Illumination: Equity strategy and market outlook

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Mark Power
020 3077 5700
institutional@edisoninvestmentresearch.co.uk

Equity market overview and strategy

- Central bank policies (notably quantitative easing) are likely to remain supportive to equity and commodity prices. While we anticipate increased volatility in markets, we remain positive on equities in the medium term as long as governments continue to print money.
- Reduced investor faith in sovereigns (ie a retreat from government bonds) is also likely to support our view on equities. The downside risk here of course is the inevitable upside pressure that will put on interest rates.
- The key issue for equity investors is to find companies that enjoy pricing power in order to sustain margins. Input prices are starting to become an issue for many companies. After six months of a 'momentum market', we now expect investors to become much more selective and sector returns to diverge more meaningfully.
- Consumer confidence surveys are improving from a low base, but the biggest driver of overall consumer spending remains high-earners. Consumer businesses with strong brands appealing to the high-earning demographics will outperform.
- Current valuations do not look stretched: the FTSE and the All-Share indices are trading on about 12x prospective earnings, well below cyclical peaks.

Equities to stay in favour, but look for companies with pricing power

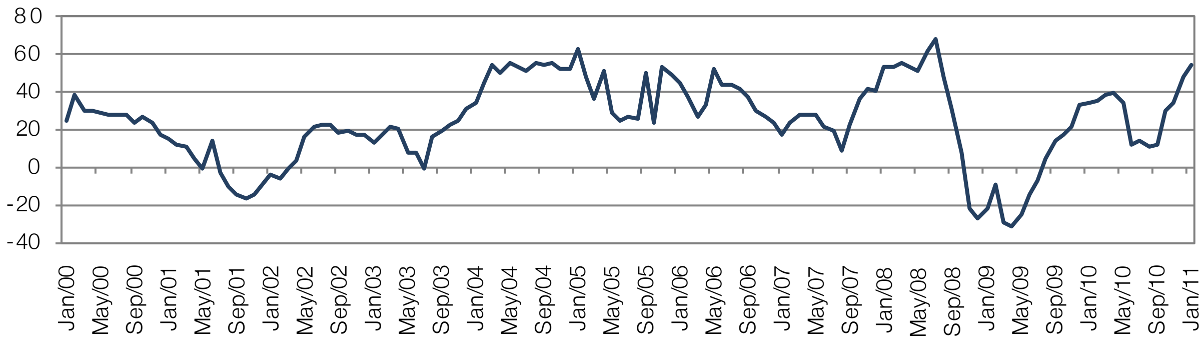
More than any other time, government actions are having a major impact on private-sector investment returns. The ever-so-visible hand of the government can be seen across all markets and instinctively it feels that the gush of liquidity in the last two years has been the major driver of asset reflation. If one structural consequence of the Fed's quantitative easing policy has been the underlying move into equities, the other has been commodity inflation. This policy and influence looks set to continue and, to our mind, while equities may still benefit from this flow of liquidity in the medium term, a key issue for the market is when, not if, this inflation starts to impact corporate margins (which continue to approach cyclical highs). Supporting this view from the US has been the recent uptick in 'prices paid' within the Philly Fed 'Business Outlook Survey' for December to the highest level since July 2008.

Coinciding with QE in 2010, market gains over the past 12 months were led by agricultural commodities (cotton is up 125% since January 2010, coffee up 58%, and wheat up 44%), precious metals and equities. Meanwhile, the major laggard asset class of 2010 were currencies (deflating currencies are of course the corollary to inflating assets). It was telling that in the last six months, the breadth of the rally has been so wide - most sectors have rallied in unison – with little selectivity apparent. In short, perceived risk has been relatively low. Notably, however, the first month of 2011 has seen commodities continue to gain (notably cotton, coca and rice) while previous metals have underperformed as growth outlooks in the US and China revive. We expect precious metals prices to resume an upward trajectory in tandem with inflation.

