Illumination: Equity strategy and market outlook

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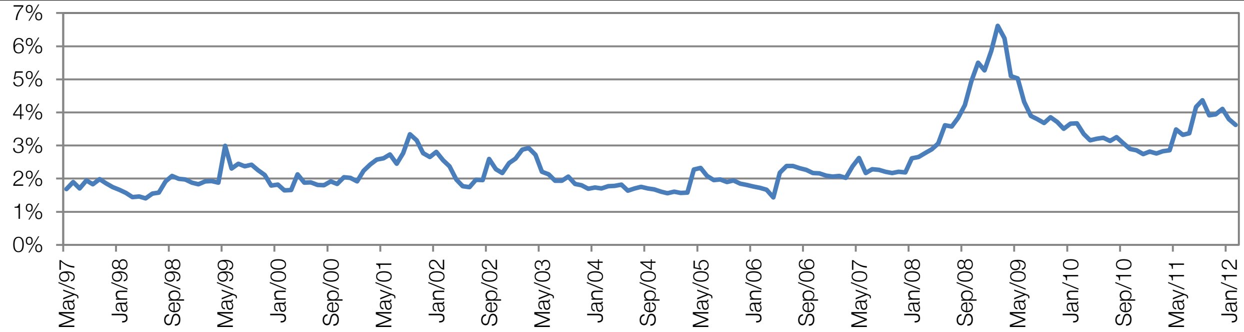
Global perspectives: The bull market in bearish analysis

- **Valuation and yield fends off the bears.** Over the last six months valuation has been the primary driver for our bull case on equities over bonds and cash. In Q4 2011, dividend yields near all-time highs on European indices clearly pointed to the scope for high returns. Valuation was invariably omitted from bearish European equity analysis. Pessimism proved to be wrong again.
- **And where were the bears in 2007?** It seems everyone is now an expert in bank credit risk, sovereign indebtedness and the implications of dysfunctional credit markets. This is a relatively new phenomenon as there has been a 10-fold increase in FT articles discussing these topics since 2008. After-the-fact analysis is not helpful to investors. The increased prevalence of bearish articles may be an example of the "confirmation bias" applied to currently modest European equity valuations.
- **No longer fashionable to be bullish.** The frequency of optimistic articles has also significantly diminished since 2008. We are inclined to argue financial reporting and analysis has become skewed to the bear case. Investors should be alert to the danger of another behavioural bias, specifically the "availability heuristic" or tendency to place greater weight on easily recalled information.
- **Cyclical recovery gains strength.** Tentative signs of recovery in the US labour market should not be ignored by Europe-focused investors. Though not as dominant as in the 1990s, the US still accounts for 25% of world GDP. Recent services and manufacturing surveys are in expansionary territory. Consumer confidence surprised to the upside despite the increase in the oil price. We note also that in the UK, permanent private sector hiring has picked up since the end of 2011, according to the most recent KPMG/REC survey.
- **Sticking with fundamentals.** Our models indicate that current economic conditions are consistent with another year of strong corporate margins in 2012, though possibly not as high as current forecasts indicate. Combined with still-modest equity valuations, the case for equities over cash and bonds remains compelling. Is it still cheap? Yes, but don't expect to get paid twice – the unwind of the eurozone break-up discount was a one-off.
- **March brings normal market turbulence.** After a smooth ride in January and February, volatility returned to equity markets in early March. We believe such volatility is normal market turbulence and reflects a transition to a market driven by prospects for a global economic recovery rather than further quantitative easing. Corporates that have beaten consensus estimates have been rewarded with strong increases in market value.
- **Oil.** It is not the level but the change that is relevant. At current prices, oil is only 10% higher than the average price in 2011. This is not yet sufficient to derail a nascent recovery. The Obama administration appears to be unsupportive of military intervention in Iran and, short of a miscalculation by Israel, the situation should remain only a worry in 2012.
- **Time to be more stock specific**. Successful stockpicking was difficult in H211 due to average correlation coefficients between stocks as high as 0.75. In line with the decline in market volatility, correlations have also fallen. Standout research on individual companies is now much more likely to be rewarded.
- **Strategy changes**. None. Optimal portfolio strategy should benefit the investor and not the broker. We advised adding beta to equity portfolios in our "Cycle within the cycle" note in February and see no reason to change our view.

