Illumination: Equity strategy and market outlook

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Global perspectives: Prepare for every possibility

- The pressure between the irresistible force of financing unsustainable developed market debt and the so far unmoveable object – the soundness of money – is increasing. These are uncomfortable times for investors as the linked sovereign-bank-monetary infrastructure in so many nations is being called into question.
- Being in denial is no response. Nor is sitting on cash, which is likely to earn a negative real return for an extended time, while at the mercy of as yet unknown effects of further QE. Unsustainable household and government debt burdens, which have built up over decades, will remain a big part of the investment landscape for the foreseeable future.
- While both the short and long end of money markets have been severely distorted by zero interest rates and unconventional monetary policy, equity markets have not. In our view, a 10-year de-rating means Europe and UK non-financial equities are cheap.
- Stimulative monetary policy and large fiscal deficits may not have returned western nations to their historic growth trajectories, but they have been highly beneficial for large-cap profitability. Our top-down models indicate 2012 non-financial profit margins will remain above average. Although consensus forecasts may be over optimistic at present, we believe this is well known by investors.
- From a regional perspective, we stay focused on core Europe and the UK. The possibility of a break-up of the euro is real, given the reality of capital flight from peripheral regions, a battle that policymakers are currently losing. For this reason we remain positive on gold in euro terms. In terms of sectors, we stick with defensive, quality businesses and balance sheets.
- We struggle to see the merit in highly-rated sovereign bonds at such low real yields. We can certainly 'explain' current prices – quantitative easing and a shortage of bank risk capital are among the reasons. But these artificial supports do not bode well for future returns. Clearly the inability of indebted nations to take financing at rates that rational investors are prepared to offer goes to the heart of the current crisis.
- On the other hand, stress in the credit markets has widened the European corporate bond spread. With interest rates likely to remain low for the foreseeable future, yields over 4% mean investment grade, non-financial corporate bonds are an attractive alternative to sovereigns, in our view.

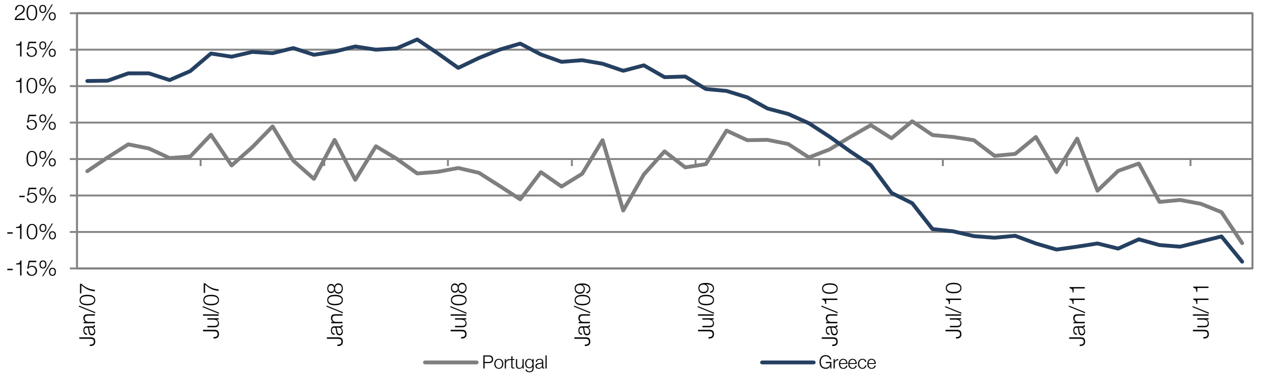
Structural changes to the eurozone still on the agenda

Despite policymakers' efforts, the departure of one or more peripheral economies from the eurozone remains on the agenda. A rapid erosion of bank deposits in Greece and Portugal indicates a breakdown of trust in the euro project, Exhibit 1. High profile business people are openly relocating activities.

