Illumination: Equity strategy and market outlook

July 2011

Published by Edison Investment Research

Edison investment research

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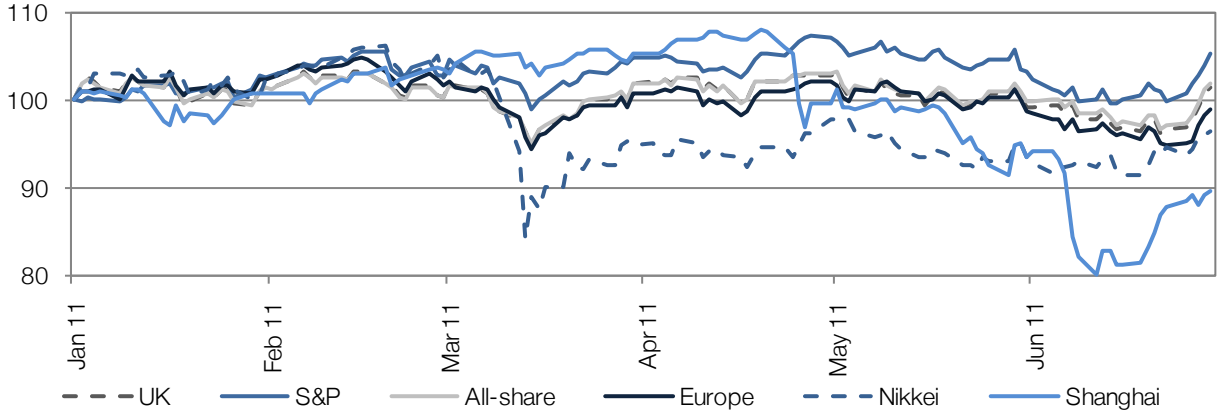
Equity market overview and strategy

- Adam Smith's invisible hand looks to have been elbowed out of the way once again. Government intervention has for some time been apparent in all sorts of diverse asset markets, from cars (via scrappage schemes) to student loans to mortgage-backed securities. The intervention of the International Energy Agency into the oil markets (releasing 60m barrels of oil in June, causing an immediate, if short-lived, 7% fall in crude prices) takes this to another level.
- Macro discussion in the first half of 2011 has been dominated by monetary policy – in particular the US Federal Reserve's quantitative easing (QE) – and its intended (and unintended) impact on bond yields, and equity and commodity prices. While the latest bout of QE might be temporarily on hold, the above intervention shows that there are other ways in which governments can meddle. For investors, this means increased uncertainty – in the short term – about whether asset markets are actually finding their *natural* level.
- With this in mind, it is hardly a surprise that the major stock markets that have seen the best performance YTD are those where the currency has been devalued. Indeed, of the major indices shown below, only the UK and US are in positive territory for the year, despite almost all bourses rebounding in sync at the end of June with the confirmation that a second Greek (or European banking system) 'bail-out' had been ratified. The worst performing index year to date is the Shanghai index.
- In this month's missive we highlight some important developments during the month of June: namely the somewhat waning optimism shown by global purchasing managers, possibly reflecting the notable uptick in profit warnings on this side of the pond, and the continued weakness of construction activity, a key economic driver.
- Our sense is that while ostensibly the 'risk-trade' is back on (with a seemingly monthly periodicity), actual risk levels are extremely elevated. Shares of companies with strong balance sheets, market franchises and low valuations will do best.