Valuation – killing bears quietly

Over the last two quarters we have consistently highlighted the value opportunity in large-cap equities over government bonds and cash. Buying assets at substantially higher yields than long-run averages has worked rather more quickly than we anticipated, with markets up over 20% since September.

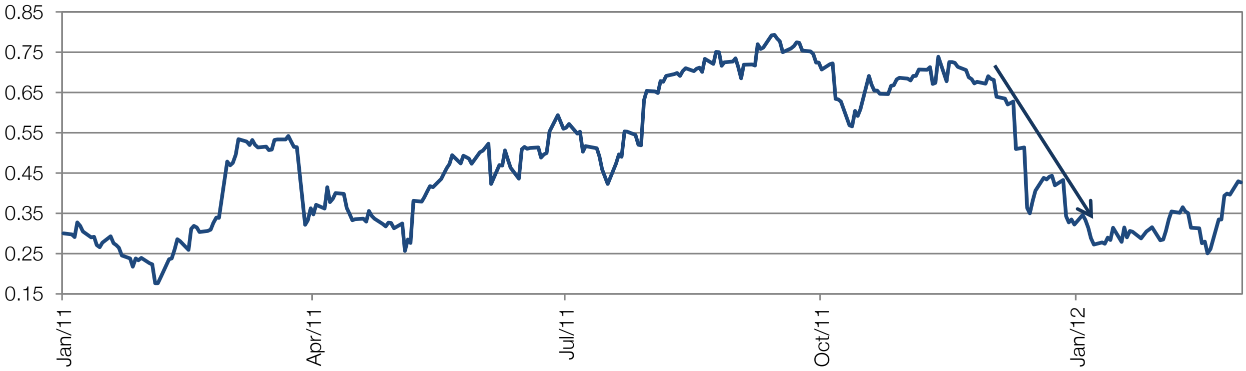
Exhibit 1: DAX dividend yield



Source: Bloomberg

Despite the market increase, equities are still a long way from expensive. The dividend yield on the DAX is still near 4%, twice its recent history and double current Bund yields. Stock correlations and market volatility are falling which will reduce the perceived risk of equities in the eyes of many market participants, thus facilitating the risk-on trade. Provided the recent economic momentum is sustained, the coming months will be a difficult time for structural bears.

Exhibit 2: Abrupt fall in average correlation between European stocks



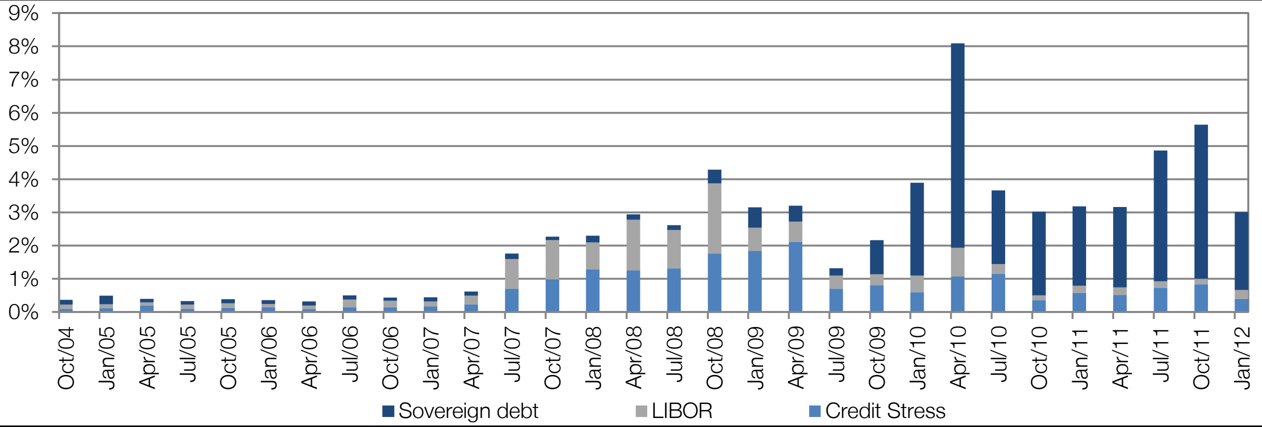
Source: Edison estimates

The bull market in bearish analysis

Though European equity markets have rebounded substantially they are still below the levels of early 2011, despite the prospect of another year of strong profitability and book value growth in 2012. Last month we linked the collapse in M&A volumes to lower market valuations but we also believe other factors may be at work.

