Illumination: Equity strategy and market outlook

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Equity market overview and strategy

- One of the more perceptive comments regarding the global economic situation we have heard in some time came from a CEO we met in early May at the Edison offices. He referred to the global middle classes as being very "restless", largely as a result of newsflow that remains volatile and, more often than not, inconsistent. The same can be said, we think, for asset markets: investors also remain skittish.
- So, another month, another spike in asset market volatility – this time in the commodity markets. This was in evidence by the dramatic shift in commodity prices (silver fell by 30% in five trading sessions, Brent crude fell by 12% in three) which came almost a year to the day after the NYSE 'flash crash' and shows the precarious position continually underlying asset markets in general. That fall in the oil price in particular surely now shows the unarguable speculative premium embedded within.
- China is a key driver of commodity markets and the 7% sell-off in Chinese equity markets no-doubt reflected a valid concern about inflation (most recently, 5.4% year-on-year (y-o-y)) tempering economic growth there. The Chinese authorities are acutely aware of this and notably fined Unilever Corporation for publically mentioning the possibility of price rises. Meanwhile, the importance of China to global multinationals is in clear evidence: BMW saw 45% of its Q1 volume growth originate from China. While rising unemployment means stagnant labour rates will likely limit traditional core inflation upside, we expect a continuation of inflation in goods funded by short-term liquidity (ie what we need) countered by deflation in goods funded by long-term financing (ie what we want).
- At first glance, global markets – with the exception of China – look to have recovered fully since the Japanese disaster in March. Yet a closer look shows that such beauty is only skin-deep. S&P volumes continue to decline and notably the US dollar index seems to be inversely correlated with the S&P which indicate an underlying weakness to the US market. With competitive devaluation the unspoken strategy of governments across the globe, it is vital for investors to be aware of currency risk.
- Yet investors are hungry for growth. We have created a basket of UK growth stocks (which we label internally as the 'go-go' portfolio) led by ASOS, ARM et al, whose valuations are reminiscent of a decade ago, yet they pale in comparison with the latest Chinese IPO: social media business RenRen which debuted at 70x its 2010 revenues. This is not a market for the faint-hearted.
- And so, a month on, myriad macro 'problems' still persist – only the location changes: inflation worries (this month, China); global growth (Germany, China); sovereign debt (Greece, again); currency devaluation (the dollar and, latterly, the euro); housing (all regions); and geopolitical (Pakistan). This is more than a wall of worry: risk remains high and portfolios should be positioned accordingly.

Summary

The purpose of this monthly is to provide a snapshot of the world events which together provide a framework for UK investors to give context to investment decisions. While we aim to be pragmatic and think that central bank liquidity (and resulting negative real interest rates) are supportive to nominal asset prices, we remain convinced that underlying risk is very high and investors should hedge sector weightings accordingly.

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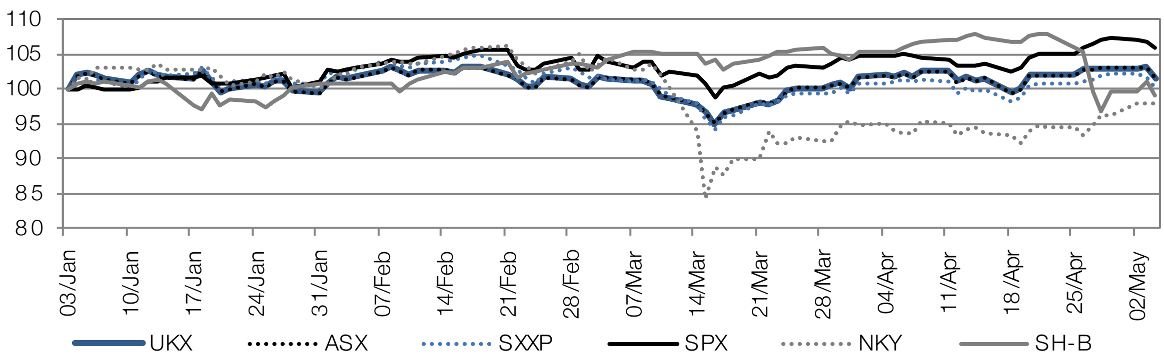
Global markets recap

