

Illumination: Equity strategy and market outlook

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Global perspectives: Guilty of subordination

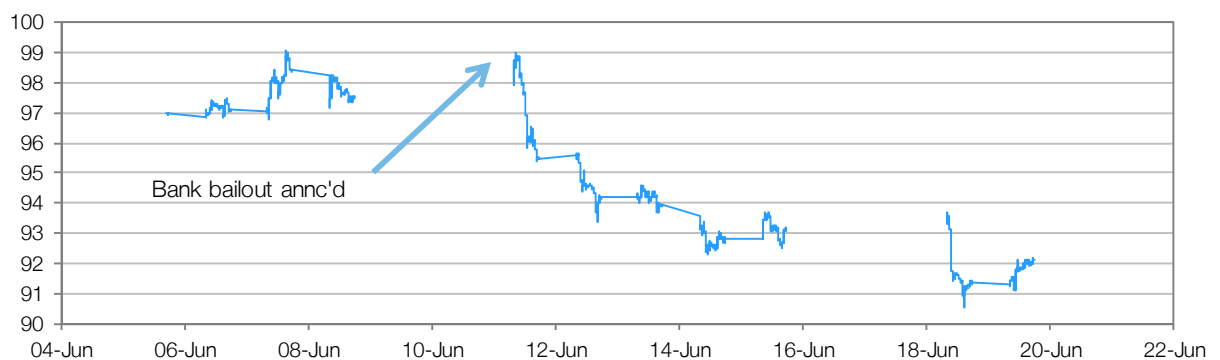
- **Is it European policy to drive out the private sector?** In February the ECB refused to take losses on its holdings of Greek bonds. More recently European Stability Mechanism (ESM) funding for Spanish bank bailouts will rank ahead of existing government creditors. As a result both Spanish and Italian bond markets are now effectively shut with yields over 6%.
- **Policymakers are refusing to underwrite the euro project.** Despite the significant sums already at stake (eg in Europe's TARGET2 settlement system) policymakers are yet to spot the conceptual solution. If they want markets to support the euro project the official sector will have to underwrite the risks. *We do not expect this policy shift to happen anytime soon and see no reason to change our strategy of avoiding the periphery of Europe.*
- **Stimulus, stimulus, stimulus.** The US Federal Reserve has opted to extend "Operation Twist" into the second half of the year after downgrading its view of economic growth. Late last week in Europe, ECB officials were reported to be making initial preparations to cut the policy rate to below 1%. In the UK a joint initiative from the Bank of England and Treasury will see an additional £140bn of credit offered to the economy. Rumours abound of a G20-backed deal to use ESM/EFSF funds to buy peripheral European bonds (but the question is whether they will rank above, pari-passu or below existing creditors). In the short run, we expect markets to be well supported.
- **US, UK – socialising the private debt burden.** In the US and UK, QE and deficit financing is allowing the private sector to slowly deleverage by supporting demand, incomes and profits. Though it may not be by design, these policies are progressively socialising the private sector debt burden. This is an economic positive – first in the sense that demand is supported and second that government debt is the lowest-cost debt. Japan's experience to date suggests that government debt/GDP ratios can easily exceed 100% without calamity – provided the central bank is willing to finance the government deficit.
- **2012 equity/bond valuations are the mirror image of 2000.** There is a positive yield spread between UK industrial equities against 10-year gilts of 2.4%. This prices-in a near 25% equity market decline over a 10-year period, assuming dividends do not grow at all. Thus, a bearish economic outlook is firmly baked into equity market values. We remain positive on equities over the medium term and are surprised many economists seem to ignore the valuation signals. In Europe the yield spread is even wider.
- **Still focused on UK and core Europe, quality names and avoiding the bank sector.** Though it is tempting to participate in a junk-led stimulus rally, the problems of the periphery are not easing, except for the notable exception of the contraction of the current account balances, which led to the peripheral's funding crisis. We are still waiting for the light to go on. Europe's leaders talk of underwriting Europe's periphery, but are guilty of subordination.

Is it European policy to drive out the private sector?

