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Illumination: Equity strategy and market outlook

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Global perspectives: Better value in bonds?

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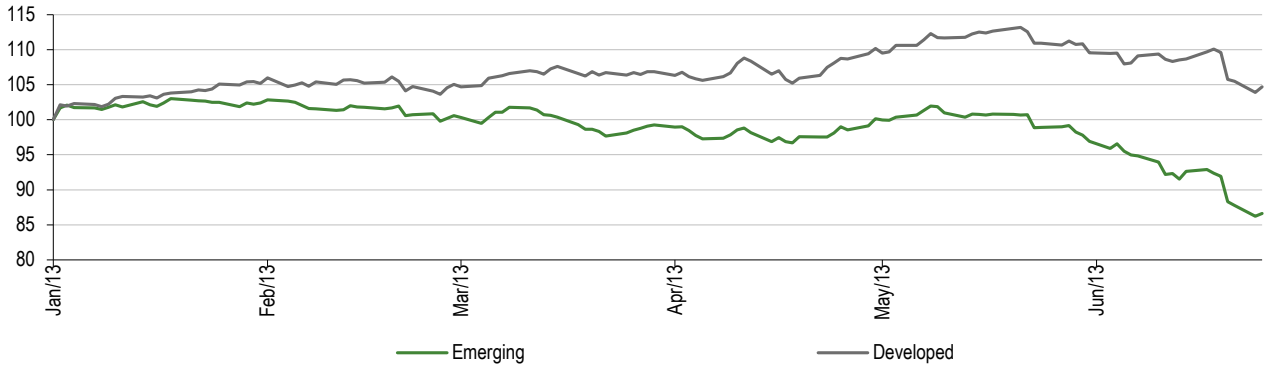
- **Federal Reserve Chair Bernanke confirms QE tapering.** We view recent market moves towards higher bond yields and lower equity valuations as a correction closer to reality. At the margin we are less cautious on equities, but screening of equity markets shows investors are exhibiting a rational response to tighter monetary policy, rather than the opening up of meaningful investment opportunities.
- **Watching for the second-order effects.** Such a rapid rise in bond yields is likely to affect economic growth over the next 12 months as expectations of tighter monetary policy constrain activity. We note that the synchronised shifts in global yield curves leave some of the periphery of Europe high and dry. 5% 10-year bond yields for the European periphery do not seem consistent with ongoing deep recessions. Combined with watered-down bank resolution and supervision reforms, the scope for increased volatility seems clear, even if markets have for now stabilised at lower levels.
- **China's moves complicate the picture.** Extreme stress in China's interbank market is highlighting that the new regime is serious about reining in excessive credit creation. Rebalancing China's economy away from fixed-asset investment may be a near-term policy objective - at the expense of growth - for the new regime. While this is the correct road for the medium term, investors are faced with the world's two largest economies on a tightening path. This may be a painful period for global commodities, equities and credit. Once again, the merits of an allocation to cash have become evident.
- **Bonds now better value, staying cautious on equities.** Equity markets have only given back year-to-date gains at most and with profits forecasts still stagnant worldwide, we see little reason to get overexcited by current valuations. In credit, the recent increase in government bond yields, combined with widening credit spreads, leave corporate debt at significantly higher yields than a few months ago, and here we are more positive. Based on Japan's experience and provided interest rates remain low, the US yield curve appears to have over-steepened.

US QE tapering confirmed

Although the speculation had already started, Bernanke's press conference of 19 June confirmed that without a material change to the incoming US data, the Federal Reserve would start to taper its asset purchase program by the end of 2013. Given the sharp rise in bond yields before the conference, we were surprised the opportunity was not taken to emphasise the dependency of tapering on incoming data rather than a calendar timetable.

Both bonds and equities have suffered sizeable losses in recent weeks, although losses in bond markets have been much more significant relative to normal levels of volatility. Developed market equities have now given up nearly all their gains for the year and emerging market equities have underperformed significantly. The yield on a 10-year treasury bond is now 100bp higher than eight weeks ago.

