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Illumination: Equity strategy and market outlook

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Global perspectives: Stall speed

- **If you lose power, reduce the angle of attack.** Central bank policy has been attempting to re-light the private sector engine of economic growth while maintaining the same rate of climb. Now the initial boost from Q4's QE is fading, global economic growth is once again close to stall speed.
- **Losing altitude to regain control is better than crashing.** In our view, asset prices have been used as a policy tool to 'reverse-engineer' economic activity. Pushing asset prices higher and keeping interest rates low was intended to create a wealth effect and an incentive for risk-taking. However, low interest rates and liquidity support are also a 'keep-alive' for low-return activities that would otherwise have been restructured. 'Zombie' banks and firms cannot invest and continue to be a drag on growth, especially in Europe. The corporate sector is holding back from M&A as valuations have risen ahead of fundamentals, delaying value-enhancing transactions. A little market turbulence may ultimately prove beneficial.
- **Misfiring on all cylinders.** Across the globe, economic data has undershot expectations – in the US, Europe, the UK and China. PMI data in the eurozone is firmly indicating a contraction is underway and economic forecasts continue to fall. In China, the most recent GDP and flash PMI numbers undershot expectations. In the UK, survey data continues to disappoint. Although in theory the recent cuts to US government spending are modest, we note US employment and manufacturing data missed expectations in April.
- **Energy and industrial metals price signals should not be ignored.** The recent sharp sell-off in the industrial commodity markets is wholly at odds with the first quarter's gains in global equity markets. Commodity-related equities have underperformed horribly. The slack in spot commodity markets, including energy, is indicative of an unexpected shortfall in global demand.
- **Earnings estimates continue to decline.** The common theme for European earnings reports is the difficult economic environment. Twelve-month forward sales estimates for non-financials have stagnated since mid-2012 in every major global region. Margins remain healthy (but with downward pressure in Europe), but equity investors need growth to generate returns.
- **Still cautious.** We are not perma-bears – we just think investors should get paid for the risks they take. Equity markets have remained firmly bid despite mounting evidence of a slowdown. At the asset allocation level, we remain cautious (not bearish) on equities and have not changed our positive view on gold despite the recent correction. Any significant decline in economic activity remains likely to result in increased monetary stimulus.

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

Stall speed

The aim of developed market monetary policy since 2008 has been to maintain the previous rate of economic growth without the engine of excess private sector credit creation. The use of unconventional monetary policy has led to episodic surges in economic activity, led by asset markets. There have been a number of side-effects of this policy. Investors have suffered a near-elimination of interest income on cash and significant compression of yields on government securities for the last five years.

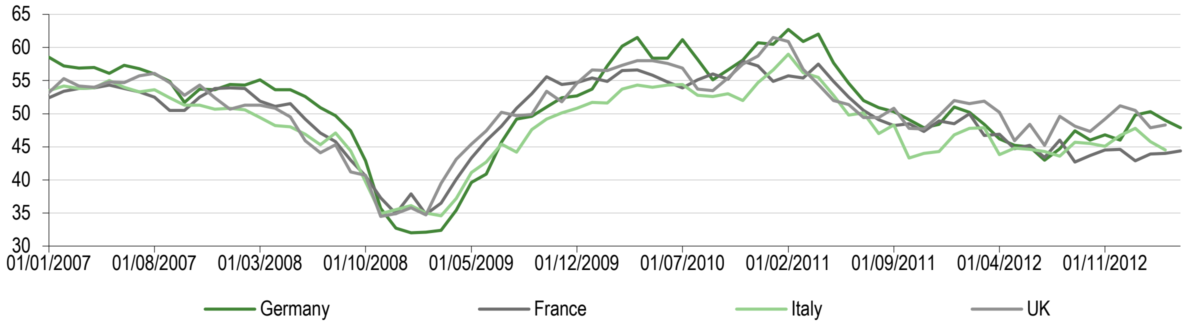
More recently, we believe there has been a significant reduction in the expected return on equities as market valuations have risen without a corresponding increase in earnings forecasts. The effects of ultra-low interest rate policy are not restricted to liquid assets. Within the real economy, the extended period of low interest rates has facilitated the survival of many low-return projects that would otherwise have failed. Clearly, this will have benefited activity and employment in the short run. But by definition, the survival of low growth and low return on capital (ROC) projects will be a drag on economic activity in future periods.

