

Illumination: Equity strategy and market outlook

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Equity market overview and strategy

- If someone had told you last month that March would see one of the worst earthquakes ever recorded in Japan causing a catastrophic nuclear disaster; that NATO would effectively invade Libya and that Brent oil would breach \$117, would you have expected the S&P500 to have been flat m-o-m at the end of March?
- Despite an increasing barrage of negative issues facing the global economy, stocks markets – after a brief period of renewed risk-aversion coinciding with the Japanese earthquake – appear nonchalant again. This makes us worry and we think prudent investors should reduce risk and reconsider hedging strategies.
- This is not news to anyone but the key risks remain: sovereign default (most pressingly in Europe, but also ultimately in the US), Middle Eastern conflicts, oil prices (and inflation), monetary policy (and inflation), the housing market (and deflation), China (global growth), and, linking all these together, corporate earnings.
- We have recently espoused the view that central bank activity is key to the equity market momentum in the short term. That view remains, but with rising headline inflation across all regions it is increasingly clear that central banks are facing pressure to become more hawkish. QE3 is far from a done deal. There is no question that headline inflation has turned markedly up and companies across all industries are fighting to maintain margins as input costs rise. Sustained wage inflation is still some way off, but the monetary policy makers are facing a major challenge to address this issue.
- A key characteristic of today's markets is synchronicity. Markets across all regions are rising and falling in unison. The interconnected nature of global capital and trade flows ensures common issues abound. In many respects UK stock indices are more a call on global asset prices than on UK economic growth. A global perspective therefore is key.
- One month on, our take on equity strategy remains broadly similar. Equities are likely one of the least ugly asset classes in an era of monetary stimulus. However, such stimulus cannot be taken for granted, and the many material risks facing the global economy cannot be ignored. It sounds simplistic but our strategy would be to reduce risk considerably, favouring high dividend yield businesses with strong balance sheets and pricing power to weather a prolonged consumer downturn. Plan for the worst, hope for the best.

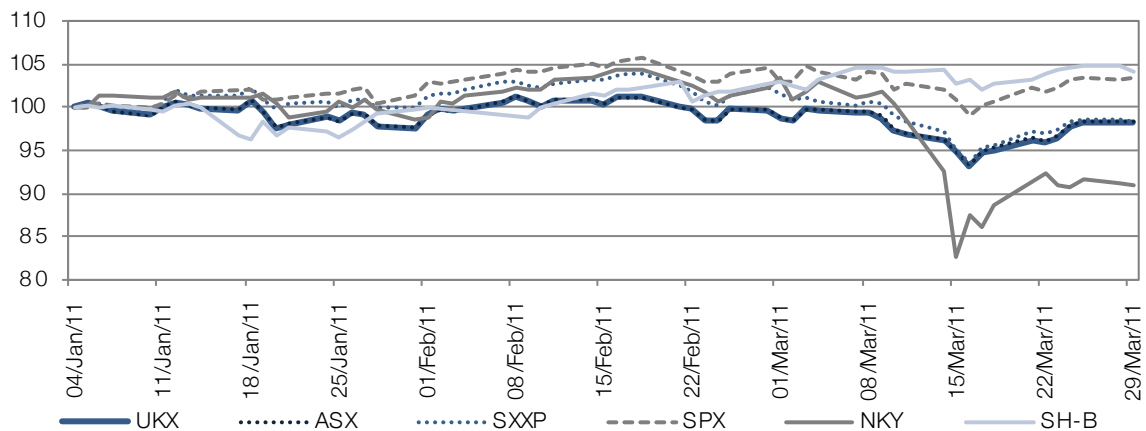
Summary

The pace at which substantial negative economic, geopolitical and natural events have been occurring in recent months has been unprecedented in recent decades. No region has been spared from turmoil of one sort or another: Japan (infrastructure devastation and potential nuclear disaster), Europe (with its ongoing banking and political crisis), UK (with its new-found fiscal austerity and resulting consumer weakness), the US (housing collapse and pending fiscal crisis) and not least the Middle East, where political uprisings continue unabated. With the obvious exception of Japan (a devastating human tragedy), most of these issues have been 'slow-burners' and had become perhaps familiar to investors who seem to be taking the taking such events in their stride, immune perhaps to their looming significance. Even the Japanese catastrophe – which continues to be reflected in the Nikkei – is amazingly not yet seen to be a threat to global trade. The chart below shows the extent to which markets have rebounded: Chinese and US-listed shares have proven most resilient.

So why spend so much time talking about global trends to a UK-focused audience? Largely because a) the UK markets (especially the FTSE) are increasingly driven by commodity prices, and b) markets are increasingly in

sync. This month we take a cursory tour of the major regions to recap on some of the key macro and micro news events of the month to give UK investors some context.