Global equity markets, with the notable exception of China, have by-and-large recovered from the shock of the Japanese disaster in March. This should not be interpreted as repercussions being limited – rather, that they are still unknown. We highlighted in passing last month that China, a key trading partner of Japan, would be unlikely to emerge unscathed from the latter's inevitable growth slowdown. In recent weeks, inflation worries have re-emerged with a vengeance in China and resulted in another interest rate hike (the second in 2011), which led to -7% sell-off in the Shanghai index, as shown below in Exhibit 1. The Nikkei continues to rebound from its March lows, though it must be pointed that that this has coincided with a concerted effort to weaken the yen – a trend that many central banks are pursuing behind the scenes. Speaking of central banks, the US Federal Reserve's much-anticipated inaugural press conference was something of a non-event. In the immediate aftermath, most commodity markets rallied, albeit temporarily, reflecting the view that while Q2 may officially end in June, the era of negative real interest rates is likely to remain with us for some time. The Fed's party-line is that 'measures of underlying inflation are still subdued' despite the contradictory statement that it also thinks that 'Increases in the prices of energy and other commodities have pushed up inflation in recent months.'

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

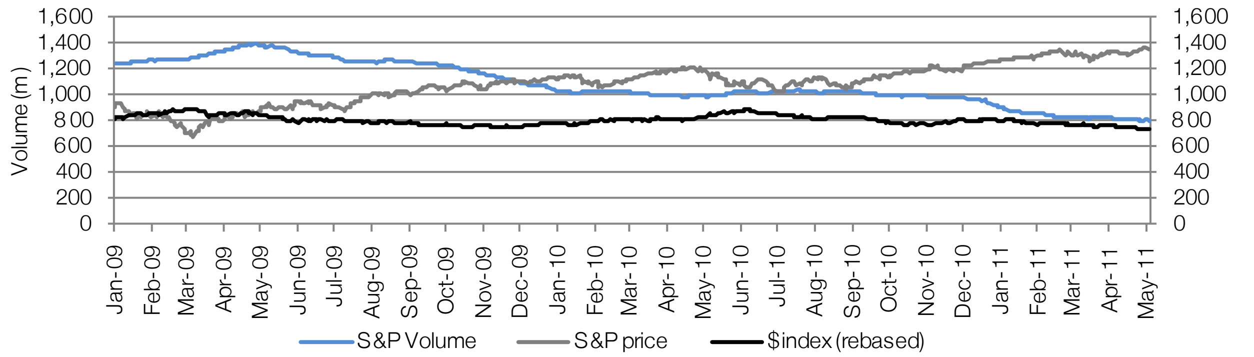


Source: Bloomberg

The S&P500 is traditionally deemed a key barometer of the health of the US (and by extension, global) economy, and the 6.5% growth in the index thus far this year is the best performance of the major global exchanges. First and foremost, Q1 earnings in the US were a major support to earnings estimates (the S&P trades on 13.6x 2011 aggregate earnings, which are forecast to grow by 16% in 2010). A cursory look at positive and negative surprises for Q1 within the index's constituents indicates almost a 3:1 ratio, according to Bloomberg. Notably, the technology sector (led by bellweathers such as Intel and Apple, both far exceeding consensus expectations for the quarter) had an even higher ratio of almost 7:1. M&A is also a tailwind (deal volume is up by 40% this year) with Texas Instruments' $6.5bn acquisition of National Semiconductor a key event (though possibly, in our view, a potential marker for the top of the cycle). However, the US faces some severe headwinds, notably at the sovereign level where it is approaching its debt ceiling; on a related note, S&P downgraded the outlook for the US' long-term credit rating from 'stable' to 'negative'.

