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Illumination: Equity strategy and market outlook

March 2013

Published by Edison Investment Research

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Global perspectives: Flip flops on the beaches

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- **Cyprus the first victim of bail-out fatigue.** The European approach to handling its sovereign debt crises has flip-flopped as the mounting costs of supporting southern Europe become evident to the north. Within the space of a week, capital controls, senior bondholder and bank depositor bail-ins have been put firmly on the agenda. All of these measures have in the past been discounted for fear of triggering capital flight from nations that are the potential beneficiaries of support programmes.
- **More reasons to avoid the periphery.** A potential loss of capital or loss of access to capital via capital controls marks a significant shift in the risk/reward balance for investments in potentially distressed European nations. In effect the downside scenario for such investments may be close to zero. This is especially relevant when the austerity programmes being implemented in Europe are causing a significant contraction in economic activity. It is difficult to argue against the view that a *de facto* breakup of the eurozone is back on the tail-risk agenda. Sharp action by the ECB may be required to restore the previous calm.
- **Cyprus may be small (0.2% of eurozone GDP), but it still has the potential to shock.** A nation that has had its largest industry effectively destroyed may rationally consider exiting the eurozone to both improve competitiveness and allow capital controls to be removed. If successful, this could represent a 'template' for other distressed nations. In the meantime, the risk of social instability in Cyprus increases the longer strict limits on cash transactions remain in place.
- **Recent headlines distract from another round of poor survey data in Europe.** The most recent set of flash PMI data undershot expectations in March. We note an increasing discrepancy between the performance of the Eurozone's two largest economies, France and Germany. In contrast, economic momentum in the US appears to be improving, helped by the continued recovery of the housing market from depressed levels.
- **Follow the smart money. While the IPO may be making a return, M&A remains muted**. We believe issuers are taking advantage of relatively strong valuations in the context of an uncertain environment for growth. On the other end of the event-driven spectrum, the modest level of M&A currently indicates only a low level of interest for equities from the corporate sector. It may pay to be alert to these pricing cues.
- **Remaining cautiously positioned.** It is hard to see how we could have become more bullish over the course of March. A growth slowdown in the UK and Europe puts earnings estimates at increased risk. In addition, the impact of Cyprus may yet prove to be out of proportion to its actual size. Within a cautious overall equity outlook we continue to recommend quality companies with leading market positions, strong balance sheets and global exposures. An allocation to gold remains a valid hedge against future inflation and/or currency devaluation.

Cyprus the first victim of bail-out fatigue

Cyprus may have presented a special case due its offshore banking model, but even the most recent agreement is punitive and the situation remains precarious in both the short and medium term. In the short run, even though the banks have re-opened the impact of depositor losses raises questions for the viability of many SMEs. In addition, capital controls will impede trade and how long they will remain in place remains an open question. In the medium term it is difficult to see how Cyprus will recover as its largest industry – offshore finance – has in effect been shuttered and the absence of devaluation gives no competitive boost to its tourist industry. Thankfully for the rest of the world, the small size of the economy means that the direct economic impact is very limited.

However, a precedent that has been set may have much further reaching ramifications. Doubt has been cast on the principle of guaranteed deposits now it is clear these can be subjected to capital taxes with the tacit approval of European powers. Senior bondholders, which have in many cases been protected from losses, are now also in the firing line. As for wholesale deposits it is unclear why anyone would maintain larger account balances with even a remote chance of bail-in when secure account facilities or short-dated government securities can be found elsewhere. We believe the funding costs for distressed banks will rise significantly following the Cypriot example. Whether or not a template for other situations - as clearly stated then immediately denied by the chairman of the Eurogroup of finance ministers - this genie is out of the bottle. We note credit default swap premiums for European financials have risen sharply in recent days, as illustrated in Exhibit 1.

Though Cyprus is an important precedent the media attention on the topic has obscured other bad news. The European economy continues to struggle in the face of a sharp increase in the trade-weighted exchange rate and the impact of austerity across the periphery.

