Illumination: Equity strategy and market outlook

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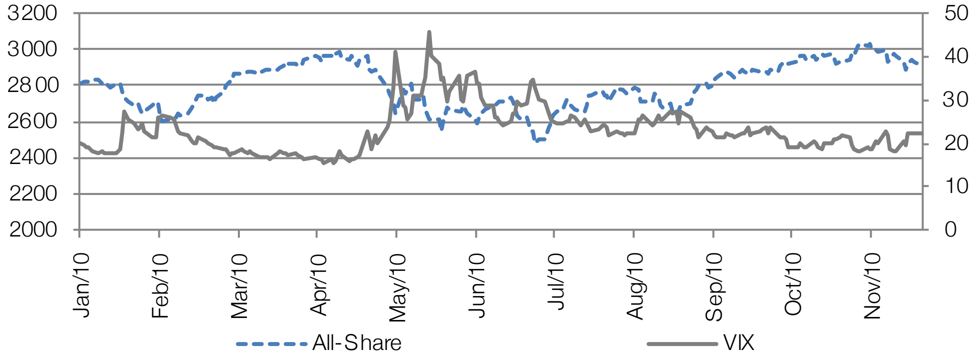
Equity market overview and strategy

Events from the last month constitute a familiar pattern to the extent that equities continue to exhibit profound swings both to the upside and downside as investor psychology appears to be overruling fundamentals. A review of the latter suggests the same familiar problems beset the global economy, namely a lack of suitable policy instruments to manage the ongoing painful process of deleveraging across the developed world. Stagnating growth and rising inflation represent other concerns. These factors have somewhat masked a recent improvement in corporate earnings, but as fundamentals move back to dominate, there is a risk that these encouraging results patterns may not prove sustainable. Looking ahead to 2011 we consequently see no reason to change our current equity strategy, favouring diversified growth (basic materials) and high cash returns (telcos, utilities) principally at the expense of the consumer and financials sectors. Gold also remains highly attractive in our view.

Set for a repeat

One year ago in our December 2009 *Equity market overview and strategy,* we forecast that markets in 2010 would exhibit none of the synchronicity they showed in 2008 and 2009 (downwards and upwards respectively) and that 2010 would be characterised mostly by volatility, where investors would “most likely gain distinction through differentiation”. Inconsistent macro and micro data, exogenous shocks (from eurozone sovereign debt crises to agricultural product price hikes via hints of war in Korea) and the resort to tired, tried and tested policies (QE II) have all seen our thesis broadly borne out. With but a month of the year remaining, the All-Share has oscillated in a range of 2485-3033, and finds itself up just 6.2%, a particularly disappointing performance when one considers the positive effect that should have been accorded by interest rates being effectively at zero. A broadly similar pattern has been repeated in other global indices.

Exhibit 1: A volatile year for equities



Source: Bloomberg, Edison Investment Research

Looking ahead, it is hard to see how the next 12 months will be markedly different. We continue to expect equities to trade within a relatively narrow band, with pronounced swings both to the downside and upside. As we have written previously, volatility (measured by the VIX index), while down almost fourfold from its Lehman spike, is still more than double where it has traded for much of the mid-2000s. Until we see a consistent and coherent approach to debt reduction (excess leverage is still the biggest issue plaguing the financial system) and/or sustainable top-line growth from corporates, it may be difficult for equities to break out of their relatively range-bound trading patterns. In reality, what this may imply is more pain: fiscal austerity needs to be combined with monetary loosening, labour markets need more structural reform and the euro probably needs to go. Further volatile dislocations may have to come before confidence can return fully.

How long such a process may take remains fully to be seen, and surprises/disappointments along the way will undoubtedly create investment opportunities. At present, the auguries are not good: GDP growth is slowing in

Germany and France, the main engines of the eurozone; industrial output has shown signs of stalling in China and India; and inflation seems to be on the rise almost everywhere.

However, the biggest issue (which matters particularly in markets that are being driven more by psychology than fundamentals) is simply one of confidence: investors do not seem to believe either in the potentially restorative powers of further quantitative easing or in the EU's latest bail-out – more may be needed of both. Furthermore, concern over these matters has also clearly overlaid emerging signs of slowly improving corporate earnings.

Trading patterns in the last month demonstrate just how quickly sentiment can change. The day after America's second round of quantitative easing was announced (4 November), the All-Share crossed the 3,000 mark, a level last seen before the collapse of Lehman Brothers in September 2008. Optimists asserted that the path to recovery was clearer and the UK market hence moved to a peak of 3033 on 9 November, up 22% from its July low and with a rise of c 10% from the start of the year. However, there has been no consolidation of these gains, with the All-Share having since declined by 2.6% and November having seen more 'down' trading days than the inverse.

These oscillations (a repetition of the trends seen for most of 2010) have been a function of several factors, but most crucially relate to sentiment/ reality centred on quantitative easing and the future of the Eurozone. After the initial excitement of QE II, the gloss seems to have worn off remarkably quickly, as evidenced not only by investors' reactions, but also by the high degrees of scepticism voiced by central bankers from a number of nations. Not only is QE II an untried policy that "smacks of desperation" (according to the Lex column in *The Financial Times*, 2 November), but also most economists appear in agreement that they have little idea whether a second round of quantitative easing will actually work.