Exhibit 1: Global indices year to date (rebased to 100)



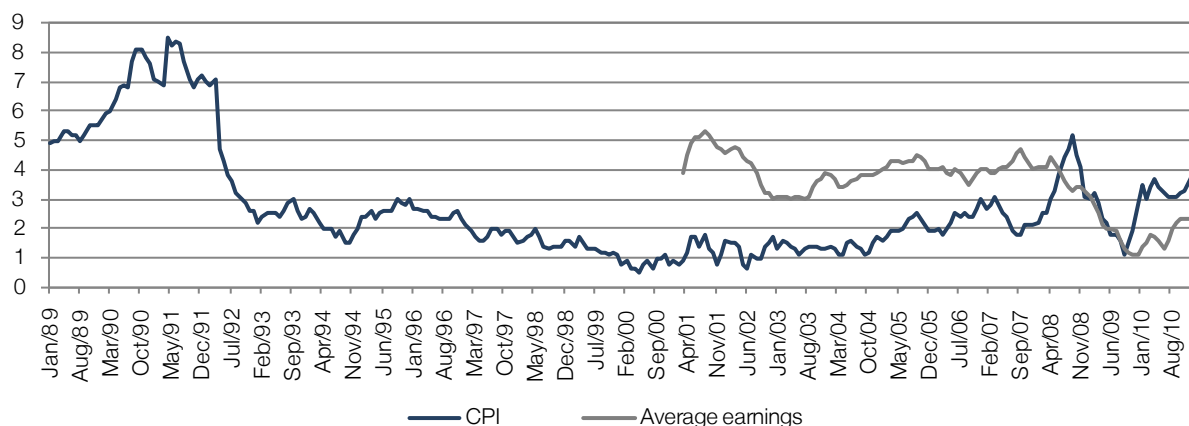
Source: Bloomberg

UK – Austerity, inflation and retail woes

UK economic news flow during the month was dominated by inflation, high street retail trends and the UK government's latest austerity budget. UK CPI inflation surged to 4.4% y-o-y in February – its highest level since 2008, notably driven by clothing price increases (up from 1.3% y-o-y to 2.8% y-o-y). The higher VAT rate introduced in January will also no doubt have a bearing on CPI for the remainder of 2011. There is obviously some debate (globally in fact) about the contrasting signals from core (so-called sticky) and headline (flexible) inflation metrics and how these should be used to drive monetary policy. The minutes from the February meeting of the MPC reflect this debate, stating: "of those members not favouring a rise, some thought the case for an increase had grown". The chart below gives some context on UK inflation trends along with average weekly earnings, which also continue to creep higher.

March was a busy month for company updates, especially in the retail sector. While overall retail sales volumes grew 1.3% y-o-y in February, ostensibly not a disaster, the m-o-m decline of 0.8% was in fact worse than most had expected and was generally attributed to the VAT increase in January. Even food retailers have seen an impact, with Justin King (Sainsbury's chief executive) expressing his surprise at "just how sudden" that the fall-off in sales has been since Christmas. Online sales remain one of the few bright spots in the sector with overall non-store sales value growing close to 20% y-o-y – a trend driving the likes of ASOS and offsetting slowing growth trends for bricks and mortar businesses such as Domino's and Booker. Practically every high-street retailer has warned of a challenging environment in the UK retail space and anecdotally our checks point to evidence from certain SME retailers (particularly of discretionary-type products) citing noteworthy consumer weakness in recent weeks. Home Retail, Dixons and Halfords would fit the bill here. John Lewis made the interesting comment that it sees consumers are becoming "more sophisticated" in dealing with inflation, which we interpret as meaning that consumer are getting adept at 'trading-down' to lower priced alternatives. It should also be highlighted that businesses exposed to Republic of Ireland consumer spending are under severe pressure too in Q1, as evidenced by the slowdown seen by Domino's in the quarter (its Irish business saw sales fall 10.5% LFL y-o-y) compared to the UK, which grew +5.5%.

