Illumination: Equity strategy and market outlook

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Global perspectives: Where is the growth?

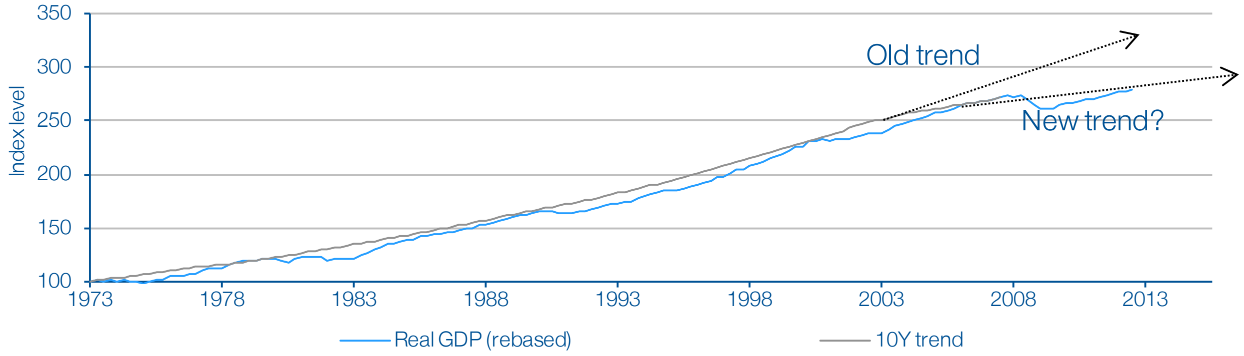
- **Central bank actions have supported asset prices and corporate profits**. The money-printing steamroller has squeezed short- and long-term interest rates to record lows. Corporate credit costs have also declined, leading to a surge of issuance in both investment-grade and high-yield credit. This significantly lower cost of capital has ensured the survival of many enterprises that would otherwise have failed and supported both government spending and corporate profits.
- **This four-year experiment in monetary policy is at risk of proving that it does not work**. Loose monetary policy was aimed at achieving growth by avoiding a catastrophic debt deflation. The weak growth exhibited by developed nations post-2008 indicates that at best loose monetary policy is insufficient to stimulate growth and at worst may be counterproductive. The collapse in productivity growth since 2008 indicates a sharply lower trajectory for UK GDP which only recently has been factored into the Bank of England's forecasts.
- **Monetary and fiscal policy becoming blurred**. The scale of central bank intervention in the developed world's bond markets is blurring monetary and fiscal policy and eroding the independence of central banks. The longer that the monetary/fiscal experiment of QE plus budget deficits continues, the greater the difficulty of reversing course without causing a contraction in real GDP similar to that seen in Greece. As it is unlikely that we will see such a reversal in the near future we remain positive on gold. Separately, the recent downgrade of France by Moody's referred explicitly to bondholders' risks of not having a central bank able to print currency to repay creditors. Should leading developed nations be reliant on money printing to avoid default? We have come a long way since 2007.
- **The actions of central banks are making life hard for savers**. With a zero-interest rate policy (ZIRP) in place for nearly four years, a cumulative loss of savings is building with little to show for it in terms of growth. Though supportive of government spending, expectations of low returns on savings for the foreseeable future may be depressing household spending, especially for those nearing retirement
- **Equity markets have bounced on survey data**. PMI survey data in Europe and China has recently ticked up from low levels, leading to a swift bounce in global equity markets. We wrote in September that the slowing economy was likely to be supported by additional monetary policy in the short-term, but we suspect the momentum will not last.
- **Corporate bonds no longer attractive**. The substantial yield compression in the corporate bond market, accompanied by strong issuance, leaves the investment case looking stretched. We are no longer looking to pick up yield in the corporate bond market. In a downturn investors should be aware that the price of a corporate bond can be rather different from a similar government security eligible as collateral at a central bank.
- **Tough choices for investors.** With ZIRP likely to continue for the foreseeable future, fixed income is likely to remain an unattractive proposition for investors. A suppression of equity market volatility through monetary policy removes a source of alpha for value-driven portfolio managers. Though headline valuation multiples appear compressed relative to recent history (although certainly not over longer time horizons) the lack of GDP-driven sales growth points to markets being closer to fair value than the raw data imply. In particular, yield comparisons with artificially low bond yields are misleading.
- **Stay long cash, gold and blue-chip equities**.