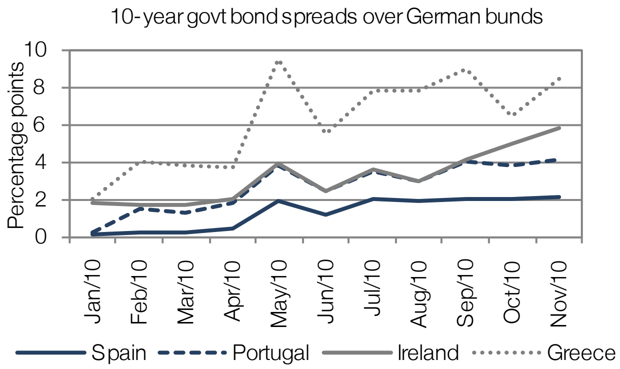
At the most basic level, the Fed alone cannot do everything to turn around the global economy and a notable lack of consensual support (more the opposite) from other nations suggests the challenge will be significant. Putting this factor to one side, our more specific concerns relate to the fact that the Fed may be over-estimating by how much and how fast unemployment can fall, a risk that will only be exacerbated by unresponsive policy-making from other recalcitrant nations. According to economic analysis by the IMF, it may take as long as four years following the end of a recession for unemployment to return to pre-recession levels, suggesting that the US (and much of Western Europe) is still on a long and painful journey. Given the challenges that QE II may face combined with the possible stagnation of the global economy, we do not discount the possible launch of QE III at some stage in 2011. As we have written previously, increasing policy (re)application also runs the inevitable risk of suffering from diminishing returns.

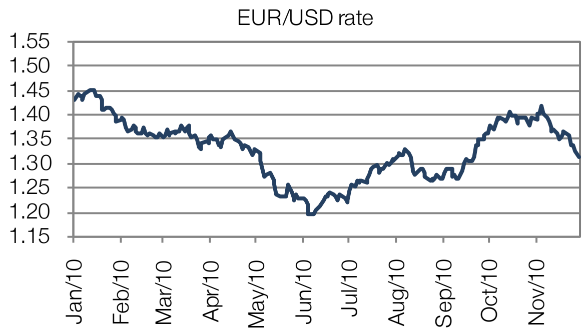
With regard to the eurozone, it has taken just over six months for all (and more) of the vociferous concerns over its stability cited at the time of Greece's bail-out to resurface. An eventual IMF/EU €85bn bail-out for Ireland combined with at least €15bn of domestic spending cuts and tax rises is unlikely to mark the end of the eurozone saga. It is interesting to note how little investor euphoria has been apparent over the conclusion of Ireland's rescue – in stark contrast to the reaction following the confirmation of the Greek support package – and movements in bond yields (see Exhibit 2) suggest that more bail-outs may now been an unfortunate inevitability. Spanish (as well as Italian, and even Belgian) spreads relative to the Bund have continued to widen.

At heart is the question of for how long German voters (even with unemployment at a 20-year low and business confidence at a 20-year high) remain willing to support failing peripheral eurozone nations. Recent history suggests there is a strong element of moral hazard attached to failing-nation behaviour and the eurozone's problems are arguably increasing rather than diminishing. Greece recently announced that its public debt (at 15.4% of GDP) was higher than previously disclosed (13.6%) and it has already begun to fall behind with its repayments to the EU/IMF. The stark reality is that at present only two of the eurozone's states (Luxembourg and Finland) meet both the deficit (not more than 3% of GDP) and debt (no more than 60% of GDP) criteria for EU membership.

While it is hard to predict how events will ultimately play out, it is fair to contend that investors will likely have to endure further bouts of substantial volatility. There remains a clear confusion between the political and economic ends of the EU and there is a clear risk not only of contagion (from Greece and Ireland), but also that failure becomes a self-fulfilling prophecy. In the interim, spreads on bond yields continue to rise and the euro weakens.

Exhibit 2: Eurozone crisis as 'periphery' nation bond spreads widen and the euro weakens





Source: Bloomberg, Edison Investment Research

If a second round of quantitative easing and the bail-out of Ireland both have their antecedents in events of the previous 18 months – and so ought not to have constituted a major 'surprise' to investors given the challenges facing the global economy – one source of revelation, particularly in the face of weak growth, has been the strength in recent corporate earnings. Over 75% of US companies reporting in Q3 exceeded consensus expectations, while the gap between those firms raising guidance relative to those cutting stands at its highest since 1999 according to Bloomberg. In the UK, a similar picture has occurred with firms as diverse as Barclays, Burberry and BT all having recently surpassed expectations when reporting results. As positive as this trend is surprising, we are forced to question the sustainability of such recent strength. Even if we are incorrect in this thesis, it appears that investors have had some tendency to overlook better performance amid macroeconomic tumult.

Our strategy pertains to one of stock selection, favouring undervalued growth with emerging markets exposure and/or highly cash generative (and shareholder-returning) businesses and against this background it is possible to identify a strong range of candidates – in the UK, for example, Aggreko, Compass Group, GSK, Reckitt Benckiser and Vodafone to name but a few. Investors in these five names have been rewarded by an average share price return of 20.2% year-to-date (some 14 points ahead of the All-Share), combined with a mean dividend yield of 3.4%.