With institutional, corporate and retail capital fleeing the periphery one would have thought that a strong demonstration of support for the eurozone project should be a policy objective. Actions speak louder than words; following the Spanish bank bail-out announcement the market spotted immediately that Spain's existing sovereign bonds would rank behind ESM bail-out cash and re-priced the bonds accordingly. The step-up in yields is very likely to become self-fulfilling; further EU funds will be required in all probability as it makes no sense for Spain to raise money at 7%, Exhibit 1.

This is the second time this year the private sector creditors have been punished to benefit the official sector. In February the ECB refused to participate in the Greek debt write-downs despite having bought bonds at close to one-half of par.

Exhibit 1: Intraday moves in Spanish bond prices (10 year) – euphoria turns to fear post bank bail-out



Source: Bloomberg

In a corporate setting only bankrupt organisations are financed with loans that take precedence over existing creditors; for going concerns corporate finance has to be secured lower down the capital structure – such as an equity increase – to keep bondholders on board. We do not think policymakers are trying to send coded messages on their private views of peripheral Europe's solvency; we believe it is more likely they have not thought it through.

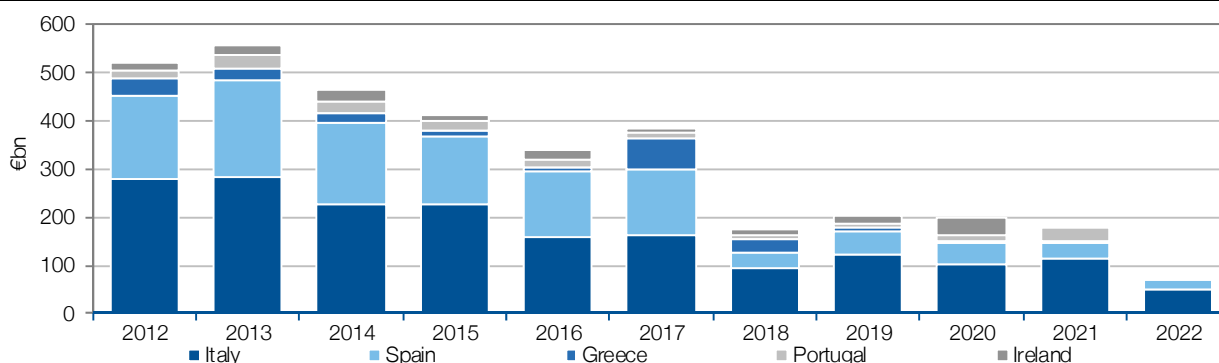
Until the euro project is underwritten by the official sector, private sector capital has every reason to flee the periphery. The inevitable leaking of secret preparations for border and capital controls was unhelpful. We have noted previously that it is difficult to make an investment case for anything other than distressed assets when the basic monetary/banking/sovereign infrastructure is broken, as it is in the periphery of Europe at present.

To become more positive on Europe's economic prospects we are looking for signs of a shift in policy. Specifically, we are looking for moves to underwrite the basic financial infrastructure in the periphery to stop the capital flight and allow the private sector to invest.

Comparisons could be drawn with the US TARP program of 2008. The US Treasury underwrote the security of the banking system by taking equity in US banks. The programme was timely, sufficient in size (c 10% of US GDP) and successful in restoring faith in the US banking system. Post-crisis, US regulatory changes have substantially improved the capital position of US banks and the overall cost of the programme to the US taxpayer was minimal.

A consequence of driving out the private sector is that the size of the bailout packages becomes enormous. We show the refinancing needs for peripheral European nations in Exhibit 2 – the total to 2015 is €2trn or 15% of eurozone GDP, compared to the current EFSF/ESM resources of €750bn. Rather than displacing the private sector, using ESM resources to offer guarantees on eurozone debt up to a certain level – perhaps 90% of GDP – would appear to be a much more efficient use of crisis-resolution capital.

