Illumination: Equity strategy and market outlook

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Global perspectives

- European policymakers have finally announced their response to the eurozone credit crisis. All of the measures had been well-trailed in the media prior to the leader's summit and possibly the only surprise was the strength of the equity market reaction. Credit markets yawned and the spread between Italian and German government bonds continued to widen post-announcement.
- The shock announcement by Prime Minister George Papandreou of his intention to hold a referendum is clearly unhelpful as it puts into sharp relief Greece's political divisions. At present the intention appears to be a vote on Greece's membership of the eurozone as well as the €130bn rescue package on 4-5 December, although this would appear to presume no loss of confidence in Papandreou's government in the meantime. This is an evolving situation and uncertainty remains high.
- During October European equity markets rose by 8% while the S&P had its best October for a decade. We have been consistently highlighting the unusually low valuations of non-financial European equities during the market declines. However, with the negative surprise of the Greek referendum we are wary of chasing the rally in the near term.
- Share prices over the past month have risen especially sharply in the riskiest sectors – banks and basic resources. But with eurozone swap spreads still at highs not seen outside the peak of the 2008 credit crisis, the stress in the inter-bank markets remains severe. In addition, the emphasis on fiscal consolidation, a key part of the accord announced last week, will keep downward pressure on troubled economies. As a group, Greece, Italy, Portugal, Spain and Ireland face a further fiscal tightening of nearly 2% of GDP in 2012 according to IMF estimates. The supposedly offsetting plans for growth remain nebulous.
- Though market commentary remains fixated on the eurozone, in our view an equally important driver for world equity markets is US GDP growth. 2011 GDP growth estimates have fallen most sharply in the US, not Europe, over the summer. However, the most recent economic data has failed to confirm earlier fears of a collapse in US growth and the S&P has rallied to within 5% of its high for the year. Medium-term US equity market valuations look stretched once again.
- A closer examination of the export and investment surge in China adds weight to our view that Chinese growth expectations are at significant risk of disappointment. China's construction market is the world's largest. Slowing Chinese growth would significantly lower demand for raw materials and would also affect the basic industries sector. However, lower commodity prices would be welcomed by Western consumers and increase the scope for further monetary easing. This sequence of events would be supportive for US and European equity markets and gold.
- We continue to see value in the equity market although the recent gains have been substantial and progress from here is less likely to be in one direction, especially after the Greek referendum shock. Uncertainty remains high, but for the medium-term investor a focus on quality should be rewarded as European and UK equity market valuations are still significantly below long-term averages.

EU policy statement in line with lowered expectations

With so many possibilities being floated it has made little sense to attempt to trade policymaker's actions over the last few weeks. We now have a statement that is in line with the more modest expectations set when Germany ruled out using the ECB to finance government deficits, at least for now.

In the statement fiscal consolidation is the first matter addressed. Cutting government spending when activity is stagnating and unemployment is high is undesirable as it tends to crush the prospect of a near-term recovery. But the die is cast; the statement makes clear nations experiencing tension in sovereign debt markets will need to be seen to be making progress on fiscal consolidation in order to qualify for financial assistance. Spain and Italy are the only nations mentioned in this part of the text.

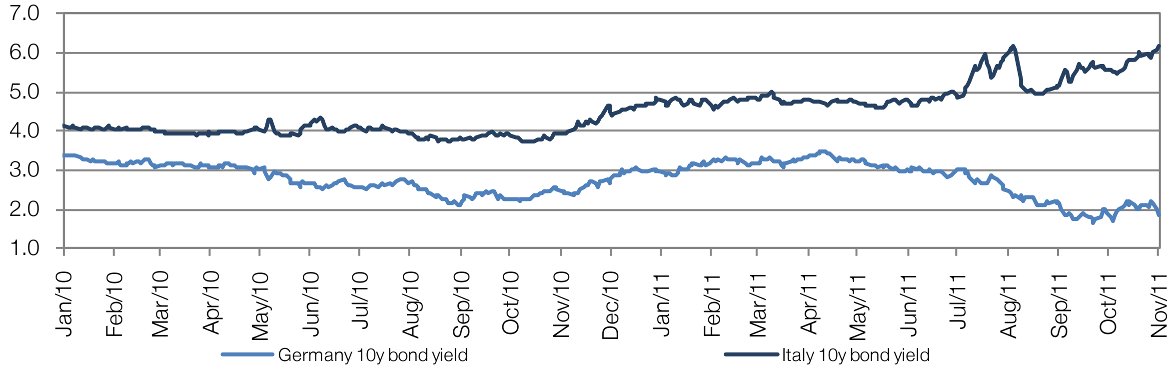
Ireland and Portugal are deemed to be making good progress towards the goal of sustainability. Greece is however still waiting for a credible EU-IMF plan to be delivered by the end of the year. An unfortunate implication is that nothing presented to date has been credible. 50% haircuts on private sector holdings of Greek debt have been agreed. The statement re-affirms that as far as private sector involvement is concerned Greece "requires an exceptional and unique solution".