Furthermore, credible reports of contingency planning at the Central Bank of Ireland for producing new bank notes (and capital controls in the UK in the event of euro turbulence) are worrisome. Banks are quietly testing systems to prepare for a re-introduction of the Greek drachma.

Spanish unemployment is reaching Depression-era levels of 22% while Ireland and Greece are not far behind, Exhibit 2. Without devaluation, restoring competitiveness requires a long period of nominal wage reductions; it is clear that some investors are deciding the process will ultimately be too painful.

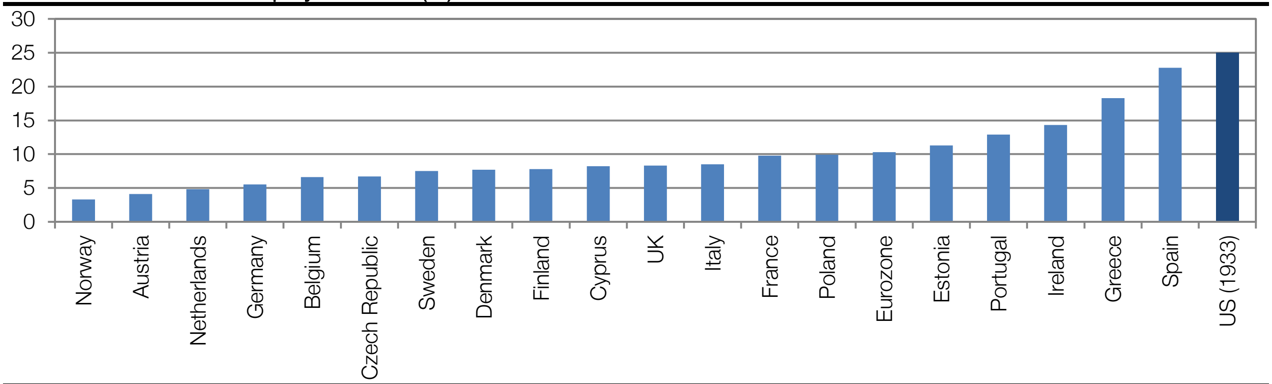
Exhibit 1: Capital flight – bank deposits (y-o-y % chg)



Source: National Central Banks

We see risks in peripheral equity markets as valuations insufficiently discount the austerity-led slowdowns in peripheral regions, let alone a euro break-up. Our equity strategy has always been focused on the core and UK and we see no reason to change this position.

Exhibit 2: Eurozone unemployment rate (%)



Source: Eurostat

Credit stress, capital ratios and deleveraging

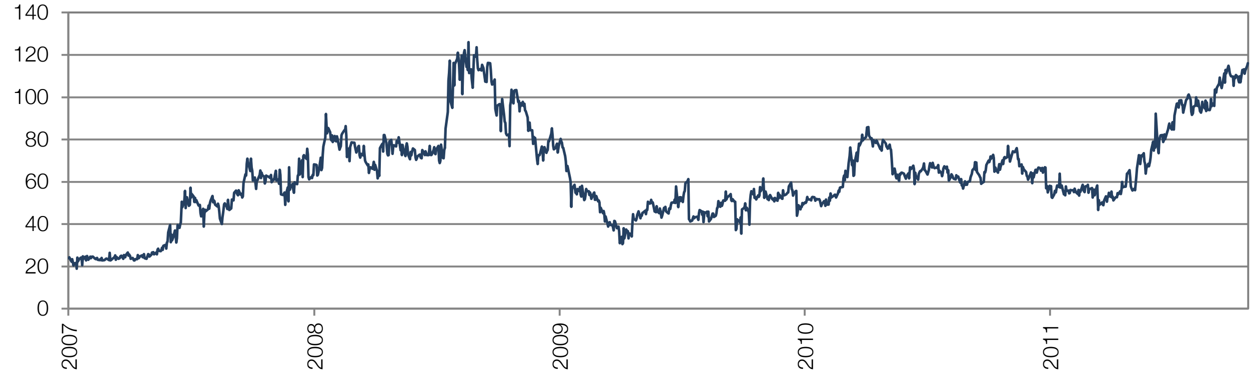
Six months ago a key objective for policymakers was, or should have been, restoring confidence in the banking system. But in early 2012, two-year European swap spreads (which reflect expectations for LIBOR) remain at levels not seen outside the peak of the 2008 credit crisis, Exhibit 3.