Look for businesses with pricing power to sustain margins

We remain favourable towards equities in the medium term, but suspect that investors will get much more discerning. Whether we can weight or even separate the various drivers of markets (quantitative easing [interest rates], M&A activity, consumer confidence, corporate spending etc) is a moot point. What seems more certain is that 24 months into this recovery rally (itself a long stretch relative to previous comparable periods), the breadth of this recovery is unlikely to continue. Investors will get more selective. With operating margins of many of best performing stocks touching cyclical highs, investors should take heed of the recent inflation signals (most notably prices paid) and focus on companies that enjoy pricing power (through brands or market dominance) and offer sensible valuations with a margin of safety. Though utilisation levels (of factories and labour) remain generally below optimal levels, margins have remained unusually resilient (especially in the US) and will inevitably revert to trend.

Exhibit 1: Input prices for businesses on the way up

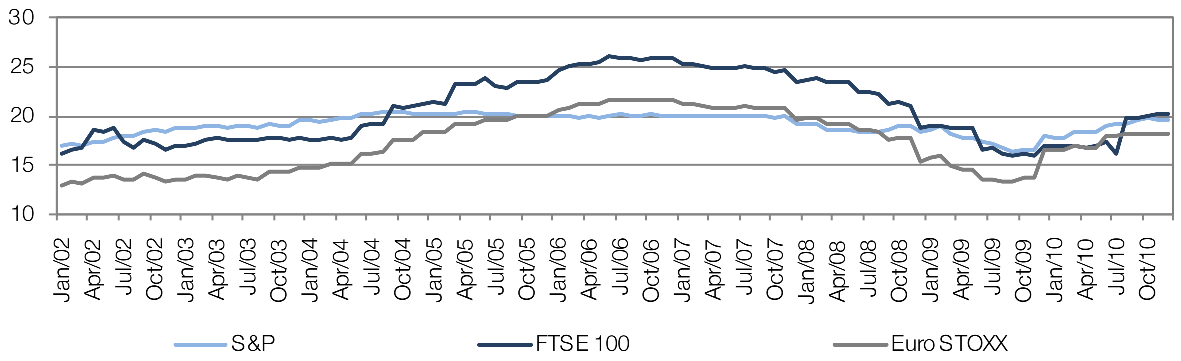


Source: Philadelphia Federal Reserve

A look at median operating margins for the major stock indices shows that in all regions company operating margins have rebounded sharply from the low seen in Q209. The question on our mind is where is the appropriate trend level for which these companies need to revert to. Our sense is that the exceptional profitability levels of the 2006-07 peak are unlikely to return anytime soon, but that current valuations probably reflect this.

Exhibit 2: But US and European operating margins at close to cyclical highs

Note: Trailing 12m operating margins.



Source: Bloomberg

Government assets to fall out of favour; equities are the least ugly

The usual suspects continue to dominate the myriad of year-ahead debates: global growth, the viability of the eurozone, impacts of government policy (public sector reforms), house prices and the pundits' favourite: the inflation/deflation conundrum. These debates are so contentious simply because there are no clear-cut answers (often with strong evidence of both sides). To wit: Chinese growth is almost deemed excessive while snow grounded UK growth in Q4; the eurozone's future is apparently balanced between a new enlarged bail-out fund and the consequences of an Irish (Portuguese, Belgian or maybe Austrian) default; and the US house prices look like a double dip according to Case-Shiller, but new home sales were better than expected in December. The great debate of course is between the deflationists (pointing to debt deleveraging) and inflationist (pointing to central banks' money printing). Each side has its merits and proponents, and in reality both sides are probably right. The overriding issue here, in our opinion, is that the global economy in 2011 is such a complex intertwined system that it is *not,* in fact, in equilibrium – a fact lost on many forecasters. Risk premia do not reflect this. Another small shock (be it sovereign default, geo political or social upheaval) would likely have an amplified effect on risk appetites and asset valuations. We do not contend to be experts on any of these areas but, simplistically, one area that we can be confident has experienced severe deflation is faith in governments and we are confident that this will continue to lead to serious pressure on currencies and a shift out of government assets (bonds) into selected equity classes, precious metals and commodities. Largely, for this reason (equities being one of the least ugly, as it were), we remain positive on equities in the medium term.