In terms of the EFSF the purpose is to support member states that are no longer able to access market funding. As the crisis has grown the size of the EFSF has not; the EFSF will therefore be leveraged but without losing its high credit standing. Leverage will be achieved via the use of credit guarantees for government debt and the possible inclusion of private and international sovereign funds in special purpose investment vehicles (SPIVs). These proposals have had only a mixed reception from China in particular over the past few days. With a leverage limit of 5x the total EFSF firepower amounts to a little over €1trn, after subtracting pre-existing commitments from the original €440bn.

In terms of bank recapitalisation a consensus of sorts has been reached on a 9% Tier 1 capital ratio following more realistic stress tests, which include write-downs on sovereign debt. The European-wide bank capital increase under this scenario is estimated at just over €100bn in total, somewhere between one-half and one-third of what independent analysts deemed necessary. It is possibly unfortunate that national regulators have been tasked with ensuring that excessive deleveraging is not the end result of this initiative; governments, national regulators and their regulated banks have every incentive to hope other member states will do the heavy lifting of recapitalisation.

The equity market response following the announcement was nothing short of euphoric, which was remarkable given that markets had already risen significantly from the lows of September. However, the acid test is the credit market and here nothing has changed. Inter-bank funding markets remain stressed and the spread between Italian and German government bonds has continued to widen. We believe eurozone credit risks are just as high as a month ago; what has changed is that rising equity prices leave significantly less value on the table.

Exhibit 1: Italian/German government bond spread



Source: Bloomberg

Greek referendum – the wrong kind of shock and awe

Greece accounts for less than 3% of European GDP and a similar proportion in terms of population. Its total debt outstanding amounts to approximately half of Lehman Brothers' debts when the firm filed for bankruptcy. Yet the similarities with other indebted European nations have leveraged its impact many times over. Papandreou's call for a referendum may have been driven by national politics, but the effect has been global.

With a Greek referendum on membership of the eurozone scheduled to take place on 4-5 December the Pandora's box of competitive devaluation versus austerity has been opened. At the outset, opinion polls suggest a majority of Greeks wish to stay in the euro. Furthermore, without external financial support, a vote against the euro would represent disaster for all Greeks living on euro-denominated state benefits. For both these reasons the referendum, if it happens, would be likely to support remaining in the eurozone. Following a positive referendum EU-IMF support would be re-instated by mid-December, theoretically in time for a €12bn government bond re-financing.

This is an evolving situation – it is not at all certain the Greek government will survive the coming weeks. The most likely scenario (a strong vote for euro membership and implicit backing for the EU-IMF bailout terms) is benign, but tail-risk protection seems prudent. We are surprised gold has not been stronger.

China – Mr 10% has left the building

Over the past 20 years China has made enormous progress. The rate of urbanisation is unprecedented and the increase in GDP per capita dramatic. What is less well-known is maintaining the rate of economic development has required substantial changes to the components of growth, shown in Exhibit 2.

In the mid-1990s, rising real incomes and domestic demand drove GDP growth of 10% per annum. Exports were not a major factor in the nation's development and the contribution of fixed asset investment was high but not atypical of an industrialising nation.

Following accession to the WTO in 2001, export and investment growth became the key drivers of GDP. When export markets collapsed after the 2008 financial crisis, China embarked on a large stimulus programme led primarily by increased lending to state-owned enterprises (SOEs).

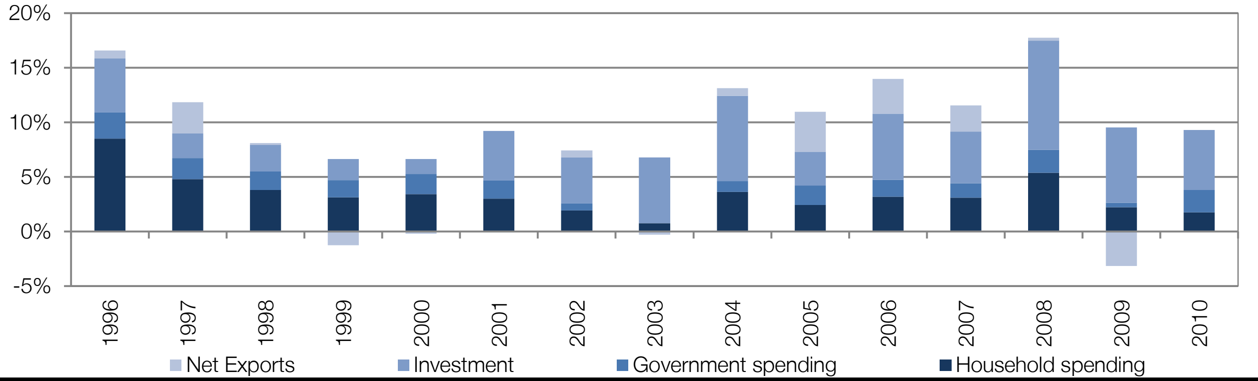
In a planned economy it is instructions rather than incentives that are the instruments of power; the money supply accordingly surged by 30% to finance new investment activity. Investments accounted for 48% of GDP in 2010 and more importantly 60% of GDP growth. Increased investment activity has offset almost exactly the decline in export activity since 2008.

