue performances, notably benefited from international/emerging markets exposure, while underlying US trends were disappointing (see, for example, Alcoa, Coca Cola, McDonalds, UPS). While emerging market growth is exciting, domestic income streams still clearly matter and constitute a large portion of many companies' earnings. Moreover, cost-cutting in the absence of top-line growth is clearly not sustainable over the medium term. A similar domestic-international dichotomy may likely play out in UK/European earnings seasons too.
- US investor caution is growing:* Notwithstanding the conclusions of the most recent Merrill Lynch fund manager survey cited earlier that show rising levels of (global) risk appetite, a two-day marketing trip we undertook to New York in mid-October suggested that investors were considerably more risk-averse. Concerns that arose from most fund managers we met focused on the lack of direction in equity markets and the increasing level of 'short-termist' bets being made on the market. On several occasions, investors highlighted that inherent leverage within the financial system remained too high, and noted that the current distressed debt cycle still has much further to run (estimates suggest that \$450-500bn of debt will need to be refinanced in the next three years). A weak IPO market and still-limited M&A activity (fewer than 25% of global companies say they are now seeking acquisition targets relative to 38% six months ago, according to a recent survey by Ernst & Young) are also of concern. Any complacency on the part of investors at recent market gains seems notably misplaced.
- Political uncertainty is another risk:* US mid-terms occur in early November and consensus expectations are for major losses for the Democrats. On the assumption that (too much) debt remains at the heart of the global economy's problems, achieving consensus on debt reduction strategies is crucial. The UK's October Comprehensive Spending Review was bold and saw cuts implemented on a level unprecedented in modern post-war times. Whether it works remains a different matter, but it is at least encouraging to see the issue being tackled. A likely divided government (at both a House of Representatives and Senate level) may result in policy stasis in the world's largest economy, further undermining investor confidence. Politics within the EU also remain highly febrile after this year's sovereign debt crises.

One final concern is the risk that US rhetoric and policy (read: likely QE for now) could induce a self-fulfilling prophecy. Multiple speeches from Chairman Bernanke have emphasised the need to keep interest rates low “for an extended period.” On one interpretation, this can be seen as implying that the Fed believes the economy will remain underemployed for an extended period. If this is the case, consumers and firms may become more cautious (hoarding cash), and hence prolong economic weakness. For equity investors this is a clearly unappealing outcome.

Towards a sector ranking: Key considerations

Edison reviews its theoretical sector allocations on a monthly basis and we see few reasons to change our stance for November. 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.

Against a backdrop of ongoing uncertainty and likely rising risk levels, we believe that the ‘bar bell’ approach makes most logical sense. In other words, our core overweight sectors (in order) of basic materials, telecoms, utilities and healthcare allow us to gain exposure to both the ‘risk on’ and ‘risk off’ mentalities that could drive performance through until the year-end and beyond. These sectors also have the benefit of high emerging markets exposure (basic materials) and substantial cash returns (the defensives) both themes we believe currently matter.

Despite the UK equity market having touched a six-month high during October we were encouraged to see that performance was driven by a range of sectors, both growth-oriented and more defensive. Moreover, performance has been reassuringly consistent with our strategic approach: our two most preferred sectors (basic materials and telcos) were October’s best performers (up 5.9% and 6.4% respectively), while our three least preferred sectors – consumer goods, consumer services and financials – all underperformed, and declined by at least 50 basis points relative to the All-Share benchmark.

We also believe it is fair to contend that the outlook has deteriorated in the sectors on which we have greater caution. Consumer confidence (and hence spending) is declining rapidly, and may also be exacerbated in the UK by impending VAT rises and public sector job cuts; regulatory risks and the need for more capital are rising within the financials sector, particularly at the banks; there are growing signs of the gloss coming off the technology sector (note recent results from Apple, IBM, ARM); and our oil team sees limited scope for price gains in 2011 and potentially beyond.