Much of these headwinds are encapsulated in the US dollar. With countries adopting increasingly protectionist practices with regard to currencies, it does not make sense to discuss asset prices in isolation of the underlying currency in which they are priced. With this in mind, it is worth examining Exhibit 2, below, which overlays the S&P index with the DXY, which is the dollar rate averaged across six major global currencies. The pair seem to be inversely correlated. Adding the volume of shares traded in the S&P in the last two years shows another clear trend: declining volume. With all of this in mind, perhaps the underlying S&P strength is something of an illusion. The conventional wisdom is that US markets are outperforming because the US economy is strengthening. In fact, most of the strength in the S&P is due to either export-led businesses (tech, General Electric and so forth) or financials. In our view, a significant reason that US stocks are doing well is because the dollar is weakening (look at the inverse correlation in Exhibit 5 since Q310), which is something of a costly victory for the foreign shareholders of those businesses.

Exhibit 2: Declining volume

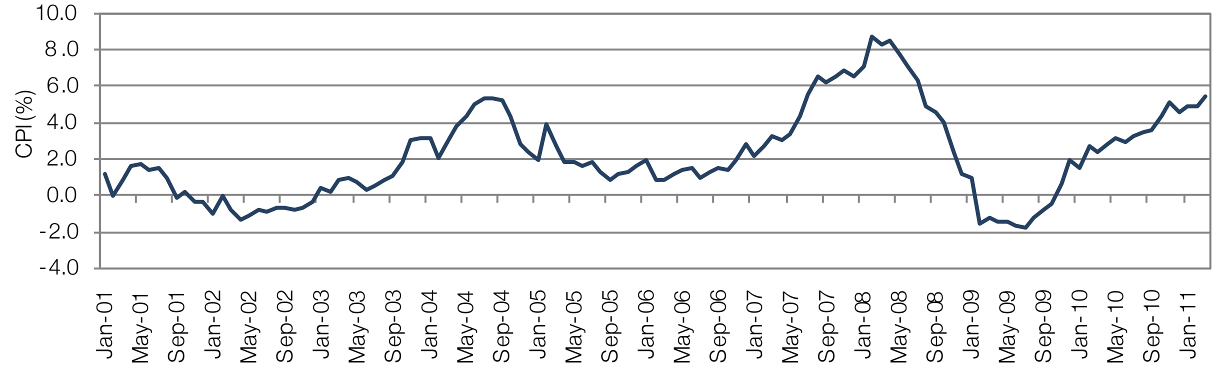


Source: Bloomberg

2. Inflation recap

Our intention is not to be repetitive in these updates, but the fact is that the same issues keep cropping-up month after month. Last month we highlighted UK CPI index (at 4.4%, its highest level since 2008); this month we turn to China, with a CPI index of 5.4%, as shown below in Exhibit 3.