There has been an extraordinary rise in bearish commentary since the onset of the global credit crisis in 2008. Examination of the quarterly occurrence of negative phrases such as “credit stress”, “Libor” and “sovereign debt” in FT articles shows a 10-fold increase following the 2008 financial crisis compared to earlier periods, Exhibit 3.

Exhibit 3: Bearish Financial Times articles



Source: FT search engine

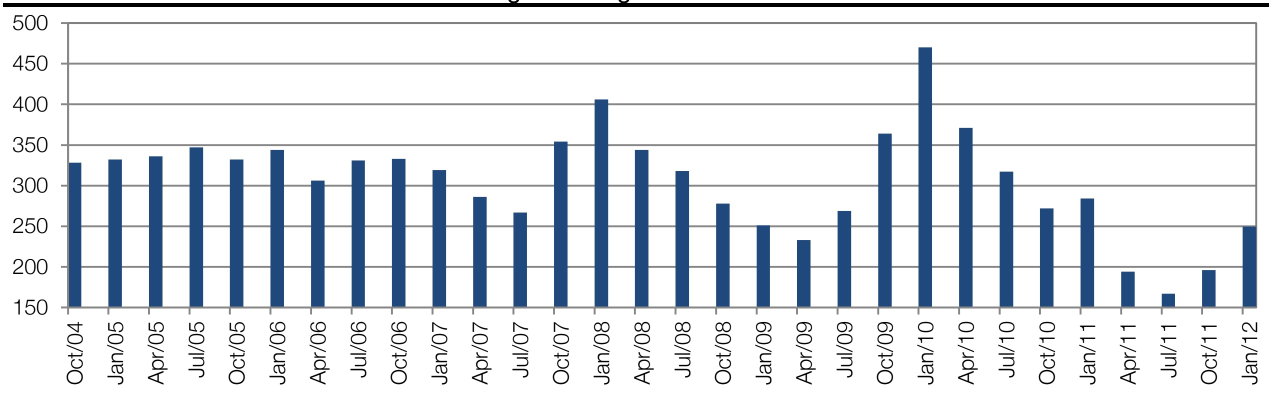
There is clearly no shortage (now) of analysts with very detailed knowledge of the workings of the banking system and peripheral European debt dynamics. It is reminiscent of other strong investment themes such as large-cap pharma (mid-1990s) or dot-com (2000). Almost by definition, once the financial industry has set up the infrastructure to distribute the information, the investment opportunity is over. Notably, before the 2008 crisis – the point of maximum risk for equity investors – a credit collapse remained a fringe issue, discussed only among academics and a small circle of hedge funds.

This was not because the data was not in the public domain. The remarkable rise in US house prices, easily available mortgage finance and the US residential construction boom were a feature of US national statistics. In Europe the ECB was issuing warnings on Greek debt as early as 2005. Even with the relatively obvious link between economic contraction and fiscal deficits post-2008, reporting on excess sovereign debt did not become prevalent until 2010.

However, at present, the risk appears to be in the other direction. The temptation is to maximise analyst return-on-expertise and frame every question in an excess debt/ageing population framework. Articles on bearish subjects have recently accounted for over 5% of the FT's written output, which includes a significant amount of non-financial content.

Avoiding behavioural biases, in this case the availability heuristic (the tendency to over-emphasise easily recalled information) plays an important part in formulating the correct investment strategy. While the empirical evidence from historical debt crises does point to a degree of moderation of GDP growth in future, does this really justify the extensive negative press coverage – and, if so, is it now in the price?

Exhibit 4: Bullish Financial Times articles – "strong forecast growth"



Source: FT search engine

What is left unspoken is often the strongest driver of returns. We note the quarterly occurrence of "strong forecast growth" in FT articles has declined significantly since the period of 2004-2007, Exhibit 4. Negative articles may be crowding out positive developments. A relatively safe prediction is that after the next bull market in equities, the ratio of bullish to bearish articles will have reversed once more.