Exhibit 2: UK CPI



Source: Statistics.gov.uk

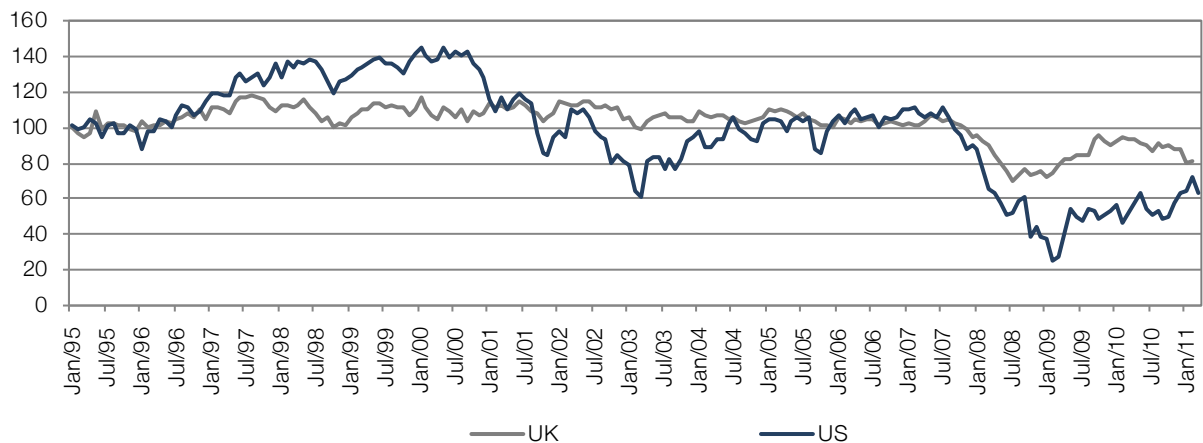
US – Will the QE3 ever set sail?

Investor focus in the US remains squarely on the prospects for further quantitative easing by the Federal Reserve. A common theme of this monthly report, we concur with the view that further monetary easing is essential to sustain current equity market valuations. Interestingly the Fed has decided to start giving press conferences from the end of April (the first is scheduled for April 27, inconveniently close to the US debt ceiling deadline and a key date for the diary). Ironically, the Fed may gain some leeway from the actions of the Bank of Japan, whose own printing presses could take up some of the slack in a bid to weaken the yen. Either way, all investors must keep an eye on global monetary policy – any signs of more hawkish behaviour would have a negative impact on equity valuations. In an interesting turn of events, PIMCO, one of the world's largest manager of bond portfolios, disclosed that its Total Return Fund – the world's largest bond fund – had taken its holdings of US government securities to zero. Ominously, this might suggest that PIMCO is sceptical of another phase of quantitative easing (the so-called 'QE3').

Meanwhile, back on main street US, the durable goods orders (ex-transportation) fell 0.6% m-o-m in February, which was much worse than the consensus expectation of a 2.0% m-o-m increase. Machinery orders – down for two consecutive months – had the largest decline (\$1.2bn or 4.2% m-o-m). Restaurant behemoth **McDonalds** missed estimates, with LFL sales growth of just 2.7% (vs 4% estimates and down from 5% reported in January). The technology sector has proven very resilient in recent quarters (buoyed in particular by a wave of strong demand and stock-building in the smartphone and tablet PC marketplaces). However, US semiconductor supplier **National Semiconductor** (often considered a bellwether of the industry due to its diverse end-market exposure) missed February quarter estimates, citing: "inventory adjustments in the distribution channel and seasonally lower shipments to wireless handset customers following the holiday sales period". Notably too, Taiwan looks to be slowing: February revenue figures for the top PC contract manufacturers on the island fell 20% m-o-m. Even **Hon Hai** (**Apple** and **DELL**'s outsourcing partner) saw an -18% decline. On this side of the Atlantic, consumer electronics manufacturer Logitech's profit warning points to an increasingly risky environment for technology investors as we face Q1 results season.

In that context, it is therefore interesting to compare the consumer confidence indicators (not for their absolute levels but for their direction) on both sides of the Atlantic. Broadly speaking, since early 2010 UK consumer confidence is falling, while the US consumer confidence is rising (albeit more tentatively recently).

Exhibit 3: Consumer confidence, on both sides of the 'pond'



Source: Bloomberg

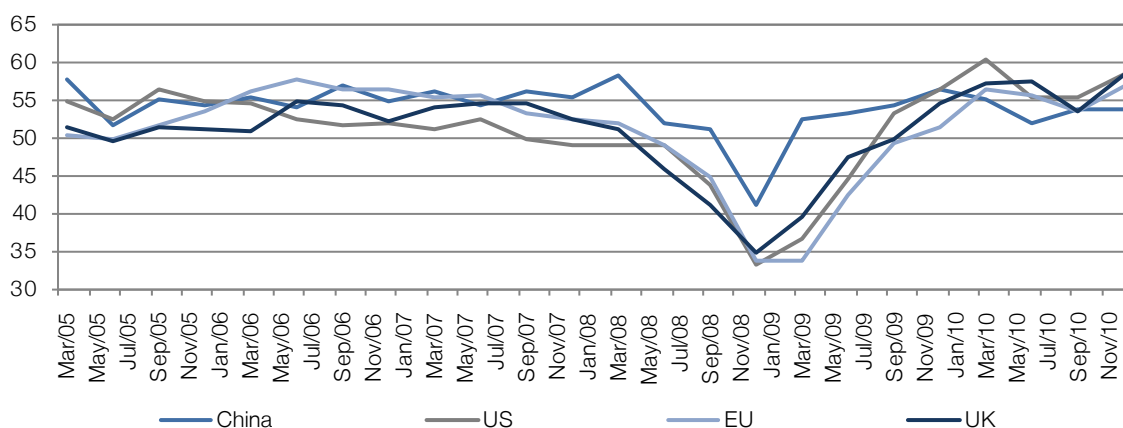
Both constituents have two key issues to deal with: rising inflation (especially food and clothing) and falling real wages. Scott Davis, chief executive of UPS, says that his company is currently evaluating what the world would look like with \$200 oil (for what it is worth, his view is that manufacturing will shift westwards). Wal Mart's head of US operations has stated publically that inflation is "going to be serious" and that the company is "seeing cost increases starting to come through at a pretty rapid rate". US food inflation for finished consumer foods surged 3.9% in February, the largest increase since November 1974 (then +4.2%). That is quite startling. About 70% of the rise was due to higher prices for fresh and dry vegetables (+49%). The fact that corn inventories in the US were 15% lower y-o-y on 1 March is unlikely to help the situation in the US. The dilemma facing the central bankers becomes clear: continue QE and risk further inflation, or cease QE and risk a massive equity market de-rating.

