Illumination: Equity strategy and market outlook

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Global perspectives: Risks are rising

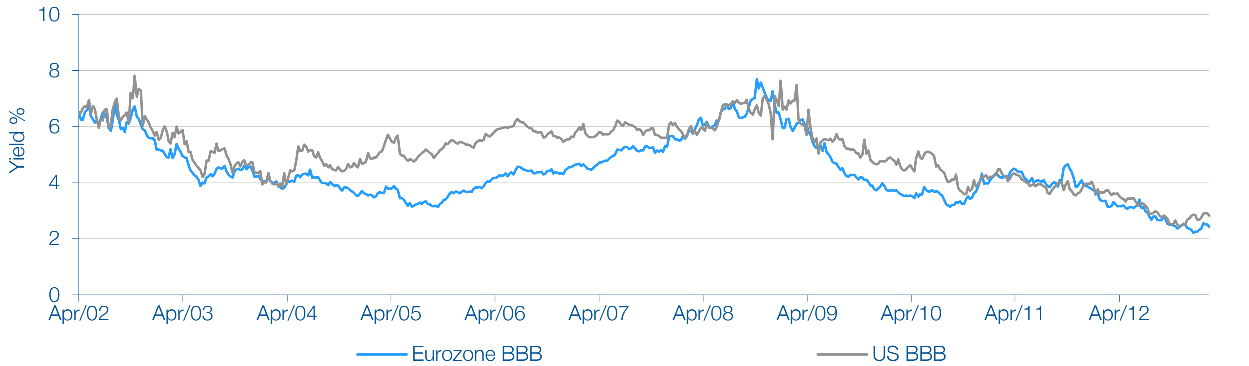
- **It has been relatively difficult to make a losing trade over the past six months.** World equity indices have risen sharply and credit spreads have narrowed for both the corporate sector and the periphery of Europe. This has created a mood of confidence that pervades the financial media. The modest increase in yields (and declines in price) for US, UK and German government bonds does not seem to have caused any significant pain to date.
- **Equity risks increase as profit growth fails to deliver.** It has been over six months since the ECB stepped in to "do whatever it takes" and the US Federal Reserve expanded its money-printing operations to US$85bn per month. The financial sector has benefited enormously from this underwriting of sovereign debt and economic growth risk by the ECB and Fed respectively. By now we would have expected to see the trickle-down effects become evident in both the real economy and in analysts' forecasts. In reality, consensus economic forecasts for 2013 have failed to tick up and sales forecasts for Western markets peaked in Q2 of 2012.
- **Valuations in a different place from last year.** If growth remains weak then the justification for sharply higher valuations is likely to be tested by the market. We believe the current enthusiasm for mid-cap equities in particular may represent a selling opportunity.
- **Investors over reliant on central bank policy.** Judging by recent market events investors may be paying too much attention to the Federal Reserve rather than focusing on corporate fundamentals. Fed-fixation may represent a systemic risk as asset markets re-correlate on down days. The release of the Fed minutes this week revealed dissent in terms of the pace of QE and created a mini panic in both equities and commodity markets. Having lowered returns on every liquid asset class in the interests of creating growth, increased returns (and lower prices) would seem to be the logical consequence of a reduction of policy accommodation.
- **Staying cautiously positioned – short-term pain for long-term capital preservation.** Our investment strategy has been too cautious in recent months as we underestimated the benefits of the most recent round of QE on financial assets. Even so, most portfolios of cash, gold and blue-chip equities would have generated substantial returns over the past six months. We would still be looking to take profits on positions that have outperformed and particularly in mid-caps.

Risks are rising

Capital market signals are at present difficult to read due to the influence of central bank policy. Equities have been rising sharply since the summer but growth indicators are not following with the six month lag that would normally be expected. In a 'normal' world it would also be odd to see ultra-low bond yields and interest rates at the same time as a sharp rally in growth-sensitive assets. Intervention by central banks has broken the usual correlations between growth and bond yields, the latter largely fixed by policy.

In this piece we consider the evidence for the profits growth needed to justify the recent moves in equities. In short, we believe investors are simply accepting lower returns on riskier assets due to the perceived sovereign debt and growth risk insurance provided by the ECB and Fed respectively. In our view, central bank policy has by design compressed returns across asset classes such as corporate credit, Exhibit 1, but has not to date created the growth dynamic needed for a self-sustaining recovery.