Where is the growth?

Despite a significant slowdown in year-on-year economic growth rates across the globe, equities have remained near the highs of 2012. Given the increasing risks to growth the support for the equity market has come from declining expectations of the cost of capital, especially in the US as the Federal Reserve has undertaken to keep interest rates low until US unemployment has fallen to acceptable levels.

Since 2008 it has proved straightforward for central banks to create shifts in relative valuations of asset classes by both changing the shape of the yield curve and appearing to underwrite growth, thus lowering risk premia for risk assets such as equities. In contrast, unconventional monetary policy has been shown to be ineffective for pushing developed economies back to the GDP growth trajectory that existed prior to 2008. The effect of quantitative easing has at best proved to be transient.

Exhibit 1: US deviation of real GDP from long-term trend

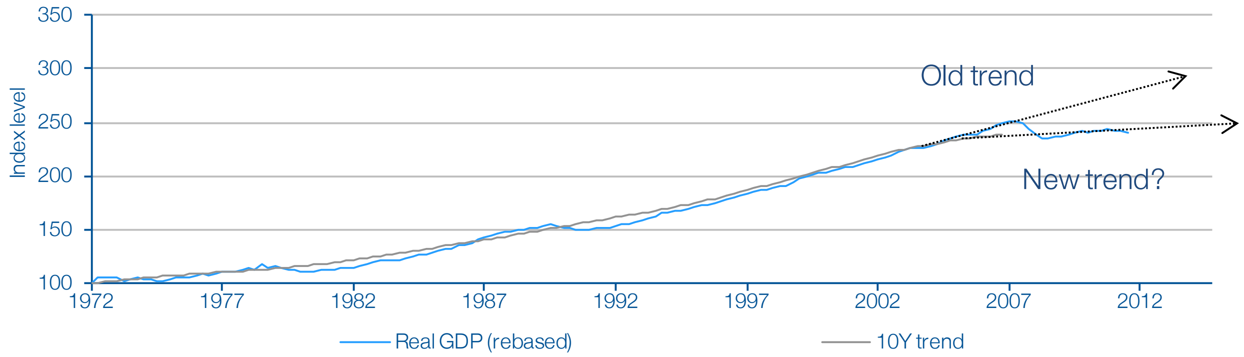


Source: Thomson Reuters Datastream

Evidence building against ZIRP as a tool for growth

Zero interest rate policy and quantitative easing (QE) were designed to encourage investors to take more risk by decreasing the returns on risk-free assets and thereby pushing investors into riskier assets such as equities. Since 2008, the link between QE announcements and stock market performance has been strong and there is little doubt that this part of the mechanism is functional.