Unsecured lending markets remain effectively closed and the eurozone banking system is currently running on a supra-nationalised basis, courtesy of the ECB's collateralised lending facilities.

Yet again the shortcomings of the structure of the eurozone have ensured a sub-optimal policy response. National regulators are responsible for ensuring compliance with the October summit resolutions in terms of bank capitalisation; this has enabled banks to focus on deleveraging rather than capital raising plans, thus creating a drag on growth. In terms of government support, certain member states are in no position to guarantee the liabilities of their banks whose liabilities account for significant percentages of GDP.

The difficulties of raising private capital have been made clear by the €7.5bn Unicredit rights issue. Though the rights were priced at a 43% discount to the then-theoretical ex-rights price, the share price is currently within sight of this, risking leaving the underwriters (ie other banks) with a significant amount of unwanted stock. While unlikely to cause immediate financial difficulties for the underwriters, a failure of this deal may leave governments as the buyers of last resort for bank equity.

Exhibit 3: Eurozone swap spread



Source: Bloomberg

Forecasters have indicated that to meet the capital requirements of Basel III, European banks would have to raise over €200bn or shed €2-3trn of assets. The first figure looks difficult to achieve from the private sector if the Unicredit experience is representative, while the second represents 25% of eurozone GDP.

The scale of the deleveraging will put pressure on households and corporates to reduce debt. Non-core activities seem easier to identify if they are overseas. For RBS it is already clear that a return to utility, UK-focused banking is a priority, to take one example. For equity investors, it would be irrational to expect a strong uptick in M&A in these circumstances – and certainly not of the value-destructive variety that was commonplace before 2008.

In the context of a contracting bank sector, we would expect more speculative (and capital intensive) lending activities to be disproportionately curtailed. We would therefore focus on companies that have strong balance sheets as re-equitisation is unlikely to be confined to the bank sector during a deleveraging cycle.

Forecasting robust but below-consensus profit margins

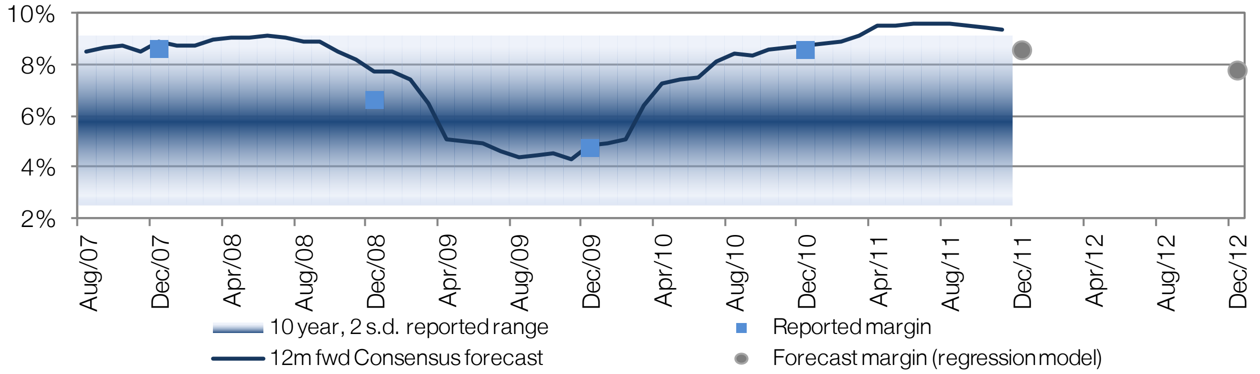
Stimulative monetary policy and large fiscal deficits may not have returned western nations to their historic growth trajectories but they have been highly beneficial for corporate profits. For European industrials we believe 2011 will represent the peak year for profit margins, based on our top-down regression model, which has explained 70% of the variation in margins in prior periods.