Exhibit 3: China's increasing inflation problem

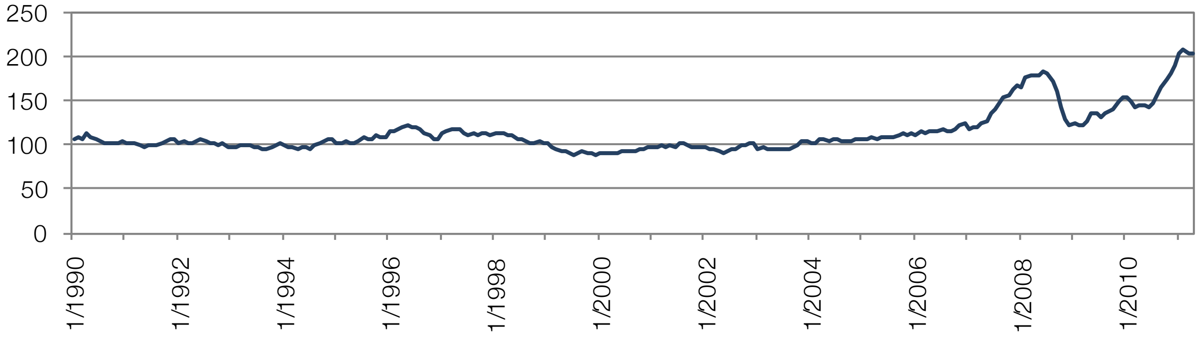


Source: Bloomberg

What is notable are the efforts by the authorities to dampen inflation expectations. We are used to seeing dubious inflation calculation methodologies by governments (note our recent highlighting of the exclusion of healthcare costs in US CPI), but the Chinese authorities went a step further this month by fining **Unilever** Rmb2m for talking about price rises (a Unilever spokesperson had told local media that detergent and soap prices might have to be raised because of higher raw material prices). Its not just in China that such behaviour can occur: in the US, MIT's Billion Prices Project (http://bpp.mit.edu), which collates data from online retailers globally and uses it as a proxy for inflation trends, was inexplicably taken offline at the beginning of May. Speculation was rife that because the raw pricing data implied that official CPI statistics may be understating the true level of inflation, the authorities were unhappy. Thankfully, the service seems to have been resumed and remains publically available.

Meanwhile, the UN's Food and Agriculture Organization (FAO; www.fao.org) released its statistics for April 2011, which showed that 'The FAO Food Price Index (FFPI) averaged 232 points in April 2011, virtually unchanged from the revised March estimate, 36 per cent above April 2010, but two per cent below its peak in February 2011. A sharp increase in international grain prices in April more than offset declines in dairy, sugar and rice, while oils and meat prices were mostly unchanged.'

Exhibit 4: World Food Price Index (deflated)



Source: Food and Agriculture Organization

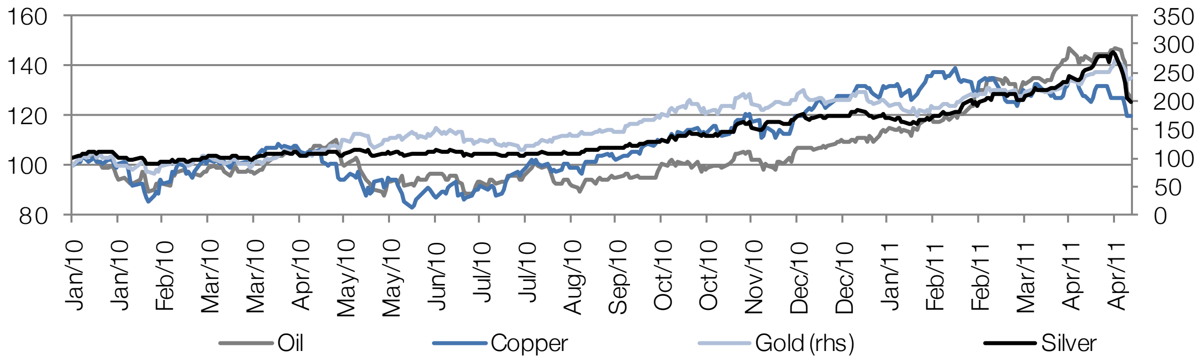
As ever, anecdotes from companies are plentiful to support these trends. Notable this month were comments from Larry Pope, CEO of **Smithfield Farms**, the largest producer of pork in the US, who made the interesting observation that such rapidly rising input prices are detrimental to the food industry. He said:

> "There are record prices for livestock but farmers are exiting the business. Why? Farmers know they won't make money."

> "We are just one bad weather event away from potentially $10 corn, which once again is another 50% increase in the input cost to our live production. What happened the last time there was a surge in corn prices, in 2008? The largest chicken processor in the United States, Pilgrim's Pride, filed for bankruptcy."

