

Illumination: Equity strategy and market outlook

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Global perspectives: The cycle within the cycle

- **Time to add beta to portfolios.** Although fundamentals are little changed, sentiment has shifted. If pushed in one direction a positive feedback system keeps going. Our call on equities over bonds has proved correct thus far; we would be adding beta into this rally and moving away from defensive names. Behaviourally, it may be difficult to buy into stocks 20% up since mid-December. Rationally, sentiment has turned and equity valuations are still very attractive.
- **All the structural issues remain – and the market does not care.** This is not the first time a sharp rally has caught bears out. We show that on the way to losing 80% of its value the Nikkei scored at least six cyclical rallies. These rallies were on average just over 12 months long and had an average gain of 40%. More recently QE2 demonstrated the same investor behaviour, leading to a 30% rise in the S&P over eight months. Perhaps, as PMI indices rebound in the US, UK and Europe, this time might be different – but we would prefer to bet that it will not be and that the rally will continue.
- **Not just sentiment.** €500bn of fresh ECB cash (QE by another name?) certainly helps oil the wheels of finance, especially with expectations of more to come. Credit spreads have contracted sharply since the start of 2012 and large-cap bank shares (admittedly counter to our ‘underweight’ view) have risen by 50% or more. It is well known that an over-sized financial system will overlay a positive feedback loop on economic and asset price dynamics; this is currently working in the equity investor’s favour. A surprise gift of low interest rates to 2014 by the Federal Reserve is helpful over the short run.
- **Still plenty to play for.** Eurozone non-financials remain cheap and UK equities are not far behind. In terms of financials, large-cap banks are high risk/high reward and we are now neutral – medium-term value creation looks difficult in the new regulatory regime.
- **But...** Armageddon has not been cancelled. All the long-term debt and demographic issues have just been pushed into the background. Investors need to stick with investing discipline and should not make hockey-stick projections of monetary stimulus-led growth into future periods. Though agreement on a second bail-out has now been reached Greece’s financial position remains precarious.. Furthermore, tensions in the Middle East have once again pushed Brent crude over \$110/bbl.
- **Strategy changes – add beta by buying specialist financials and mid-cap oil & gas.** Specialist financials should benefit where the larger banks have exited businesses. A recovery in credit spreads, equity market volumes and M&A will all be helpful. Please refer to our sales team for specific names under coverage. In terms of adding growth exposure we have some interesting mid-cap ideas from our oils team. These companies offer standalone value and could benefit from M&A or provide a useful hedge should geopolitical tensions increase. We believe bond-sensitive utility positions should now be cut.

If you are going to panic, panic early – add beta now

Since September we have consistently pointed to the value opportunity in equities over highly-rated government bonds. This call is now more than 10% in the money as sentiment has improved.

In early January we urged investors to prepare for every possibility; now the near-term picture is becoming clearer (with a significant caveat discussed later) and we believe it is time to raise the stakes. Behaviourally, it is difficult to buy into rising markets – which is why the move is often prolonged and extends well beyond what fundamentals would justify.

