Illumination: Equity strategy and market outlook

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

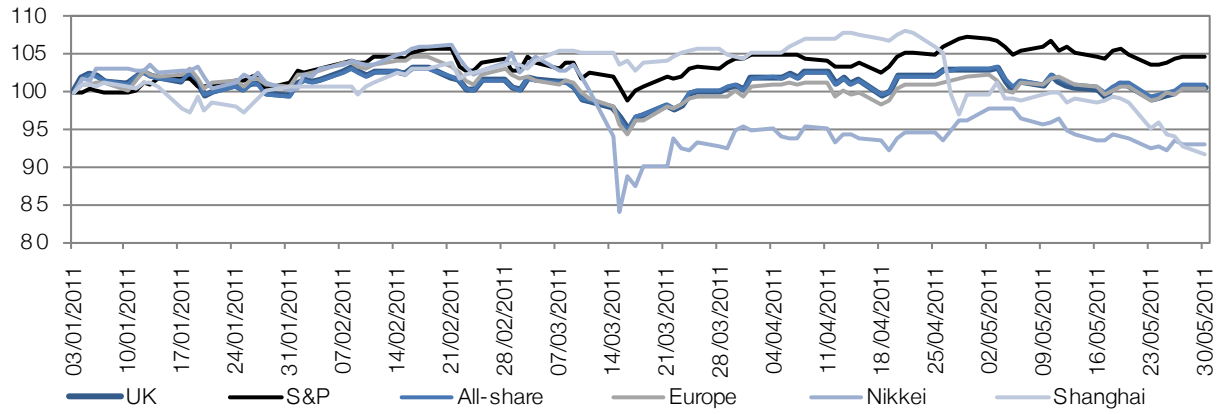
Equity market overview and strategy

- Caution remains the order of the day and this stance seems to be borne-out in the relatively stagnant performance of UK markets so far in 2011. On the face of it, it seems counterintuitive (Japan excluded) that 'western' stock-markets would significantly outperform their Asian peers: of the five major global bourses, only the S&P is up meaningfully (+5%) in 2011.
- Three major issues continue to face-down markets: growth, inflation and debt (most notably of the sovereign kind). Most of our monthly missives so far this year have centred (some might say obsessed) on inflation trends. This month we turn our attention to growth – or lack of it – the 'stag' in stagflation.
- The dilemma around the world is that the onerous levels of fixed debt facing individuals and corporations can only be made manageable through growth. On a micro level, margins in many industries are back to cyclical highs, rendering further earnings growth realistic only via top-line expansion.
- Questions surrounding the sustainability of global growth have resurfaced (as they did early in 2010), but this time stimulus options are greatly reduced. The market seems sanguine, attributing the slowdown to the Fukushima after-shock and global inventory de-stocking, both deemed to be short-term effects. China's monetary tightening and US consumer deleveraging remain huge headwinds for global growth.
- Yet Investors seem to be crying-out for growth, as evidenced by the re-ratings of growth-stocks and IPOs (cf LinkedIn, Renren et al). In the UK, Domino's Pizza's decline shows what happens when growth stalls.

Global market summary

It seems counter-intuitive that the best performing indices YTD have been the Western bourses (led by the S&P). Even allowing for the natural disaster that befell Japan, the Shanghai index has taken two quite dramatic leg-downs in the last month. To some extent, China has been playing catch-up and, arguably (as we mentioned last month), the weakening dollar does distort the nominal gains in the S&P.

