Illumination: Equity strategy and market outlook

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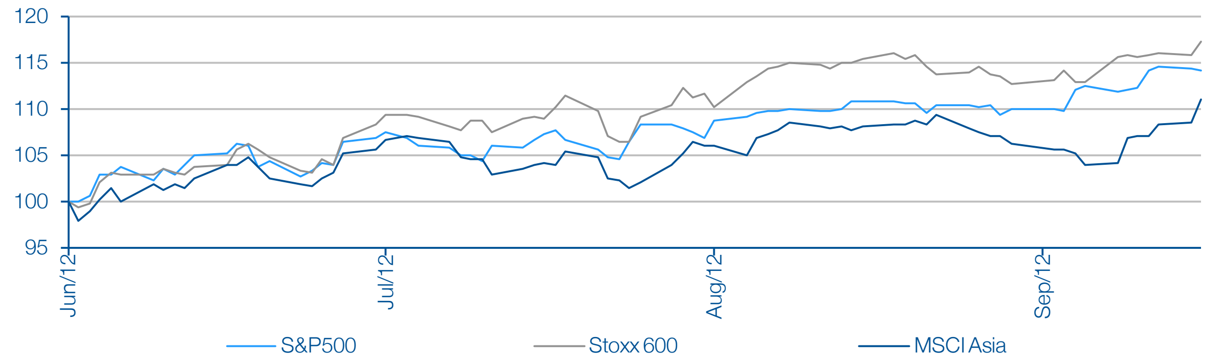
Global perspectives: Still taking profits

- **Macro risk discounts fully unwound.** Within the space of 10 days earlier this month, central banks took two key near-term risks off the table. The European Central Bank (ECB) has ensured that peripheral European governments can continue to finance themselves while the Federal Reserve has undertaken to underwrite the economy by targeting a return to full US employment.
- **An excellent time to be reviewing portfolios and taking profits where necessary.** Since we published our bullish views on European equities in June, the market has risen by more than 15%. Valuations are not a precise instrument but a shift of this magnitude moves the needle. For sectors, we are no longer bearish on basic industries. Price/book multiples are near decade lows and the recent monetary stimulus has put a floor under commodity prices.
- **New Fed target: unemployment.** We have been surprised by the recent statement by the Federal Open Market Committee (FOMC). Recent data did not match the conditions precedent to other episodes of quantitative easing. Shifting the target of US monetary policy to employment is a notable change and will increase inflation risks substantially. We struggle to see how this policy is going to be effective in lowering employment, but the Fed has made its position clear.
- **In our view, the scenario of only marginally better real growth but significantly higher inflation has risen.** Therefore we would look to add to gold positions even at these higher levels. High-quality government bonds remain our least-favoured asset class while at yields less than targeted inflation. We also believe corporate profits are at risk from a surge in input costs; P/E multiples may therefore expand, but for the wrong reasons.
- **ECB policy absolutely necessary but insufficient.** The recent Outright Monetary Transaction (OMT) initiative has significantly reduced the cost of short-term government funding for peripheral Europe, which is undeniably a positive. The ECB has also acknowledged the prior policy of subordinating private sector creditors was highly counterproductive. But, although theoretically an unlimited programme, the ECB's actions remain subject to politicians accepting conditionality, in other words, fiscal straightjackets. For as long as the prescription is fiscal adjustment without devaluation, the risks remain on the downside in the European periphery.

Still taking profits

Despite significant policy developments at both the ECB and the Federal Reserve, we believe investors should continue to review portfolios to see where profits might be taken. Following a 15% rise in European equity markets since June, equity valuations are now insufficiently compelling regardless of the significant risks to economic growth.

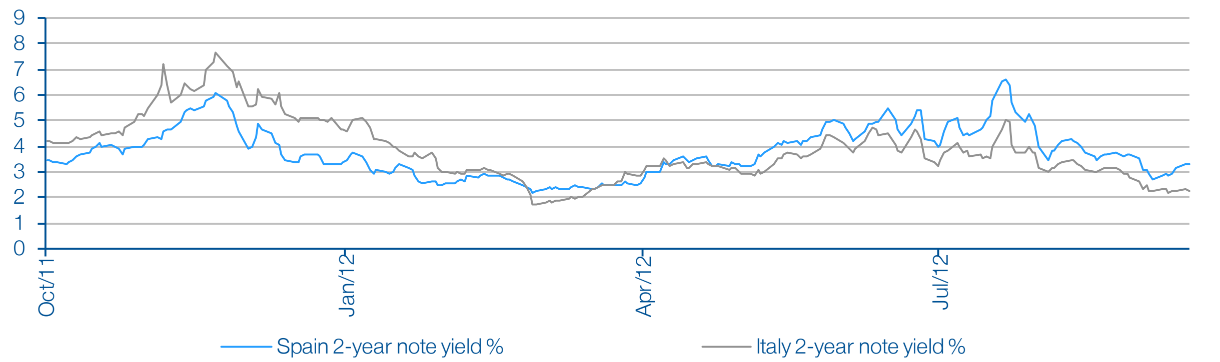
Exhibit 1: Global equity market performance



Source: Bloomberg

We do not believe European periphery risk has diminished significantly despite a substantial rally in peripheral European debt. Though in the short-term ECB unconventional monetary policy has successfully reduced funding pressures, Spanish and Italian politicians are unlikely to apply for conditionality (i.e. further austerity) until forced to do so. Until conditionality packages have been agreed, any Outright Monetary Transactions (OMT) are prohibited.