Exhibit 1: Corporate credit costs, US and Europe

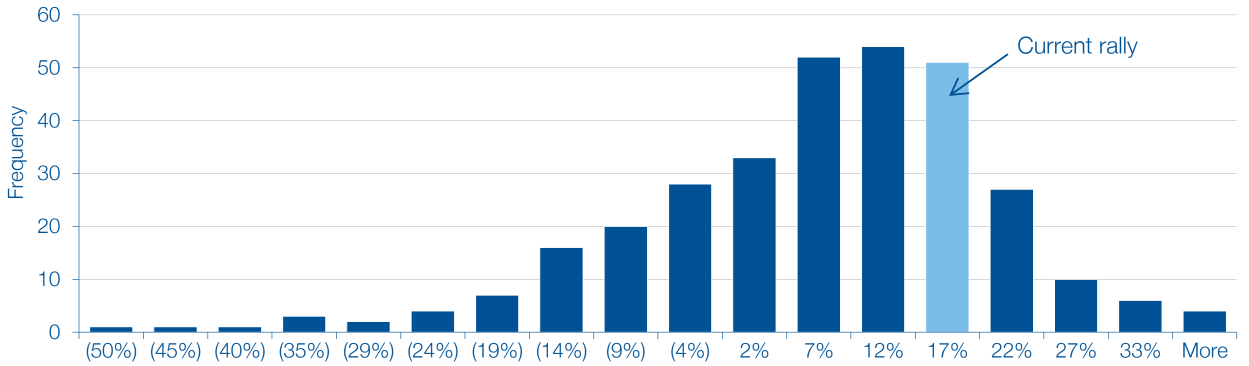


Source: Thomson Reuters Datastream

1. Economic forecasts for 2013 – stubbornly resistant to upgrades

The rally in equities, especially in the mid-cap sector, has been statistically notable over the past six months, Exhibit 2, with only a few time periods offering higher returns over the past 30 years. In the circumstances we should by now be expecting a significant improvement in economic sentiment. This evidence is proving difficult to come by. Economic forecasts for 2013 appear stubbornly resistant to upgrades. The current consensus calls for 2% growth in the US, 1% growth in the UK and recession in Europe, as shown in Exhibit 3.

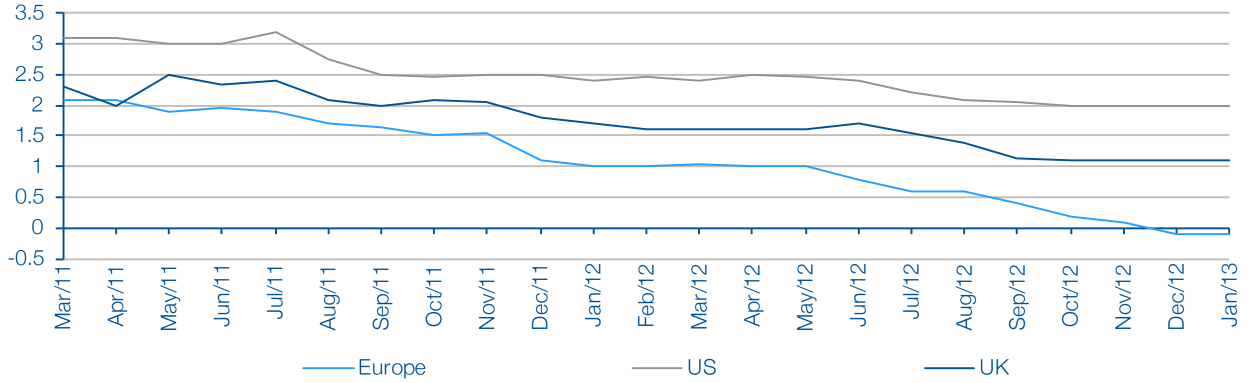
Exhibit 2: Mid-cap rally in context - histogram of 6m returns for FTSE 250



Source: Thomson Reuters Datastream

Purchasing managers' indices continue to indicate contraction or stagnation rather than any strong recovery in Europe. The most recent services and manufacturing survey fell to 47.3 from 48.6 in January, undershooting economists' forecasts of an improvement to 49. Expectations-based surveys such as the German ZEW index have recovered strongly since last year. However, we note this series is highly correlated with the prior six month's performance of the stock market rather than being predictive.