Exhibit 1: Market ranges



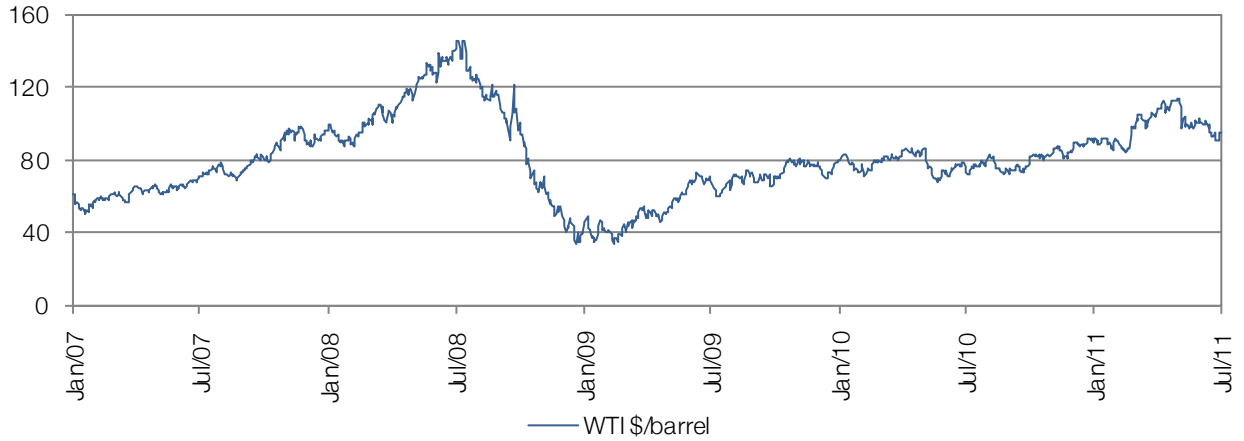
Source: Bloomberg

Global market summary

Priced in local currencies, of the six key indices that we track above in Exhibit 1, the best performing indices this year have been the S&P500 and the main UK (FTSE and All-Share) indices. It is not a surprise to us that the local currencies underlying these indices have also been among the weakest: the big drivers in both cases are the export businesses.

Exhibit 2 below shows the trend of the oil price over the last four years and it is broadly coincident with the S&P index. The actions of the IEA to release 60m barrels of crude from strategic reserves last month certainly took the market by surprise and had an immediate effect of lowering crude futures prices by 7%. The second knock-on effect (which was probably intended) was that it dramatically increased the risk for investors in oil futures. Interestingly, it seemed afterwards as if much of the sector rotation pushed proceeds from these rapid oil divestments into 'safer' US government debt – a convenient consequence given that the Fed was beginning to unwind its QE2 programme. Quantitative easing may take many forms as central banks and governments get creative.

Exhibit 2: Western Texas Intermediate Crude $/barrel



Source: Bloomberg

Suppressing inflation through intervention

Clearly, the IEA's action should remove some of the speculative premium from the oil market in the short term. In fact, it seems as if governments are trying to curtail what might be considered 'undesirable inflation' and any indications thereof. On that note and without wanting to sound too conspiratorial, it is worth highlighting the ongoing increases in silver margins by the Chicago Mercantile Exchange (CME) which has led to silver falling by over 30% at one point in the month. It would seem to us that this is another attempt to stymie the speculative portion of this market – a market like oil, which is seen by many as an indicator for inflationary conditions. On the subject of precious metals, gold (which fell 3% over the month) was topical too when it was reported by CLSA's Christopher Wood that the central Bank of Bank of Belgium has loaned out an incredible 40% of the 216 tonnes of gold bullion in its ownership. A stark reminder, as Wood puts it, "that the paper gold market is significantly larger than the physical market."

