# Illumination: Equity strategy and market outlook

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# Global perspectives: Central bankers save the world

- **No clear signals.** A modest recovery in survey data in Europe and China is at odds with evidence of a slowdown in the US. At extremes we rely more heavily on valuations as a predictor of returns, but now that European markets have recovered from the deep discounts of earlier in the year the European value case is less clear. In the US valuations are looking stretched, while in contrast Chinese stocks have ebbed to decade-low price/book multiples and recent growth in the money supply indicates policymakers may be coming off the brakes.
- **Yet more money from the US Federal Reserve**. This month brought confirmation of a further US$1trn of money printing from the US Fed for 2013. The quiet assassination of the bond market vigilantes by central banks has allowed politicians to avoid the difficult decisions on fiscal policy. In the low-growth developed world simple mathematics indicates that fiscal burdens will remain challenging and the absence of clear policies for dealing with them – other than money printing – adds to private sector uncertainty and investment risk.
- **Improvement in survey data outside US.** PMI data outside the US has ticked up, especially in Europe. A halt to the capital flight and reduction in interbank credit stress within the eurozone have been achieved and this has been associated with a rebound in purchasing managers' survey data. We are still waiting for this to be confirmed by export and industrial production data, which continues to stagnate. We also note the recent improvement in China's economy.
- **Survey data in US has weakened.** The world's largest economy has shown evidence of losing momentum in Q4. A variety of surveys have declined, notably the small business confidence indicator. Some of the declines in survey data may be due to fears of a fiscal cliff or adverse weather, but even GE has warned of a decline in end-customers' investment spend in Q4.
- **GDP forecasts for 2013 re-based to a sensible level.** The scope for a negative surprise in world GDP for 2013 has been moderated by the steady decline in forecasts, which are now indicating only modest growth in most major markets, outside China.
- **Valuations – near normal in Europe/UK, cheap in China and expensive in the US**. The improvement in eurozone credit markets has led to a sharp recovery in equity market values, which in our view places European and UK valuations back in the 'normal' zone. On medium-term valuation numbers the US continues to look expensive, while China's market has de-rated to decade lows.
- **Mixed signals point to balanced portfolios**. We do not believe that now is the time to be positioning portfolios aggressively. Though markets have been rising on improving survey data random short-term fluctuations in economic activity should not be confused with a return to structural growth, especially when the structural problems clearly remain in place. Fixed-income markets remain unattractive even if yields are likely to be held at low levels by central bank purchases. A diverse portfolio including cash, gold and high-quality equities is likely to yield more and provide better purchasing power protection over the medium term.

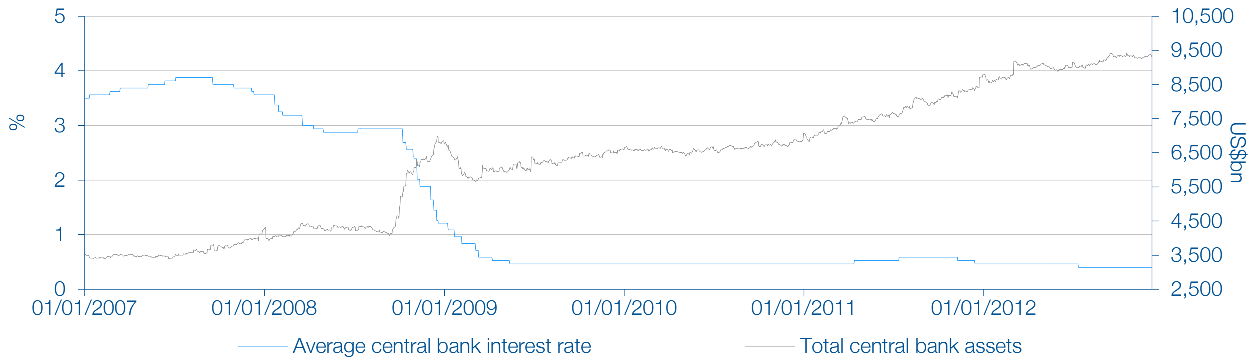
## Central bankers save the world

To a central banker, it would seem that every economic problem can be solved by printing money. Since 2008 interest rates have been cut to zero and developed market central bank balance sheets have tripled to over US$9trn or 15% of world GDP. The US Federal Reserve has committed to add a further US$1trn over the course of 2013, while the Bank of Japan is under pressure to re-start quantitative easing and target 2% inflation since the election victory of the LDP earlier in the week.