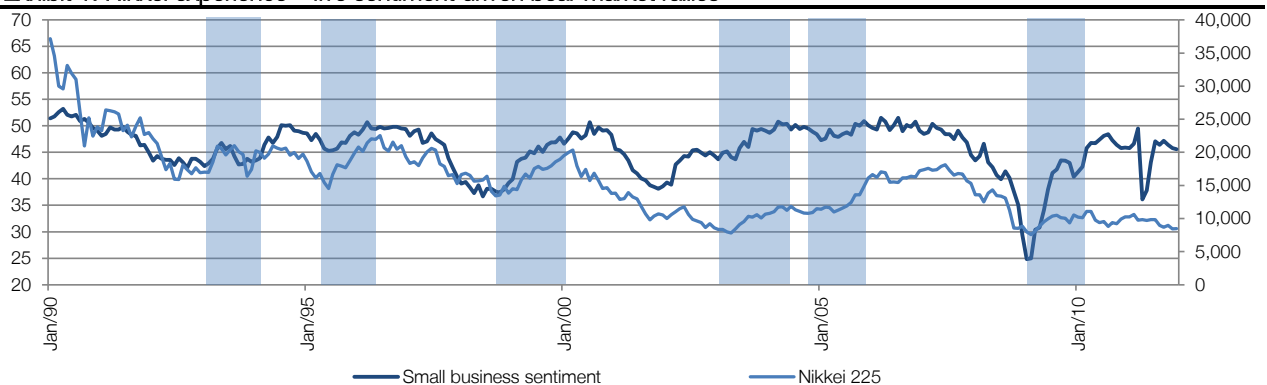
The cycle within the cycle

We have not forgotten that longer-term debt and demographic issues are likely to pressure structural growth rates. But against this demoralising background, which unfortunately will be with us for some time, numerous cyclical fluctuations in growth are inevitable.

Of course it would be a mistake to confuse cyclical growth accelerations with a return to pre-crisis growth rates, in the absence of meaningful technological innovation. That is not what we are arguing here. But professional fund managers cannot ignore the scope for substantial market moves on a cyclical upswing lasting up to a year.

Exhibit 1 shows how the Nikkei, on its way to declining by 80% from the peak, rallied by at least 20% on no less than six occasions over the last 20 years. The average length of the rally was just over 12 months and the average return was an astonishing 40%. We highlight the Japanese experience as the structural and valuation challenges were known to be severe at the time. Yet the market, quite ‘irrationally’, rallied hard into cyclical upturns. The empirical evidence demonstrates the real and painful risk of being short-term wrong.

Exhibit 1: Nikkei experience – five sentiment driven bear market rallies

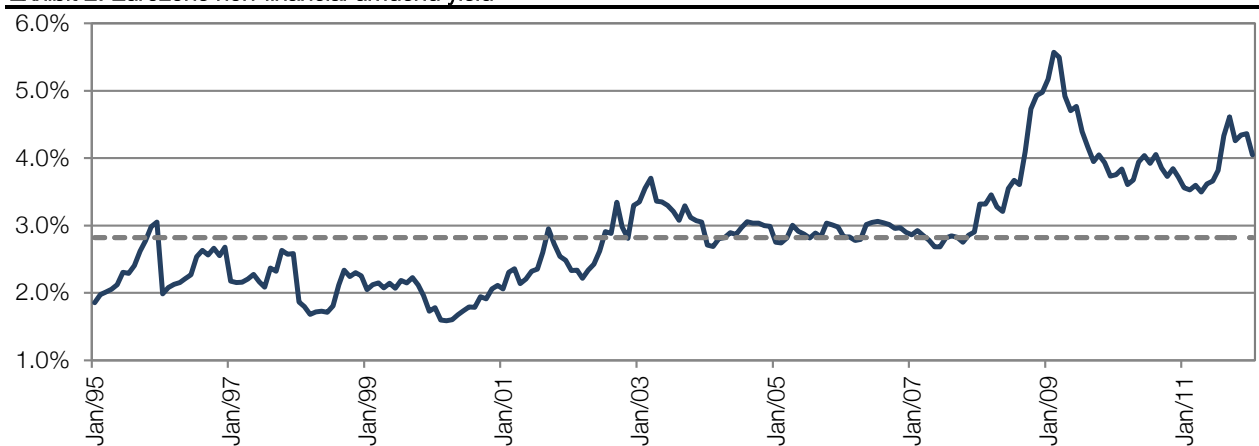


Source: Bloomberg, Edison

Readers of a certain age can probably remember the repeated fiscal attempts to ‘fix’ the Japanese economy in the 1990s followed by the adoption of quantitative easing in 2001. The message is clear – how the story ends may be relatively obvious from the beginning (ie driven by valuation and supply-side economics) but the path is critical to investors; the most recent example the QE2-induced 30% rally in the S&P ending in March 2011.

Before leaving the example of Japan we should of course point out the valuation picture in Europe at present is very different from Japan in the 1990s – investors can currently buy European equities at yields that are both high in absolute terms and substantially in excess of long term ‘risk-free’ bond yields, Exhibit 2. There is still plenty to play for.