Consensus estimates have been falling but are still too high, in our view. However, unless the economic environment deteriorates significantly, we believe profit margins are likely to be above trend in 2012 and corporate cash flow likely to remain strong, Exhibit 4.

A trigger to shift from our lower-beta sector positioning will be consensus forecasts more bearish than that implied by the economic outlook.

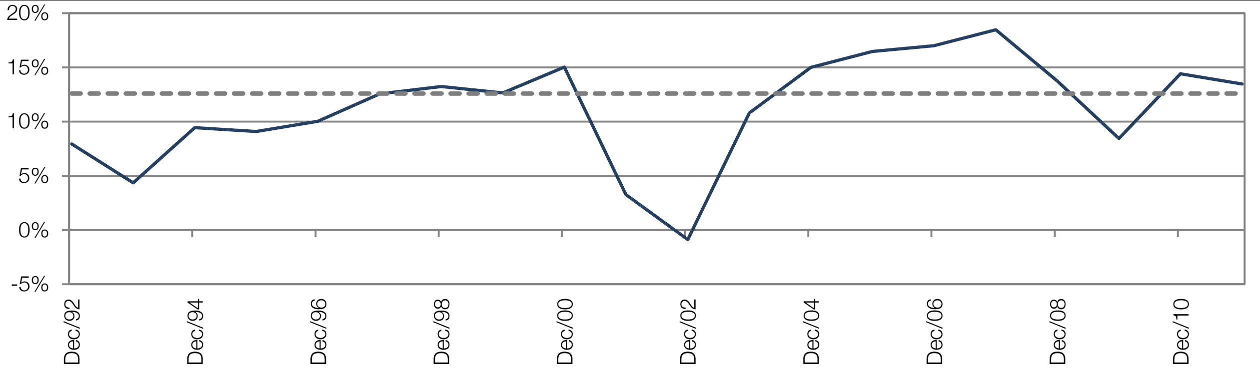
In terms of ROE, listed non-financials (including non-cyclical sectors) did not, in general, gear up their balance sheets during the leverage boom of 2004-2008. Poor returns after the dot-com bubble and over-competition from private equity for M&A targets helped restrain over-investment and deal making. This caution contributed to a strong ROE performance in the subsequent three years, Exhibit 5. We believe non-financial ROE is likely to remain at double-digit levels in 2012, implying strong book value growth.

Exhibit 4: European industrial profit margins – consensus and Edison forecasts



Source: Bloomberg, Edison estimates

Exhibit 5: Eurozone non-financial ROE and median



Source: Bloomberg, Edison estimates

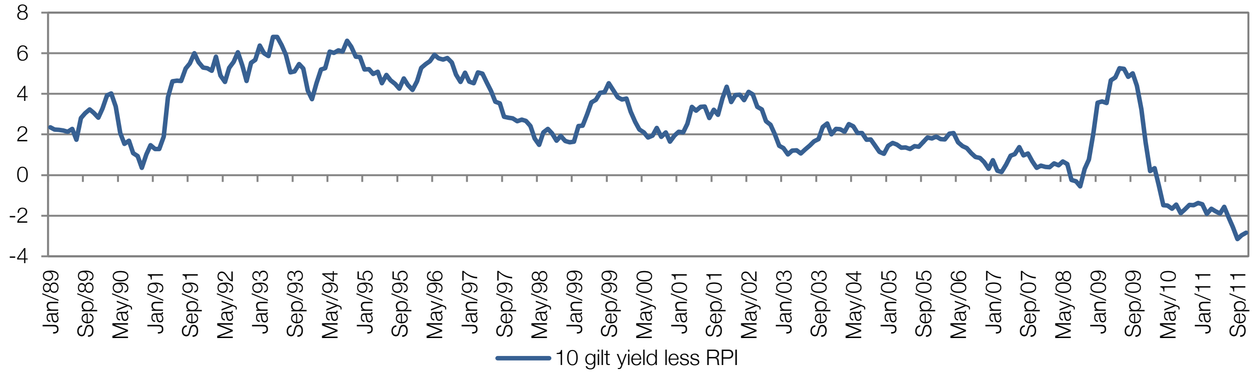
Distortions at the short and long end of the yield curve