We do not believe it is a coincidence that M&A remains subdued despite a cash-rich corporate sector. Despite the fall in funding costs, the corporate sector has not relaxed ROC criteria for acquisitions. With first-hand experience of the difficult trading environment, the corporate sector is also being realistic about prospects for profits growth.

Economic volatility creates restructuring opportunities. The compound growth from a successful restructuring can rapidly cover the up-front costs of the initial disruption. Within a dynamic organisation, the continuous pruning and restructuring of poorly performing units is a key part of delivering growth. But for the aggregate economy, it is quite possible that central bankers' determination to suppress economic volatility has contributed to the slow-growth environment as low-return activity has been allowed to prosper.

Suppression of economic volatility has also created tension in FX markets. The depreciation of the yen is currently the focus and it remains to be seen how long this will be tolerated by the US and China. In recent weeks, the US has warned Japan to refrain from competitive devaluation and to adhere to its G7 and G20 commitments. The price of reverse-engineering growth through monetary policy and fiscal deficits is that if the policy fails, the resources expended in the endeavour will need to be written down. This is not a trivial matter as central bank assets have reached over 20% of GDP in developed markets. However, we see little scope for central bankers to reverse course at this stage, unless they wish to explicitly lose their independence. If this quarter's economic stall persists, it is likely to be followed by more monetary stimulus.

Exhibit 1: European purchasing managers' indices – manufacturing



Source: Thomson Reuters Datastream

Misfiring on all cylinders

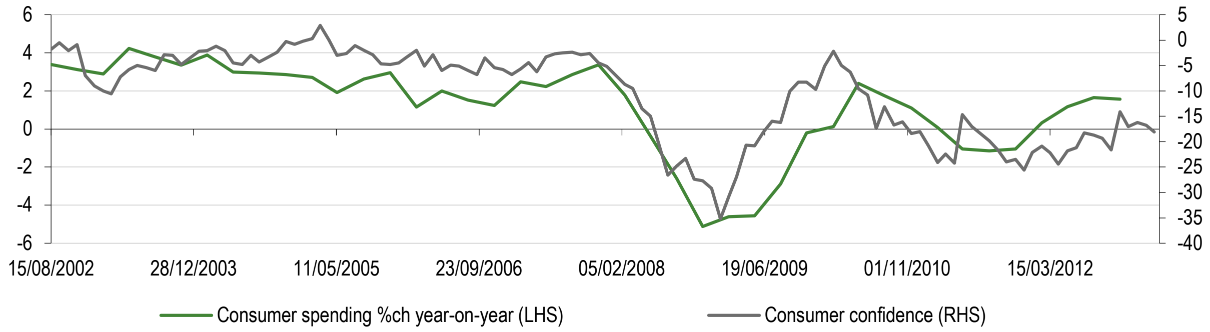
The scope of the disappointing economic data over recent weeks is significant and global. In Europe, survey data have undershot expectations and continue to indicate a contraction across the eurozone, Exhibit 1. The slowdown is no longer confined to the periphery with a notable recent slowdown in evidence in Germany. Vehicle sales in Europe fell sharply in March, with a 79% fall in Cyprus no doubt the result of stripping many potential car buyers from either access to their money or their cash assets. A eurozone recession in 2013 is now built into consensus economic forecasts.