Exhibit 2: Eurozone non-financial dividend yield

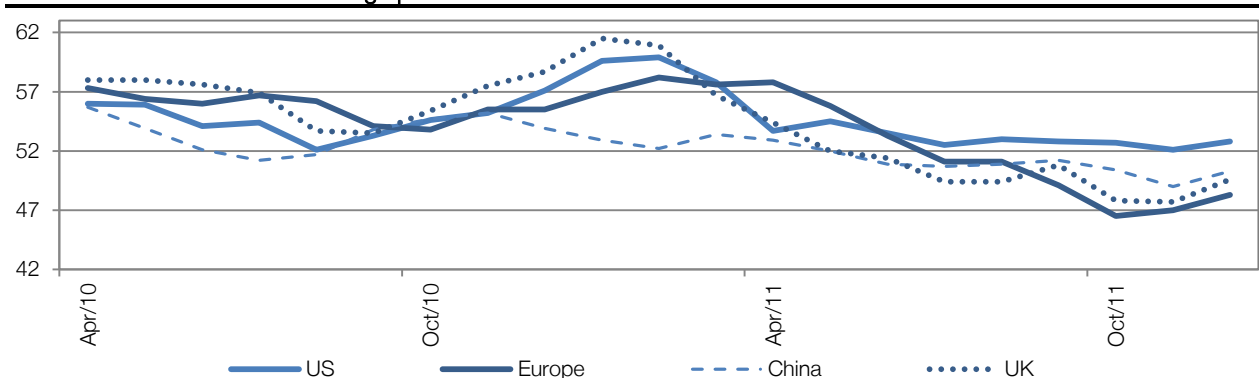


Source: Edison estimates

PMI moving sharply higher – US, eurozone and UK

Exhibit 3 shows that PMI indices have turned in the US, eurozone, UK and China. The US is the key here; employment numbers are finally surprising on the upside. Some of the adjustments in the US are behind us – the housing market has fallen by 30% to affordable levels on a price/income basis and the banking sector is much better capitalised than in Europe.

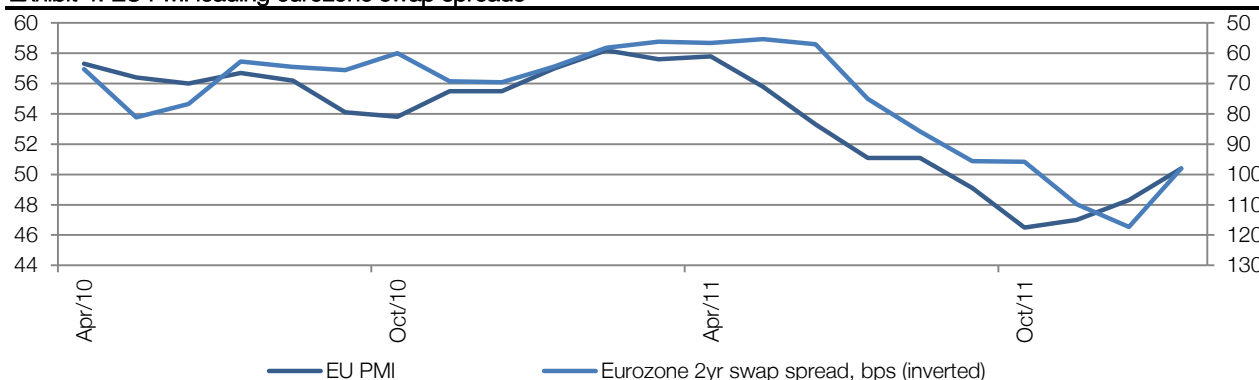
Exhibit 3: Global PMI indices ticking up



Source: Bloomberg

In our view, the market's fears of a meltdown in Europe were driven by the slowdown in global growth. Exhibit 4 shows how the real panic set as growth expectations fell in Q3 of 2011. The triggering of a significant (ie not just peripheral) European debt crisis led to further growth downgrades. With positive growth expectations returning credit stress is falling; the death spiral for now has been reversed.