Exhibit 3: The 30-year government bond bull market is coming to an end.

Source: Bloomberg

What about interest rates?

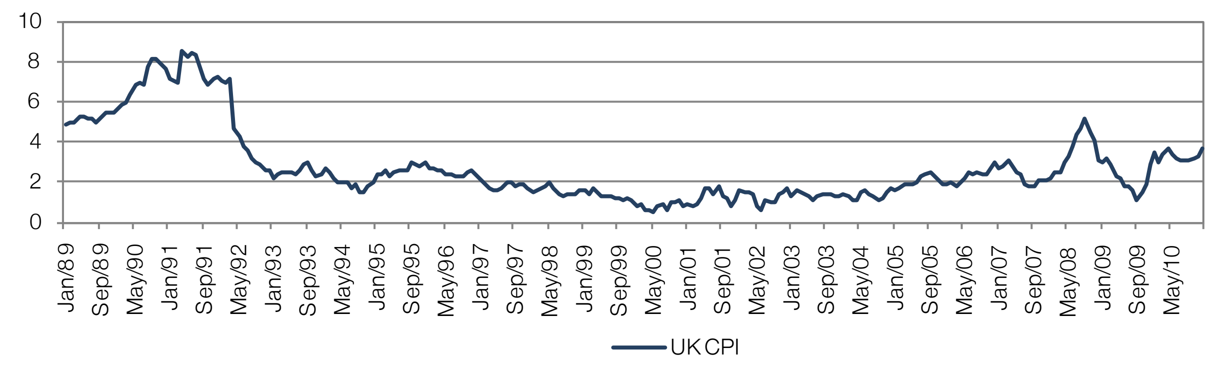
The delicate balancing act for central bankers will be to manage the interest rate cycle. So while equities as an investment class may benefit from the flow of funds from government bonds, a key headwind will be the eventual rise in interest rates that consumers and the companies underlying these equities will face. Investors should be wary of interest-rate sensitive sectors.

Inflation in evidence, but not impacting businesses' margins, yet

In today's world, it seems that we have inflation in the things we need but deflation in the things we want. So the price of beef for a Big Mac is up 22% last year (and rising) whereas the price of an iMac fell 33% over the last 10 years. Anecdotally, we see evidence that inflation is being understated across the board not just through the official statistics but also notably through 'virtual inflation' where services and product features are being reduced but prices are not (cf crisp packets getting smaller but prices staying the same). A cursory look at UK's CPI is therefore instructive to see the weighting and trends of individual components of the basket. The overall CPI index was up 3.7% in December (a "bona fide shock" according to the *FT*), but two notable sub-components experienced high rates of inflation – transport and food. Accounting for 16% and 11% of the index weighting respectively, these components grew by 6.5% and 6.1% over the prior period. Evidence, surely, that fuel and food prices are creeping into the CPI figures.

Exhibit 4: UK Inflation rears its head

Note: Rebased to 100.