Global purchasing managers point to growth, but only just

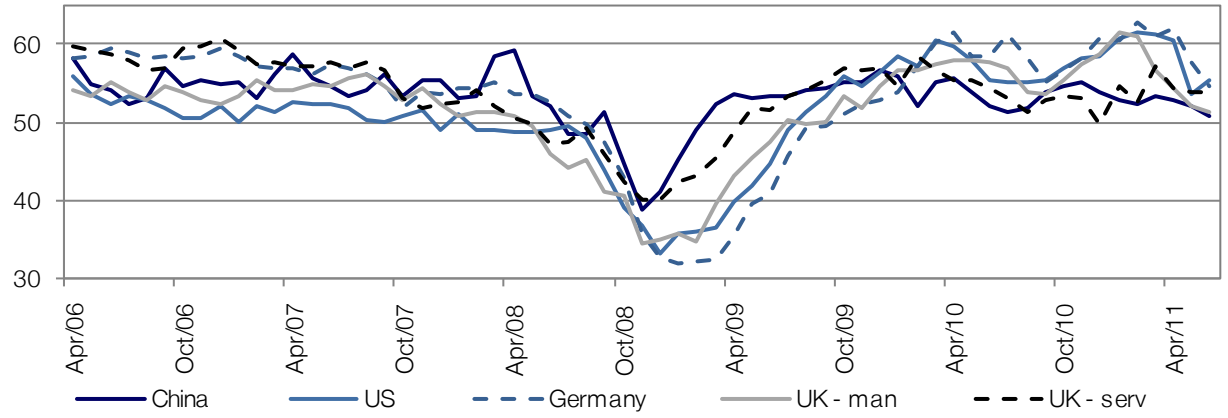
Meanwhile back in the real world, purchasing managers continue to remain broadly positive as represented by the fact that most of the key PMI survey indices continue to remain above 50, implying expansionary outlooks. The relative decline in Germany's PMI is possibly indicative of a broader euro slowdown, however. Consensus, ever the optimist, seems to be of the view that the gradual slowdown of the indices is in fact encouraging and

supportive of a 'soft landing' scenario. The reality is probably more that these PMI surveys do not have great predictive power – we mention it to give context on some commonly referred to global metrics.

While the PMI surveys may not be especially predictive, we take more interest in the occasional series of comments from the US survey panel. Here is a selection (and you can see why the US was keen to intervene in energy prices):

- "Prices continue to increase eating into margins which will inevitably impact the long term organic growth outlook for the US."
- "Aluminum pricing, like other commodities I suspect, has really eaten into our margin. Mills and Fabricators alike are increasing their cost, besides the actual commodity. Paper Roll and Film suppliers are adding a temporary surcharge to their goods to cover costs they are incurring. Seems to be getting popular among the bigger players."
- "Our prices are up (asphalt/oil), and the weather is hurting the construction industry right now."
- "Inventory increase to cover any fall out from Japan crisis. Commodities are still pushing up our cost."
- "Business keeps increasing but pricing pressures continue to rise as well. Often we see no valid reason for some of the increases other than trying to improve margins."

Exhibit 3: Global Purchasing Managers (PMI surveys)