There is little question in our view that incremental money printing supports asset prices and in the short-run stimulates the economy. The medium-term negative effects seem to be getting too little attention. Money printing, when it targets government bonds (which is invariably the case) reduces pressure on politicians to confront fiscal problems.

Suppression of the market rate of interest removes the correct pricing signals and incentive for real political debate, masking the debt problem until it becomes more severe. Now that much of the excess credit of the previous decade has been socialised it is inflation, not deflation that is the tail-risk.

Exhibit 1: Central bank balance sheets – US, Euro-area, Japan and UK

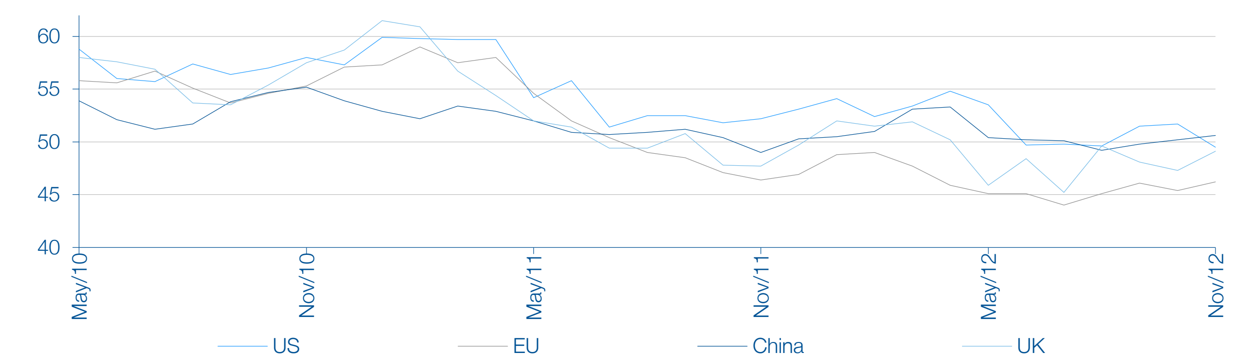



Source: Thomson Reuters Datastream

## Improvement in survey data, outside US

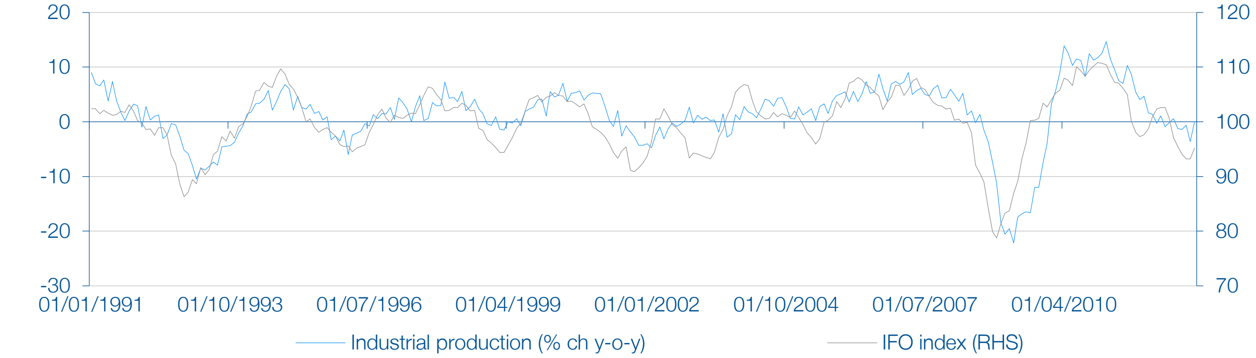
PMI survey data in Europe has improved considerably since October although it remains well below the 50 level, indicating that activity is still contracting, Exhibit 2. A halt to capital flight and a reduction in credit stress within the eurozone have clearly benefited sentiment. Notwithstanding this improvement industrial production in Germany is still lower year-on-year, Exhibit 3. Clearly, characterising this recovery as robust would at present seem to be premature.