Beyond such best-in-class businesses, as mentioned previously, our concerns relate to sustainability. There is only a finite amount of cost-cutting and leverage gains companies can bring to bear in the absence of top-line growth. Revenue improvement, such as it is, may also be likely further undermined going forward by rising inflation. A number of consumer-facing businesses in particular (e.g. Marks & Spencer, Next) as well as some global industrial players (e.g. ArcelorMittal) are already warning of this risk and whether cash-constrained consumers and corporates will accept input-cost pass-through and continue to spend remains highly uncertain.

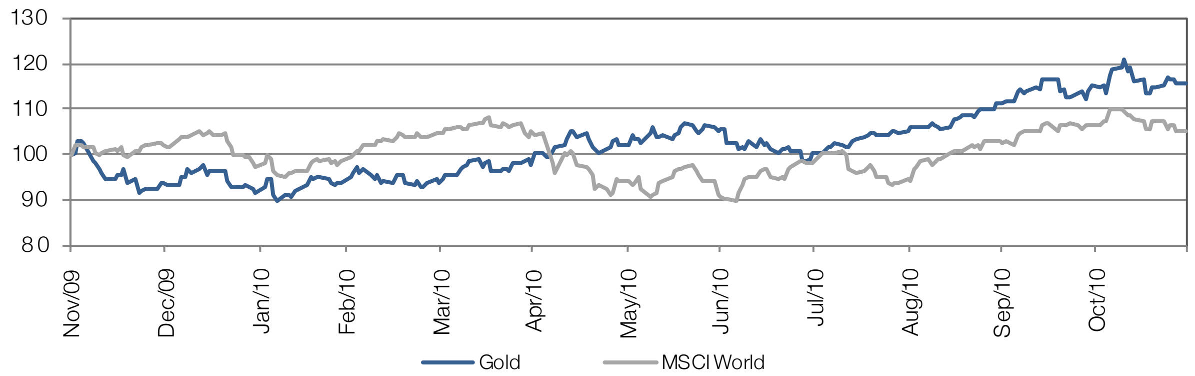
After the robustness of the Q3 reporting season, we are also concerned that there may perhaps be undue optimism levels ahead of the impending fourth-quarter reporting season. With internal planning and budgeting likely to complete soon, the next two months will also likely see companies issuing guidance for 2011 for the first time. Again, we see here some risk for disappointment.

As a result, we see limited reason for changing our theoretical asset allocation strategy, particularly since our central thesis is for further volatility, at least for the early part of 2011. We therefore continue to advocate the adoption of 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.

Additionally, at the risk of repetition (from previous editions of *Insight*), we continue to stress the merits of gold. 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. World Bank President, Robert Zoellick, has also recently suggested the return to a modified gold standard, further stoking positive sentiment. The precious metal hit a 52-week high on 9 November while it has outperformed the MSCI Global equity index by 20.9% on a year-to-date basis. On a three-year view, we believe it could reach $2,000/oz, some 40% above current levels.

Exhibit 3: 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 stumbling

The story of 2010 for UK (and global) equities has been one of pronounced swings as Exhibit 1 amply demonstrates. Trading patterns from the last month have served only to reinforce this thesis, with the All-Share having traded down 0.8% despite having hit a 52-week high on 9 November. As in previous months, the number of positive and negative trading days have been roughly equal (down days have won out slightly), while an equal number of the market sectors we track have gained relative to declined in value (see Exhibit 8 below).

While the UK's performance can hardly be described as satisfying, domestic investors can at least take comfort from the fact that the FTSE-100 and the All-Share have comfortably outperformed their European counterparts, with the relative gains between these indices having widened in the last month. On a year-to-date basis, the All-Share has outperformed the Euro Stoxx by 8.7 percentage points, up from 6.5 points a month ago, with a similar pattern repeated between the FTSE-100 and the Euro Stoxx 50.

In the last month, the disparity in index performance has, however, been most notable between perceived 'safe' and 'failing' eurozone nations, with the German market (DAX30) having outperformed the Spanish bourse (IBEX35) by over 15 percentage points. On a 12-month basis, the spread between these two indices has exceeded 40 points. We see good reason for such trends to continue and, were it not for the strength of the DAX, then the Euro Stoxx's performance would likely be notably worse.

The robustness of the DAX is notable, having gained 15.0% year-to-date, over 10 points better than the All-Share. This has been helped by a favourable macro picture in Germany (discussed earlier) and stimulated by a large number of well-performing export-led businesses. Returning to the UK, it is also clear to see that those sectors that have delivered the most impressive gains year-to-date – namely industrials and basic materials – have a strong non-domestic bias. As we discuss in more detail below, the health of the global economy will be crucial to these gains being maintained going into 2011.

Exhibit 4: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	4.7	(0.7)	10.0	12.5	9.1
FTSE All-Share	6.2	(0.8)	10.2	12.8	10.7
DJ EURO STOXX 50	(7.7)	(4.2)	5.0	8.2	(2.2)
DJ EURO STOXX	(2.5)	(2.8)	7.3	10.7	2.8
France CAC40	(5.3)	(3.2)	7.3	9.4	1.3
Germany DAX30	15.0	3.6	15.8	19.0	22.0
Spain IBEX35	(20.0)	(11.6)	(4.6)	5.6	(18.1)
Italy MIBTEL30	(14.6)	(7.1)	0.6	5.7	(9.5)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	12.4	3.5	5.0	4.3	11.3
FTSE All-Share vs EURO STOXX	8.7	2.0	2.9	2.1	7.9

Source: Datastream, Edison Investment Research

Outlook: Six key questions for 2011

As inevitable as it is topical, December constitutes the moment when it seems appropriate to look ahead to the coming year and consider what factors may influence equity markets and what may be the sector/stock implications from our observations. Below is a (non-exhaustive) list of considerations we feel important.