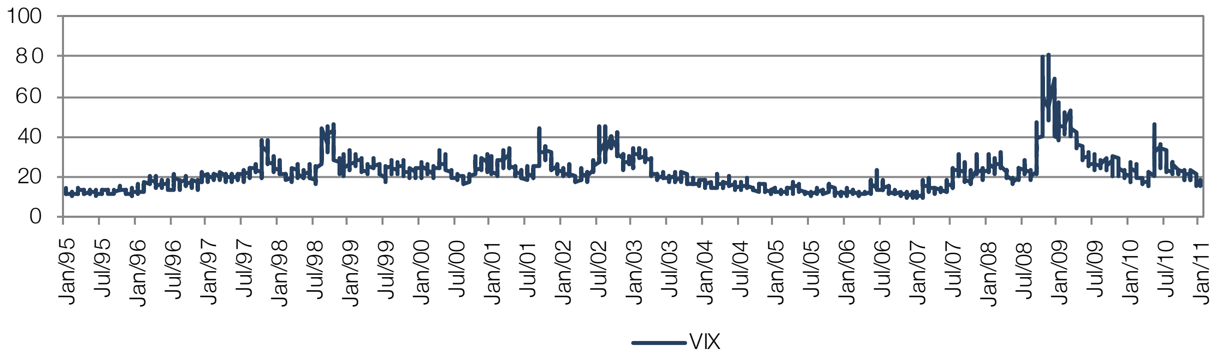
Source: www.statistics.gov.uk

Unsurprisingly, officials are downplaying the seriousness of this trend. As Paul Fisher of the Bank of England put it in a recent interview, "we're not seeing generalised inflation yet. As long as we don't, we can be more confident that the upward pressure is coming from cost shocks rather than from pressure of demand." In the US, the CPI index is on the face of it less alarming, though there are many reasons to question the validity of the US CPI index as a reflective inflation measure (for example, the Bureau of Labour Statistics weights healthcare at just 6.5% of the inflation index even though it is 18% of US GDP). Back in the real world, companies are increasingly talking about the impact of commodity prices on input costs. It is not just McDonalds that is feeling the pressure with beef prices; in the UK, food ingredients businesses are attempting to fix forward milk prices with farmers, which is highly unusual (unlike cereals, milk usually trades on a spot price). Clothing retailer ASOS confirmed last week that it was not seeing substantial price changes yet but thinks "it will come". ASOS also confirmed that it was experiencing sourcing price pressures (citing "Chinese labour and freight" in particular), but again said it did not expect to pass through on prices. Notably ASOS is not a price setter for its third-party goods (selling at brand RRPs) so margins are possibly more susceptible. Companies that are price-takers will be under increasing pressure. Similarly, AB Foods said that higher cotton prices will have "some impact on margins" and that in its grocery business "selling price increases are planned, or have already been implemented, to recover higher commodity costs, particularly in wheat, corn oil and spices." In the US, rising prices have been confirmed for 2011 by McDonalds, Evenflo (infant and juvenile products), 3M, DuPont and Coach (fashion accessories). Having seen the last upward trend in prices interrupted by the financial crisis in 2008, the chairman of Nestle, Peter Bracbeck thinks the current trend "could be lasting". Time will tell what impact such attempts to pass-through these input cost rises will have on profitability.

Risk attitudes

To be clear, we believe that actual investment risk (as in the possibility of capital losses) remains higher than perceived risk and that market indices remain susceptible to sharp increases in volatility. Nonetheless, markets seem relatively sanguine to continually embrace risk assets (note that the best performing stock in the FTSE in 2011 and YTD is ARM, trading on 50x 2011 EPS). Perhaps it is no surprise then that the last six months of sustained gains across multiple sectors coincided with a period of declining volatility (post Greece). Again, we think this is not sustainable. Risks remain high (back to the 1998-2002 levels – surely the 2003-06 low levels were exceptional?) and the market probably has got complacent in bidding up all sectors indiscriminately.