Exhibit 1: Market ranges



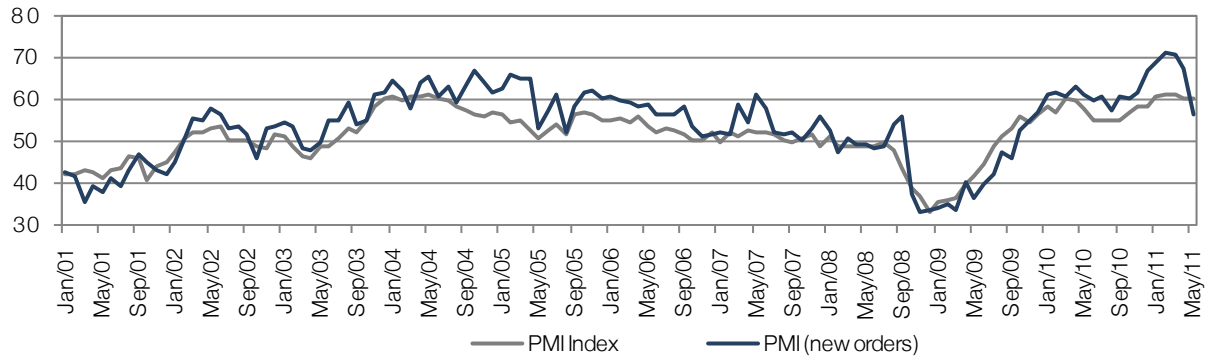
Source: Bloomberg

Bill Miller of Legg Mason has pointed out some peculiarities with the S&P's strength, which had its strongest first quarter since 1998. Only two of the S&P sectors (energy and industrials) outperformed the broader index in Q111, which last occurred in Q100 when the tech bubble was peaking. As Miller points out, this is not a healthy sign for the market.

Global growth – lead indicators turning?

Three core issues remain central for most investors: inflation, global growth and debt levels. The performance of the indices would suggest that markets remain remarkably sanguine about all three, though it seems to us that there has been a noticeable increase in the macroeconomic data points, which gives cause for concern. A case for deteriorating growth is easy to make for each of the core economic regions. In the US, housing is still a drag on spending (ditto the UK), in Europe peripheral countries are undertaking forced internal devaluations and some remain at risk of default, the Chinese are tightening credit, and meanwhile Japan is struggling to rebuild. The significance of negative economic indicators in recent weeks has been downplayed so far and attributed to the temporary shock caused by the Japanese tsunami and a cyclical inventory de-stocking phase. As ever, we are more concerned that the effects of stimuli are waning and high debt levels and rising inflation is stifling consumption. Central banks do not have much ammunition left to revive these stimuli. Exhibit 2 below shows the National Association of Purchasing Managers (NAPM) Purchasing Managers' Index, which at 60.4 remains close to cyclical highs, and while turning is still well above the level (50) which would indicate economic contraction. However, overlaying PMI new orders shows a much sharper decline in the last month. This indicator might suggest that another US slowdown is in the works (and the most recent Case-Shiller housing data indicating a double-dip would also be supportive to that view). Other proprietary lead indicators, such as ECRI's, would support this trend on a global scale.

Exhibit 2: Lead indicators turning?

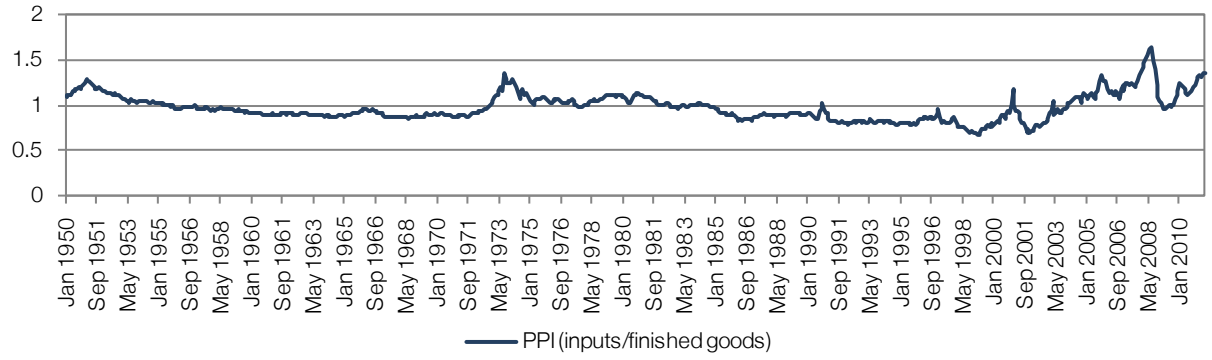


Source: Bloomberg

US companies facing increased pressure

While there have been some very high profile corporate disappointments in recent weeks (Cisco, HP and Gap have all issued significant profit warnings), so far the perceived wisdom is that these are all 'company-specific'. What is unarguable is that corporate profits are at all-time highs as a percentage of US national economic output, input costs are rising (and pressure on said margins is approaching multi-decade highs) and demand is waning. Exhibit 3 shows an update of a thematic chart we have used in the past. Using US PPI crude input prices (prices paid) and price received we can create a proxy for US corporate margins. While pressure on margins has been slowly building since 2002 (in sync with the so-called commodity super-cycle), the relative pressure on corporate margins is similar to that last seen in the early 1970s. This chart is most useful as a directional trend setter – notably, there is no sign of the trend abating.