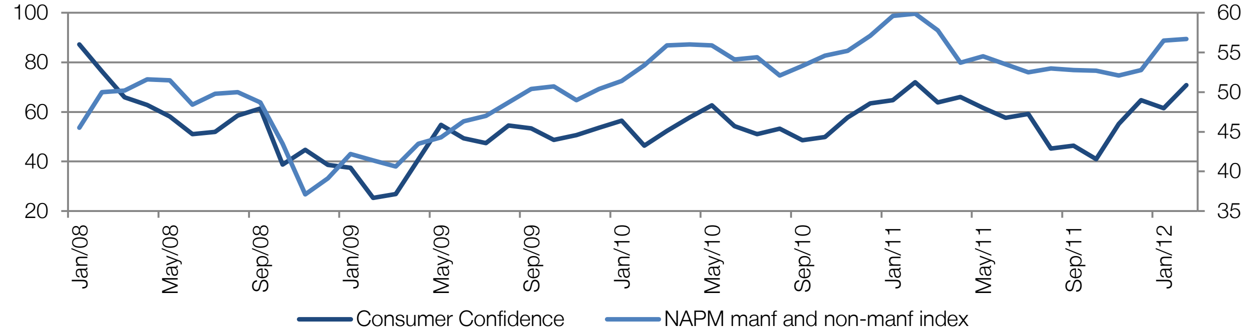
Finally, there is a risk that an enlarged community of bearish writers exhibits signs of group polarisation, or the tendency to converge to the most extreme and potentially unrealistic views. While the tails of the distribution should always be considered as the impact may be extreme (and hedged against if necessary), this should not be at the expense of close analysis of the far more likely outcomes nearer the mean.

Western central banks have thus far successfully avoided both deflationary debt spiral and uncontrolled inflation. Given the tools at their disposal, muddling through at 2% inflation over the next five years is a rather more likely outcome than critics may care to admit.

US cyclical recovery gaining strength

The world's largest economy, accounting for 25% of world GDP, is finally responding to the years of stimulus applied to it. Consumer confidence is touching highs not seen since the onset of the credit crisis of 2008, Exhibit 5. The recent rise in the oil price appears to have had no measurable effect on the US consumer so far.

Exhibit 5: US survey data improving in 2012



Source: Conference Board, NAPM

Furthermore, payroll data has consistently surprised to the upside since November. In reality, private sector payrolls bottomed two years ago and have been rising steadily since.

Purchasing manager's indices have remained strong in February, especially in the services sector, which dominates US economic activity. Again, the recent rise in the oil price does not appear to have had an impact here.

The last piece of the jigsaw is the US housing market, which continues to decline and is now over 30% lower than the peak of 2007. Though US house price/income ratios have returned to more normal levels there has been little incentive for banks to grow lending books while, from a regulatory perspective, short of capital and unable to pay dividends.

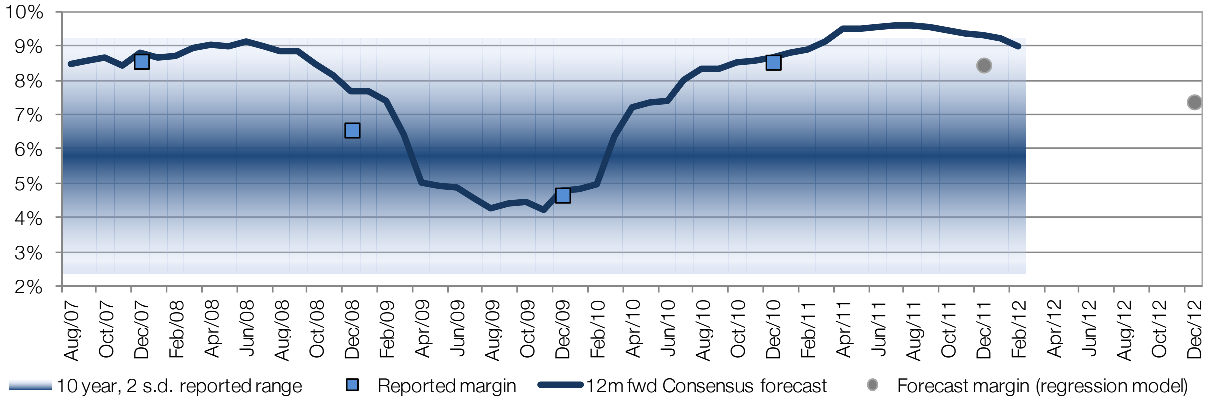
With the publication of the Federal Reserve's most recent stress test results, this is about to change. By signalling that (most of) the large banks now have sufficient capital to pay dividends, the lending spigot may have just been turned back on. Notably, according to the most recent Federal Reserve's senior loan officer survey, commercial loan criteria have been eased over the second half of 2011 and commercial loan demand has picked up strongly in 2012. In addition, residential and consumer loan demand has stabilised over 2011.