When does the world start growing again?

Policymakers and investors in 2011 will have to contend with a world where GDP growth in almost every nation – both developed and emerging – will decelerate relative to 2010. While this does not suggest that the global economy will return to recession any time soon, we remain sceptical about whether a slowing growth scenario is fully discounted; and with output set to decelerate, risks logically seem weighted on the downside. Current data points from around the world are also far from encouraging.

In the US (still the world's largest economy, and where *The Economist* forecasts a slowdown in 2011 GDP to 2.3% relative to the estimated 2.6% for 2010), durable goods orders have declined for two of the last three months, with October's 3.3% drop comparing to a 5.5% rise the previous month. The ISM index remains above 50, but has fallen in the last month, with inventories rising faster than new orders, a negative indicator. Meanwhile, the unemployment rate remains stuck at 9.6% despite 151,000 jobs having been created in the last month, the largest increase since May. Moreover, recently rising consumer confidence (up in November for the first time in three months) masks the fact that the US Conference Board's gauge is still almost 20 points below its five-year average.

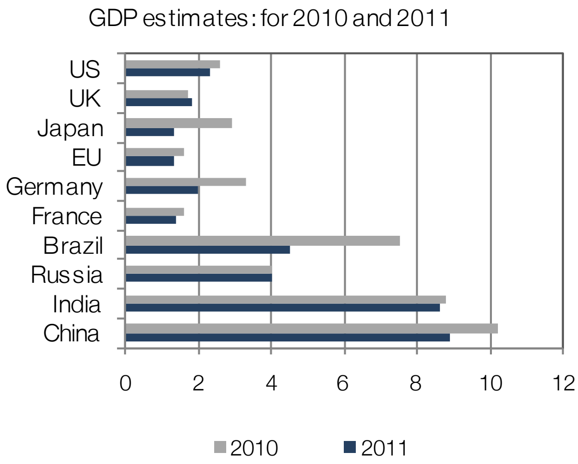
The picture is little different elsewhere in the developed world. Data released by Eurostat since the last edition of *Insight* highlighted a slowdown in eurozone GDP growth in Q3 to 0.4% (against a 1.0% reading for Q2). Despite record post-reunification confidence levels and employment rates in Germany, the rate of GDP growth over the last quarter shrank by more than threefold (2.3% to 0.7%) and Germany's relative success cannot mask the broader challenges besetting the eurozone. Industrial new orders are dropping (September's 3.8% decline compares to a 5.1% rise for the previous month) and, most notably, unemployment stands at over 10.1%, higher than it has been in 12 years and also above levels in either the US or the UK. It is still rising in 19 of the EU's member states and stands at above 20% in Spain.

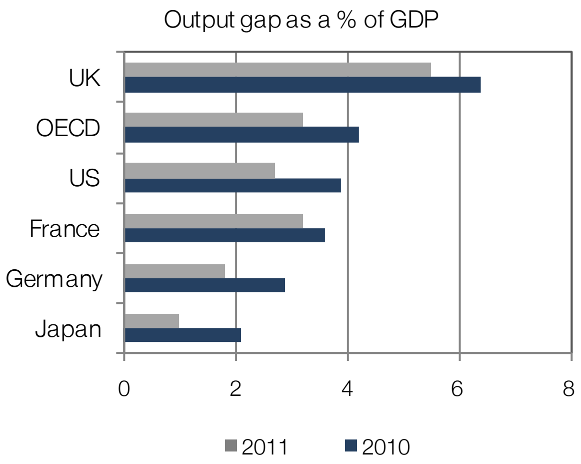
Despite robust manufacturing growth (at its fastest in the last 16 years according to figures released on 1 December), the UK can draw little comfort from its 7.7% unemployment rate. The current rate of growth in manufacturing may not be sustained, a view endorsed by the Bank of England's latest report (10 November) which states that "growth may slow in the near-term". The OBR has also recently (29 November) trimmed its UK GDP estimates both for 2011 and 2012.

Optimists premise their better-growth outlook on two factors: first, that significant unused capacity exists in the economies of the developed world (see output gap data in Exhibit 5 below); and second, that deteriorating western world growth trends may be offset by robust emerging market patterns. Both assumptions may be called into question. With regard to the output gap, closing it requires efficient and coordinated policy stimulus. Even if QE II in the US does bring better growth (the expectation), then it will also likely result in higher inflation, which would logically eat-away at improved production. Furthermore, QE II alone may not deliver an improved performance; it needs to be combined with fiscal reform. How this can be enacted in the US, with a now divided legislature, remains to be seen.

More broadly, even if there will likely be political stability in the world's major developed economies in 2011 (no general elections are scheduled), it seems unlikely that a consensus will emerge regarding coordinated fiscal and monetary policy, combined with an absence of aggressive exchange rate devaluations. With unemployment rates still stubbornly high, there is also a strong case for labour market reform. The developing world may be able to help the western world through some of its transition, but assuming that growth rates here will continue at their current pace also seems debatable – and hence implies some additional risks – as we discuss in more detail below.