Exhibit 1: Performance of world equities year to date (US$)

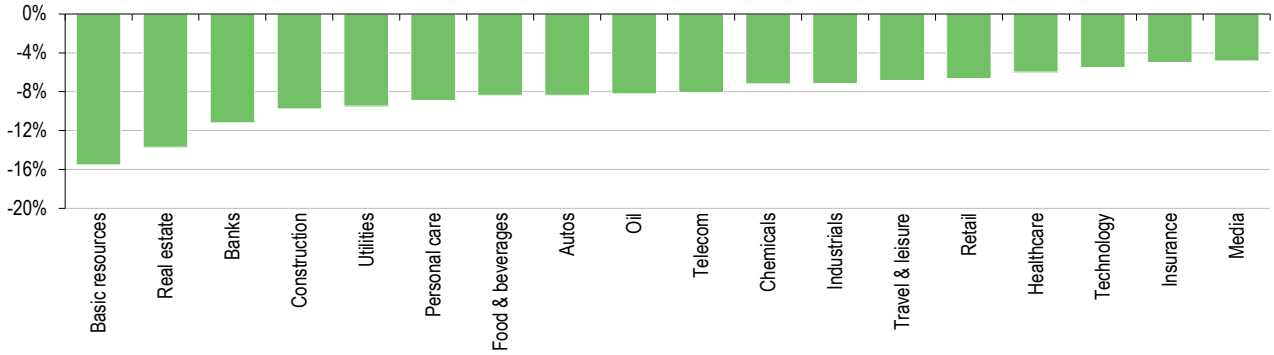


Source: Thomson Reuters Datastream

In terms of sectors, higher-beta global sectors such as basic resources and banks have underperformed the most since the peak of the market in mid-May, Exhibit 2. A pincer movement of tightening dollar liquidity and stress in the interbank market in China led to a double impact for commodity prices. With few exceptions, the past month has seen price declines in almost every risk asset market. Recent reports of the death of 'Risk-on/risk-off' trading were perhaps exaggerated, while the benefits of an allocation to cash – even at a zero yield – proved themselves once again.

At present, we caution investors that there are two very different interpretations of rising bond yields. Although a steeper yield curve is traditionally associated with stronger real growth, this may not be the case when interest rates are very low and economies are highly leveraged. We point to Japan's experience before 2006 and find that higher bond yields can also be linked to slowing growth. We therefore stay cautious on growth sensitive assets such as equities, but are warming to bonds.

Exhibit 2: Global equities sector performance since market peak (22 May 2013)



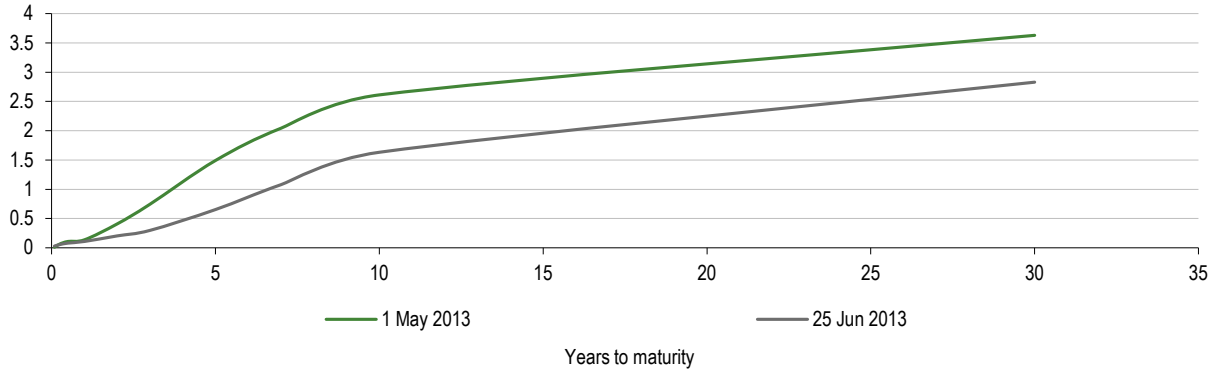
Source: Thomson Reuters Datastream

Watching for the second order effect of higher bond yields

Over the course of the last three decades, the objective of monetary policy has shifted from inflation-fighting to attempting to stimulate growth through zero interest rate policy and unconventional means (QE). The clear success of the former over the debatable results of the latter suggests that pro-growth monetary policy may be more akin to pushing on a piece of string than central bankers may care to admit.

In recent weeks, we believe equity markets have quickly adjusted to higher risk-free rates. However, the implications of higher bond yields on growth are not clear-cut. With forward guidance for interest rates still suggesting very low rates for the next year, if current long-term rates are maintained the sovereign yield curve in the US will have steepened significantly, Exhibit 3.

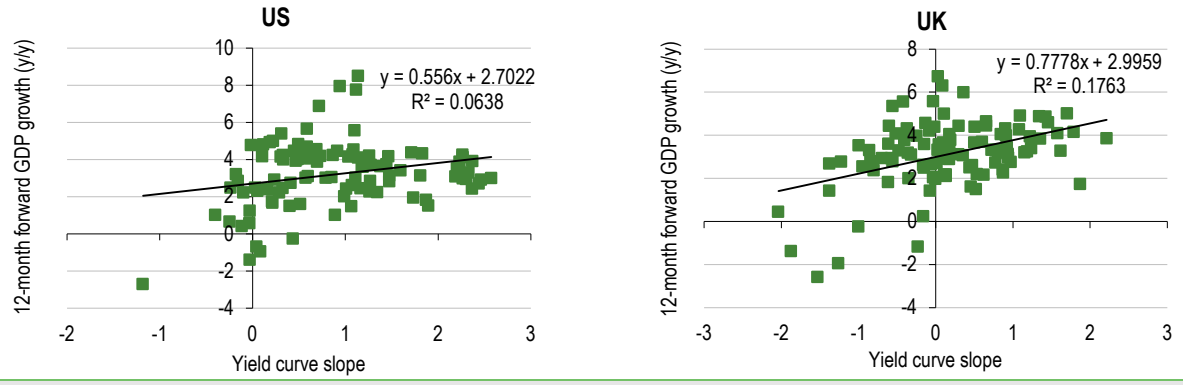
Exhibit 3: US – Sharp steepening of yield curve since 1 May 2013



Source: Thomson Reuters Datastream

Market convention would have a steeper yield curve associated with a higher level of future GDP growth, which is supported by the statistical evidence for the US and UK since the 1980s up to 2007, Exhibit 4.

Exhibit 4: US, UK – POSITIVE relationship between slope of yield curve and future GDP growth, 1980-2007



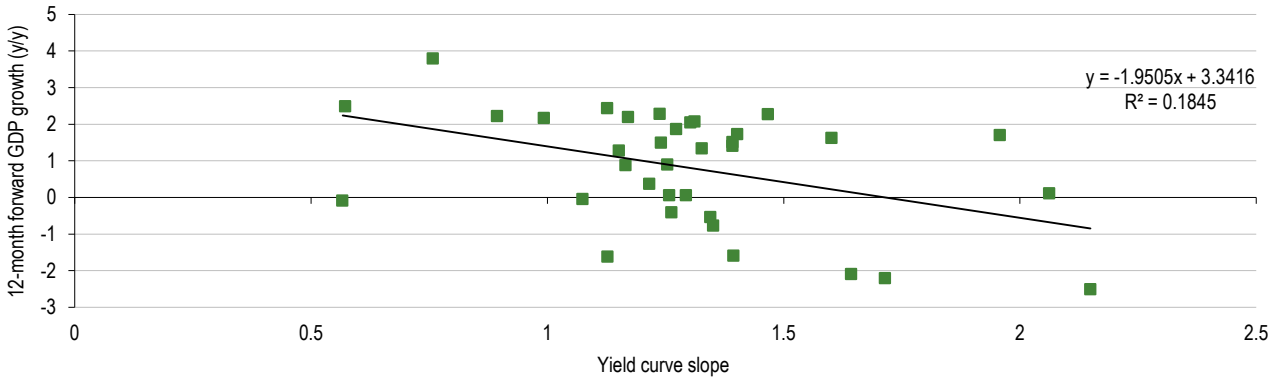
Source: Thomson Reuters Datastream. Yield curve slope measured by yield difference between 2y and 10y government bonds

However, due to the earlier suppression of long-term bond yields by QE, it seems counterintuitive to us to expect the recent 100bp rise yields to be indicative of higher growth in 2014. The combination of QE and extensive forward guidance has effectively shifted the yield curve away from where it would otherwise have been. The debt position of both the US and other developed nations is also very different from earlier economic periods.

The closest analogy we can find is that of Japan, where the interplay of zero interest rate policy, excessive debt and QE has a longer history. Over a 10-year period between 1996 and 2006, Japanese two-year rates were less than 50bp. During this period of time, the slope of the yield curve was *inversely* related to economic growth, as shown in Exhibit 5. Specifically, a 1% increase

in the slope of the yield curve – just as we have seen in the US recently – was associated with a 2% decline in GDP growth over the coming 12 months.

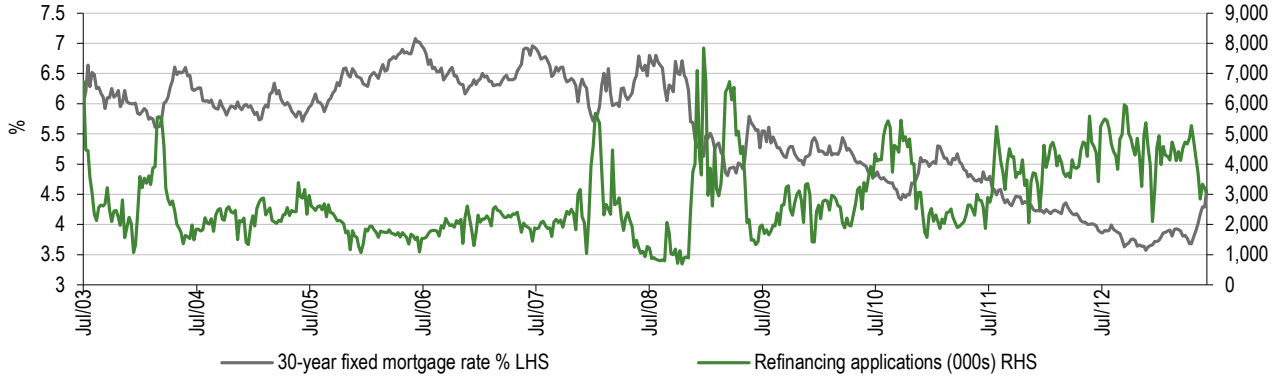
Exhibit 5: Japan – NEGATIVE relationship between slope of yield curve and future GDP growth 1996-2006



Source: Thomson Reuters Datastream, Edison calculations

If the artificial lowering of long-term bond yields was a stated aim of QE policy (to secure the objective of higher growth), it is by no means clear that higher rates following tapering are in fact suggestive of a stronger growth outlook for the US economy, despite Bernanke's carefully worded comments on the matter. A coherent case can be made for an opposing view. Losses on bond and equity portfolios will have a negative wealth effect on consumers. Bank balance sheets will suffer and thus at the margin constrain lending. In terms of the US mortgage market, the immediate impact of higher rates is clear – US mortgage refinancing applications have shrunk sharply over the month of May, Exhibit 6.

Exhibit 6: US mortgage refinancing applications month-on-month % change



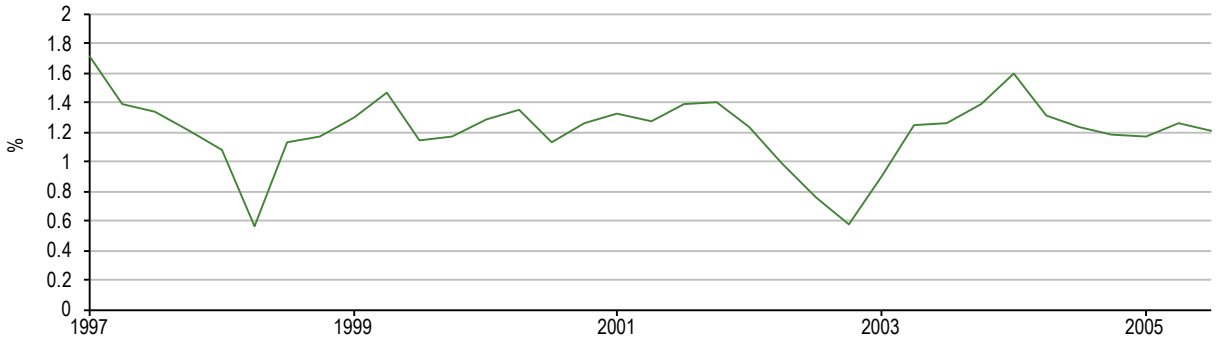
Source: Thomson Reuters Datastream

The experience of Japan's yield curve slope is also instructive when it comes to bond yields. Exhibit 7 shows the yield curve slope was mean reverting over the period 1996-2006, fluctuating for most of the time between 120 and 160 basis points, outside times of financial market stress. The current slope of the US yield curve on the same basis is over 200bp.

In previous notes, we have highlighted that if central banks secured their policy objectives, a 2% inflation rate and 2% real growth would be indicative of a 4% medium-term government bond yield. However, the likely negative coefficient on GDP growth from rising bond yields means we are unlikely to see such high yields anytime soon; in the short run, it appears yields are more likely to fall even in the absence of QE, as 2014 growth expectations shrink during H2. Inflation expectations are falling and US Q1 GDP was revised lower to a 1.8% from 2.4% annualised rate due to slower-than-expected consumer spending and business investment.

Therefore, we would use the recent rout in the bond market to look at building positions in investment-grade corporate credit where spreads have also widened significantly and ultimate default risks remain low.

Exhibit 7: Japan – mean reversion in slope of yield curve 1996-2006

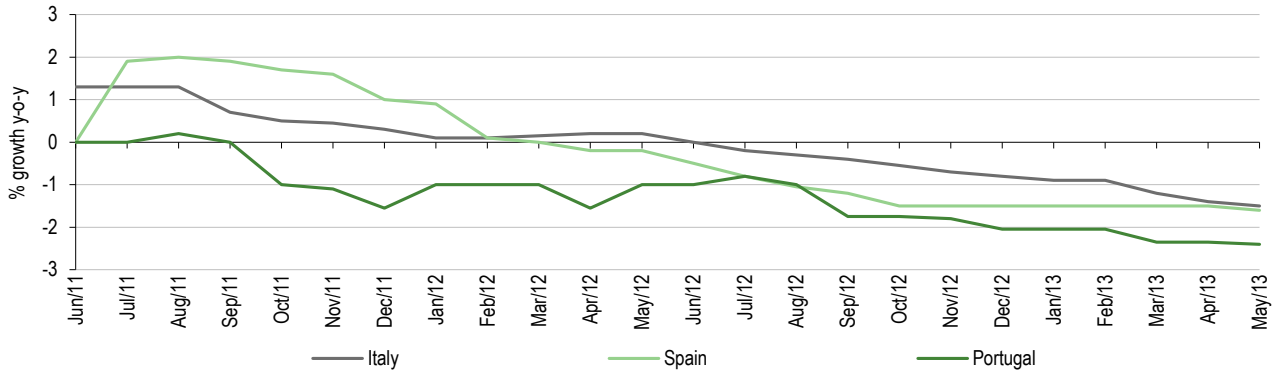


Source: Thomson Reuters Datastream

Bond yields on the rise in the European periphery

The synchronised, if not formally coordinated, actions of the ECB, US Federal Reserve and Bank of Japan, was correlated with a significant lowering of the yields on peripheral European sovereign bonds from mid-2012. This yield compression has partially reversed and adds to funding pressure on the European periphery. Yields of 5% on 10-year government bonds are inconsistent with the deep recessions currently ongoing in Spain and Portugal (Exhibit 8) even if sovereign funding is being obtained on a shorter-term basis.

Exhibit 8: Periphery of Europe – 2013 GDP forecasts



Source: Thomson Reuters Datastream. Note: Forecasts based on the continuation of current QE policy.

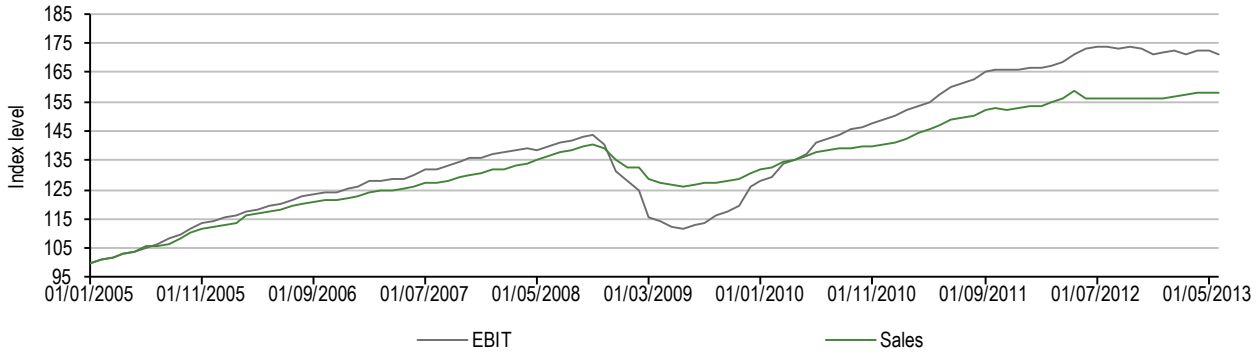
Europe has clearly not made effective use of the 'covering fire' provided by the world's central banks and continues to self-inflict policy wounds, reflecting the lack of common ground between the member states. Being forced to use the tools of international diplomacy to resolve essentially domestic matters has led to long delays and significant compromises in what are still provisional agreements on initiatives such as bank resolution and supervision. Europe has been warned – recent comments by the Bank of International Settlements make it clear that "whatever it takes"-style monetary policy is not a replacement for structural economic and political reform.

Should global bond yields continue to rise, it is entirely possible that another peripheral funding crisis and re-emergence of capital flight from the periphery may occur. Although PMI indices show the rate of contraction is slowing in Europe, the situation remains precarious and highly political in our view. We certainly cannot rule out a crisis episode by the end of the year, especially if US bond yields were to rise over 3%.

Staying cautious on equities

For the corporate sector, Exhibit 9 shows no improvement in US sales and profits trends we highlighted in previous notes, and the picture in Europe and the UK is similar. Developed market equity valuations have moved only to levels seen earlier in the year, which is insufficient to move us from our cautious stance. Tightening US dollar liquidity is also having predictable effects on emerging market asset prices, which have underperformed sharply in recent weeks.

Exhibit 9: US 12-month forward sales and EBIT forecasts



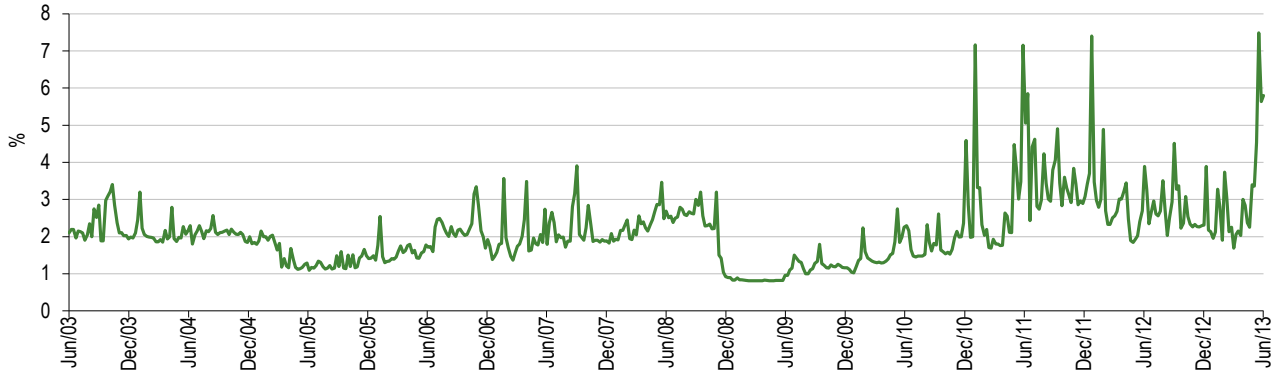
Source: I/B/E/S, Edison Investment Research calculations

China gets serious on preventing resource misallocation

The new regime in China appears to be insisting on structural change through the mechanism of throttling bank liquidity. Overnight interbank rates in China have spiked to levels not seen outside 2008 in recent weeks, Exhibit 10. The ramifications for real change in China's GDP composition are steadily feeding through to declining prices for industrial metals and mining company shares – a 180-degree shift from consensus thinking a few years ago.

China certainly has significant challenges in terms of lowering its exceptionally high fixed-asset investment share of GDP of more than 40% to a more sustainable level. In the meantime, China's manufacturing PMI indices have turned negative. Just as in the rest of the globe, declining activity and tighter money are toxic for equity prices and Shanghai composite has fallen 20% from its 52-week high.

Exhibit 10: Overnight interbank rates – China



Source: Thomson Reuters Datastream

Bonds better value, still cautious on equities

A 100bp shift in 10-year government bond yields is a big move, and as credit spreads have also moved wider, investment-grade corporate debt looks much more attractive than a few weeks ago. Our analysis of Japan suggests the yield curve is unusually steep in the US and UK at present and

if interest rates stay low and growth disappoints as we expect, bonds are likely to recover some of their losses over the course of the year.

For equities, a 10% move down from the highs is not uncommon and only puts valuations back to where they were earlier in the year. A lack of momentum in global sales forecasts highlights the headwinds equities face even before the impact of higher bond yields on economic activity. We consider the first-order effects of a higher discount rate embedded in equity prices, but perhaps not the second-order effects of slower growth, and therefore remain cautiously positioned in this asset class.

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