Exhibit 2: UK deviation of real GDP from long-term trend

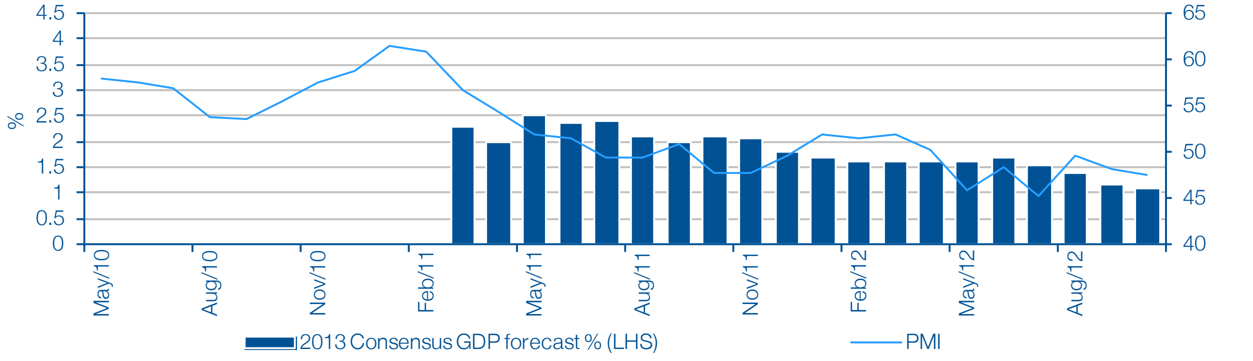


Source: Thomson Reuters Datastream

However, while strong economic growth and business confidence have caused strong stock market appreciation in the past, it was always the assumption that this linkage worked in reverse that challenged the common sense notion of cause and effect. Four years into this experimental monetary policy and several rounds of unconventional easing later, sustainable growth on the pre-2008 trajectory appears no closer, Exhibits 1 and 2. The Bank of England has recently openly questioned whether further QE will make any difference. We note that UK growth expectations have been consistently falling over the course of 2012, Exhibit 3, a pattern replicated in the US and EU.

If, as seems likely, growth is on a permanently slower trajectory (for, among other reasons, the headwind of demographics, global resource constraints and poor productivity growth post-2008) this has major implications for asset allocation. Equities would appear to have de-rated to reflect the lower growth world. For bonds, given the state of sovereign balance sheets the implications of permanently slower growth are more complex.

Exhibit 3: Consistent downgrades to 2013 GDP growth forecasts - UK



Source: Bloomberg consensus, Markit

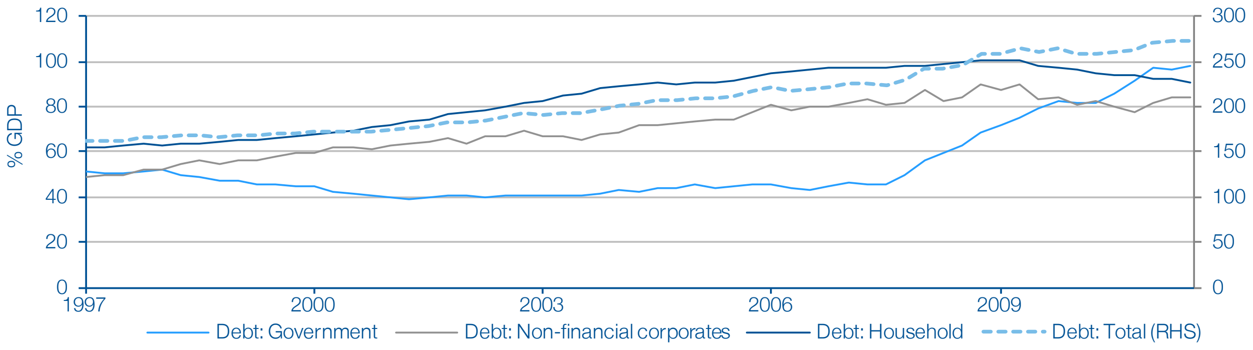
Monetary financing becoming a way of life

The UK Treasury has not only reportedly jumped through hoops to appoint Mark Carney over better known candidates for the role of Bank of England governor, but has also recently reclassified approximately £37bn of interest charged on government bonds bought under the Bank's QE programme as belonging to Treasury

The purpose of this reclassification appears to be to reduce the reported budget deficit. In effect, the UK government is now benefiting from money printed at zero cost to finance its spending. This is a precedent that should be watched carefully for further erosion of the monetary and fiscal distinctions. Only recently the independence of the Bank of England from the UK Treasury was described as a veneer by officials quoted by the *Financial Times*.

In France, a risk factor cited by Moody's in its recent sovereign debt downgrade was that France lacked a central bank able to print money to finance government bond redemptions, should that be necessary. The distinction between tax-funded bond redemptions and printed money-funded redemptions should be an important one, which is becoming slowly lost as rhetoric moves towards acceptance of monetary financing.

Exhibit 4: Socialisation but no deleveraging – UK debt by sector



Source: Thomson Reuters Datastream

Without real growth, many developed market governments are facing difficult choices. Cutting spending now, after the socialisation of private sector debts such as in the UK, Exhibit 4, would cause activity to fall and deficits to widen as they have in the periphery of Europe. This scenario could easily lead to severe short-term funding and political challenges.