Exhibit 5: 2011 GDP estimates point to a slowdown; the developed world's output gap remains significant





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

When does the BRIC bubble burst?

Few doubt the structural case, as the economies of Brazil, Russia, India and China necessarily continue to industrialise and modernise. However, the reality is more complicated: first, there is the issue of timing – how quickly will it happen; next, will all countries benefit equally; and, finally what comes after BRIC? Investors also need to be selective in how they seek to gain exposure to this theme either through domestically listed plays or with, for example, the Shanghai Composite Index down 13.2% year-to-date, but the Sensex Index in India up 14.3% since 1 January.

In the near-term, growth rates will likely slow, but remain significantly above developed market levels (see Exhibit 5 above) and, in India, industrial output has now shrunk for two consecutive months. More significantly, inflation has emerged as an incipient threat, both here and in China. The challenge is how to manage robust growth without the risk of over-heating and how to implement interest rate rises without choking growth. Visibility on these factors is low.

We do not expect the BRIC bubble to burst any time soon, but investors should be mindful of assuming that these economies alone can drive the world back to prosperity, especially with growth also currently slowing in a number of peripheral Asian economies such as the Philippines and Thailand. Analysis from the IMF (reproduced in *The Economist*, 30 October) suggests that every percentage point of incremental GDP growth in China takes at least five years to feed through to a 0.4 point rise in global GDP.

A relative slowdown in growth (China should see its c 10% GDP rate come down to close 7%) combined with rising inflation remain near-term risks. Diversified basic materials stocks remain our favoured strategy for gaining exposure to emerging economies (and investors following this approach have gained >25% in the last year). However, we would also advocate thinking beyond this tactic, considering other geographies (especially Africa) and also sectors.

Will we be best by inflation or deflation?

The question of global growth is inextricably bound up with that of inflation, which we see as an additional risk for investors. Beyond Japan, which has seen structural downward pricing pressures for the last 20 years, the US economy seems an exception in being preoccupied with deflationary concerns, with consumer price inflation currently at its lowest level (0.6% for October) since 1957. Critics of Chairman Bernanke's policies are wide of the mark in asserting that QE II can both not work *and* that it will result in inflation. The concomitant of one is the other, but even putting this to one side, we believe inflation is more likely than not to grow in force during 2011, eating into already slowing growth. Stagflation is a plausible scenario in our view; gold a clear beneficiary.

Inflation is emerging in two distinct areas. First, the UN Food & Agriculture Organisation is already warning that the world should "be prepared" for higher food prices next year. Its index is close to peak levels witnessed during early 2008 and has risen by five percentage points in the last month. According to the UN, levels are "dangerously close" to creating a crisis. This view has been reiterated by a number of industry bellwethers, with the CEO of Unilever, for example, stating on 4 November than food inflation is "returning in force". The other concern relates to Chinese (and other BRIC) demands for raw materials combined with the growing power of the consumer in these economies. In China, inflation hit a two-year high in October of 4.4%, up 0.8 points relative to the previous month.

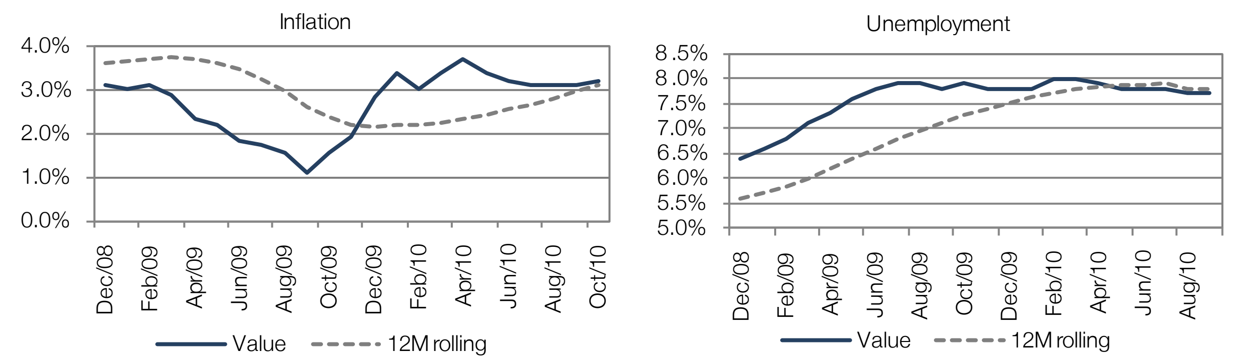
Some steps have been taken to cool inflation, with interest rate rises implemented over the last month in China, India (for the sixth time in 2010), South Korea and Australia. However, the bigger concern relates to the rate at which rising input prices will feed into the economies of the developed world, where the rhetoric also currently and firmly remains one of keeping interest rates in check.

The UK constitutes an interesting (and potentially worrying) case study. Here, the inflation rate stands at 3.2% for October, up slightly relative to the previous month and still rising on a 12-month rolling basis. The Bank of England warns that it is likely to "remain elevated throughout 2011" and cites a "highly uncertain" outlook (comments from 16 November *Inflation Report*). Factory gate inflation – ie producer prices – rose 4.0% in the last month and input price inflation is running at 8.0%, its highest in two years according to the Office for

National Statistics. VAT rises on 1 January will also only likely exacerbate matters. Among the retailers, Marks & Spencer, Next and Sainsbury's are already warning of the consequences.