Exhibit 2: Gross financing needs of the European periphery



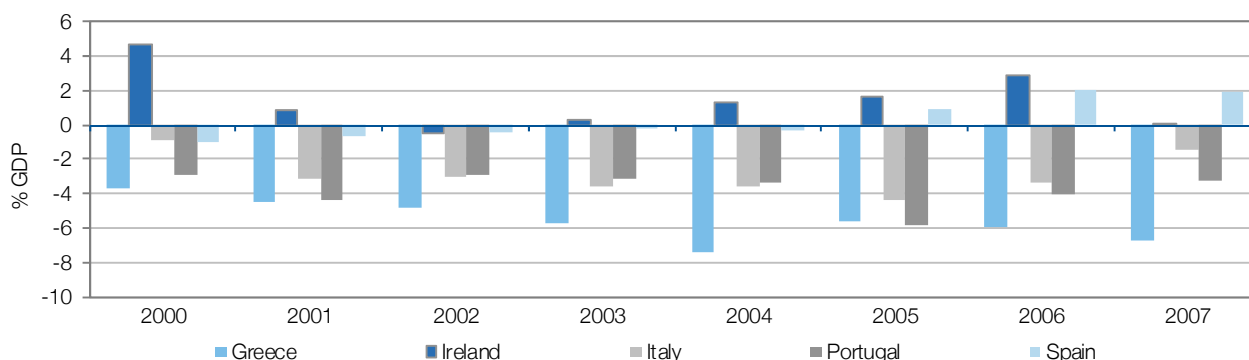
Source: IMF, Bloomberg

Where unconventional government lending was required (ie above a certain percentage of GDP) a policy of taking a junior debt tranche – potentially with GDP warrants – would ensure the existing private creditors had the incentive to remain in place.

As in the US, after private sector capital flows have been restored attention can turn to structural change. We note with interest even the Bundesbank is debating ideas such as a fiscal union – a necessary step for a banking union; its key concern is the lack of democratic legitimacy for a European fiscal policy. Debate over a fiscal union is clearly wasted time while the mechanics of the current bail-out packages are so poorly structured, even if a fiscal and banking union does represent the ultimate solution.

Politically, Greece set an unfortunate precedent as gross fiscal irresponsibility is largely to blame for its travails. Voters now associate bail-outs with fiscal irresponsibility. Of course this is far from the case in Spain – or Ireland – where construction and lending bubbles driven by ECB policy rates appropriate for Germany were at least partly to blame, Exhibit 3.

Exhibit 3: Good PIIG, bad PIIG – pre-crisis fiscal balances for peripheral nations



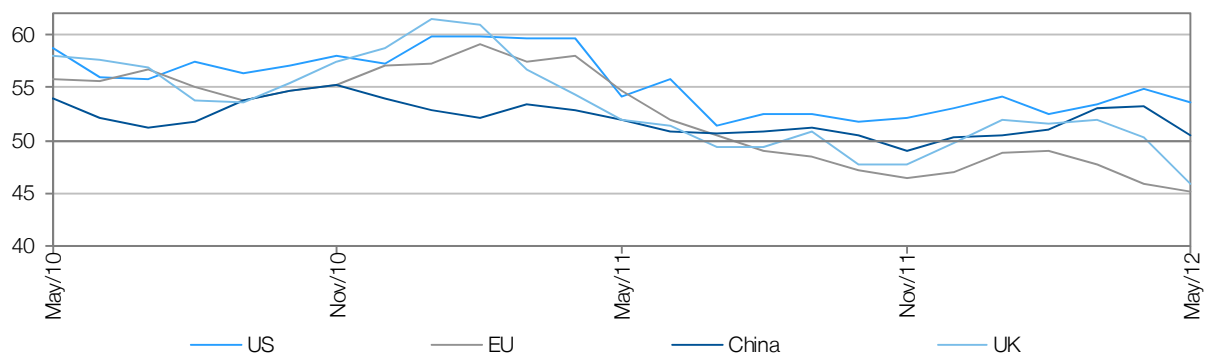
Source: IMF

We recognise that current European thinking is a long way from these ideas. However, investors should watch out for signs of moves in this direction as it may be the only option left to save the euro.