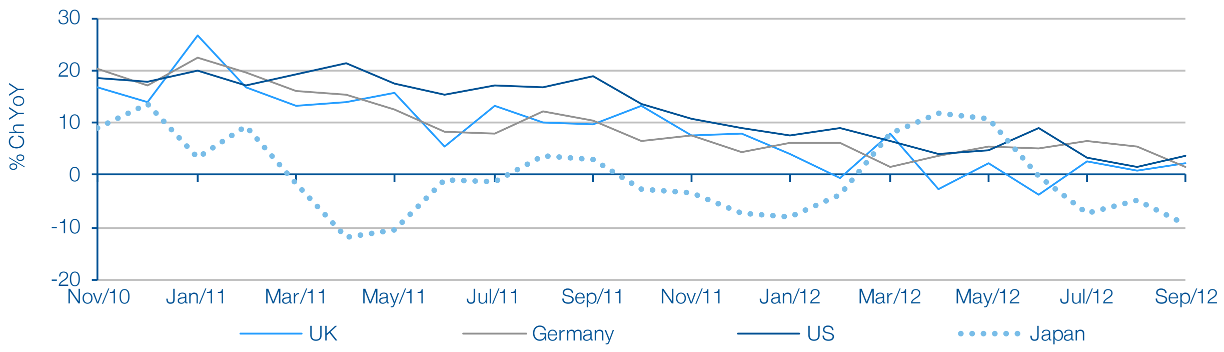
Using central banks to finance deficits at low rates eliminates the near-term deficit financing problem until inflation appears. Should this happen (and the historical evidence suggests it might) a spiral of government spending would be required, if spending is to be maintained in real terms.

Therefore, with high-rated government debt at such low yields and clear risks to purchasing power so evident, we remain underwhelmed by the opportunities on offer in this asset class. At best investors will receive returns below targeted inflation; at worst there could be a significant erosion of value if inflation takes hold. We remain in favour of owning gold as a store of real purchasing power even if the yield is marginally negative. The opportunity cost versus cash – or longer-dated bonds – is likely to remain modest for the foreseeable future.

Equity markets have bounced on survey data

Recent upticks in survey data against depressed expectations have led to a near 5% bounce in equity markets from mid-November. In our view it is far too early to tell if this will lead to a more sustainable recovery; current market valuations do not offer a significant cushion against growth disappointment with non-financial indices at 10-year highs. In contrast to survey data, recent export data would appear to confirm a significant slowdown in world trade growth, Exhibit 5.

Exhibit 5: Export growth – US, UK, Japan, Germany



Source: Thomson Reuters Datastream

Political risks also remain firmly in place – the US fiscal negotiations are some way from being resolved; as expected both sides have tried to calm markets to enable the negotiations to proceed without external pressure. In Europe the negotiations over Greece have been painful to watch and it will be interesting to see how it works when real money is involved should Spain request a bailout.

If a further example of the lack of harmony in Europe was needed it was the spectacle of the breakdown in European budget negotiations where, aside from the UK's objections, France and Germany appear to have been divided.

Equities: Earnings quality diminishing

We are becoming concerned that while dividend yields are important there is a new consensus emerging that the yield differential between equities and long-dated government bonds is a good enough reason to own equities, regardless of the risks.