Global corporate activity

Notwithstanding the inflationary pressures facing citizens across the globe, manufacturers seem to remain upbeat. As shown in the chart below, purchasing managers' indices (also in sync) in the US, Europe and UK continue to trend gradually upwards, while China (perhaps worth noting) seems to be rolling over. The Chicago ISM survey just released (better than expected) included some interesting selected comments from participants of the survey (purchasing managers within US corporations). Here is selection:

- "Commodity inflation hurting profits. Issuing first pricing increase in 3 year to help recover."
- "Chemical Pricing is through the roof right now. Instability in oil markets as well as high demand & low supply due to crop feedstock are serious concerns. Steel and Plastic have risen. Continued inflation will have negative impacts on our ability to pass costs on to our customers in the short term."
- "1. It seems like it's time for everybody to jump on the "price increase" bandwagon, justified or not. 2. Disasters in Japan will cause inventory to blip upward as contingency plans are placed into effect. 3. Challenges remain for offsetting any price increases incurred during 2011."
- "We are in trade show registration/management. We have seen an increase in show attendance for the past 6 months. People are starting to attend shows again. They are also increasing the number of people sent to the shows from individual companies. We saw a significant drop over the past 2 years as companies sent 1 instead of 3 people or skipped certain shows all together. This may be a sign that things are improving."

Exhibit 4: Purchasing managers (also in sync)

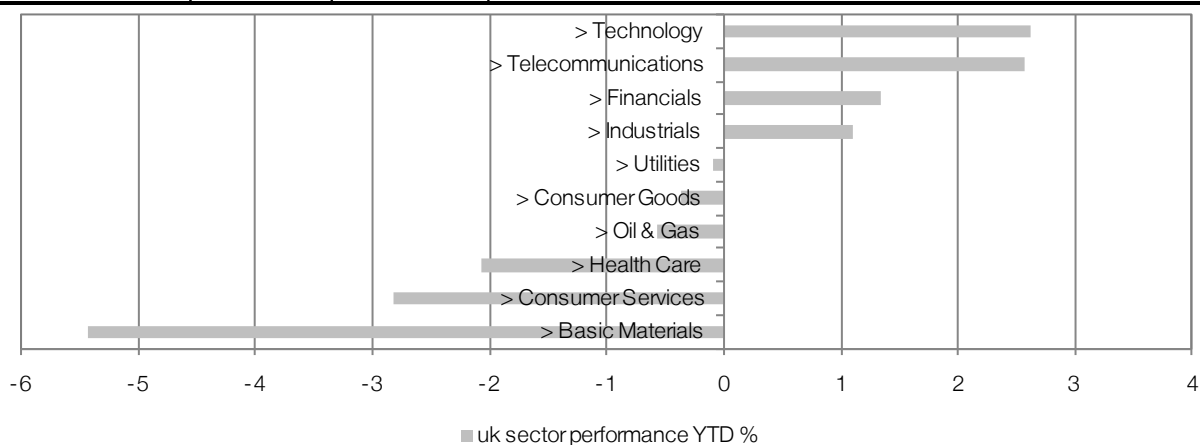


Source: Bloomberg

UK sector performance update

The sector median returns year to date mask as usual a disparate set of underlying company returns (cf healthcare), however the underlying trends seem broadly on the mark. Technology is certainly en vogue (as represented by some of the stratospheric valuation levels), while at the other end of the spectrum large and mega-cap miners have suffered significant under-performance YTD. Our suggestion would be to look for some of the higher-quality mining names, which may have become oversold, certainly look at healthcare and definitely look at utilities for yield. In remaining sectors, the criteria have to be resilience through a cycle.

Exhibit 5: UK sector performance (median % YTD)



Source: Bloomberg

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