Exhibit 2: Global PMI indices




Source: Bloomberg, Markit

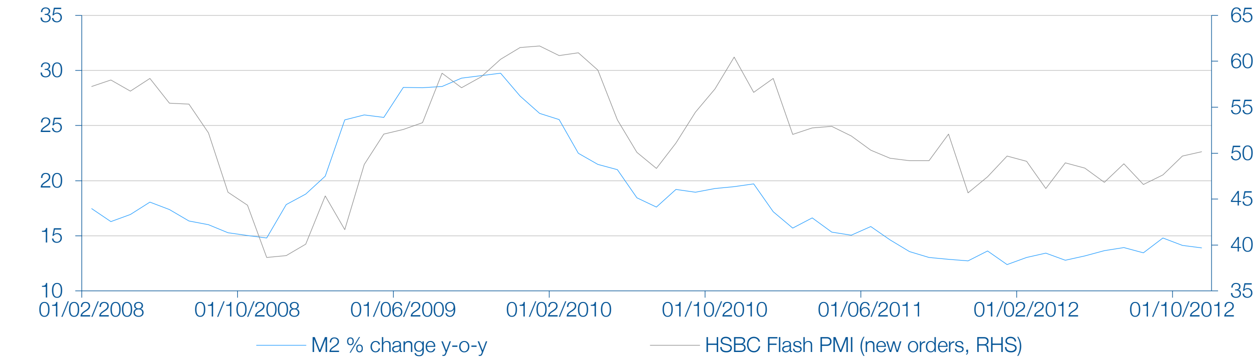
Exhibit 3: Germany – industrial production and IFO index




Source: Thomson Reuters Datastream

For investors the China story during 2012 proved disappointing as an unanticipated slowdown brought the stock market to four-year lows. At present the picture is improving, with survey data ticking up and also an increase in money supply growth, which is indicative of policymakers coming off the brakes, Exhibit 4. We took profits on a year-long underweight basic industries view in September and since then the iron ore price has rallied by more than 30%. As export markets have slowed China has little choice but to allow further fixed asset investment in 2013 if growth is to be maintained, even if this represents a departure from the ultimate goal of a more consumer-oriented economy.

Exhibit 4: China – PMI index and M2 money supply



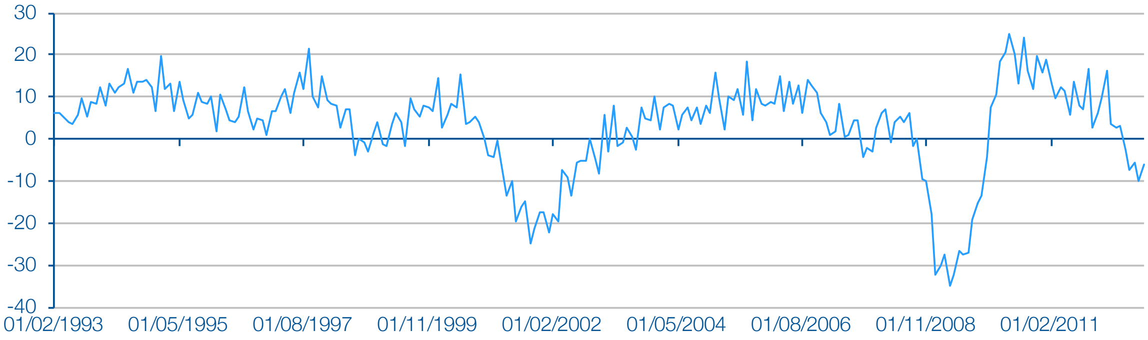

Source: Thomson Reuters Datastream

## US survey data has weakened

Even as European economic data has improved, US momentum has weakened. A number of surveys have indicated that growth is slowing and non-defence capital goods orders have fallen sharply year-on-year, Exhibit 5. In a recent outlook call GE indicated that its customers' Q4 investment spending has softened and revenue guidance has been cut during the quarter. At the other end of the spectrum the NFIB small business survey highlights a striking decline in respondents' optimism for 2013, Exhibit 6.