Meanwhile, farmers and businesses across the global may get some respite from the dramatic sell-off in commodity prices, notably in silver but also in oil, which saw its largest ever price decline in absolute dollars. Exhibit 5, overleaf, shows the extent of the sell-off in the global commodity markets, the trigger for which most market commentators struggled to understand. Many blamed a combination of Chinese inflation risks to growth, weak economic data from Germany (more on this later), renewed geopolitical risk, the looming end to Q2 and associated uncertainty, contagion from the silver sell-off, and so forth. It is quite possible that one or all of these issues proved a trigger, but is more than likely because of the inherent instability, and resulting speculative premium, of the market than anything else.

Exhibit 5: Commodities reversion to mean



Source: Bloomberg

In past updates, we have opined about the trend of inflation in the things we need (such as food) and deflation in the things we want (such as cars). Such statements give rise to extended debates between inflationists and deflationists about how to define inflation and we have ourselves tried to distinguish between so-called sticky' and 'non-sticky' inflation constituents. There may be another way to think about what is going on. We know that central banks are playing with the yield curve by buying-up long-dated bonds. It seems to us that the market where these bonds are being redeemed is not recycling this cash into further long-term bonds, but rather into short-dated bonds, basically out of fear of inflation. This means that there is an excess of short-term liquidity 'looking for a home', which ultimately pushes up prices for goods and services financed by short-term money. This was in evidence during the month when for the first time since the financial crisis, short-term treasuries were offering negative yields. In other words, this drives inflation in goods which are financed by current spending. Meanwhile capital and financing are scarce for longer-term projects, causing deflation in goods that require long-term financing, such as houses. This is just a pet theory, but it makes sense to us.

3. Global growth recap

While German industrial orders fell unexpectedly in March (-4% month-on-month (m-o-m) compared with +0.1% expected by consensus), it is hoped that this is within the normal volatility of capital goods orders. A survey of German purchasing managers by Markit showed that order activity could also have fallen in April. However, anecdotal updates from companies suggested that German exporters continue to do well.

The extent of the dependence on China for global growth was demonstrated very clearly by BMW in its Q1 earnings update. It sold 321,000 vehicles, up by 21% or 55,000 compared with Q110 results. Of this, however, sales to the Chinese market grew by 25,000 year-on-year (y-o-y), ie accounting for 45% of the volume growth of the group. Incidentally, BMW expects to ship an all-time record of 'well over 1.5m units' in 2011 – a trend no doubt also buoying the supply chain (and evidenced by auto semiconductor manufacturer Infineon's guidance raise). Presumably, BMW's (and the supply-chain's) new-found optimism is highly contingent on sustained Chinese demand. BMW's co-patriot Siemens is also a key beneficiary of global growth, and while raising its FY11 guidance it cited revenue growth of 18% y-o-y in China for Q111.

UK Weather and Inflation expectations

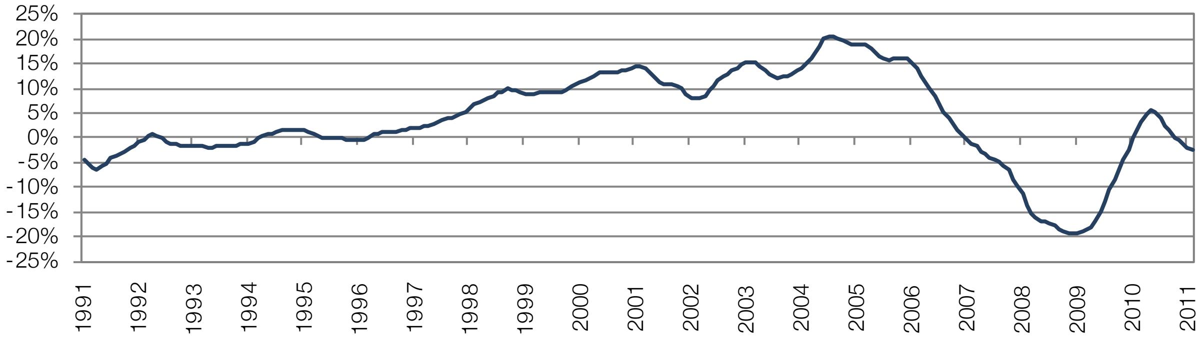
Domestic UK businesses seem increasingly subject to the vagaries of weather, which also seems to have become more volatile. While snow impacted delivery businesses extensively in the winter of 2010/2011, the glorious weather in April 2011 had mixed effects for retailers: fashion chain Next raised guidance while confectioner Thorntons lowered guidance, despite efforts to counteract lower chocolate sales with increased ice-cream sales. Meanwhile, Illuminator stalwart ASOS continues to take over fashion retail and announced on 13 April that it is now generating more sales outside of the UK than inside for the first time.