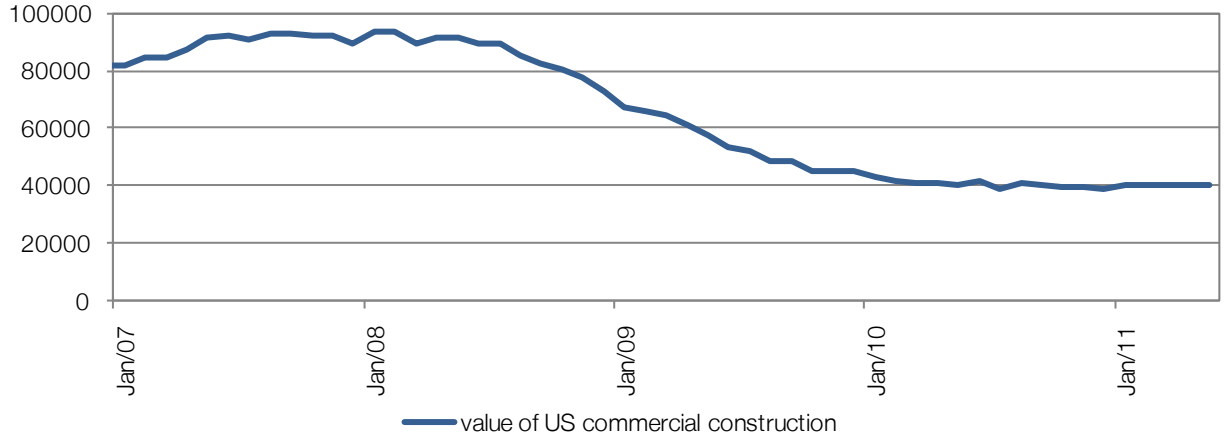


Source: Bloomberg

Q2 profit warnings

By and large there are two trends in the US corporate world; the exporters are enjoying a revival helped by 1) the weak US dollar and 2) global demand trends in emerging markets. However, businesses exposed to indigenous sectors, such as consumer retail (especially mid-market players) and construction, are continuing to struggle. Exhibit 4 below shows the extent of the decline in the US commercial construction market since 2007. Many will argue that this trend is well known in the market and is 'in the price' of the affected companies. Nevertheless, for companies with high fixed costs (especially debt) taken on at the top of the cycle, the chart shows that they are unlikely to grow their way back to previous profitability levels any time soon.

Exhibit 4: US commercial construction



Source: Bloomberg

A similar situation exists in the UK. Data from the Office for National Statistics show that orders for construction work fell 23% in Q111, the largest fall in almost 25 years. Ominously, the value of new orders also had the biggest ever fall quarter on quarter since 1987, which led to speculation that the UK construction sector could be entering a double-dip after its shortlived recovery since 2009.

Q2 profit warnings

Notwithstanding the aforementioned strength in the UK stock markets, we have noticed a sharp increase in the frequency of profit warnings in the UK and Europe in the last month. The list below gives a flavour of the sectors being affected. It is clear that the UK and European consumer is in retreat with clear evidence of 'trading-down' affecting many consumer electronics companies, in particular:

- Chartered International (UK-based global engineering)
- Philips (Europe-based global Lighting & Electronics conglomerate)
- H&M (Europe-based fashion retailer)
- Akzo Nobel (Europe-based global chemicals manufacturer)
- Cable&Wireless (UK/global telecoms)
- Imagination (UK-based global semiconductors)
- Wolfson (UK-based global semiconductors)
- Kesa (UK-based electronics retailer)
- Ocado (UK-based online grocer)
- TomTom (Europe-based global electronics manufacturer)