Stagflation remains the worst of all possible worlds, rising prices and high unemployment, with the output gap failing to close. A more optimistic consideration would suggest that judicious policy-making (via interest rate rises) can help ward off inflation, but it will take time for the evidence on this to become clear. In the meantime – and also, even of a scenario where deflation were to come to pass – then we reiterate our view that investors can benefit most through retaining their exposure to gold.

Exhibit 6: UK inflation and unemployment trends suggest stagflation may be coming



Source: Office for National Statistics, Edison Investment Research

Wither the consumer?

The consumer matters, being responsible for more than 60% of GDP in the UK and over 70% in the US. How the economy performs is, therefore, highly contingent on the strength of domestic consumption. In the UK specifically, with the full impact of October's spending cuts (and job losses) still to come combined with January's increase in VAT, risks seem heavily weighted towards the downside. The indicators are negative, with retail sales growth currently slowing (according to the ONS), and the Nationwide's consumer confidence index at 53 for October, its lowest in 18 months and down from a recent peak of 120 in February.

From an investment perspective, domestically-oriented consumer plays would logically be the biggest potential losers from a moribund consumer, reinforcing our negative stance on these sectors. Additionally, we see negative implications for other sectors under the consumer umbrella, particularly airlines and media. With regard to the former, our concerns relate not only to consumer exposure, but also to the effect from a high oil price combined with ongoing capital intensity requirements. Turning to media, 2011 will be see the negative impact of a lack of super-quadrennial events and therefore limited scope for upside potential to estimates.

Will there be light at the end of the tunnel for the financial sector?

Our other major negative sector stance for the past year (in contrast to our consistently positive stance on basic materials, discussed earlier) has been the financial sector. In this respect, and in common with the consumer space, we find it hard to construct a positive case for the year ahead. Our concerns relate to excess leverage and insufficient liquidity within the financial system, both factors that will likely be compounded by the still-unknown consequences on ongoing eurozone sovereign debt exposure. The implementation of Basel III regulation is another risk factor. We find little cause for comfort within the financial sector.

Could M&A help restore investor confidence?

Investors faced with a slowing growth-rising inflation scenario may be able to find some scope for optimism from potential deal-making. Even if the current environment does favour M&A (companies might logically look to 'buy' growth if they are unable to generate it organically), it is unlikely to be a panacea for equity markets in our view.

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Deals have happened for much of the last year, but at a noticeably slower rate than in the past. Risk aversion levels remain high and not all companies have the requisite balance sheet strength. As we have written in previous editions of *Insight*, 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).

Moreover, present appetite for M&A is low, perhaps unsurprising, given an uncertain macro environment. According to a recent survey by Ernst & Young fewer than 25% of global companies say they are now seeking acquisition targets, relative to 38% six months ago. The IPO market is also subdued. With more than 150 transactions cancelled this year (note the recent postponements of the proposed floats of First Wind in the US and Bluestar Adiesso Nutrition in Hong Kong), equivalent to a combined total of $55bn, risk aversion levels clearly remain high. Market volatility/ uncertainty have been typically cited as the reason for deferral. We therefore suggest choosing carefully. Mid-cap UK equities may provide fertile ground for stock-picking, with over 20 FTSE-250 companies having succumbed to deals in the past year, but we expect this to be a selective rather than broad trend for 2011.

Towards a sector ranking: Key considerations

We review our theoretical sector allocations monthly and we see few reasons to change our stance for December and looking ahead into 2011. 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.

Exhibit 7: Edison sector rankings and rationale for December; and how they compare to a year ago

Position	Dec-10	Rationale	Dec-09
Best	Basic materials	M-term fundamentals, global exposure, valuation	Telecoms
	Telecoms	Valuation, cash returns; some global exposure, M&A potential	Basic materials
	Utilities	Valuation, cash returns; some global exposure, M&A potential	Healthcare
	Healthcare	Defensive profile; underperformance creates opportunity	Utilities
	Industrials	Earnings momentum positive but slowing; risks emerging	Industrials
	Oil & gas	Poor macro prognosis; recent gains unjustified	Technology
	Technology	M&A potential, but valuation demanding; US trends also negative	Oil & gas
	Financials	Risk aversion levels rising; valuation not supportive	Consumer services
	Consumer services	Structural concerns given outlook; heavy domestic bias	Consumer goods
Worst	Consumer goods	Structural concerns given outlook; heavy domestic bias	Financials