Even before the implementation of the stimulus package many of China's basic industries were believed to be suffering from significant over-capacity. In addition, both land prices and construction (by no means depressed before 2008) surged to levels that now appear indicative of irrational exuberance at least.

Despite making public its intention to move to a more consumption and services led growth model as long ago as 2004, China's growth model is more reliant on investment spending than ever. One wonders whether the positive aspects of a centrally planned economy – namely the ease with which large pools of resources can be marshalled – are crowding-out the inherently randomly distributed intellectual assets that, if left unhindered, could evolve into a stronger service sector and diverse consumer culture.

China no longer even aspires to growing at the 10% rates of the past, as the current five-year guidelines make clear. Our concern is the pattern of recent economic development makes even the 7% target subject to significant downside risks. Mr 10% has left the building, half-finished.

Exhibit 2: China - Contribution to GDP growth



Source: China economic information network

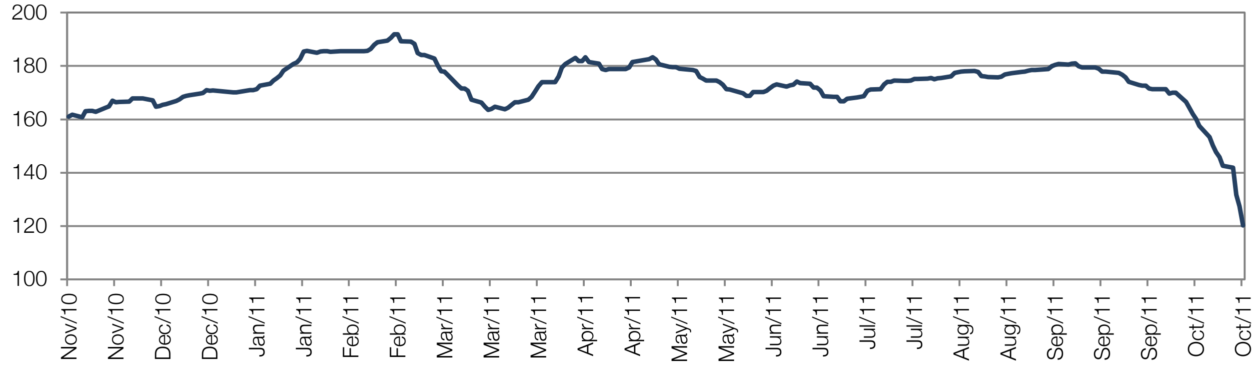
Timing is everything

Within China itself most of the indicia of an economy-wide investment bubble are present, with the notable exception of a dramatic build-up in mortgage debt. Recent statistics indicate >50% year-on-year declines in residential transaction volume in major cities (and reports of buyers angrily storming developers' offices when they realise they have bought before bulk discounts of up to 30%) would appear to indicate air is coming out of the bubble.

If the debt statistics are a fair reflection of the real debt position we should expect this to be a slow process and those overexposed to property will suffer poor returns on their investment over a long period of time rather than an abrupt crash. A corrective recession in construction activity with its attendant impact on commodity demand would of course be expected in the circumstances.

While the market has been focused on the eurozone credit crisis, the Chinese spot iron ore market has fallen precipitously during October, Exhibit 3. Whether this is indicative of a structural issue or is instead merely a cyclical slowdown remains uncertain. However, it is a big move, which, if sustained, will affect the near-term earnings of the major iron ore producers.

Exhibit 3: Spot iron ore



Source: Bloomberg

China: Strategic implications for investors

From a macro perspective we have become increasingly concerned about the rising investment share of China's GDP growth. Investment has continued to grow at double-digit rates despite evidence of over-capacity in many industrial sectors. Almost all the indications of a housing bubble are apparent – with tightening credit and declining transaction volumes the housing market could be at Kindleberger's stage of "financial distress".

With Chinese equities at only fair value on the basis of the (limited) valuation data we have, the recent underperformance of the market does not make it a bargain from a top-down perspective. On a relative basis European or even Japanese equities look more attractive. Both these markets trade at significantly cheaper levels than their long-term averages.

For commodities we believe that strong Chinese growth, weak developed market growth and ample monetary accommodation supportive of commodity speculation are sometimes taken as long-run certainties. We believe this is far from the case. An alternative scenario of weaker than expected Chinese growth and lower commodity prices leading to improved real incomes in developed economies is quite plausible, in our view.

From a strategy perspective we believe European basic resource equities are no better than fair value despite their compressed earnings multiples. A proper Chinese construction bust would have deflationary implications. Commodity prices would be expected to fall significantly and we believe the market is right to recognise the risks.

Edison's full report on China's export, investment and real estate challenges is available for institutional clients. Please contact gjones@edisoninvestmentresearch.co.uk for a copy.

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