Quadruple stimulus supporting markets – US, Europe, China, UK

Central banks are gearing up to unleash a further round of monetary accommodation to offset the relapse in growth and confidence worldwide. Since April, PMI survey data has declined markedly, Exhibit 4.

Exhibit 4: Global manufacturing PMI survey data



Source: NAPM, Markit

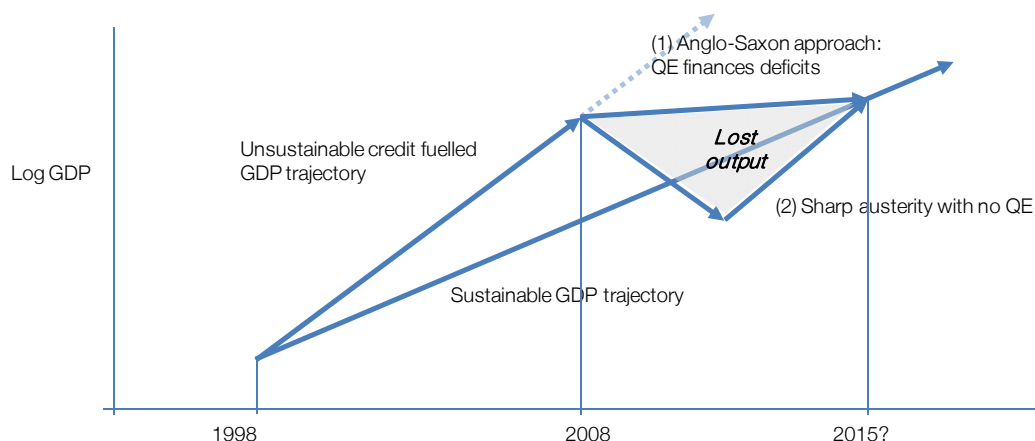
Last week the UK announced a £140bn programme led by the Bank of England and Treasury aimed at improving the supply of credit to the real economy. As recently as last Friday, Bloomberg was reporting that ECB board member objections to cutting the policy rate below 1% had been overcome. In the US, Operation Twist is to be extended into the second-half of 2012 while in China the bank reserve ratio has been cut twice this year. The recent opening of share accounts by China's social security fund suggest the government may be about to start purchasing shares on the Chinese domestic equity market.

In our view, central banks will continue to ease policy to lower the risk of a collapse in demand as they will have few tools to deal with the consequences should such a collapse occur. The prospect of another round of monetary accommodation has already stabilised markets around current levels. Globally, the only objections in principle come from the inflation hawks of the ECB.

US, UK – why socialising debts is good for corporate profits

Four years after the collapse of Lehman Brothers the developed world is still dealing with the aftermath of a decade of credit-fuelled and unsustainable GDP growth. The policy challenge is returning the economy to the sustainable GDP trend (driven by technological change and labour productivity) without suffering an unnecessary loss of output, shown schematically in Exhibit 5.