Exhibit 2: Italian and Spanish two-year yields



Source: Bloomberg

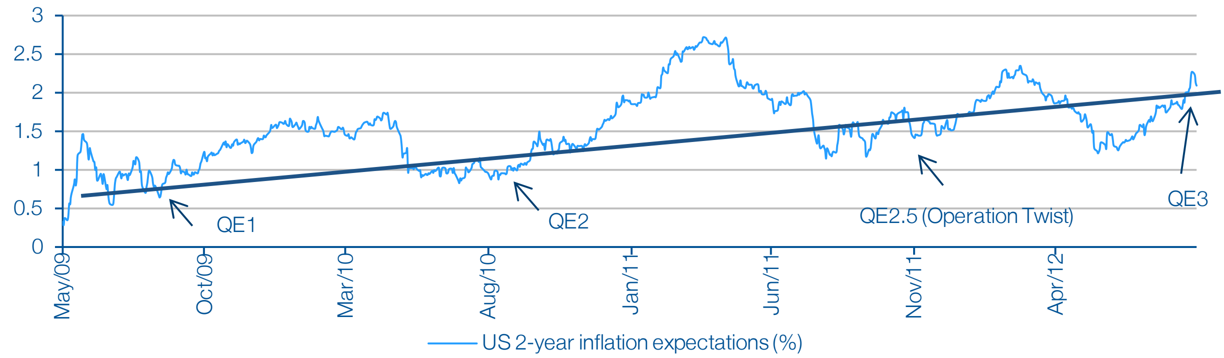
US Federal Reserve – moving to an employment target

We have been caught out by the Fed's recent announcement of QE3 when neither inflation expectations nor US growth seemed to warrant immediate action. Prior episodes of QE have been preceded by a significant softening in asset prices, inflation expectations and the economy. This time was different.

Targeting employment is a seismic shift in Fed policy. Taken at face value the Fed's statement implies open-ended QE until US employment returns to an internal Fed definition of an acceptable level. Fed Chair Bernanke seems concerned that the structural unemployment rate could rise (and potential GDP fall) if no action is taken. This is a valid concern but perhaps action on what is a structural question would seem to be in the domain of politics.

Markets have quite rationally re-priced inflation risk as the amount of QE required to raise employment in the absence of a coordinated government policy may be substantial. An additional risk is that consumers will respond to higher energy bills and cut their spending. A positive feedback loop – of QE leading to more inflation and less demand and followed by yet more QE – has become a new tail-risk.

Exhibit 3: QE – ever increasing inflation starting point



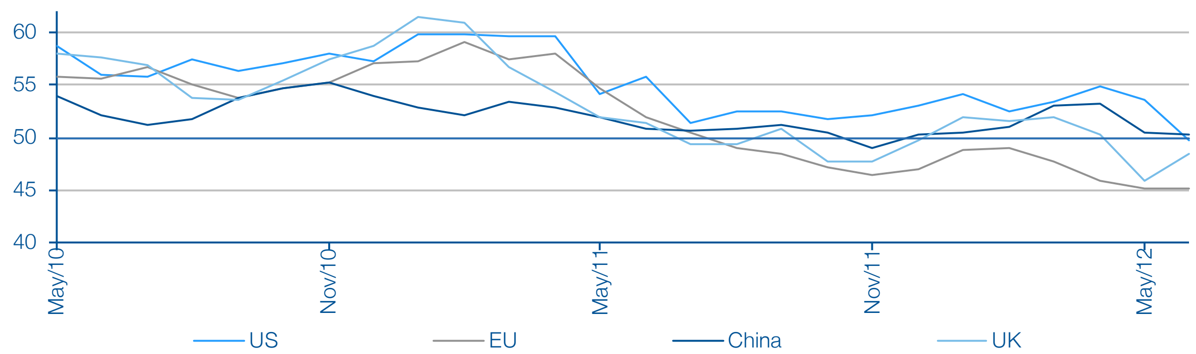
Source: Bloomberg

For investors, we believe sub-2% 10-year US Treasury yields sit uncomfortably with a new Fed policy of prioritising employment growth over inflation, a policy that other central banks may yet emulate.

Economic growth – policy-induced time extension

Although we have doubts on the medium-term efficacy of more QE, ECB and Fed action is likely to support economic activity into the end of 2012 or at least slow the rate of decline. We had been concerned that activity was declining quickly but US QE3 in particular is likely to provide a near-term boost to demand.