Exhibit 2: UK exports year-on-year change %

Source: Thomson Reuters Datastream

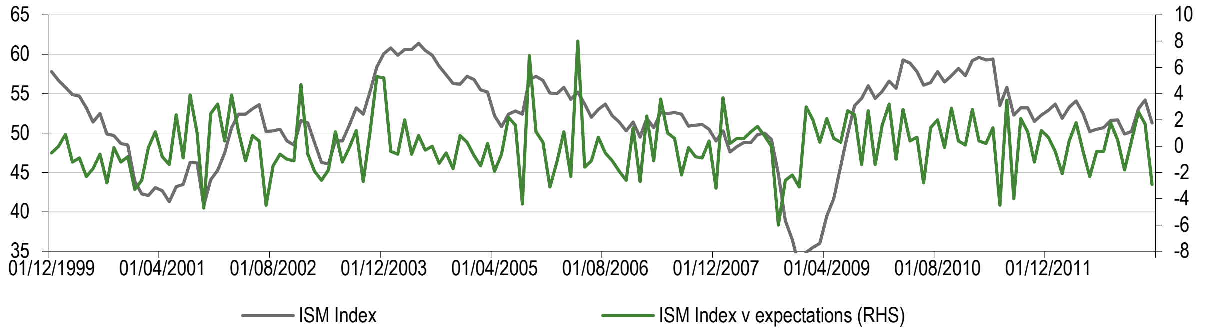
In the UK, the most recent PMI reading of 48.3 is indicative of an ongoing contraction of manufacturing output. UK goods exports (excluding oil) are contracting year-on-year while consumer confidence is falling again, Exhibits 2 and 3. Consumer confidence has a strong correlation to the growth of actual consumer spending, which shows few signs of returning to its pre-2008 average as households save more to reduce debt. Although UK consumers have stopped accumulating debt, the household debt/GDP ratio of 95% is still very high in a historical context and the UK savings rate may remain elevated for some time.

Exhibit 3: UK consumer confidence and spending



Source: Thomson Reuters Datastream

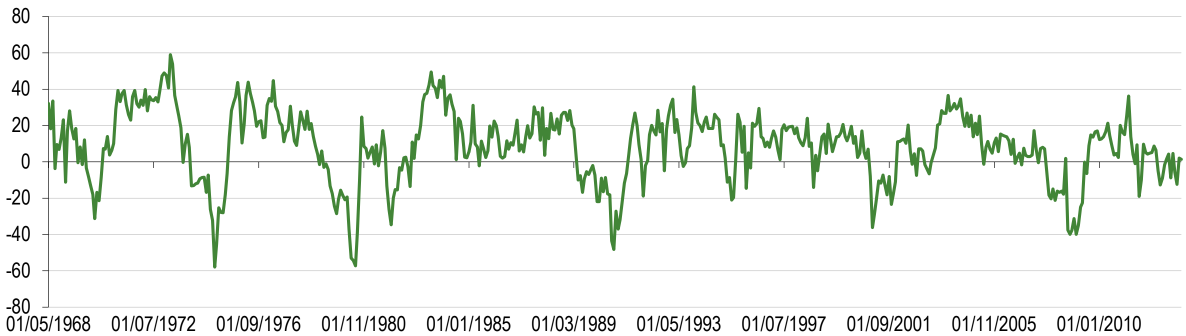
Exhibit 4: US ISM survey misses expectations



Source: Thomson Reuters Datastream

With a consensus GDP growth forecast of 1.8% the US is still considered to be the most dynamic developed market in 2013. The impact of the recent cuts on US government spending may only be equivalent to 0.6% of US GDP, but the recent data, which include a substantial miss versus expectations in the ISM manufacturing index, Exhibit 4, raise concerns. The Philadelphia Fed survey is now at levels consistent with all the previous major recessions of the last 40 years, with only a small number of false positives, Exhibit 5.

Exhibit 5: US Philadelphia Fed Survey



Source: Thomson Reuters Datastream

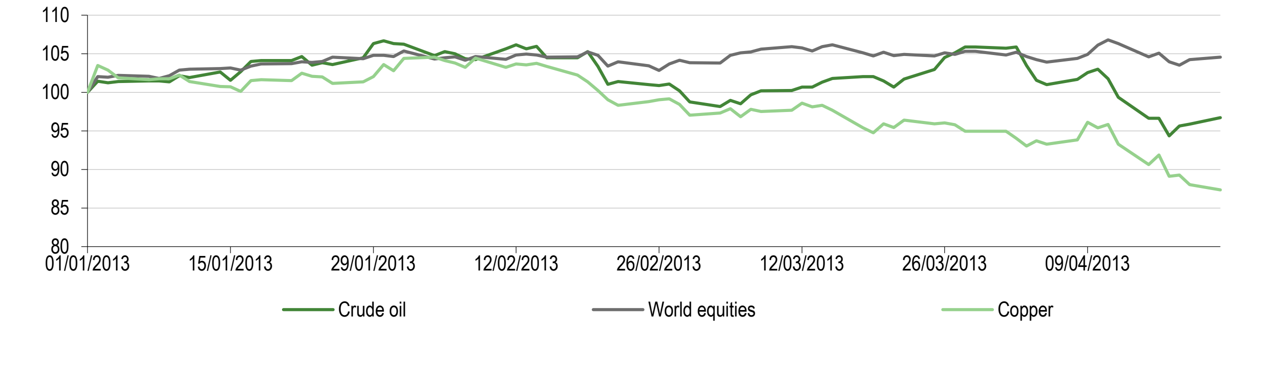
For China, Q1 GDP at 7.7% missed expectations of 8% and the prospect of slowing momentum was reinforced by the flash PMI of 50.5 missing expectations of 51.5. Nevertheless, for now the message is clear from China's leadership; a lower growth trajectory is a policy objective.