Regardless of the outcome of the negotiations over the US fiscal cliff, which appear at present to be stumbling, a significant fiscal drag of around 1% of GDP per annum will depress economic activity in developed markets from 2013 onwards, Exhibit 7. The good news is that consensus GDP forecasts have already fallen significantly for 2013 and therefore a muted growth outlook is to a degree embedded in investors' expectations.

Exhibit 5: US durable goods orders

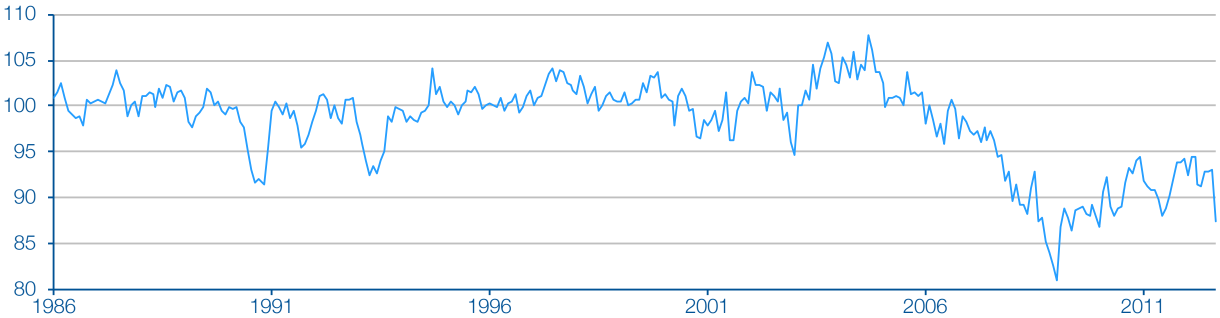



Source: Thomson Reuters Datastream

## Valuations: 'OK' in UK and Europe; expensive in US and cheap in China

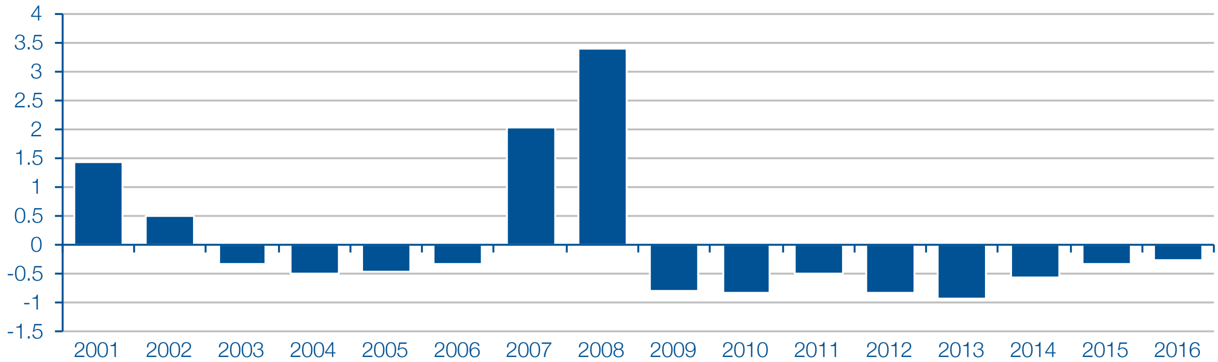
The value opportunity in European equity markets we highlighted earlier in the year has passed. Valuations for Europe and the UK, when adjusted for reduced sales growth guidance, now indicate returns closer to long-term averages than any kind of bargain level. Non-financial indices are at their highest ever levels **including the dot-com bubble of 2000**, after doubling from their lows of 2008, Exhibit 8. Given the level of uncertainty inherent in the outlook, in our view this is generous and quite possibly driven by a lack of sensibly priced fixed income instruments. We have written in previous issues about the dangers of using the yield gap as an argument for owning equities.