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

Position	Nov- 10	Rationale	Oct- 10
Best	Basic materials	M-term fundamentals, global exposure, valuation	Basic materials
	Telecoms	Valuation, cash returns; some global exposure, M&A potential	Telecoms
	Utilities	Valuation, cash returns; some global exposure, M&A potential	Utilities
	Healthcare	Defensive profile supported by value and yield	Healthcare
	Industrials	Earnings momentum positive but slowing; risks emerging	Industrials
	Oil & gas	Poor macro prognosis; valuation demanding despite u/performance	Financials
	Technology	M&A potential, but valuation demanding; US trends also a -ve	Technology
	Financials	Risk aversion levels rising; valuation not supportive	Oil & gas
	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, 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%	9.6	1.5%	12.5%	5.9%	14.9%	6.4%	32.0%
	Telecoms	6.1%	8.0	4.8 %	15.5%	6.4%	10.5%	15.1%	19.4%
	Utilities	3.8 %	10.1	4.9%	10.1%	5.4%	10.0%	10.8 %	22.4%
	Healthcare	7.6%	11.9	4.5%	(0.8 %)	(2.3%)	2.7%	2.3%	5.5%
	Industrials	7.3%	16.7	2.5%	19.4%	2.7%	8.7%	5.2%	26.0%
	Oil & gas	16.1%	19.7	3.6%	(5.0%)	3.9%	10.2%	(7.3%)	(3.2%)
	Technology	1.7%	20.1	1.2%	24.3%	(3.7%)	6.0%	7.1%	30.5%
	Financials	24.2%	17.0	2.9%	4.7%	(0.4%)	1.4%	(0.6%)	4.3%
	Consumer services	9.9%	12.2	2.8 %	9.5%	1.4%	6.1%	(0.5%)	15.9%
Worst	Consumer goods	11.3%	13.6	3.4%	8.0%	0.9%	6.1%	3.3%	15.8 %
Average		100.0%	13.4	3.1%	6.4%	2.0%	7.0%	1.5%	11.7%

Source: Datastream, Edison Investment Research

Exhibit 6 above 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 how our sector preferences have changed in the last month. We have made only one change in this respect, swapping the oil & gas sector with the financial sector. This has partly been driven by performance, with the latter sector having underperformed relative to the former over four percentage points in the last month and by over eight in the past three.

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

Basic materials: Momentum, growth and value

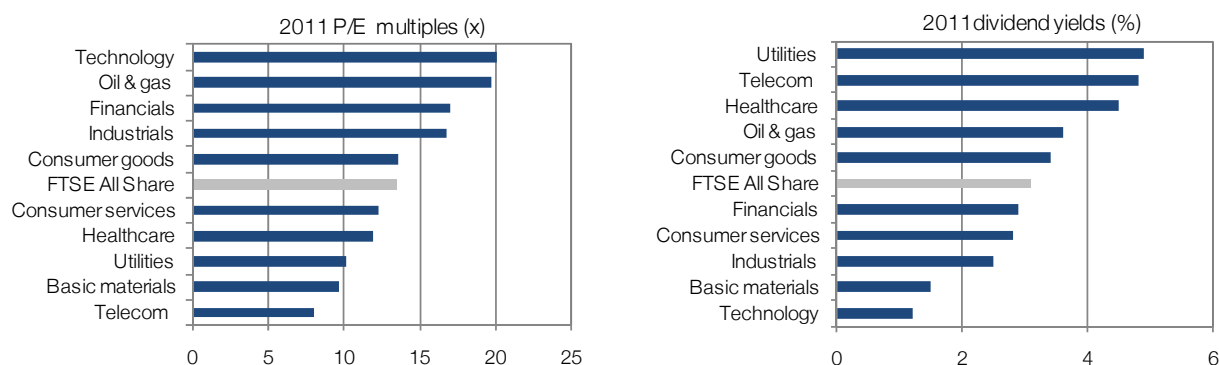
We have been encouraged by positive recent and more medium-term (one year) performance and believe there is substantially more to go for given structural long-term growth trends and also currently supportive (sub 10x 2011 P/E) valuation. We favour this sector owing to its global characteristics, and 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 October, while retail sales also moved higher and GDP continues to grow at over 9% pa. Meanwhile, in India, factory output rose 13.8% in the last month, accompanied by another expansion in PMI data, 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. Despite strong performances over the last quarter – particularly from the telco and utility sectors – 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) and the current reporting season should also demonstrate robustness. Our relative preference for telco over utility and pharma is a function of valuation (8.0x 2011 P/E), and cash returns (4.8% sector yield). Healthcare looks relatively the most expensive of the three defensive sectors and also offers less scope for near-term M&A potential. Elsewhere, 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.

Exhibit 8: Defensives screen well on value and yield



Source: Datastream, Edison Investment Research

Industrials: Risks to rise

The performance of the industrial sector has been robust year-to-date (up 19.4% since 1 January) and investors may also welcome the increased clarity that has now been provided by the Strategic Defence & Security Review and Comprehensive Spending Review. However, we believe that a headline P/E of more than 16x and a premium of greater than 20% relative to the UK market implies that much future upside potential has already been discounted. Meanwhile, cost-cutting and operating leverage benefits may have begun to run their course; the Q3 reporting season may represent an apogee for the sector.