Exhibit 5: VIX index (the 'fear gauge') has subsided from the Greek crisis

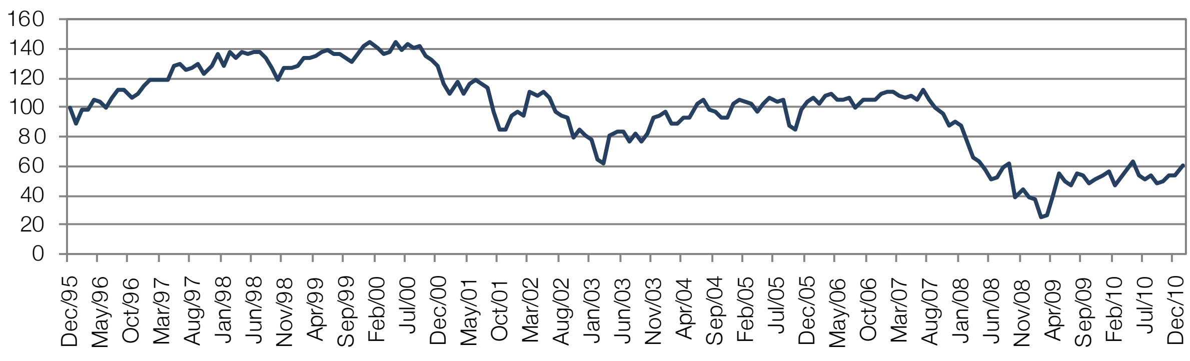


Source: Bloomberg

Consumer confidence – the Plutonomy is the key driver

Many commentators point to the strength of consumer stocks, such as Apple and NetFlix in the US and ASOS and Zara in Europe, as evidence of a revived consumer confidence and spending outlook. The broader consumer surveys do not necessarily support this (though improving, they remain at cyclical lows), neither does real hourly labour rates nor unemployment figures on either side of the Atlantic. The reality is subtly different. Our view is that the Pareto principle (or 80-20 rule) is alive and well within discretionary consumer spend areas: a small percentage of populations continue to account for a disproportionate amount of spending. For this reason (and to be fair, there are others such as emerging markets), luxury goods brands such as LVMH and BMW have maintained resilience through the recession, while companies aimed at the middle-market (the likes of Nokia, Wal-Mart, VW) have all experienced accelerating underlying deflation. Nowhere is this in evidence more than in the mobile phone market, where Apple enjoys about 5% volume market share but over 50% of the industry's profits.

Exhibit 6: US consumer confidence index

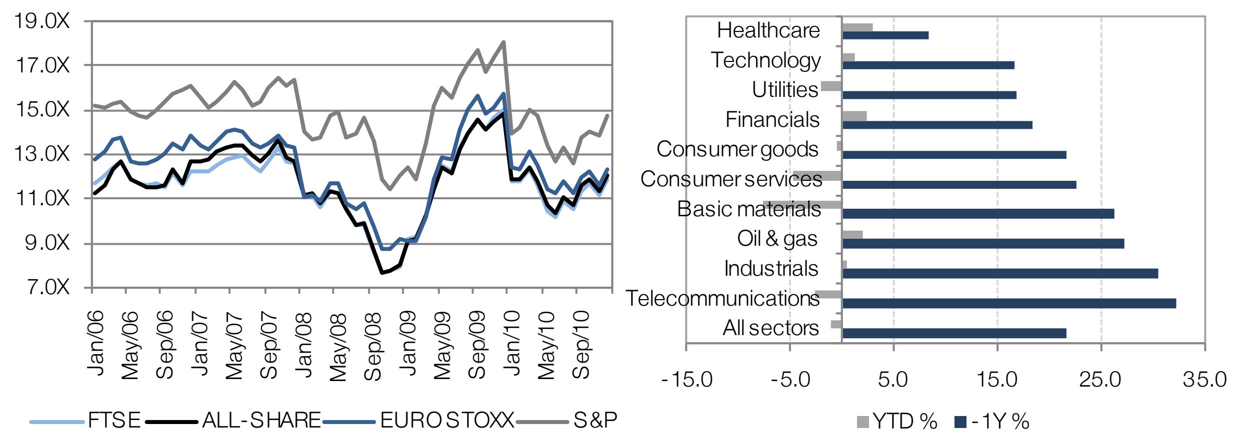


Source: Bloomberg

Valuation

Unfortunately, the valuation data shown below for the major bourses in the US and Europe does not provide enough historical data to provide context on current *forward* P/E valuations. Clearly, the US premium is still intact and the S&P is now trading at almost 15x prospective earnings according to Bloomberg. The UK and European markets are more reasonably valued (on average) with a forward multiple closer to 12x earnings. Of course, without knowing the growth prospects, it is hard to say definitively whether these multiples are cheap, but at least we can say that they are relatively cheap compared to recent years. Finally, we note with interest the early signs of rotation seen in January 2011 – especially for the healthcare sector: one of the worst performing sectors in 2010, is the best performer in January 2011. This is perhaps a clear sign of sector rotation and possibly increasing investor discernment.

Exhibit 7: Global valuation levels (12m forward P/E) on left; FTSE sector performance on right



Source: Bloomberg

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