Exhibit 4: Global PMI indices

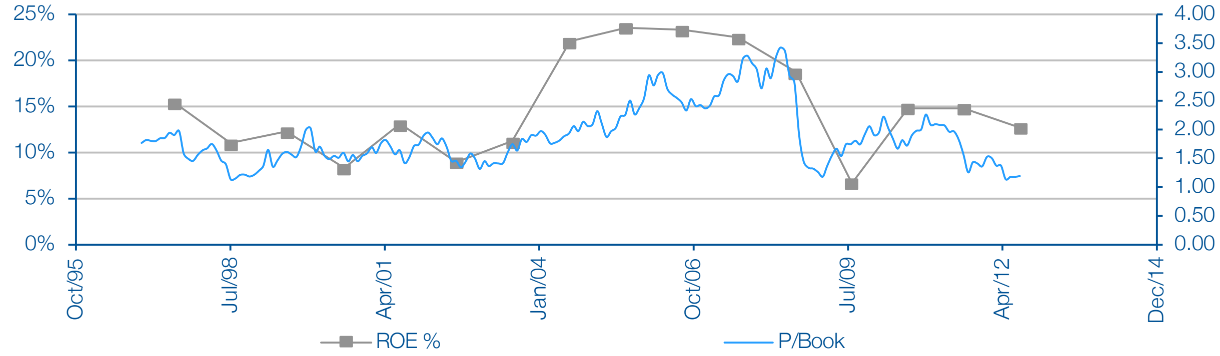


Source: Markit, NAPM, Bloomberg

As a side effect, improved global demand will also take the pressure off the European periphery as distressed nations will be the most responsive to external stimuli. These markets are now a difficult call for investors as the short-term benefits to global demand may quickly fade. We are choosing to remain underweight risk generally and the European periphery in particular as we believe the boost from QE will be transitory.

Both the time-extension for the global economic cycle and the inflationary effects of QE also support basic industries. We note the sector is currently trading near trough price/book multiples for the last decade and have therefore moved to a neutral view from underweight.

Exhibit 5: European basic industries price/book and ROE

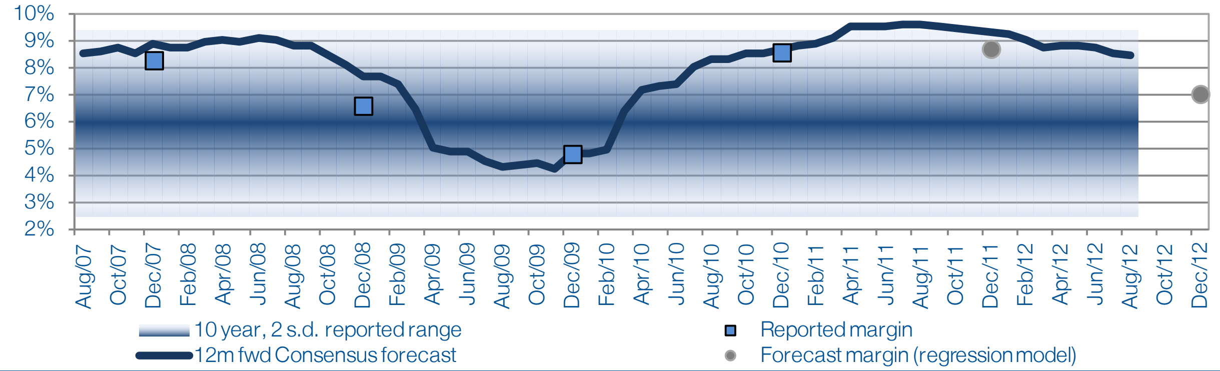


Source: Bloomberg, Edison calculations

Profit margin forecasts still too high

Bottom-up analyst profit margin forecasts continue to be too bullish compared to our top-down models. Therefore we believe profit margin risk is rising and that orders will need to pick up soon or the number of profit warnings is likely to increase markedly. A pincer movement of slowing demand and higher input costs is not a helpful environment for corporate profitability.

Exhibit 6: European industrial sector profit margin forecasts – analyst consensus vs Edison's top-down models



Source: Bloomberg, Edison estimates

Conclusion

We believe that flexibility to respond to events – which means having ample cash on hand – will prove beneficial to investors as there is much higher degree of uncertainty in the economic outlook than is usual. This is driven by the uncertain interaction of slowing economic activity and substantial additional monetary stimuli.

While attractive in the medium term, equity valuations are not nearly as compelling as they were in June and investors should continue to take profits, in our view. This is not a call to exit the equity market however – there are still many defensive blue-chips that have not participated in the recent rally and still trade at attractive multiples.

Long-dated developed nation government bonds remain our least-favoured asset class. Although the market is supported by central bank buying in the US, UK and Japan, investors are unlikely to earn real returns over the medium-term at current yields. Given the new focus on employment at the US Federal Reserve we would continue to hold and add to gold positions, even at current prices.

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