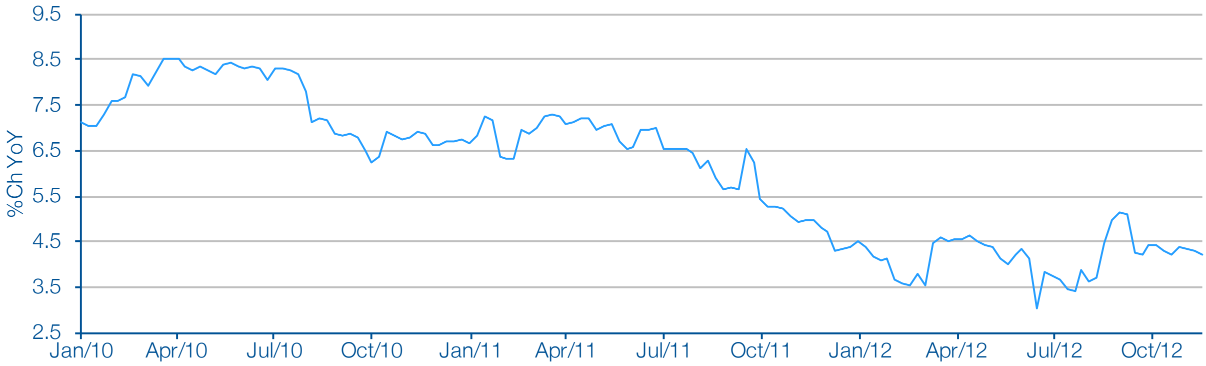
Our least favoured argument for owning equities over bonds is the yield gap. Our valuation work points to equities being close to fair value, with relatively high dividend yields offset against muted growth prospects. The yield gap is in our view due to the artificially low yields on government bonds (due to expectations of ultra-low interest rates) rather than the prospects for equities.

With corporate profit margins at or near all-time highs (driven by QE and budget deficits) there seems to be limited scope for margin expansion given the current growth outlook and the historical mean-reverting tendency of profit margins. This leaves sales growth as the key driver of profits growth. Here the data are not encouraging. Analyst estimates of 12-month forward sales growth for the UK have declined since 2011, Exhibit

6. Prior to 2008, analyst estimates for sales growth averaged 6.5%, but the current consensus calls for 4.5%. It should not be a surprise therefore to find that market dividend yields have risen.

Drilling into the indices at the individual stock level confirms the top-down picture. Many of the largest index constituents have fundamentally gone ex-growth or have at best a GDP-linked growth outlook rather than a secular growth story.

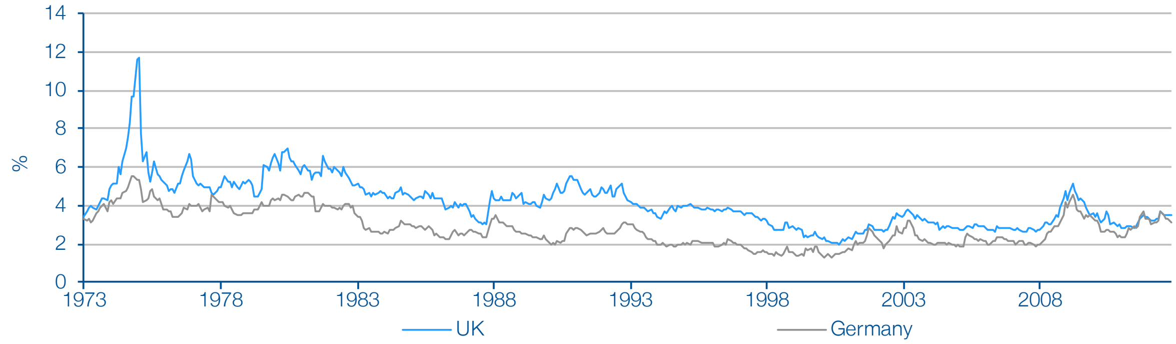
Exhibit 6: Analyst 12-month forward sales forecasts (UK)



Source: I/B/E/S

Due to the likelihood of a structural slowdown in growth we see equity valuations for the UK as close to fair value, but with higher than average fundamental risks due to the unusually uncertain outlook for the main macroeconomic variables. Over the summer we became significantly more bearish on equities as we felt that the higher than average dividend yield was merely a compensation for lower than average growth prospects, rather than a sign of significant undervaluation. We would also highlight that perspective is important; though current valuations are near decade lows a fund manager from the 1970s would find today's equities rather expensive, Exhibits 7 and 8.