Exhibit 1: Itraxx senior financials CDS premium (basis points)

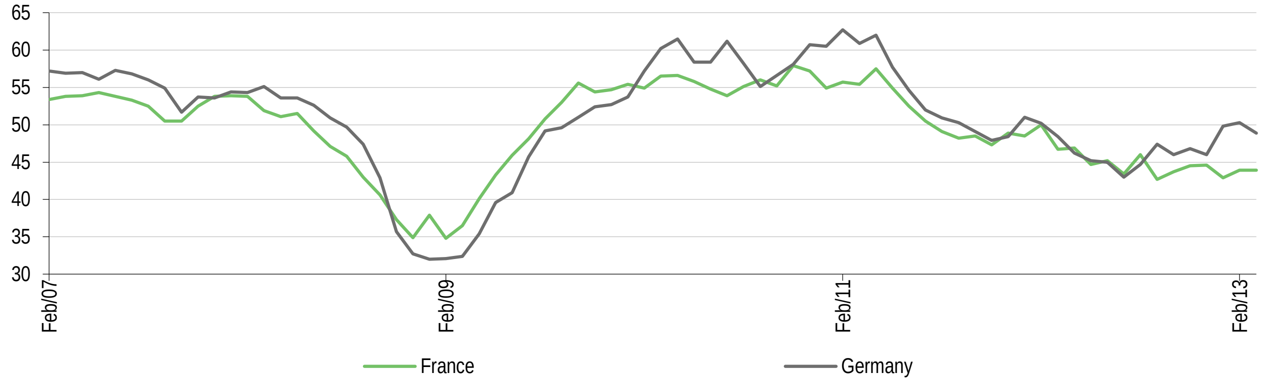
Source: Thomson Reuters Datastream

European economy losing momentum

The most recent set of eurozone survey data has undershot expectations and points to further decreases in activity. The loss of momentum is most acute in the periphery, where the Bank of Spain recently lowered its GDP forecast to a 1.5% contraction for 2013. We also note an increasing divergence between France and Germany's survey data, Exhibit 2. For the eurozone as a whole, consensus economic forecasts are still falling and indicate a contraction of 0.1% for 2013.

In the US the picture is brighter, with survey data remaining in expansionary territory. A combination of significant quantitative easing combined with the benefits of the shale gas boom and a gradual recovery from the housing market correction of 2008 contrasts with the still difficult situation in Europe. The improvement in the economy has maintained equity prices at relatively expensive medium-term valuations.

Exhibit 2: Divergence of survey data between France and Germany

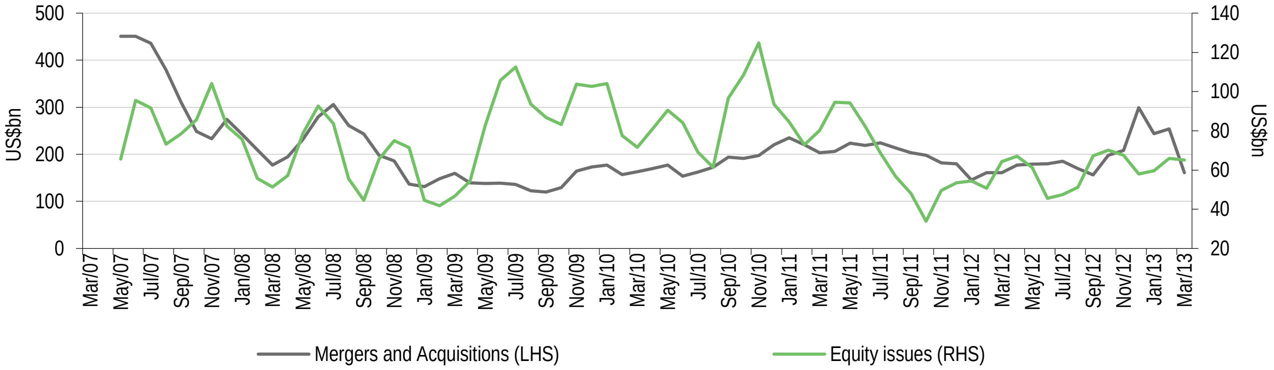


Source: Markit

Follow the money – equity issuance picking up, M&A still muted

There has been a distinct thaw in the IPO market in Q113 and it is notable that at the same time M&A remains muted, Exhibit 3. We believe corporates and private equity owners are taking advantage of buoyant markets to ssue equity rather than making new acquisitions. This gives a strong hint towards the private views of corporate insiders. We would be tempted to follow their lead.