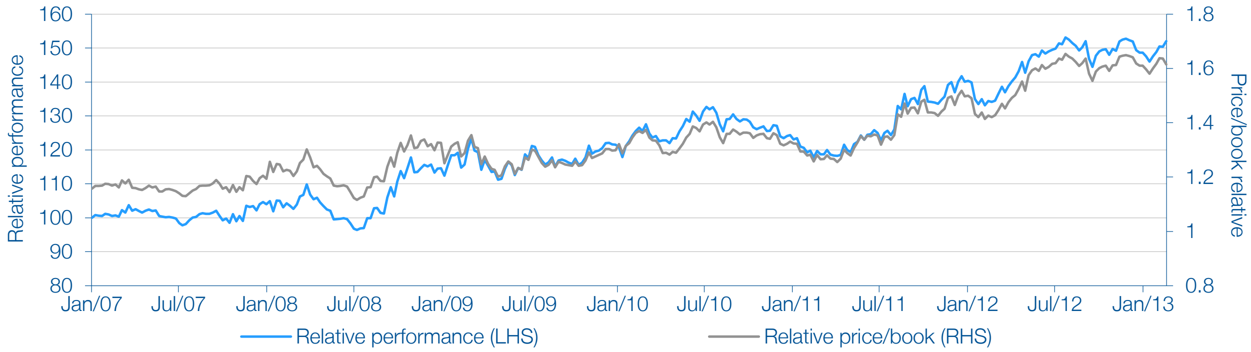
Exhibit 3: Consensus economic forecasts



Source: Bloomberg

A lack of GDP growth is providing further impetus to the debate over the use of monetary policy to stimulate growth in the UK and Japan. This is raising fears that nations will turn to currency devaluation in an attempt to stimulate growth. For investors the salient point is that sequential devaluations of major currencies will amount to currency debasement. The medium-term benefits of owning assets which maintain purchasing power in these circumstances are clear and we remain of the view that gold at current prices remains a good hedge against such a scenario. In our view, inflation fears may also have led to the relatively high rating and outperformance of the consumer staples sector, Exhibit 4.

Exhibit 4: Outperformance and re-rating of UK consumer staples sector

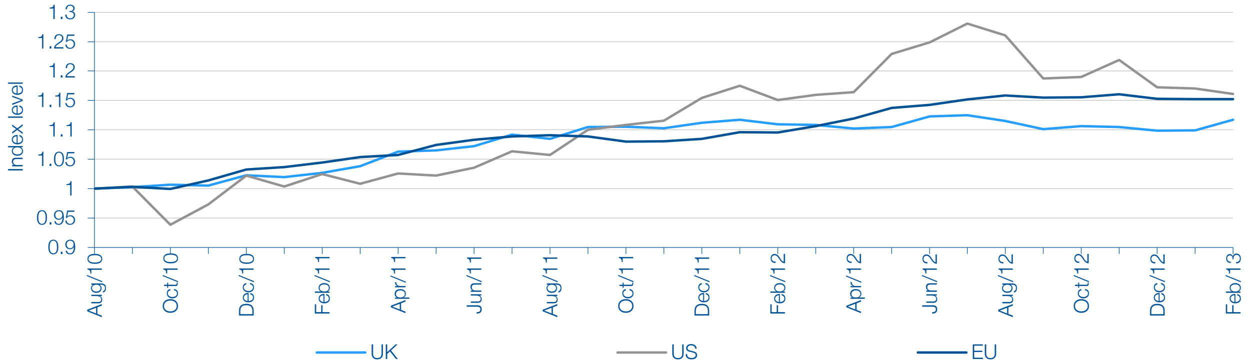


Source: Thomson Reuters Datastream

2. Consensus earnings forecasts have stalled

Without strong economic growth companies have been struggling to grow revenues. Exhibit 5 shows a peak in forward sales forecasts in Q212 for the largest non-financials in the US and a flattening for European markets. The stagnation in sales forecasts has also pushed corporate profit margins down from historical highs. While loose monetary and fiscal policy has sustained activity and corporate profits since 2008 the growth factor remains elusive. Formulaically, equity returns are the sum of the dividend yield and the growth rate. We believe investors looking at relatively high dividend yields for equities (at least in the context of the past 20 years rather than 50 years) should carefully consider the impact of weak economic growth on company valuation.