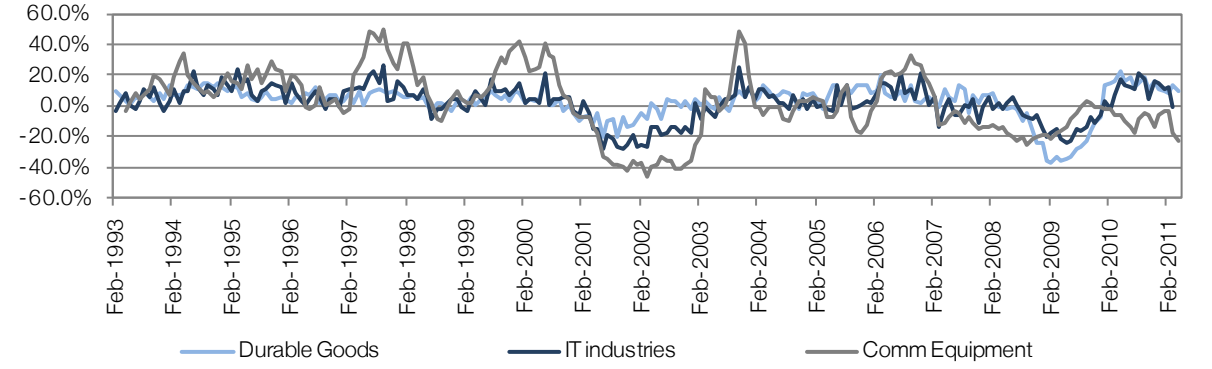
Exhibit 3: Corporate US margin compression



Source: Bloomberg

The April US durable goods statistics provided further grist to the bears' mill. The headline durable goods order growth is rolling over with headline durable goods orders (not-seasonally adjusted) up 4% y-o-y, the lowest growth since December 2009. To be fair, the April 2010 comparable was very high (+23%), but the central issue is the same – growth looks to be slowing. To accentuate this point, the more cyclical sub-sectors such as technology are seeing an amplification of this trend: IT industries saw negative order growth in April and communications equipment orders fell a whopping 22.8%. This gives serious pause for thought.