Looking ahead, we have concerns about potentially deteriorating earnings momentum and rising input costs (see, for example, Arcelor's recent earnings release) may constitute an additional risk. Given the heterogeneous nature of the sector, within industrials, we favour those stocks that offer global, and particularly emerging market exposure.

Oil and gas: Near-term gains may not prove sustainable

BP's woes seem like a distant memory (the stock is up more than 40% since its 29 June trough) and strong recent results from Shell, Exxon and Total have also helped boost sector sentiment. Despite gains of over 10% in the last three months, the oil & gas sector remains the worst performing in the UK on both a six-month and 12-month view (down 7.3% and 3.2% respectively). We therefore see some potential for the sector to continue to benefit from a 'catch-up' effect although further upside may be constrained by two factors. First, headline valuation (at close to 20x P/E) is not supportive, while the macro prognosis appears to be deteriorating. Our team discussed the outlook in a recent note (see "The market remains well supplied", 15 October), but supply and demand remain imbalanced, while inventories stand at close to record levels.

Technology: More downside potential to come

The 3.7% downward correction to the tech sector in October (making it the worst performer in the UK) looked both welcome and overdue, especially given the 24% year-to-date gain and a headline P/E of c 20x. We note recent disappointment from US heavyweights Apple and IBM, which may have prompted some profit-taking in tech, and this certainly played out when ARM (the UK's largest tech company) reported on 26 October. At a fundamental level, chip industry forecasts (from SIA, iSuppli) have recently been trimmed, suggesting momentum could be turning, while we feel much of the sector's year-to-date momentum has been driven by hopes over M&A. Some acquisition activity may still materialise, but is likely to be concentrated towards the lower end of the market cap spectrum (particularly given that UK tech constitutes just 1.7% of the All-Share by market cap).

Financials: Performance disappointing, outlook uncertain

Despite market outperformance during late Q2 and early Q3, on both a six- and 12-month view, the underperformance of financials has been exceeded only by that of the oil & gas sector. In the last month, the sector lagged notably, losing 240 basis points relative to the All-Share. We find it difficult to see what may drive the sector near-term given several concerns. First, new Basel regulations may force banks (in particular) into another round of capital raising. Standard Chartered, BNP Paribas and Société Générale have all recently come to the market; more may follow. Next, results from the recent European and US reporting season have been highly mixed (better from Citi, JP Morgan and UBS; worse from Bank of America, Credit Suisse and Morgan Stanley). Furthermore, the ongoing debate in the US over foreclosure documentation may also undermine sentiment and reduce future clarity. Finally, a headline multiple of c 17x for the UK's financial sector does not suggest that there is a strong value case to be made at present.

Consumer goods and services: underweight on fundamentals

The performance of the consumer-facing sectors continues to weaken and we see potentially greater risk to earnings estimates within the consumer space than elsewhere in the market. On a one-, three- and six-month view the sector has lagged relative to the UK market and we expect this trend to continue. The most recent data from the British Retail Consortium highlights that sales growth is slowing down (just 0.5% for September versus 1.0% for August), while non-food sales turned negative for the first time since August 2009. This trend is also supported by the most recent distributive trends survey from the CBI (retail sales growth dropped in October relative to September), while Nationwide's Spending Index stands at its lowest since November 2008. Companies including Debenhams, Home Retail, Kingfisher and Mark & Spencer have all also highlighted increasing notes of caution in recent releases and interviews. 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.

Conclusions

Stock markets have edged higher and risen by more than 10% since July, but we do not feel that these recent gains will prove sustainable. In particular, we believe excessive faith has been placed in the potentially restorative powers attached to a further round of quantitative easing. Such a policy may not help correct underlying issues and could only serve to stoke already nascent inflation.

Furthermore, the current Q3 reporting season may be as good as it gets in the near term; benefits from cost savings have mostly come through and future revenue growth (even with more QE) may become harder to discern. Until we see consistent, organic, top and bottom-line growth from corporates, equities will likely to continue to lack direction. A more favourable macro backdrop would serve to improve the outlook, but the UK approach to deficit reduction seems lacking elsewhere, particularly in the US. Monetary policy alone will not help the need for global deleveraging.

The upside case for equities is further constrained by valuation levels, where we see relatively limited support at present. Against this background, we retain our current equity strategy, favouring diversified growth (basic materials) and high cash returns (telcos, utilities) principally at the expense of the consumer sectors. We also reiterate the merits of gold, which we feel will remain a prime beneficiary of most future likely economic scenarios.

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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