We may be entering a period of transition in terms of market drivers. Since 2008 the primary bullish drivers have come from government and central bank stimuli. It should not be a surprise to find the Federal Reserve pulling back from more QE as US growth and credit demand returns. For equities, especially cheap European equities, growth is good.

Sticking with fundamentals – another year of strong margins and ROE

An improvement in European survey data has nudged our cyclical sector margin forecasts higher and consensus earnings forecasts are stabilising. Though the consensus does appear optimistic, we believe that 2012 will represent another year of at least robust margins and returns on capital in Europe, Exhibit 6.

Exhibit 6: Edison top-down EBIT margin forecast and consensus estimates – European industrials



Source: Edison estimates, Bloomberg

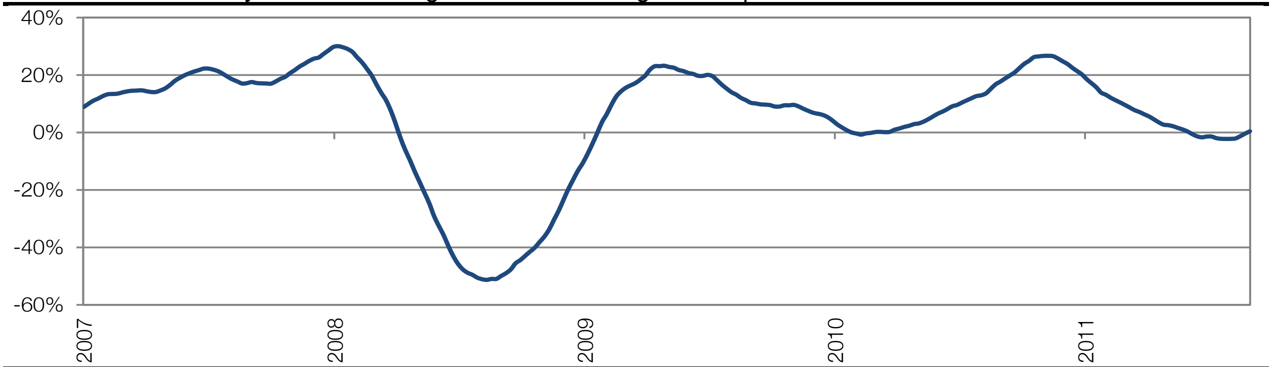
In this context, we believe two factors will come into play. First over coming months institutional investors will move quickly to discount another year of strong profits. Second, strong cash flows and low balance sheet leverage may drive a substantial uptick in announced M&A, following on from transactions announced in Q1. 'Pre-event' names are likely to outperform as investors price in heightened probabilities of long-delayed deals coming to fruition.

Oil – not an issue at current prices

We do not believe the recent rise in the oil price is a concern at present as the average spot price in 2012 has been no higher than the average price in 2011. Even if prices are sustained throughout 2012 at current levels of US$125 this would represent an increase of only 10% on 2011 which is just too small to create a significant drag on growth. Exhibit 7 shows the scenario was very different in 2010/11 when oil prices rose by US$45 or 50% over six months following the announcement of QE2 in the US. This represented a tax of 2.3% of world GDP on oil consumers and a similar negative stimulus.

We continue to be attentive to developments in Iran. Although an evolving situation it has cooled somewhat over recent weeks as the US has indicated muted enthusiasm for military action, either by itself or by proxy.

Exhibit 7: No oil shock yet in 2012– rolling three-month average Brent spot over 12 months



Source: Bloomberg

Conclusion

We believe European equities remain at attractive levels on the basis of current valuations and strong fundamentals – high margins, strong balance sheets and returns on capital. We do not believe the current oil price is a barrier to growth or consumer confidence at present. Avoidance (for now) of a second credit crisis in Europe has eliminated a significant downside risk but we believe this has now been priced in. Though valuations in Europe remain attractive, from here upgrades to growth will be the primary driver of short-term returns in our view. A pull-back in QE from a dovish central bank – the US Federal Reserve – is good news. US unemployment data is improving. There is no need to change the strategy or take profits in equities yet.

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