Exhibit 5: Global policy alternatives schematic

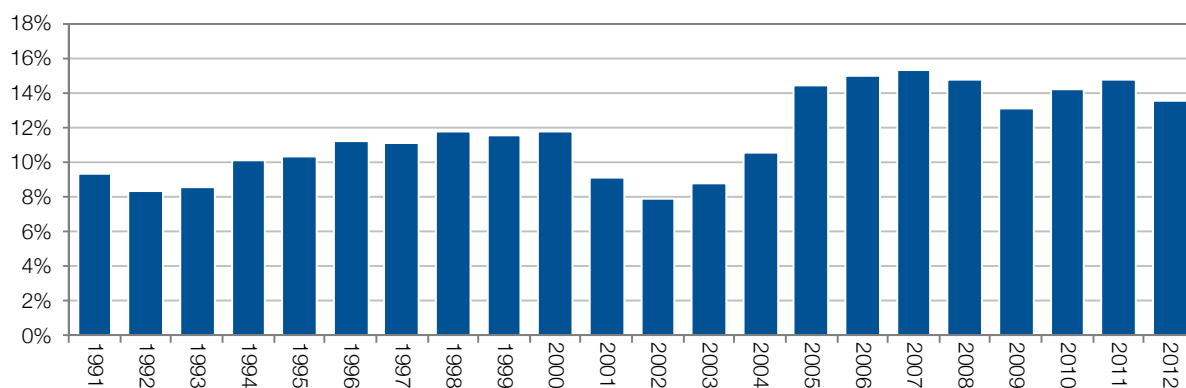


Source: Edison Investment Research

The combination of QE and large government deficits is allowing the private sector to deleverage by supporting demand, incomes and, crucially for equity investors, corporate profit margins, Exhibit 6. Though it may not be by design, these policies are progressively socialising the private sector debt burden. As the private sector saves, the government sector expands its balance sheet, or in other words socialises private sector debt.

This should be considered the least-worst solution. Japan's experience shows this debt socialisation can be carried to extremes without a bond market collapse, hyperinflation or riots on the streets (Japan's government debt/GDP is now over 200%). The alternative is a collapse in demand, a wave of bad debts throughout the household and corporate sector and a socially problematic level of unemployment.

Exhibit 6: UK non-financial EBIT margins



Source: Edison Investment Research estimates

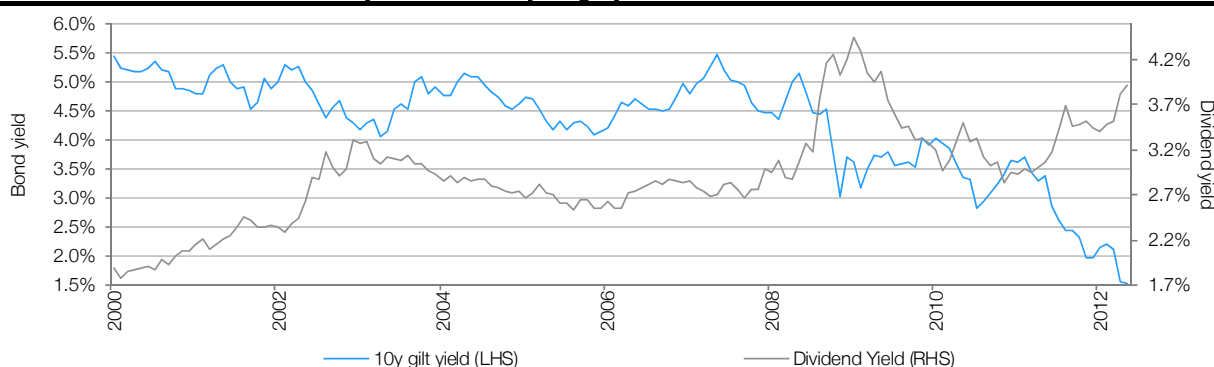
Though rather abstract, our view that those nations willing to employ QE and deficit financing will muddle through (until productivity growth catches up and GDP starts to grow at its sustainable rate) is a necessary part of our argument for owning equities over bonds at current valuations.

At current valuations, AAA government bonds are on a tightrope. A discovery that the economy has reached a sustainable level of GDP would send yields sharply higher. The other scenario, a collapse in demand, would dramatically increase deficits and lead the market to question debt sustainability – and therefore also risk sending yields sharply higher.

2012 equity/bond relative valuations – hold a mirror to Y2K

At present, the UK's weighted average non-financial dividend yield is 3.9%, compared to a 1.5% yield for 10-year gilts, Exhibit 7. On a 10-year time horizon this 2.4% yield advantage implies a near 25% decline in the equity market, assuming no dividend growth. In other words, a high degree of scepticism on growth is already embedded in investors' expectations.

Exhibit 7: UK non-financial dividend yield versus 10-year gilt yield



Source: Edison Investment Research estimates, Bloomberg

The non-financial market dividend yield is not a statistical anomaly based on a few large-cap or highly leveraged names; if we run a simple screen of non-financial UK stocks that have:

- a yield of 3% or more,
- less than 25% weighting of debt in the enterprise value,

- a price/book ratio of less than 2x, and
- growing sales and net income

then of the 750 companies with a market value of >£100m we end up with a list of over 25 names, shown in Exhibit 8. We must emphasise here that these names are NOT recommendations but are shown to illustrate the statistics. For this list, the average dividend yield is 4.5% and the average price/book multiple is 1.4x. An average forecast ROE of 13% is consistent with the I/B/E/S consensus forecast long-term growth of 9% per annum. These are hardly challenging valuations.