Exhibit 4: EU PMI leading eurozone swap spreads



Source: Markit, Bloomberg

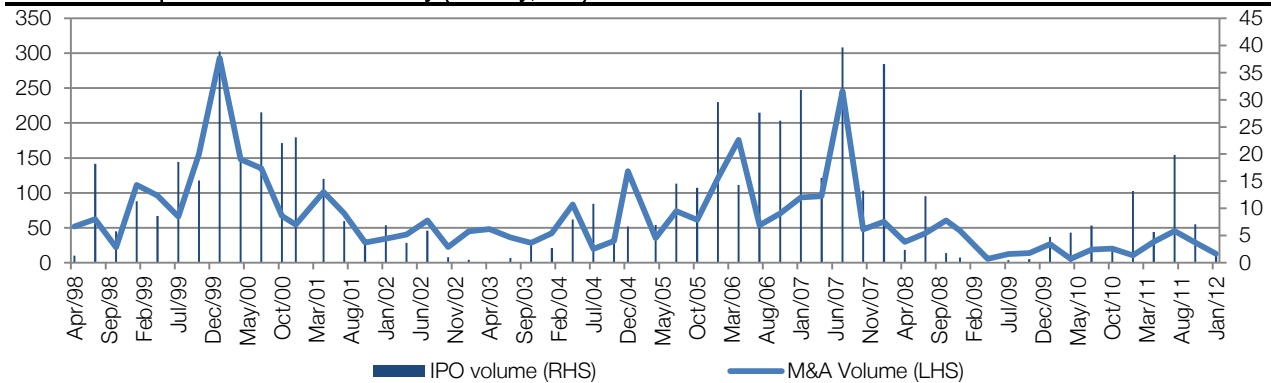
Not just sentiment but hard cash too

€500bn of hard cash from the ECB, with the promise of more in February, has certainly helped ease tension in the interbank markets and €-LIBOR rates have been falling since the start of 2012. Avoiding a banking crisis should have been a priority from the start although it can be difficult to determine (as in March 2009) how much intervention is required.

Although much of the money has ended up back at the ECB (but from banks that did not get the cash from the ECB) there has been a large coincident decline in Italian and Spanish bond yields. There is even talk of banks engaging in sovereign debt carry trades; perhaps MF Global has been forgotten. For now the ECB is ahead of the curve.

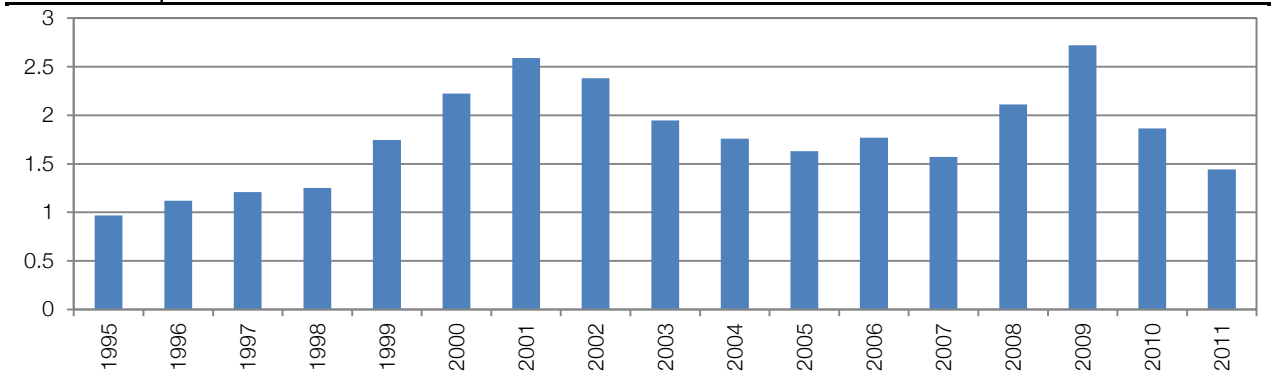
Taking the worst outcomes off the table may provide the confidence corporates require to execute strategic transactions and invest. 2011 saw European M&A volumes decline to decade lows, shown in Exhibit 5. While it is an exaggeration to suggest the corporate sector is 'awash' with cash – stronger balance sheets are an entirely rational response to a weak banking system – the potential to leverage balance sheets to execute M&A is clear, Exhibit 5.