Exhibit 6: NFIB confidence survey




Source: Thomson Reuters Datastream

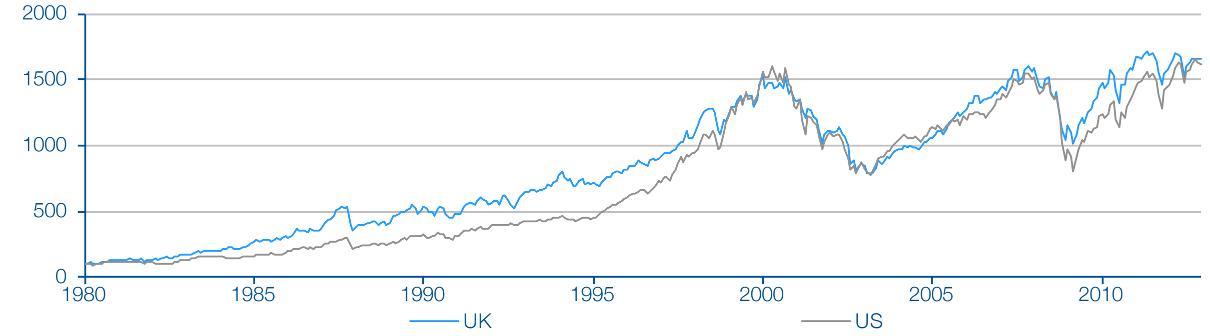
Exhibit 7: World fiscal drag (% GDP)




Source: IMF, Edison Investment Research calculations

One market that has completely missed the party is China. Here a combination of heady expectations and a surprise slowdown led to a striking divergence between the market performance of the world's largest high-growth market and the supposedly slower growth developed world. From a strategic perspective we turned negative on China and the basic industry sector over a year ago. It would now appear to be a different short-term investment case as the risk/reward balance has shifted. The money supply is now growing in China and purchasing managers' survey data has ticked up sharply. With equity valuations significantly lower than developed markets on a price/book basis, Exhibit 9, now does not seem the time to be underweight even if significant structural challenges remain.

Exhibit 8: UK and US non-financial indices at record highs

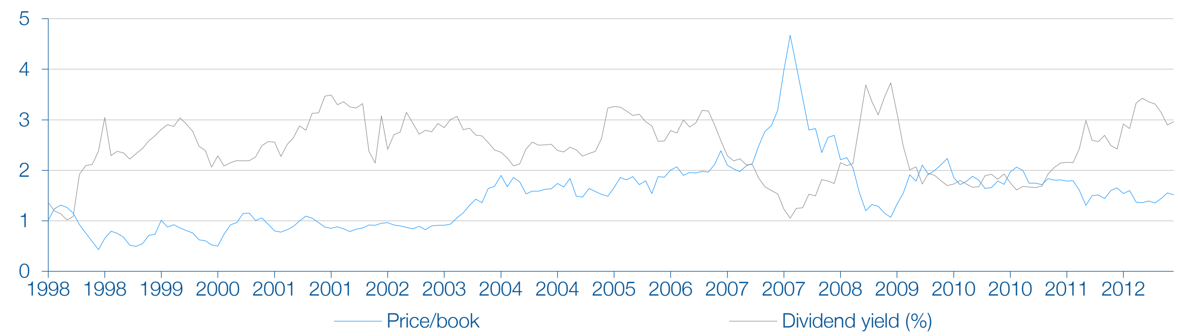



Source: IMF, Edison calculations

## Mixed signals point to balanced portfolios

We do not believe that aggressive portfolio positions are justified at the current time. Though markets have been rising on improving survey data, random short-term fluctuations in economic activity should not be confused with a return to structural growth, especially when the structural problems clearly remain in place. Fixed-income markets remain unattractive even if yields are likely to be held at low levels by central bank purchases. A diverse portfolio including cash, gold and high quality equities is likely to yield more and provide better purchasing power protection over the medium term.

Exhibit 9: China non-financials: Price/book and dividend yield




Source: Thomson Reuters Datastream

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