The MPC faces an increasingly difficult challenge in setting UK interest rates. The most recent decision to keep rates on hold was hardly contentious, given the most recent drop in inflation and, more importantly, the weak Q1 growth, and it seems that the market assumes that further rate rises will be put on hold for the foreseeable future. An inflation report from the Bank of England, due in mid-May, should give some more food for thought. However, the overriding issue facing the MPC committee and investors is the outlook for UK growth, which currently looks quite dismal especially on the high street. Balancing the need for growth stimulus with lurking inflation, and expectations thereof, is the dilemma.

US ISM services declines

The vagaries of the myriad of economic indicators can be overwhelming to the observer, and it could be argued that one can always find an economic indicator to support an argument. So for balance, we will highlight the apparently positive release of US Non-Farm Payroll for April, which showed its highest gain ($244,000) since February 2006. That this included a birth/death adjustment of 175,000 is a moot point. However, given our cautious stance on markets, we advise giving higher credence to the ISM Services Index, which fell from 57.5 in March 2011 to 52.8 in April perilously close to indicating a contraction. Of particular note was the 'new orders' component of the survey, which fell by 11.4% m-o-m. In the US and UK, the housing markets are key to any recovery; with this in mind, we highlight the pre-eminent Cash-Shiller Index, which indicates that the composite 20-City index in the US is now falling at a rate approaching 4% y-o-y. The upshot of this, we think, is a likely resumption of quantitative easing, dollar weakness and nominal asset price strength.

Exhibit 5: US housing (Case-Shiller 10 City Index)

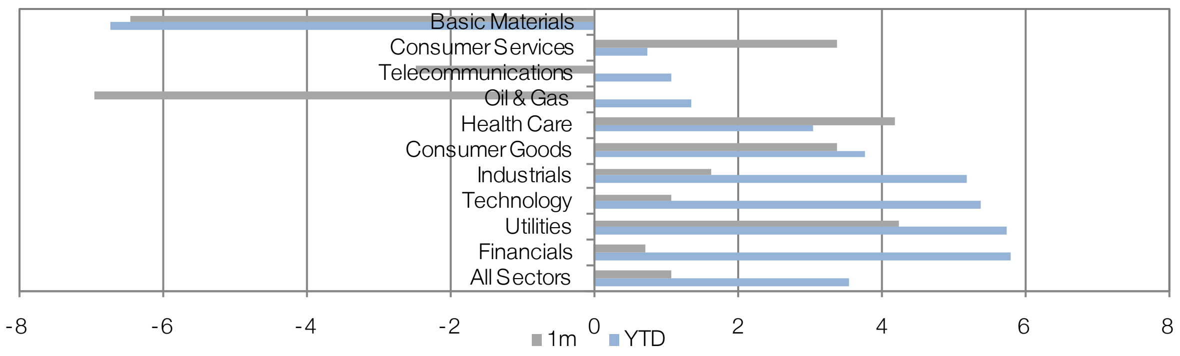


Source: Bloomberg

UK sector performance to-date

Financials and Utilities have been the best-performing sectors within the all-share index YTD. Perhaps unsurprisingly given the commodities rout in early May, basic material and Oil & Gas sectors have been the worst-performing YTD and in the last month respectively. Of note is the strong performance for April/May in Healthcare and Utilities – a trend which is likely to continue.

Exhibit 5: UK All-Share sector performance %



Source: Bloomberg

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