Source: Edison Investment Research

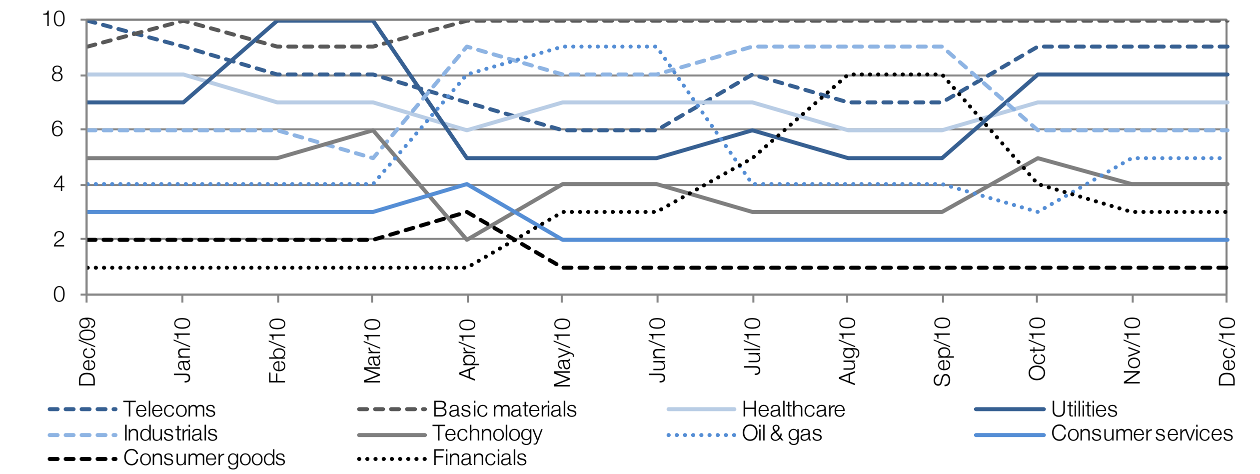
As exhibits 7 and 8 highlight, our views have remained highly consistent over the last 12 months. While there have clearly been variations, the basic materials sector has persistently sat in either first or second place within our conceptual framework of sector rankings, while the consumer sectors have also been among our least favoured for all of 2010.

Our conviction in basic materials has been vindicated by a 27.2% gain in the last 12 months, a performance bettered among the UK sectors only by technology (29.8%), although this latter sector has a but 1.5% weighting in the All-Share relative to 13.4% for the former. On telecoms, which began 2010 as our most favoured sector and has been our second most preferred (after basic materials) for the last three months, we have also been rewarded with a market-beating gain. The sector us up 17.7% in the last 12 months, some seven points ahead of the All-Share benchmark.

On the negative side, we began 2010 being most cautious on the financial sector, and while we turned more optimistic during the summer (July through to September, which coincided with a brief period of outperformance), we downgraded the sector again in October and have been cautious since. This strategy has worked, with financials having been the second worst performing sector (up just 2.5%) in the last 12 months. Only oil and gas – compounded by BP – has performed worse. Despite our caution on the consumer, the performance of these sectors has been somewhat more robust, with consumer services performing in line with the market and consumer goods gaining 680 basis points on a market relative basis. This performance, however, only serves to reinforce our negative conviction for the year ahead.

Exhibit 8: How our rankings have changed in the last 12 months; consistency in core sector calls

Note: sectors ranked from 10 to 1, with 10 being the most preferred and 1 the least.



Source: Edison Investment Research

Exhibit 9 below shows our current 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 have made no changes relative to the previous month.

Exhibit 9: Edison sector rankings, key valuation and performance data

Note: * All Share benchmark weight.

Position	Sector	Weight*	P/E	Yield	YTD	Last month	Last three	Last six months	Last 12 months
Best	Basic materials	13.4%	10.9	1.5%	16.6%	1.4%	26.9%	25.2%	27.2%
	Telecoms	6.3%	8.1	4.9%	14.5%	0.2%	12.2%	23.2%	17.7%
	Utilities	3.8%	10.2	5.2%	8.1%	0.3%	4.8%	20.5%	14.4%
	Healthcare	7.2%	13.4	4.4%	0.9%	(1.7%)	2.0%	10.9%	6.0%
	Industrials	7.1%	18.5	2.6%	18.0%	(2.5%)	13.5%	13.6%	25.4%
	Oil & gas	16.4%	12.9	2.9%	(5.0%)	1.0%	13.8%	6.7%	(1.2%)
	Technology	1.5%	22.4	1.3%	23.2%	(2.3%)	8.2%	15.5%	29.8%
	Financials	23.6%	18.4	2.9%	1.9%	(3.1%)	2.9%	8.7%	2.5%
	Consumer services	9.6%	13.5	2.8%	8.4%	(1.8%)	8.7%	9.8%	17.5%
Worst	Consumer goods	11.1%	14.7	3.4%	9.6%	0.8%	9.9%	13.2%	11.0%
Average		100.0%	14.3	3.0%	6.2%	(0.8%)	10.2%	12.8%	10.7%

Source: Datastream, Edison Investment Research

Basic materials: Momentum, growth and value

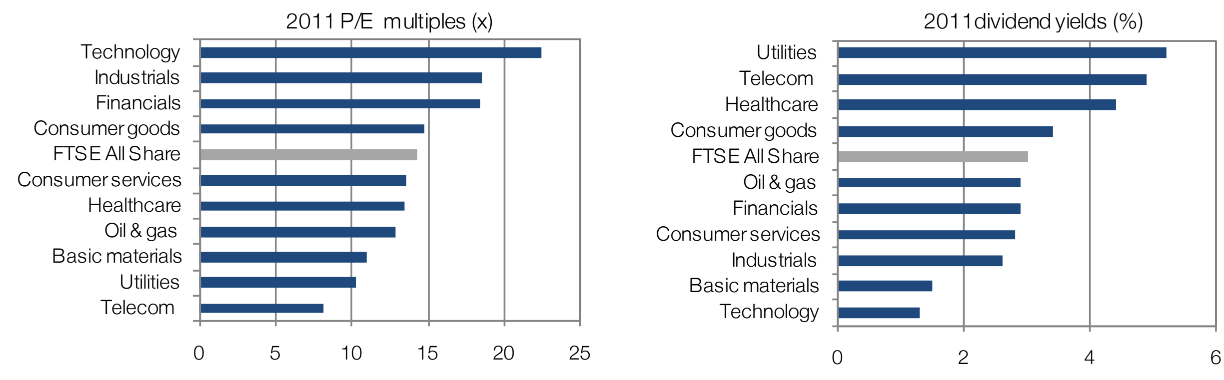
As discussed earlier, we have been encouraged by positive recent and more medium-term (one year) performance and believe there is substantially more to go for given structural long-term growth trends and also currently supportive (c 11x 2011 P/E) valuation. We favour this sector owing to its global characteristics, and particularly its exposure to the BRIC economies.