Ultra-low short-term interest rates and unconventional monetary policy targeting government bonds have distorted both ends of the risk-free credit markets and the slope of the yield curve. A permanently flat yield curve has adverse implications for bank ROE. In addition, the very large market in money-market instruments is struggling to deliver positive returns after expenses that will ultimately have knock-on consequences for bank funding.

In the UK, yields on 10-year gilts are at exceptionally low levels relative to trailing RPI inflation, Exhibit 6. Since 2008 the size of the gilt market has more than doubled to £1trn. Approximately 40% of the net issuance has been taken up by the Bank of England, with the express intent of lowering gilt yields to stimulate the economy.

At these levels we consider gilts to offer poor medium-term value. A significant downturn in the economy, possibly caused by external factors, could even call into question the UK's fiscal position and counter-intuitively send gilt yields higher, absent yet more QE.

Exhibit 6: 10-year gilt yield less trailing RPI



Source: Bloomberg, Edison estimates

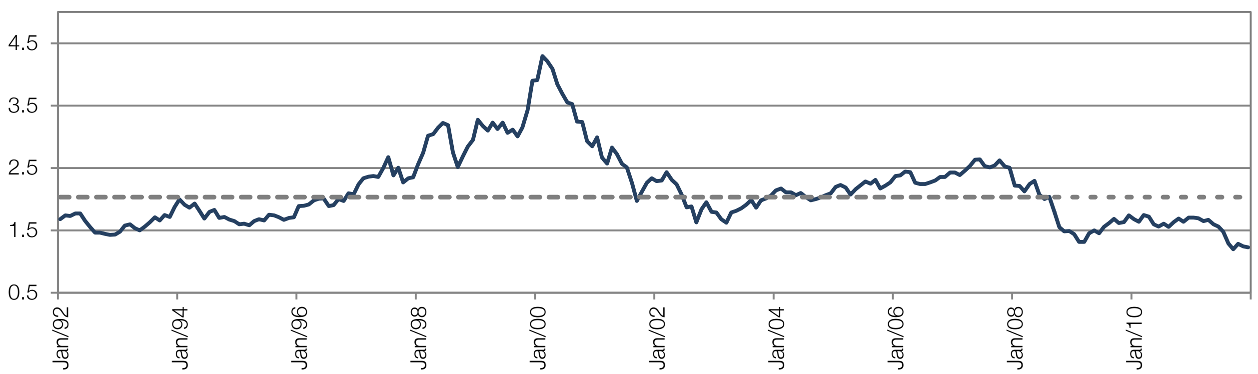
Where fixed income is less obviously over-priced is in the corporate bond market. Here yields of 4% or more are obtainable for non-financial investment grade issuers. Investment-grade corporate bond spreads have nearly doubled to around 200bp over the last six months. In line with our views on return on equity we are not anticipating a significant decline in corporate cash flow in the large-cap space. Non-financial credit quality would therefore appear to be stable. Large-cap leverage is also modest.

At present, the primary risk to corporate bond prices is not fundamental but liquidity driven; if the crisis worsens, these bonds would underperform highly-rated sovereign bonds. For investors able to take liquidity risk, switching away from gilts to investment-grade corporate bonds offers a substantial pick-up in yield.

Equities – valuation points to 10% pa expected return

Value investing is easy in hindsight and a tough discipline in real time. Because of economic uncertainty, on a price-to-book basis eurozone non-financial equities have not been cheaper in the last 20 years, Exhibit 7. Notably, nearly 50% of sales of the Stoxx600 non-financials are from outside Europe.