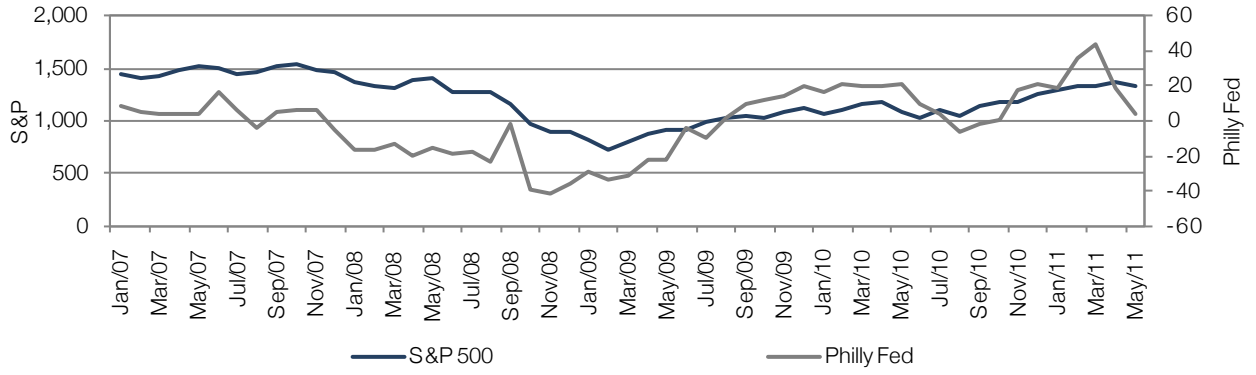
Exhibit 4: US durable goods



Source: US Census

In this context, is it any wonder that the CEO of sector's bellwether company, Cisco, said that previous medium-term growth targets of 12-17% are now "off the table"? While communications equipment is clearly driven by corporate infrastructure demand, it is notable that recently reported market data showed that 2010 marked the first year in history for which the PC industry saw declining volumes of consumer PCs. While the durable goods statistics may be considered backward looking by some, the Philly Fed index (a corporate survey to measure manufacturing conditions by the Philadelphia Federal Reserve, ie more forward-looking) was also very disappointing; it saw its lowest reading since October. For the first time in eight months, firms reported that unfilled orders and delivery times were falling. Historically, the Philly Fed has proven a useful lead indicator on the S&P 500's performance.

Exhibit 5: S&P vs Philly Fed



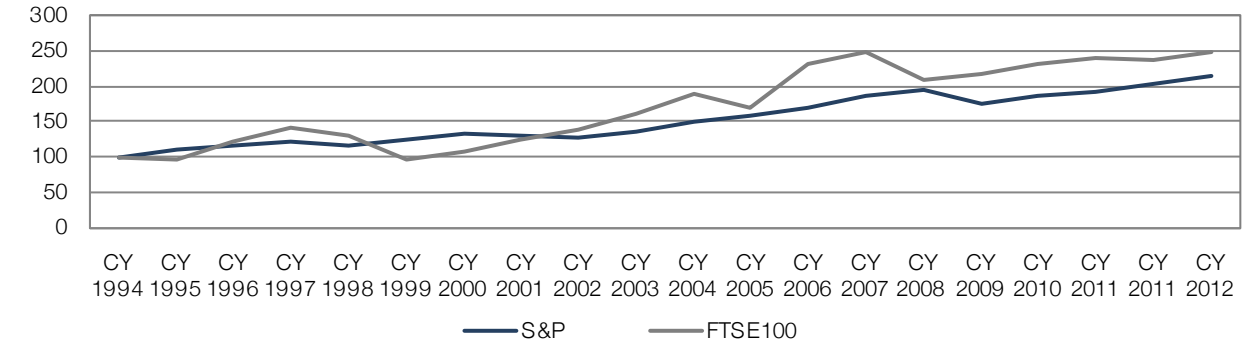
Source: Bloomberg

UK spotlight

Closer to home, the Bank of England lowered its growth outlook for 2011 UK GDP from 2.9% (last updated in February) to 2.7%. 2012 has been similarly revised from 3.2% to 2.8%. The reductions in the growth outlooks were attributed to a "delayed recovery in consumption and a less pronounced boost from net exports". We have highlighted the rising inflationary pressures facing the UK economy in many previous monthly missives and this now combined with the slowing growth outlook renews the spectre of stagflation.

What is very interesting to us though is that aggregate growth expectations for the S&P 500 and the FTSE 100 – as measured by cumulative sales forecasts of the index's constituents – remain strong. Clearly, each index has material exposure to overseas sales and notably prices in a depreciating base currency, but nevertheless one cannot help but feel that this indicates that the macro headwinds have not yet fed-through into analyst models. This could imply that earnings revisions could lose a lot of momentum in the coming months.

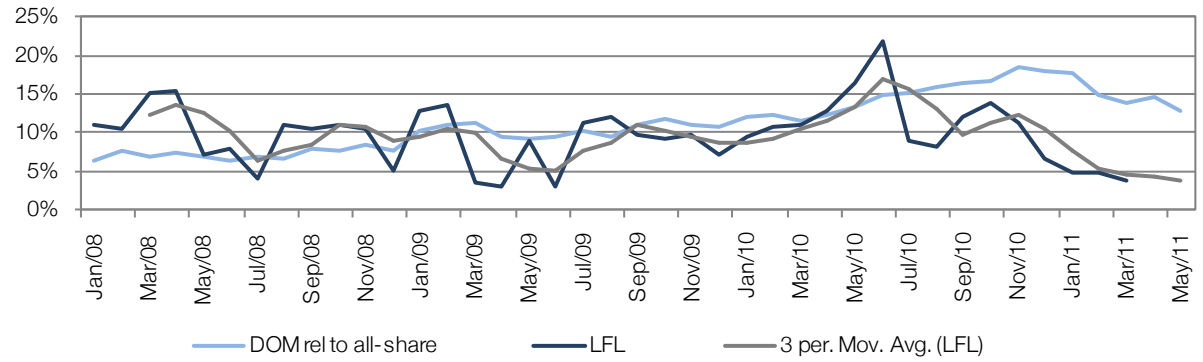
Exhibit 6: Analysts still seem bullish on growth