Dr Copper reporting a slowdown

Although gold has been making the headlines the entire industrial commodity and energy sector has been pointing to an unexpected slowdown in demand. Copper has fallen by 10% in recent weeks, with a similar size decline in the price of oil.

While helpful from an input cost perspective for inflation, these declines are consistent with a rapid deceleration of global economic momentum. The contrast between the performance of the equity markets and global commodities is striking, Exhibit 6. We think equity investors should be paying more attention.

Exhibit 6: Energy, copper and equities divergence year to date

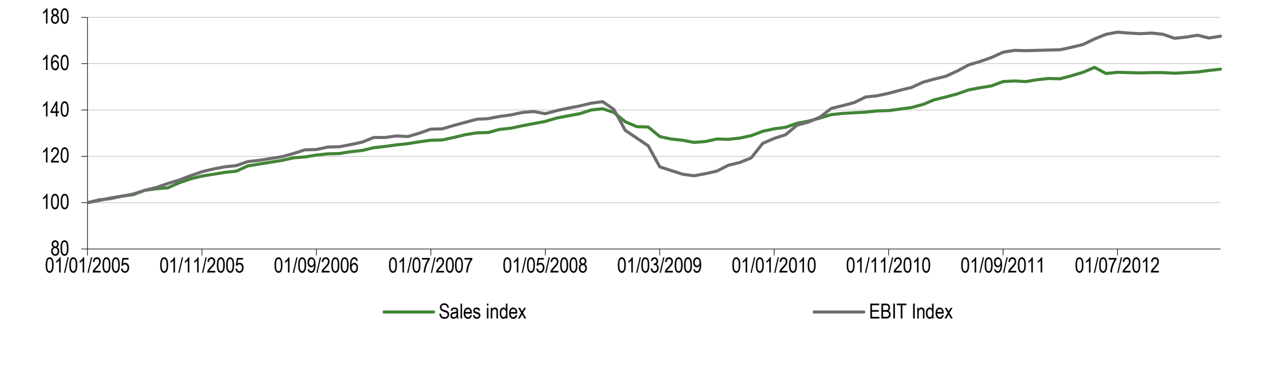


Source: Thomson Reuters Datastream

Earnings estimates stagnant

This earnings season has not been a disaster so far, but this is against a background of carefully managed expectations. In the US, 12-month forward EBIT forecasts peaked in mid-2012 and have failed to respond to the most recent round of either QE or the dramatic recovery in investors' confidence over the last eight months. Normally, we would expect 12-month forward estimates to drift up with the passage of time at between 4-6% per year. However, as Exhibit 7 shows, even in the US, which has the highest level of forecast GDP growth among developed markets, earnings momentum is lacking.