Exhibit 5: European M&A and IPO activity (monthly, €bn)



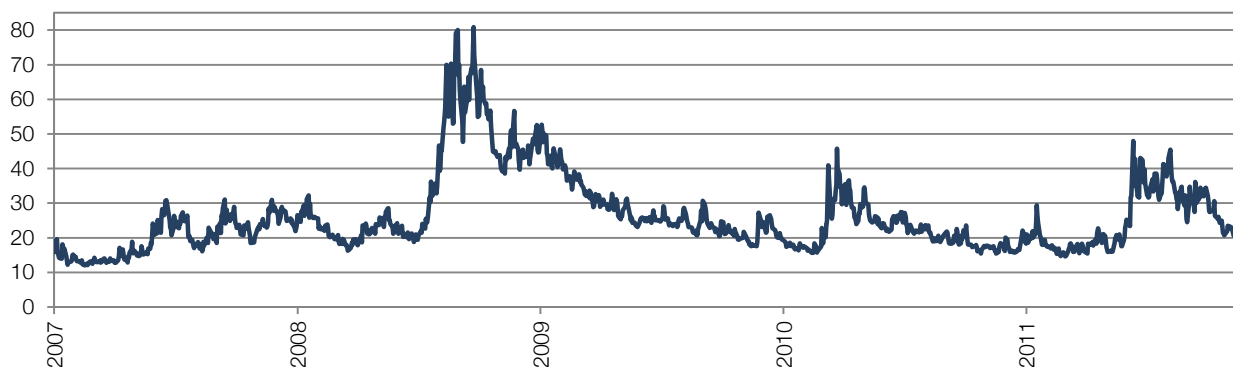
Source: Bloomberg

Exhibit 6: European non-financials – Net Debt/EBITDA



Source: Bloomberg, Edison estimates

Furthermore, high equity market volatility is often blamed for making M&As difficult as acceptable transaction values become harder for executives to determine. We note index implied volatility, measured by both the VIX and VDAX, has fallen back to long-term average levels over the last six weeks, Exhibit 7.

Exhibit 7: S&P index implied volatility – VIX index

Source: Bloomberg

Buts...

There are big butts. Though Greece now looks likely to avoid default in March its financial position continues to look precarious. Nevertheless, even a qualitative application of efficient market theory would have at least some of the impact of a Greek default discounted in the price, given the copious press coverage.

A less openly discussed matter in financial circles is the tension in the Middle East. Here we have negotiations involving aircraft carriers and nuclear weapons. Well-placed Western rhetoric would appear to be preparing the ground for more aggressive intervention. This is a risk that does keep us awake at night as a significant conflict would immediately cause a major economic problem, given the potential for an interruption in oil supplies. Our oils team believe there is already at least a \$10 Iran risk premium in the Brent oil price. Investors may recall that \$130 oil essentially undid the success of QE2 as US consumer confidence fell in response to the higher oil price.

Our oils team recommends a number of mid-cap E&P companies that fit both the cycle within the cycle theme (and a pick-up in M&A) and benefit from higher oil prices. These names are also attractively valued on a standalone basis at present. In the hopefully unlikely but possible scenario of escalating tension in the Middle East, these are likely to remain attractive assets to own and should outperform other types of growth exposure.

Separately, European economic policy remains as uncertain as ever. For example, a call by the IMF to increase bail-out resources was followed by news Merkel was considering running the ESM and EFSF in parallel – followed a few days later by Merkel ruling out increases in bail-out funding.

In January Germany was also a surprise promoter of a relaxation in bank capital rules, pushing for exemptions for European bancassurers and delays to full implementation of Basel III to 2018. But we are not making an investment case based on ever-changing policy. We are focused first on valuation; second on the fact of reduced credit stress and third on increased global survey optimism.

Strategy changes – buy specialist financials and mid-cap oil & gas

In terms of financials we are now prepared to look at some of the specialist financial names that were irrationally sold off during the market decline of 2011. Please contact our sales team for the specific names and an explanation of the investment case. With the larger banks likely to be in deleveraging mode for some time this should open up opportunities for smaller players to win market share at attractive margins.

In terms of oil & gas the potential for a mini-M&A wave among the mid-cap E&P companies is our base case. Investing in likely M&A targets makes no sense if the M&A is in the price. For our selected companies, our oils team believes this is far from the case, given the large discounts to standalone NPV. To fund the switch we would be looking at cutting utility holdings that traditionally underperform in a rising bond yield environment.

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