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 six months – particularly from the telco and utility sectors – we see substantial valuation attractions (reinforced by recent strong results, for example, from BT, National Grid and Vodafone) 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).

Our relative preference for telco over utility and pharma is a function of valuation (8.1x 2011 P/E), and cash returns (4.9% sector yield). Relatively, healthcare looks the most expensive of the three defensive sectors and offers less scope for near-term M&A potential, hence its relative undperformance. Elsewhere, Vodafone is in the process of disposing of assets and unlocking value, while Cable & Wireless, United Utilities and Northumbrian Water have all attracted bid speculation in the past months.

Exhibit 10: 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 18.0% since 1 January) and investors may also welcome some of the increased clarity that was provided by the Strategic Defence & Security Review and Comprehensive Spending Review. However, we believe that a headline P/E of more than 18x 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 last earnings release) may constitute an additional risk. Other UK industrials that have also referenced greater caution regarding the outlook in their recent releases include Cobham, Hill & Smith, Rolls Royce and Smiths Industries. 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

With the oil price close to a six-month high, and BP's well-documented problems now seemingly having passed, the sector has rallied 13.8% in the last three months, a performance only bettered by the basic materials sector. That the sector remains in negative territory (down 1.2%) on a 12-month view appears to create an opportunity, while valuation (c 13x 2011 earnings) is also supportive.

While these factors may help drive some further near-term performance (and the Saudi Oil Minister has said on record that he sees oil in a "comfort zone" of $70-90/barrel), we are concerned that 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

As discussed earlier, the tech sector's weighting in the UK market (at 1.5%) is small, but it remains the best performer in the All-Share since 1 January. As a result, we see its market relative underperformance on both a one- and three-month view as being as welcome as it is overdue, especially given the sector's rating of more than 22x forward earnings.

Beyond valuation and performance, fundamentals give us cause for concern. Despite recent rises to guidance from Dell and HP, Apple and Cisco have recently warned. Moreover, October's US durable goods figures were particularly weak for electronics (down 7.7%) and communications equipment (down 12.3%), while chip industry forecasts (from SIA, iSuppli) have also recently been trimmed. On the positive side, for UK investors some further M&A activity may materialise, but we expect this to be concentrated towards the lower end of the market cap spectrum.

Financials: Performance disappointing, outlook uncertain

With bank exposure to Irish (and Portuguese) debt at the forefront of many investors' minds, the performance of the UK financial sector – down 3.1% in the last month, worse than any sector – is unsurprising. The sector has also lagged over every time period we analyse (see Exhibit 9 above) and we expect this to continue for the near-term for several reasons, Eurozone uncertainty notwithstanding.

First, new Basel regulations may force banks (in particular) into another round of capital rising. Standard Chartered, BBVA, BNP Paribas and Société Generale have all recently come to the market; more may follow. Next, results from the recent reporting season have been highly mixed with Barclays citing a subdued economic environment and slowing new business growth, Lloyds citing weak mortgage demand and RBS highlighting increasing losses. Among the UK majors, only HSBC sounded an upbeat note, and one driven largely by overseas exposure. Finally, sector valuation, on a headline multiple of more than 18x forward P/E is not supportive in our view.

Consumer goods and services: underweight on fundamentals

Both the consumer services and consumer goods sectors have underperformed on a market relative basis in the last three months, but have gained more than the All-Share on a one-year view. As discussed earlier, we see risks weighted to the downside and expect recent underperformance to continue into 2011. Our concerns are driven by poor consumer confidence and declining retail growth, both which may likely be compounded by VAT hikes and potentially higher unemployment.

Companies including Debenhams, Home Retail, Kingfisher, Next, Marks & Spencer and Sainsbury's have all highlighted increasing notes of caution in recent releases and interviews (Next, for example, sees "a very sluggish, low to no-growth consumer environment for some time to come"). 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

Equities may have risen more than 15% from their July lows, but events from the last month serve as a more appropriate indicator of current sentiment. Global indices continue to exhibit profound swings both to the upside and downside as investor psychology appears to be gaining the upper hand over fundamentals. An assessment of the latter suggests that the same familiar problems beset the global economy, namely a lack of suitable policy instruments to manage the ongoing painful process of deleveraging across the developed world. Stagnating growth and rising inflation represent other concerns.

Looking ahead to 2011, we believe that until there is a consistent and coordinated approach to monetary and fiscal policy, equities may likely remain volatile. Lack of future visibility may also cloud the outlook for corporate earnings growth, which has shown a recent improvement, but may not prove sustainable in our view. It is against this background that our strategy for equities stays centred around favouring diversified growth (basic materials) and high cash returns (telcos, utilities) principally at the expense of the consumer sectors. Gold also remains highly attractive in our view.

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