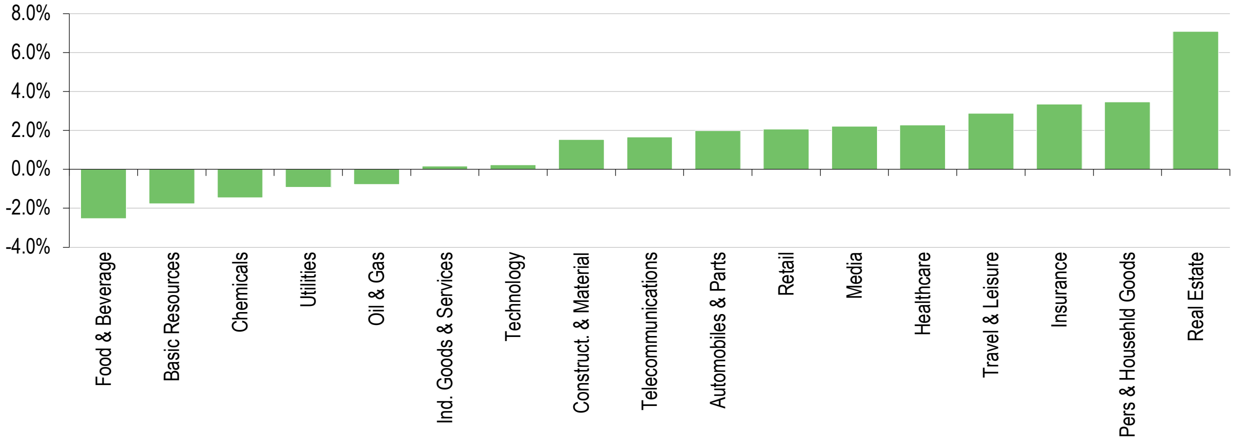
Exhibit 7: 12-month forward sales and EBIT index – US non-financials



Source: Thomson Reuters Datastream, Edison Investment Research calculations

A more detailed sector-level analysis of US sales forecasts indicates above-consensus performance of the real-estate and personal care sectors offset by significant downgrades to food and beverages and basic resources over the last eight months. Growth in other sectors remains muted, Exhibit 8.

Exhibit 8: US – sales momentum split by sector

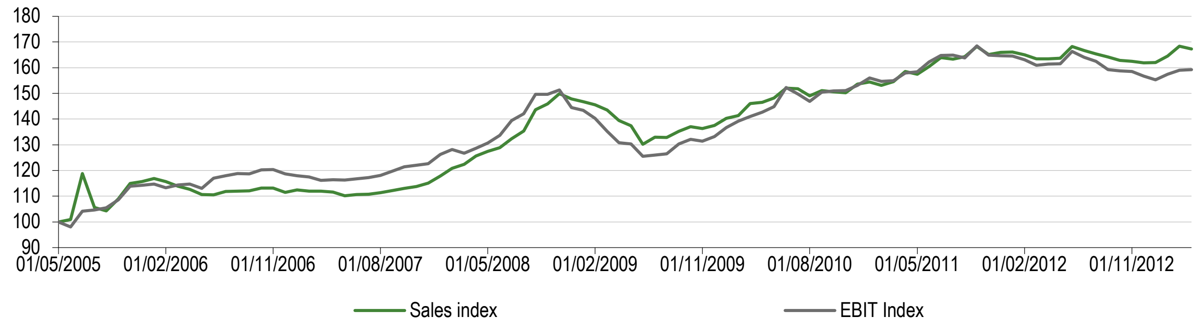


Source: Thomson Reuters Datastream, Edison Investment Research calculations

The US has benefited from a number of positive influences compared to Europe. In addition to the more decisive steps taken to re-capitalise the US banking system (and in turn the willingness to allow the housing market to correct), the domestic shale gas revolution may have affected energy sector forecasts, but this will have been a net benefit to overall corporate performance.

Furthermore, the benefit of the US domination of the global online media and retailing sectors is conspicuous. Although Apple may until recently have been the darling stock of the current cycle, both Amazon's and Google's revenues have risen by close to 10x since 2005, thus eating the lunch and dinner of the traditional retailing and media sectors of Europe in particular. The inability of European nations to develop global leaders in the most rapid growing segments of the economy is contributing to a significant relative economic underperformance in our view. We believe the much higher rating of the US stock market compared to Europe and the UK is at least in part due to the stronger fundamental performance of its constituents.