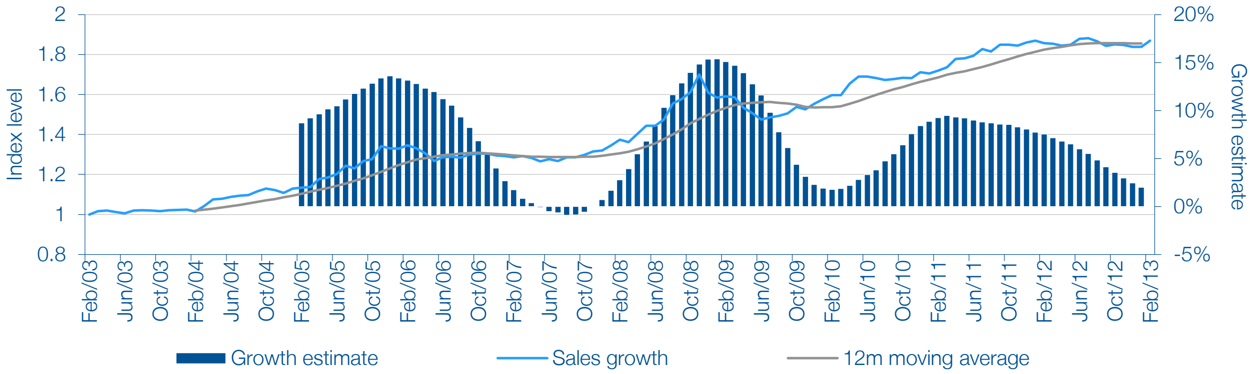
Exhibit 5: 12m forward sales estimates stagnating in developed markets



Source: Thomson Reuters Datastream, I/B/E/S, Edison calculations

Though in theory any short-run acceleration and deceleration in sales growth should have relatively little impact on equity valuations, we have found empirically this has been far from the case over the past 10 years. In reality, a modest slowdown in sales growth has a disproportionate effect on returns due to multiple compression on a smaller than expected level of profits. This is an example of how markets can efficiently discount 'small' news but can suffer large mis-pricings during long recessions.

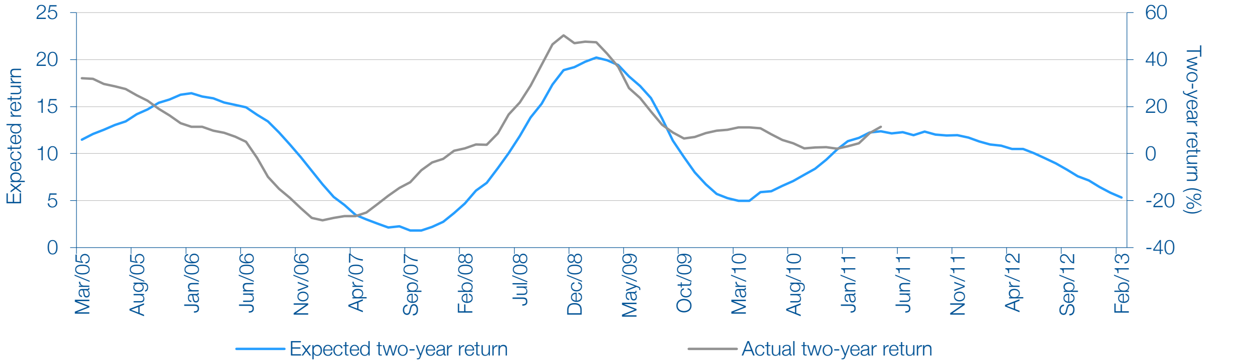
Exhibit 6: A simple moving average model of sales growth for UK non-financials



Source: Thomson Reuters Datastream, I/B/E/S, Edison calculations

In Exhibit 6 we have created a simple sales growth model based on the moving average of 12m forward analyst sales forecasts for UK non-financials. This (very) naive growth projection is then used to forecast the expected return on equities (taken as growth rate plus dividend yield) over the following two-year period. Rather alarmingly this very simple formula has over the past 10 years explained over 50% of the variation in two-year returns! In short, if purchases are made when sales growth forecasts are weak returns are often poor as shown in Exhibit 7. Right now, the absence of sales growth is an amber signal for investors at least. The tailing-off of sales growth forecasts over the last six months is in stark contrast to strength of the market rally.