Exhibit 8: Screening for high-yielding UK stocks

Company Name	MV (£m)	P/Book	Yield	FY1 P/E	FY1 ROE	Company Name	MV (£m)	P/Book	Yield	FY1 P/E	FY1 ROE
BBA Aviation	983	1.6	4.4%	11.3	18%	Lookers	229	1.2	3.9%	8.7	13%
Bodycote	651	1.4	3.6%	9.4	12%	Low & Bonar	157	0.9	4.4%	8.7	13%
BP	81,207	1.1	4.8%	6.8	22%	Mears Group	228	1.5	3.2%	9.3	12%
N Brown Group	706	1.8	5.4%	9.1	22%	Meggitt	2,899	1.6	3.1%	10.5	11%
Computacenter	481	1.2	5.3%	8.7	16%	Mondi	2,023	1.0	4.1%	11.2	12%
Cineworld Group	304	1.9	5.7%	10.4	16%	Ricardo	159	1.9	3.9%	11.2	19%
Cookson Group	1,744	1.3	3.8%	8.5	11%	Rio Tinto	59,027	1.8	3.3%	6.8	10%
Carillion	1,183	1.2	6.4%	6.3	14%	RPS Group	448	1.2	3.1%	10.7	8%
Cranswick	388	1.7	3.8%	10.3	14%	Tesco	24,755	1.4	4.8%	8.8	16%
Debenhams	1,056	1.5	3.7%	8.9	18%	Tui Travel	1,867	1.3	7.1%	7.1	3%
Inchcape	1,584	1.2	3.5%	9.1	11%	TT Electronics	243	1.3	3.3%	9.3	13%
Informa	2,187	1.6	5.0%	9.0	5%	Vodafone Group	87,911	1.1	7.6%	11.3	8%
Interserve	377	1.3	6.6%	6.7	21%	WPP	9,655	1.4	3.7%	10.4	13%
Kingfisher	6,729	1.2	3.3%	11.1	11%	List Average:		1.4	4.5%	9.2	13%

Source: I/B/E/S, Datastream

Despite the statistical evidence that buying equities when they are as cheap as this leads to higher than average returns, we often suffer the pushback – yes, the yield is fine but there is no growth. It is true that the growth outlook for the immediate future is highly uncertain. However, this argument fails to recognise that quality business franchises have a long-dated call option on economic growth. When equities are fairly valued this option premium has to be paid for via a reduction in the yield. At present, this option is deemed out of the money and available for free, in our view. Equity investors' patience is being rewarded with an exceptional level of income, both in absolute terms and relative to current bond yields.

Markets are well-known for failing to discount events beyond an institutional time horizon or those that look highly unlikely – as sellers of Spanish CDS for single-digit basis points have found to their cost. But by the time the deleveraging cycle is over and sustainable growth returns (driven by innovation-led productivity growth), the equity re-rating will be well underway.

Conclusion

We believe European policymakers have not grasped that solving the acute phase of the peripheral funding crisis requires incentivising the private sector to co-invest in a successful outcome. Further subordination of private creditors will simply increase the burden on an overstretched official sector.

Despite our rather pessimistic views on the outlook for Europe the valuation signals for equities over bonds are clear – and the reverse of the position in 2000. We believe equities are pricing-in meaningful declines over the medium term. We believe this is too bearish given the valuation starting point, even if strong economic growth will remain elusive for the foreseeable future.

Strategically we therefore favour quality names that are outside the bank sector and the periphery of Europe. Tactically, policymakers have taken note of the slowdown in the global economy. A drip-feed implementation of various monetary stimulus measures worldwide means that in the short run equity markets are likely to continue to be well supported.

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