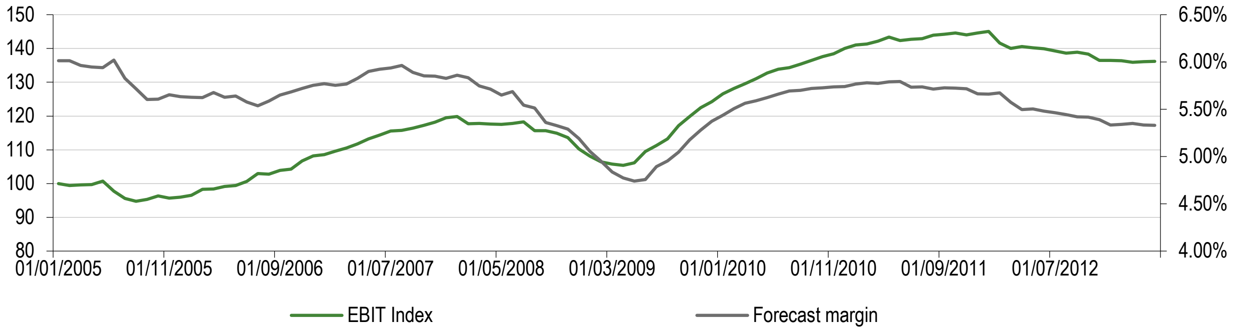
Exhibit 9: 12-month forward sales and EBIT index – UK non-financials



Source: Thomson Reuters Datastream, Edison Investment Research calculations

If the US corporate sector, with all its advantages, is struggling to maintain earnings momentum, the remainder of the developed world is finding conditions even tougher. For the UK, sales forecasts have also stagnated like the US, but in addition we are seeing some margin compression at the aggregate level, Exhibit 9. Most of this decline is driven by sharply falling estimates for the basic resources sector. However, few sectors are demonstrating any meaningful upward momentum with the exception of the food and personal care sectors, where the translation effect of the weakening of sterling is more obvious for these global but less volatile earnings streams. In retail, while sales are stagnant, EBIT and forecast margins are falling, perhaps reflecting top-line pressure from online (US) competitors as well as domestic input cost inflation, Exhibit 10.

Exhibit 10: 12-month forward forecast EBIT and margins – UK retail

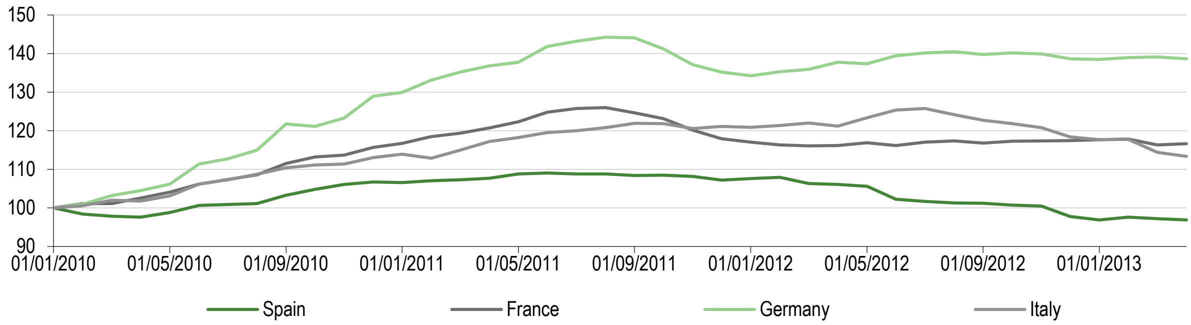


Source: Thomson Reuters Datastream, Edison Investment Research calculations

In Europe, the picture is surprisingly similar to the UK, despite the former's well-known issues with the periphery. As in the UK, 12-month forward sales and EBIT forecasts peaked in mid-2012 with downgrades led by basic industries and supported by good momentum in the food and personal care sectors.

From a country level split, the impact of the ongoing eurozone crisis is clearer. Sharp downgrades in Italy and Spain are being offset by the more resilient performance of Germany, Exhibit 11.