Exhibit 7: Forecast returns and actual for UK non-financials



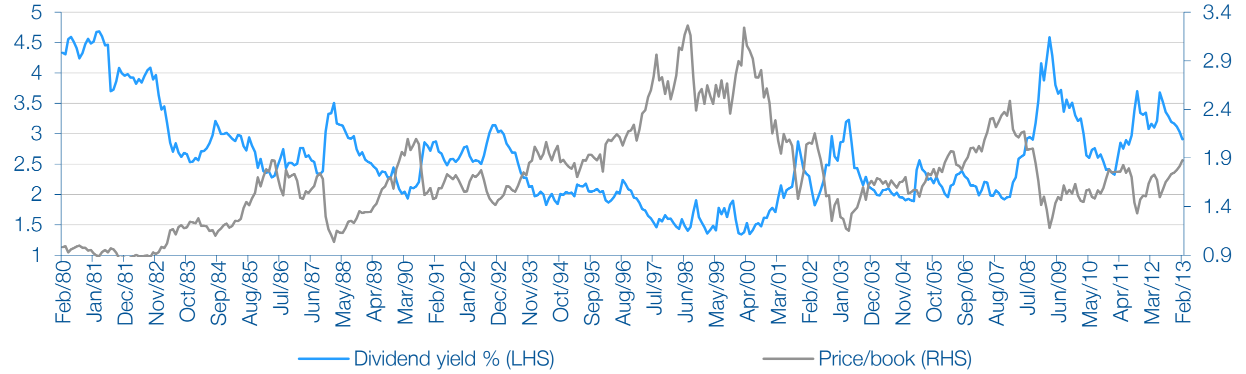
Source: Thomson Reuters Datastream

3. Valuations no longer at extreme levels

A year ago the DAX was trading at dividend yields seen only during the 1970s and briefly during the credit crisis. Since then yields have declined to under 3% and price/book multiples have expanded by 40%, Exhibit 8. Valuations, while some way from expensive, are clearly no longer in dirt-cheap territory.

Therefore at present valuations require investors to believe that profit growth near historical levels is the base case. We are more cautious as we see little evidence for this; although margins have fallen from peak levels they are still above average and economic growth in Europe continues to disappoint. The probability of another opportunity to buy shares at distressed levels over the next 18 months is too high to justify being fully invested, in our view.

Exhibit 8: German non-financials – valuations no longer extreme



Source: Thomson Reuters Datastream

4. Surprise dissent at the Fed and monetary tightening in China

The market response to the Fed meeting minutes of 29-30 January was telling. The minutes reveal that several committee participants have raised very legitimate questions over the costs and benefits of asset purchases. Potential costs included future inflation, threats to financial stability from speculative activity and capital losses incurred by the Fed as asset holdings are unwound. These potential costs are well known and have been widely discussed in the press. However, just the *possibility* of an early exit or variation in the size of the current QE programme was enough to generate the largest daily stock market losses this year. This clearly points to a market that has lost its reference to value and is instead overly-dependent on central bank policy.

We absolutely share the view that QE and volatility suppression has significant and under-appreciated costs. The elimination of income on savings for a cohort of cautious savers and retirees will have had an impact on spending. The limited level of financial sector restructuring in Europe has prevented entrepreneurs from generating the kind of profits which give rise to the animal spirits from which strong recoveries are made. Furthermore, without the discipline of market interest rates governments have been able to incur much larger levels of indebtedness and at lower costs than otherwise.

Separately, China appears to have become significantly more hawkish on credit expansion in recent weeks. The central bank has been draining record amounts of liquidity from the banking system and real-estate credit controls have been introduced in a number of regions. While early in the process, policymakers would appear to have decided that activity in the world's second largest economy needs to slow to prevent overheating.

Conclusion

Our primary concern is that investors have become too complacent about the risks to growth. Large gains across multiple asset classes mean that most market participants have not felt the pain of losses for several quarters. Yet the risks to profit growth is clear – earnings forecasts have been ebbing since Q112 and the trend has not shown any recent improvement in response to monetary policy as would be expected by now.

With a muted growth environment and evidence of an over reliance on central banks to drive asset prices, we believe investors should stay cautiously positioned in both equities and credit. To be clear, our cautious investment strategy would have underperformed in recent months and we certainly underestimated the benefit of the most recent round of QE on the financial sector. Even so, a portfolio of cash, gold and blue-chip equities would have generated substantial returns over the past six months. We would still be looking to take profits on positions that have outperformed.

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