Exhibit 3: Global IPO and M&A volumes



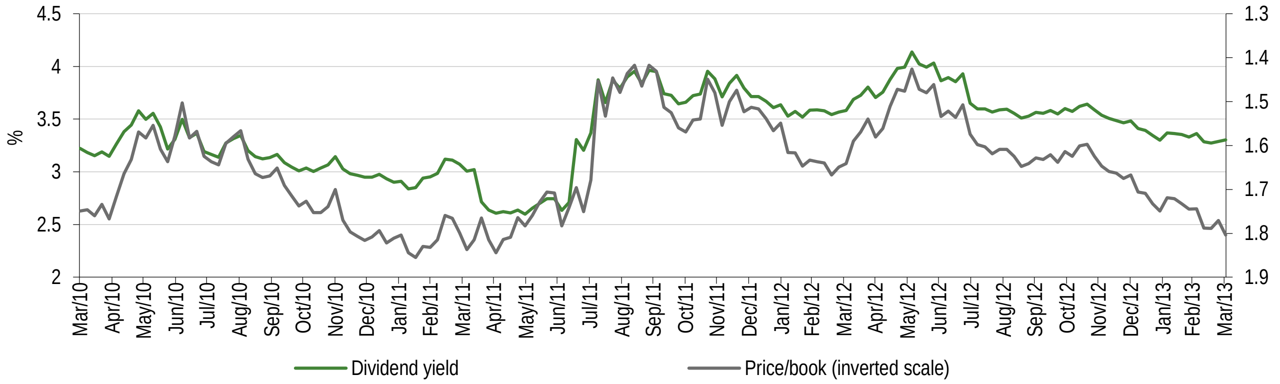
Source: Bloomberg

Equity valuations still price in the out-of-the-woods scenario

Market valuations in Europe and the UK have stayed remarkably resilient given the deterioration in the economic outlook and the uncertainties over the direction of policymaking in the eurozone. This 'out-of-the-woods' valuation scenario is over optimistic in our view,as recent events in Cyprus have made clear. Within the market it is becoming increasingly difficult to find the compelling value situations that were commonplace only 12 months ago.

Now that financials are underperforming again we question whether the overall market can continue to make gains. There is a remarkable correlation between the relative performance of the financial sector and the overall market, shown in Exhibit 5. When financials outperform the market has typically risen strongly. The most recent peak financial sector outperformance coincides almost perfectly with the top of the market reached in early February. Since then financial underperformance has accelerated and we question whether the rally can continue in the short term in these circumstances.

Exhibit 4: European non-financials dividend yield and price/book

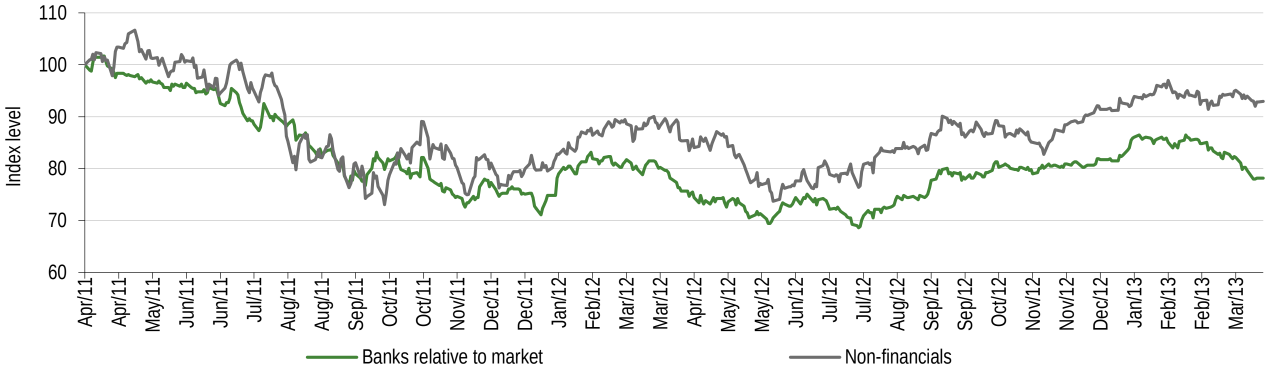


Source: Thomson Reuters Datastream

Conclusion

It is hard to see how we could have become more bullish over the course of March. A growth slowdown in the UK and Europe puts earnings estimates at increased risk. In addition, the impact of Cyprus may yet prove to be out of proportion to its actual size. Within a cautious overall equity outlook we continue to recommend quality companies with leading market positions, strong balance sheets and global exposures. An allocation to gold remains a valid hedge against future inflation and/or currency devaluation.

Exhibit 5: European market performance led by financials



Source: Thomson Reuters Datastream

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