Exhibit 7: Valuations at decade lows, but not multi-decade lows – dividend yield



Source: Thomson Reuters Datastream

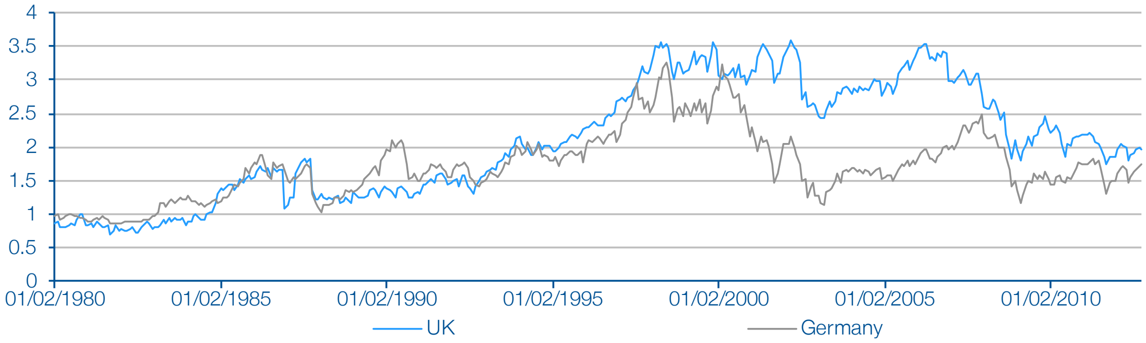
Tough choices for investors

It is undeniably a difficult time for investors as many of the traditional sources of alpha have been squeezed out of the market by monetary policy and the synchronised nature of the global slowdown. Interest rates are close to zero in most major markets.

The term premium, or increased yield for longer duration bond investments, has been compressed by quantitative easing. Corporate credit spreads have narrowed significantly over the summer to the point that the risk/reward balance has shifted to unattractive levels. Equity volatility has been suppressed, for now, by the perception of a central bank 'put option' on economic growth.

Geographic and sector or asset class diversification has become less useful due to wide risk-on/risk-off trading bands. A near-collapse in capital markets activity, Exhibit 9, leaves arbitrage funds short of opportunity. The absence of a strong growth response to monetary policy leaves equities fairly valued, but for many investors equities are too volatile to be a significant component of a portfolio.

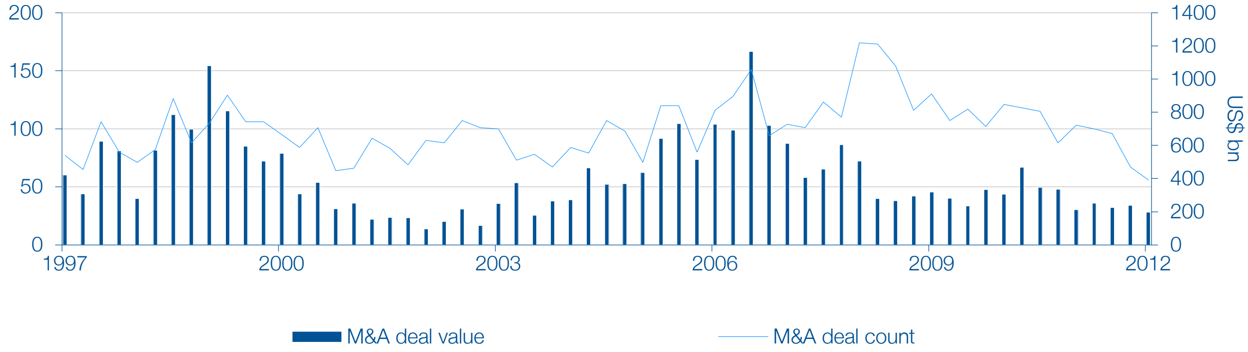
Exhibit 8: Valuations at decade lows, but not multi-decade lows – price/book



Source: Thomson Reuters Datastream

We believe that the market is currently presenting few opportunities to generate strong risk-adjusted returns. Though most portfolio managers are focused on optimising portfolios we believe now is the time to be reducing optimisation and focusing on the robustness of a portfolio. This means sacrificing some upside potential in return for ensuring an acceptable portfolio performance under most economic scenarios.

Exhibit 9: Global M&A activity muted



Source: Thomson Reuters Datastream

Therefore we would suggest investors to keep ample cash on hand to take advantage of opportunities that will present themselves over the next 12 month, to own an allocation to gold as a store of real purchasing power; to avoid long-dated government bonds and to focus on recession-resistant equities with high-quality business franchises.

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