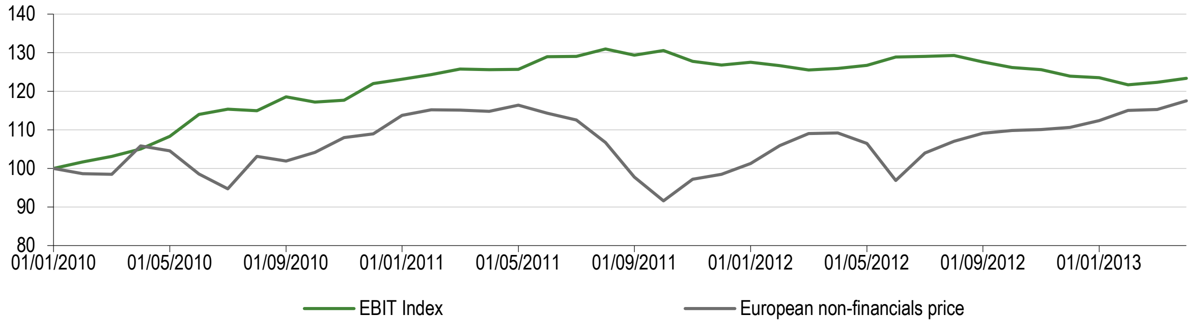
Exhibit 11: 12-month forward EBIT forecasts – France and Germany vs Spain and Italy



Source: Thomson Reuters Datastream, Edison Investment Research calculations

Overall the message is clear from both the data and recent corporate earnings releases. Companies are struggling to grow or even maintain profits. The divergence between profits growth and equity markets has increased the scope for a market correction if investors realise the growth part of the equity return has disappeared. For some time, we have argued that as margins are relatively high in a historical context, strong GDP growth is a necessity to deliver top-line driven increases in profits. With consensus economic forecasts still on a declining trend (and only indicating modest growth for the US and UK and a recession for the eurozone in 2013), we wonder if both profits estimates and equity markets are reflecting hope rather than rational expectation, Exhibit 12.

Exhibit 12: Disconnect between EBIT and equity market performance



Source: Thomson Reuters Datastream, Edison Investment Research calculations

There are very few M&A deals being done in the UK and Europe. We believe this reflects entirely rational corporate caution over both the earnings outlook and equity valuations.

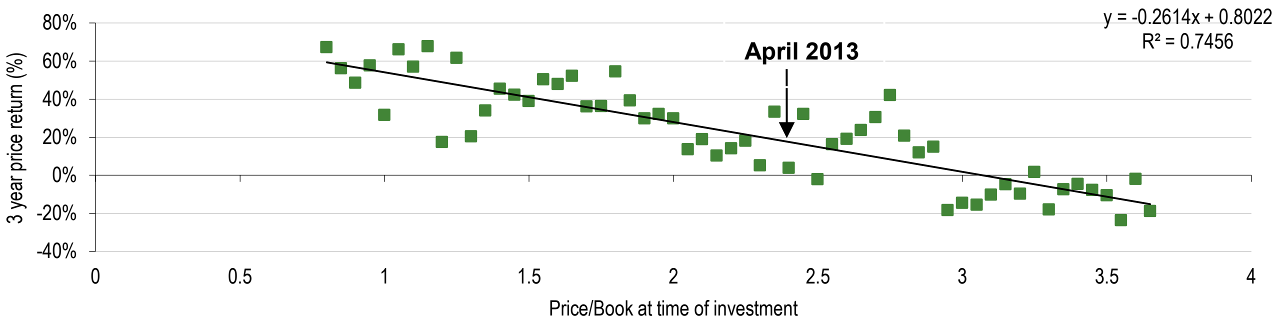
Valuation in a lower-growth and more uncertain world

We do not subscribe to the view that equities are a one-way bet, even in a world where some seem to view quantitative easing as a form of 1980s-style portfolio insurance. With long-run returns for equities only in the high single-digits (even during the extraordinary period of economic expansion over the 20th Century), a sharp rise in the market can severely affect the risk/reward balance.

During the previous two years we have been bullish – on occasion very bullish – on equities, believing the expected returns to be sufficiently high to justify the *known* growth risks and also in the knowledge that the strong possibility of extensive further monetary policy stimulus raised the probability of good short-term performance.

Three years ago, the S&P was close to 1,000 points and it has since risen by 60% or a rather higher-than-average annualised return of 17% pa. Despite their economic issues, UK and European equities have also demonstrated exceptionally strong returns of 10% pa since 2010. It is time to review the valuation parameters to check they are consistent with the outlook.