Exhibit 7: Eurozone non-financials price/book history

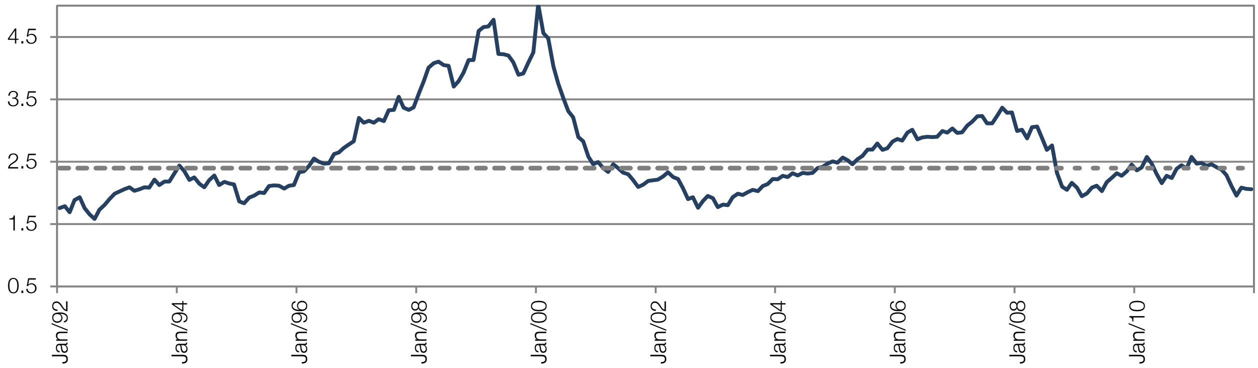


Source: Bloomberg, Edison estimates

Furthermore, the dividend yield of 4.2% on the Dax is near the highs of the last 50 years. In the past, buying at such levels would have led to strong returns. This time is unlikely to be different but we recognise the volatility along the way is likely to remain elevated, which will dissuade many investors.

Similarly in the UK, valuations are at historically attractive levels, Exhibit 8. Often, when price/book multiples are low, ROE is also impaired but this is not the case at present. In our view, large-cap non-financials are benefiting from windfall profitability from the economic policies necessary to keep the economy afloat as SMEs and the bank sector struggle. We do not show P/E multiples as they are (correctly) compressed and overstate the valuation case.

Exhibit 8: UK non-financials price/book history



Source: Bloomberg, Edison estimates

Investors should remain alert to the possibility of windfall taxes on profits and/or dividends. Importantly, moves to limit global free trade or labour flexibility should be scrutinised as this is where multinational corporations have the greatest competitive advantage. There are few signs of material change in these regards at present, but the risk increases the greater the stress on the sovereign.

Our expected return of 10% for European (including UK) non-financial equities is based on a yield of a little over 4% combined with book value growth and a steady return to average valuation levels over the next five years. Around this central expectation is clearly a relatively high level of uncertainty. We therefore recommend focusing on defensive, quality names with strong balance sheets, business franchises and cash flows. In our view, the market is not differentiating between the inherent qualities of such corporates and other, more speculative, issuers and sectors.

In particular, we believe the bank sector should continue to be avoided during the deleveraging/recapitalisation cycle. And, given our concerns on China, we remain underweight on basic materials where, in our view, valuations do not reflect the risks.

Regionally, a focus on core Europe and the UK remains appropriate. Modest valuation differentials do not compensate for even remote chances of a euro break-up. In the more likely event that a euro-break up does not occur, peripheral European economies will still suffer from severe austerity policies.

Gold – reluctantly still a holder

Despite the substantial price gains over the last decade, there are still good reasons to be a holder of gold. Further rounds of quantitative easing are probable, and a break-up of the eurozone possible. Recent gold price weakness has been substantially reversed in euro terms. We acknowledge that the case for gold in US dollar terms is a little weaker, as the metal appears to have been used recently to raise US dollar liquidity into the year-end.

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