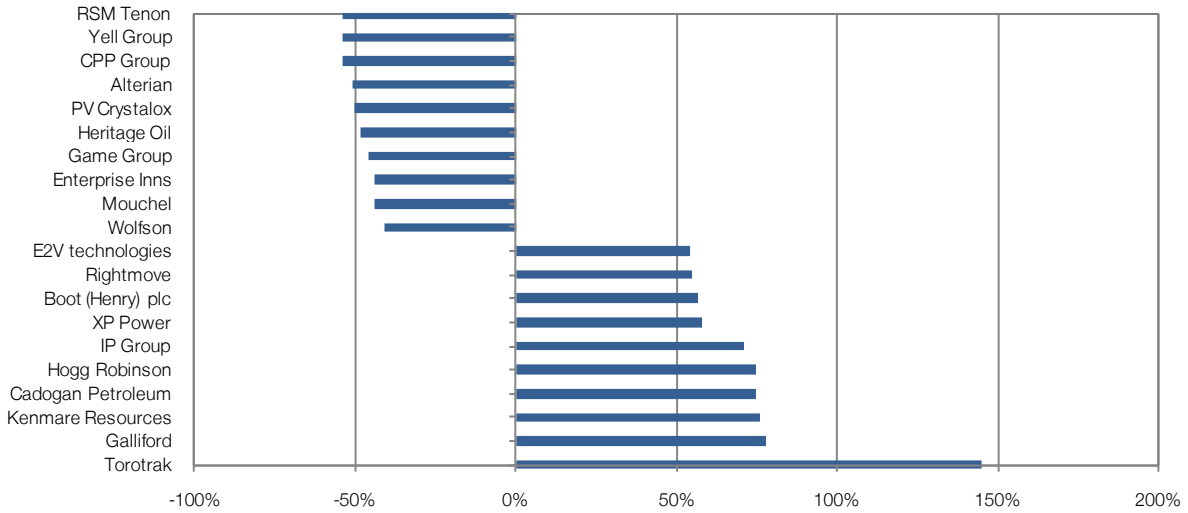
UK spotlight – inflation steady in May

UK inflation held at 4.5% in May, another month in which the CPI has overshot the Bank of England's 2% target. Presumably it is deemed to be more important to devalue the pound than to retain its pricing power. Notably, Food and Fuel prices continued to rise, up 1.3% month on month with a balancing effect from lower transport prices in the index's basket despite transport remaining the largest constituent within the index (accounting for 1.29 percentage points of the 4.5% increase).

Exhibit 5 shows the best and worst performers YTD of the All-Share index, as you would expect a disparate group of businesses with largely company-specific reasons for their rankings. Many of the best performers are

energy-related, although Galliford's performance has bucked the trend in UK construction. At the other end of the spectrum, Yell Group stands out, down 44% YTD and the travails of 2011's worst-performers Game Group, Enterprise Inns and Mouchel have been well documented. Given the uptick in M&A in the technology space, the collapse of Wolfson's share price (largely reflecting key customer RIM's woes) means that, on about 1x prospective EV/sales, there is value emerging.

Exhibit 5: All-share performance YTD, best and worst performers

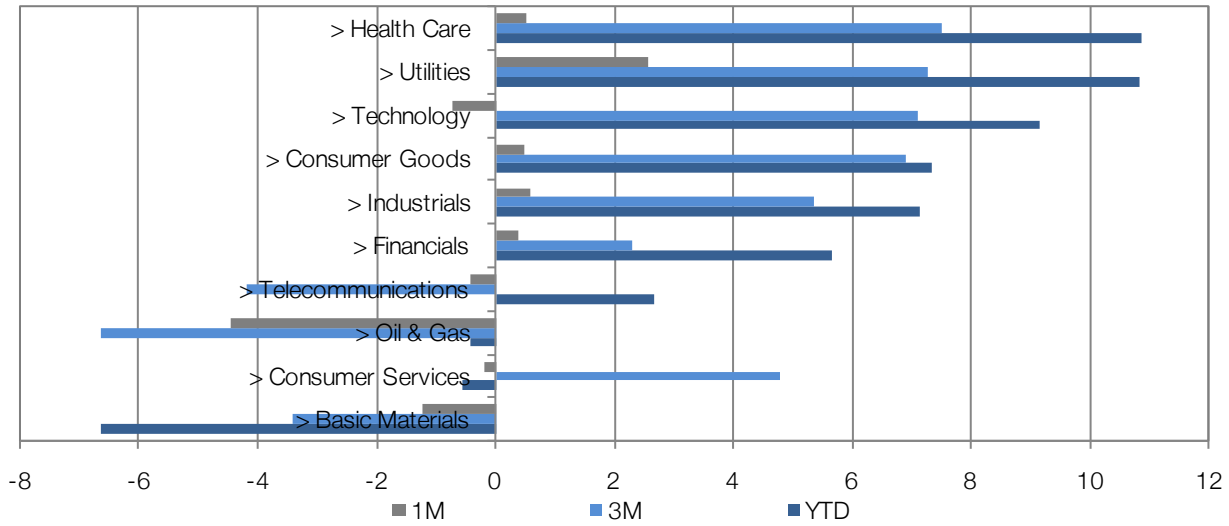


Source: Bloomberg

UK sector performance to date

Sector-wise, we see a continuation of the trend from last month in the All-Share index. Defensive sectors remain in vogue, with healthcare and utilities both leading the charge. Technology also remains strong (possibly due to its relatively smaller size; the sector performance is being skewed by some individual stocks such as ARM).

Exhibit 6: All-share sector rotation



Source: Bloomberg

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