Source: Bloomberg

Regular readers will be familiar with our watch-list of UK 'go-go' stocks: Ocado, ARM, Supergroup, ASOS, Abcam and (until recently) Domino's Pizza. So-called because of their racy valuations, these stocks are a throw-back to the dot-com era when investors craved growth. With ASOS and ARM on 59x and 43x FY12 P/E respectively, one cannot help but feel that it will end in tears once again. Domino's has shown how unforgiving the market can be when such high growth expectations are not realised. Exhibit 7 shows Dominos' monthly like-for-like sales (reported retrospectively) compared to its relative share price performance. The June spike in lfl was no doubt attributable to the World Cup and associated promotions, but the writing was on the wall at that time – lfl growth continued to fade through Christmas. Domino's growth failed to buck the trend and the shares have under-performed the all-share index by 30% in the intervening period.

Exhibit 7: Case study: Domino's Pizza – what happens when growth slows

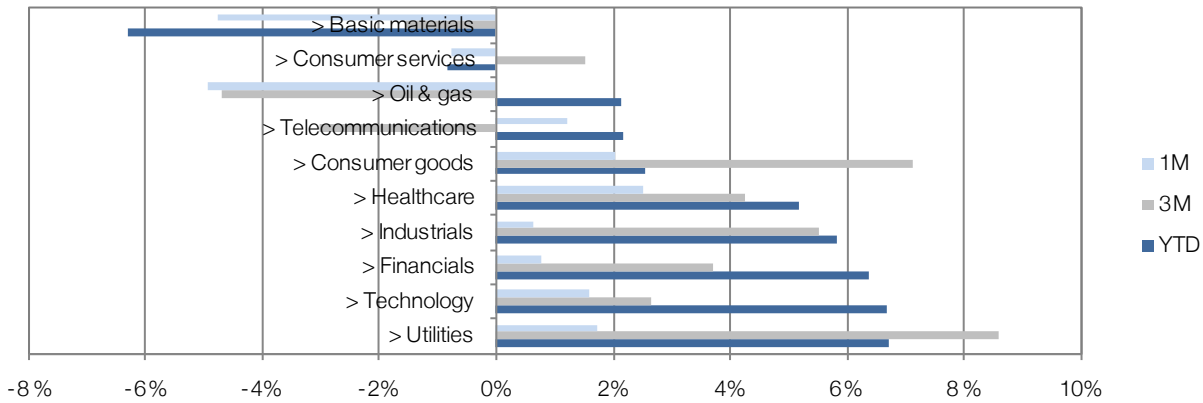


Source: Dominos, Bloomberg

UK sector performance to date

The All-Share index has experienced quite broad sector strength year to date, with the basic materials and consumer services sectors being the obvious laggards, a trend that has continued in the last month. Strongest median performers in the last month have been healthcare and, somewhat surprisingly, consumer goods. We would highlight the improvement in the ranking of Telecoms in the last month, a notable reversal of performance relative to the three-month view. Fundamentally we are intrigued by the improvements in the UK telecoms space (especially mobile), as first flagged by Alternative Networks and verified – with conviction – by UK bellwether Vodafone last month. The simple story here is that mobile broadband and smartphone usage have been major success stories and have driven data demand to such an extent that pricing power is slowly returning to mobile operators. We suspect that this trend combined with the defensive underpinning of the sector will attract much more investor interest in coming months.

Exhibit 5: All-Share sector rotation



Source: Bloomberg

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