Exhibit 13: Price/book and three-year equity market return – UK non-financials since 1980



Source: Thomson Reuters Datastream, Edison Investment Research calculations

When comparing current valuations to long-term averages, we believe we should consider appropriate adjustments to ensure the empirical data remain relevant. There have been wide variations in price/book multiples over the last 30 years. At valuation extremes, the conclusion is clear – ie very high (low) price/book multiples lead to losses (strong gains), as shown in Exhibit 13, but at present the valuation situation is more nuanced. Price/book multiples are only a little above their 30-year average in the US and UK and at their average in Europe.

However, for much of this sample period, there were no underlying debt, demographic or environmental constraints on economic activity. In contrast, for those who lived through that time, inflation and the threat of thermonuclear destruction appeared to be the key risks. While the Cold War ultimately turned out to be the dog that did not bark, the volatility of inflation was a key part of economists' explanation of the low market multiples of the 1970s, Exhibit 14.

Higher inflation should not affect market multiples according to the classic dividend discount model (equity return = dividend yield + dividend growth rate) as higher inflation within the discount factor is offset by higher nominal growth. However, the volatility of inflation was empirically associated with a much higher-risk premium and lower equity ratings during the 1970s.

Exhibit 14: FTSE All-share dividend yield since 1960

Source: Thomson Reuters Datastream, Edison Investment Research calculations

Today we believe that investors should use a relatively modest long-run growth rate for dividends due to the likely slowing GDP growth of developed nations. Sub-par GDP growth is clearly embedded in UK gilt and US Treasury prices. However, these prices are further distorted by the effects of quantitative easing. We believe a better long-run assumption would be to assume the success of central bank policy, with both inflation and real growth in the region of 2%. This implies a nominal, un-manipulated, government bond yield of 4%.

For the equity risk premium, we believe it is inflation uncertainty that investors should focus on. The long-run effects of the unprecedented expansion of central bank balance sheets are difficult to predict. Therefore, we believe investors should use a risk premium for equities of 3-4%, at the upper end of historical experience.

Our revised parameters therefore imply a return of 7-8% per year for equities should be the hurdle, or in other words levels close to long-run averages – *even in a world where bond yields are compressed by policy*. As on our parameters 4% of this return will come from growth, this leaves the 'fair' dividend yield between 3% and 4%. By coincidence, UK non-financials are currently yielding close to the middle of this range at 3.4%. Although it may seem inexact, the 3-4% yield range may yet prove to be the trading range for equities for the foreseeable future. We were certainly very bullish on European equities as yields on the DAX broke through 4% in 2011 and 2012.

In Q213, the starting point is very different. Valuations, on a price/book basis for US, UK and European equities are at or above their 30-year average. While still consistent with our long-run assumptions about discount rates and growth, there seems little in the way of a discount to reflect the risk of a profits downgrade cycle.

We should at this point highlight the distinction between being *bearish* and being *cautious*. Being *bearish* would imply we felt that returns on a three-year view are likely to be negative. At present, valuations are not that extreme (Exhibit 13). However, we are *cautious* as in our view other investors are yet to factor in the difficult outlook for profits growth in the near term.

Given current valuations, it is entirely possible that further successive rounds of QE may only have a moderate effect on the stock market as investors maintain the appropriate required return for equities. If the stock market fails to rally, elimination of the wealth effect from quantitative easing may even challenge the justification for it, given the limited effect it appears to have had on the real economy to date.

Conclusion: Still cautious and for good reason

Investing when the valuations are deeply discounted is invariably difficult and the acute phase of the European debt crisis was no exception. The valuation signals and the outlook for equities are more nuanced now. Valuations are reasonable but not compelling given the slow-growth environment that is likely to persist for some time in developed economies. Earnings momentum is non-existent and evidence of a growth slowdown has appeared in commodity markets and survey data. We are not surprised market momentum has ebbed significantly since February.

We remain cautious and would recommend focusing on building equity portfolios from companies with robust business franchises, balance sheets and global exposures. We also see insufficient reward for investing in potentially distressed jurisdictions, such as the periphery of Europe, at present.

Berlin +49 (0)30 2088 9525
Friedrichstrasse 95
10117 Berlin
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
United States

Sydney +61 (0)2 9258 1162
Level 33, Australia Square
264 George St, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand