Illumination: Equity strategy and market outlook

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Global perspectives: Waiting for a clear shot

- **In recent years a number of easily visualised and widely discussed risks have failed to materialise.** These "asteroid impact" risks have included a total collapse of the developed world's banking system, a break-up of the eurozone, major social instability, a hyper-inflationary episode or a slide into deflation.
- **None of these events, which were always low probability, have thus far occurred in the world's larger economies.** In response, judging by developed market equity valuations, investors now fear little. This is not the same as having little to fear.
- **In our view, investors should now be taking a much closer look at the rather mundane but equally important investment risks of growth and valuation.** Economic growth in developed markets remains weak in a historical context. The cost of the global credit bubble in terms of lost output may not be reflected in asset prices, but is clearly visible in the GDP data.
- **Even more importantly, both the US and UK equity markets look extended on traditional valuation parameters.** The median dividend yield in these markets is back to 2007 levels. A key driver has been the amount of global monetary stimulus, which has driven a wedge between asset prices and underlying weak economic performance. Reverse gear has now been engaged in terms of monetary stimulus. The US Fed minutes indicate a strong likelihood that US QE will be tapered by the end of this year.
- **What to do while waiting for a clear shot.** We highlight that following the recent sell-off, emerging market equities are now attractively valued based on dividend yields and compared to 10-year average earnings. While at interesting long-term valuation levels, a modest allocation to emerging markets would also benefit from any delay to US QE tapering.

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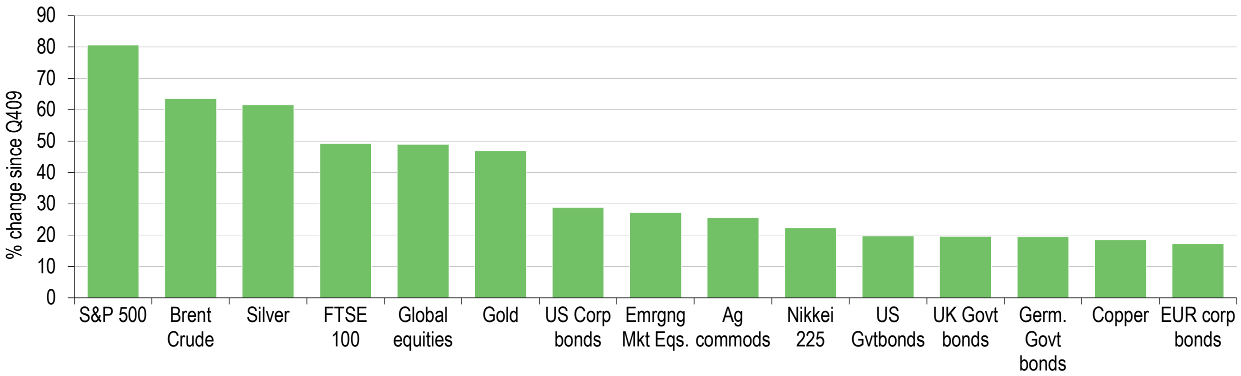
Investors' "wall of worry" has been climbed

An unusually high level of investor caution following the market declines of 2008 paved the way for a bull market with both bonds and equities performing substantially in excess of normal expectations since then, Exhibit 1. Bonds were the direct beneficiaries of central bank purchases and real yields for a time were pushed into negative territory. Despite only disappointing growth in both emerging and developed markets, equity investors who have been prepared to ride the volatility have benefited from some of the strongest-ever gains over the last four years.

Exhibit 1: Bull market of Q2 2009 – Q3 2013

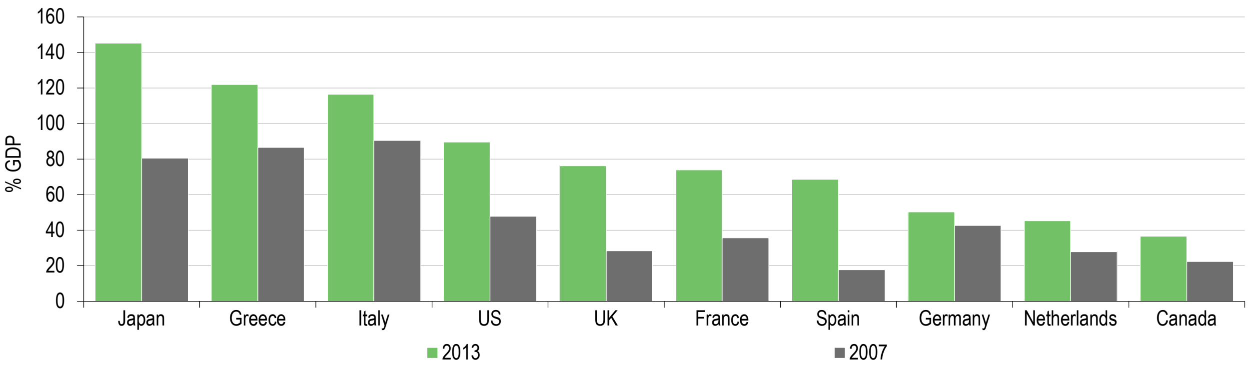


Source: Datastream. Note: Returns include dividends/coupons reinvested and shown in US$.

This long period of exceptional returns is a strong disincentive to question the rationale for remaining invested. There has been no reward for selling since the turn of the decade – a period sufficiently long to have seen careers burnished and positions entrenched for those with bullish views. In short, the wall of worry has been climbed, leaving the optimists in charge.

The absence of questions may be contributing to the inherent contradictions observable across asset classes. Highly valued equity markets would normally imply confidence in robust growth in GDP and/or corporate profits such as in the 1960s or 1990s. Yet central bankers are keeping interest rates at ultra-low levels and depressing bond yields via QE to prevent a relapse in economic activity and a slide into deflation. Meanwhile, precious metals have also delivered strong returns despite being more strongly linked to inflation, which has thus far been absent. If investors have stopped questioning these contradictions, dangerous times for financial markets may lie ahead.

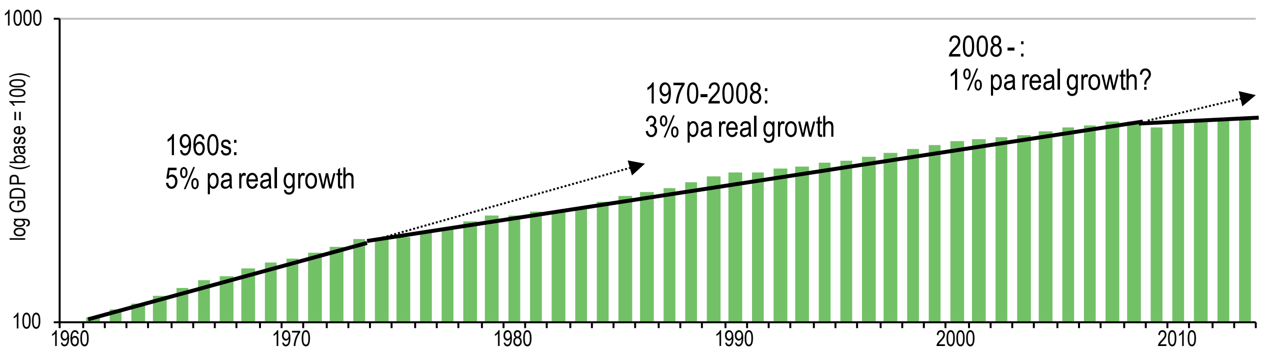
Exhibit 2: Change in government net debt as % GDP



Source: OECD

For us, intellectual tensions have never been higher. We could attempt to rationalise evidence of inconsistency between still very low bond yields and high equity valuations with a new model of growth later, but stronger for longer. However, perhaps a better and simpler interpretation of the data would be that markets and economic data are in fact giving conflicting signals as a direct result of experimental central bank policies. The correlation between central bank balance sheet expansion and asset prices has only been strengthened by the recent global market volatility, a direct result of indications the US QE program will be tapered by end-2013.

Exhibit 3: G7 Real GDP growth trends



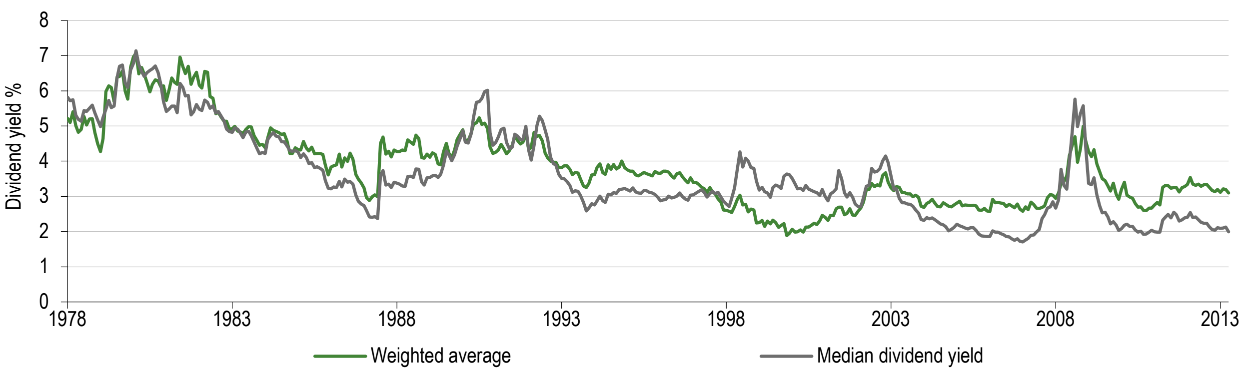
Source: OECD

During the four-year period between 2009 and 2013, we have been very bullish at times but more recently changed tack. Much of the world's economic activity remains supported by record-high volumes of government debt, Exhibit 2, and there is increasing evidence of a structural break away from previous G7 GDP growth rates, as shown in Exhibit 3. This lack of GDP growth is translating into a lack of top-line growth for the corporate sector and in our view puts a big question mark over equity valuations, which are at or near 2007 levels. The wall of worry may have been climbed, but the risks are now elevated.

Equities – valuation signals flashing red

If we were to choose a single measure to guide our investment strategy, it would be to completely ignore the noise from economic analysis and focus solely on valuation. The key advantage is the historic stability of the mean reversion in returns, both for individual sectors or securities within equity markets and at the index level. Investing at an attractive rate of return with an adequate margin of safety generally trumps the uncertainty of trying to predict a specific economic outcome over a specific timeframe.

Exhibit 4: UK non-financial equities – median dividend yield

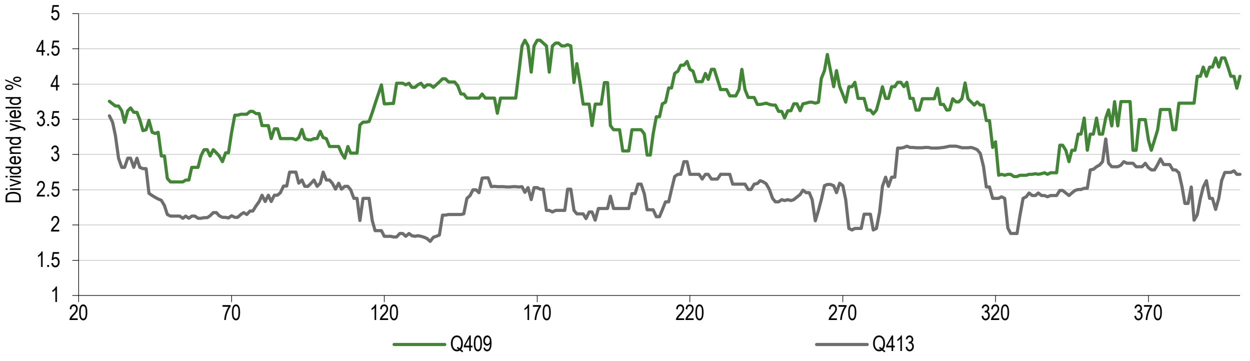


Source: Datastream, Edison calculations

In terms of equities, valuation signals are flashing red. For example, the median UK stock is trading at a dividend yield very close to the 25-year record low of 2007, Exhibit 4. The more typically quoted measure of weighted average dividend yield for market-capitalisation-weighted indices such as the FTSE100 is less extended. However, the non-normal distribution of market capitalisation means the weighted average dividend yield is effectively dominated by a few very large cap stocks.

To illustrate just how far much of the UK equity market has been re-rated, in Exhibit 5 we have calculated a 30-company "windowed" dividend yield by first ranking the UK market by size and then sliding the "window" through the list. We have repeated the exercise for the present day and Q409. Q409 represented the period immediately after the first (successful) round of US quantitative easing and was by no means a distressed environment.

Exhibit 5: UK non-financials – 30-company sliding 'window' dividend yield calculation



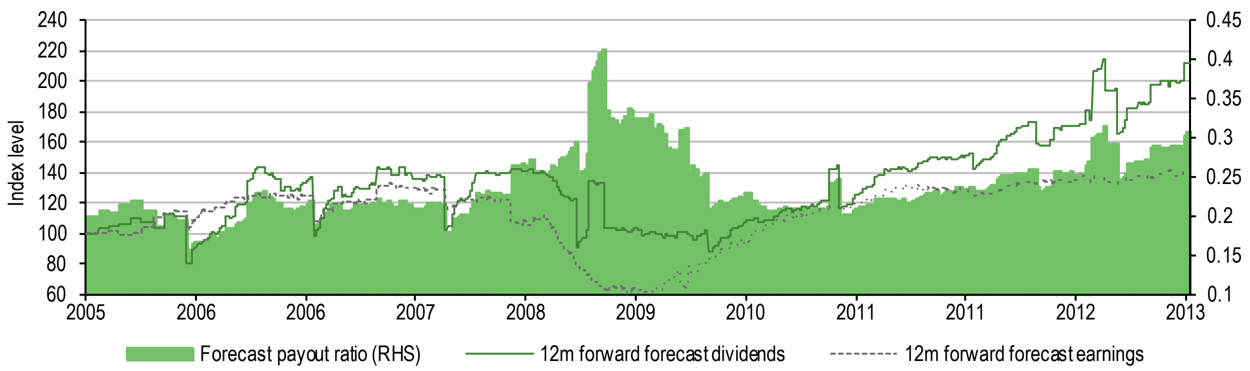
Source: Datastream, Edison calculations

Exhibit 5 shows, as expected, that while dividend yields for the 30 largest UK non-financials are effectively unchanged, there has been a substantial compression in yield throughout the remainder of the market. The average 'windowed' yield is now 2.5% compared to 3.6% in Q409. This means the opportunity set for active portfolio managers who wish to build a diversified portfolio of perhaps 30 UK names is nowhere near as attractive as only a few years ago.

Dividends rising faster than earnings

We would be less anxious about the compression in dividend yields if dividends themselves were at a cyclical low. However, the reverse is true; dividends have been growing much faster than earnings for mid-cap indices in both the US and UK in recent years, Exhibits 6 and 7. The forecast payout ratio (dividends/earnings) is also exceptionally high for a non-recessionary period.

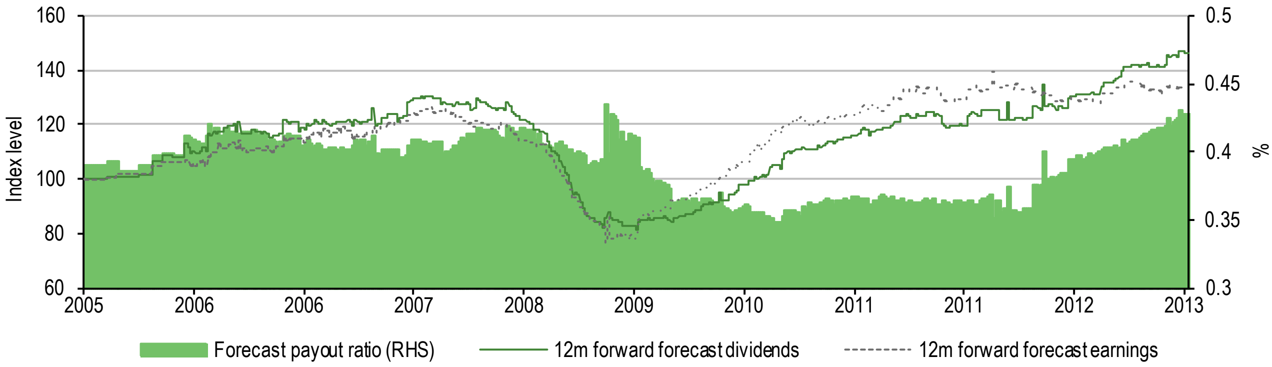
Exhibit 6: US mid-caps – median dividend growth outstrips earnings growth post 2011



Source: Datastream, Edison calculations

The focus on dividends will be welcome for institutional shareholders starved of yield, but raises the question of whether the corporate sector is investing sufficiently for growth. The lack of sales momentum for the corporate sector in developed markets is telling in this regard, a topic we have highlighted in earlier notes. Thus far, the recent improvement in economic momentum in Europe and the US has not been reflected in improving sales forecasts for the corporate sector.

Exhibit 7: UK mid-caps – median dividend growth outstrips earnings growth post 2011

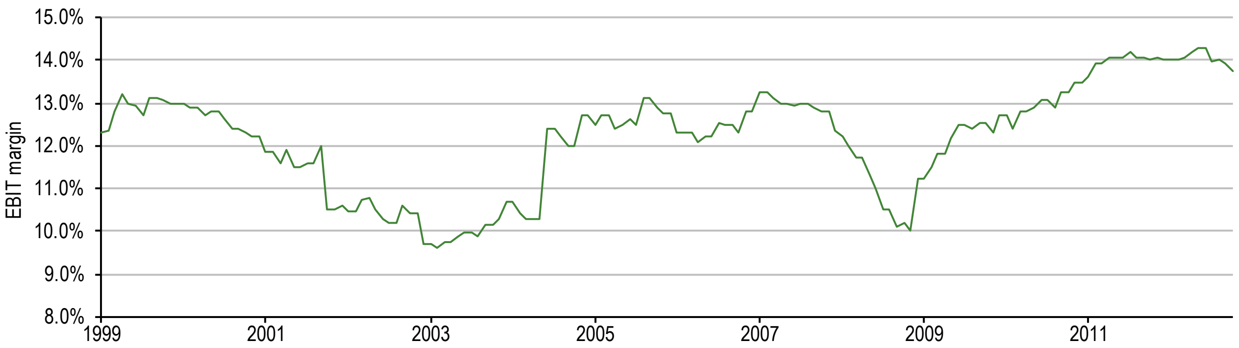


Source: Datastream, Edison calculations

Non-financial margins high and declining

It is also straightforward to show that in turn, earnings themselves would seem closer to cyclical highs than trend levels. An examination of consensus margin forecasts for 2014 versus their long-run history shows that analyst optimism runs strong; the median UK non-financial margin forecast is a standard deviation above the normal level for the last 10 years, Exhibit 8, with similar stretch forecasts for other markets.

Exhibit 8: UK non-financials – median consensus margin forecast at peak levels

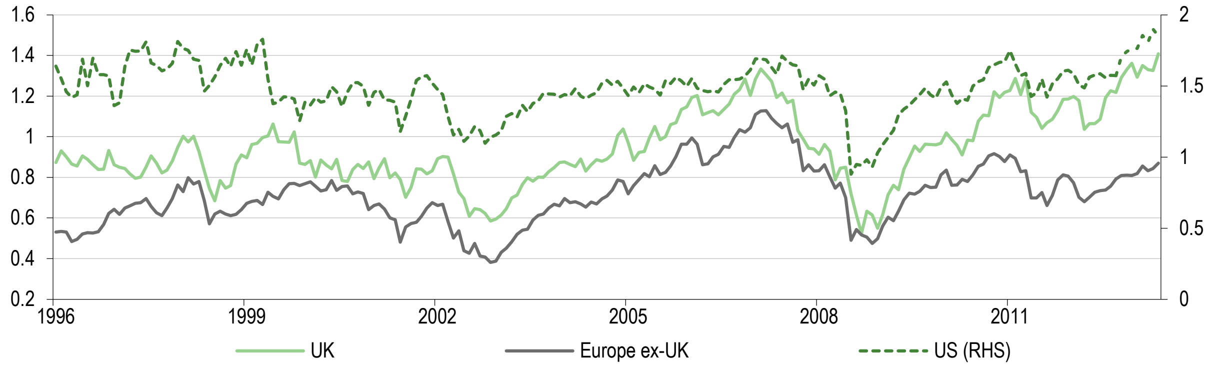


Source: Datastream, Edison calculations

Price/sales at a seven-year peak

Sticking with the policy that the simplest measures are the best, we have also calculated the median price/sales ratio for non-financials in each of the developed economic regions. On this measure, UK and US non-financials are close to the peak levels of 2007, Exhibit 9. No doubt some of this premium could be justified by the robust profits performance of the corporate sector over the last three years. However, this argument feels too close to a rationalisation – and an ex-post rationalisation at that – for those investors anxious buying stocks after they have risen so much. We note that European stocks appear cheaper on this measure.

Exhibit 9: Median price/sales for UK, US and EU non-financials



Source: Datastream, Edison calculations

Asset prices no longer the focus for central bank policy

Although central banks have been somewhat coy about the policy of pumping money into the economy to raise asset prices in recent years, QE is now giving way to forward guidance with the specific aim of increasing employment, subject to an inflation constraint. By implication, asset prices may no longer be a policy objective.

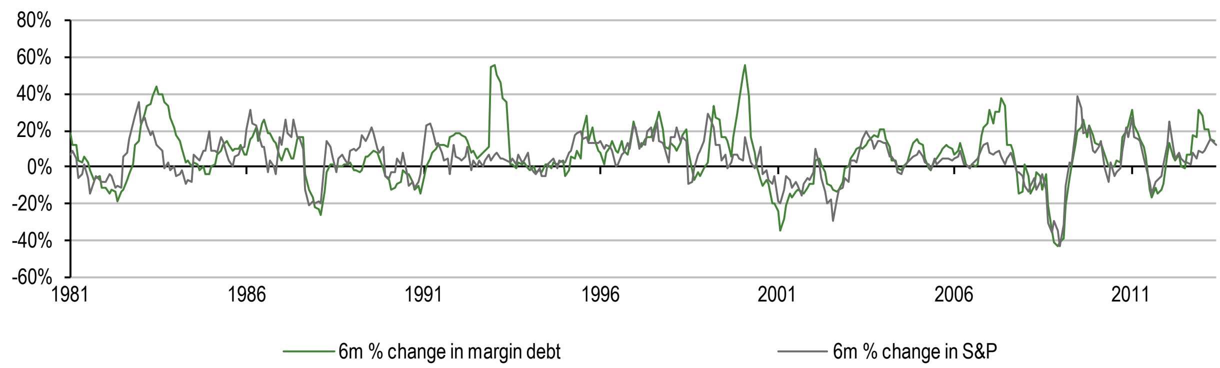
In this regard, we note also the unevenness of the economic recovery that has entered the political domain. Weak economic growth, combined with strong increases in asset prices, has benefited the wealthier segments of the US population much more than the poor. The potential for a political interaction with markets is high as the next US Fed Chair is currently being chosen; President Obama has been remarkably specific on wanting a Fed Chair "who makes sure we're not seeing artificial bubbles".

For investors, this change in policy emphasis from QE to forward guidance in effect takes away portfolio insurance and adds increased employment costs to the aggregate corporate income statement. In other words, profit margins may have good reason to have peaked in 2012. Rising employment will also improve the fiscal position of sovereigns as personal incomes and payroll taxes increase; thus declining deficits will mechanically lower the corporate profits share of GDP.

Technical factors – NYSE margin debt

There is a remarkable correlation between the 6m change in NYSE margin debt and the performance of the S&P 500 over the same period. Although excess growth in margin debt has previously been associated with events such as the market collapse of 2008 and dot-com bubble, more recently it appears to have cycled in tandem with US QE policy, Exhibit 10.

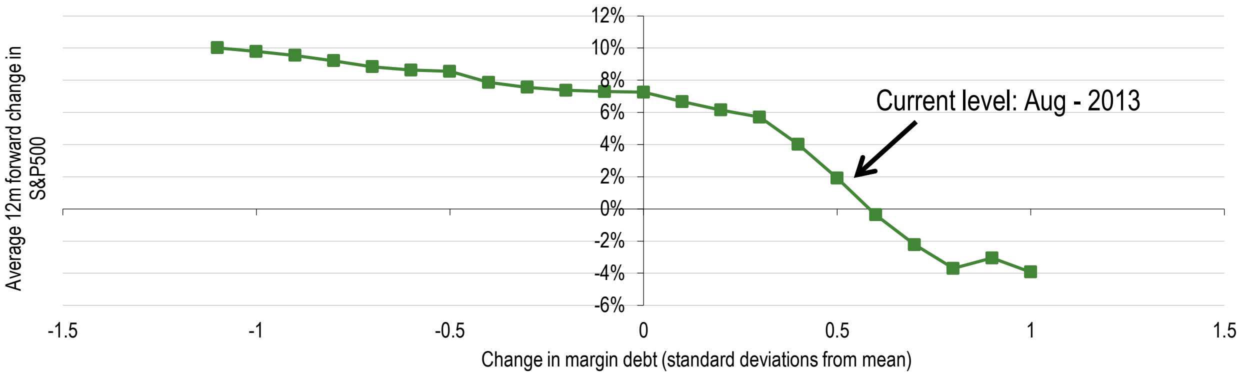
Exhibit 10: 6m growth in NYSE margin debt and 6m change in S&P 500



Source: Datastream, Edison calculations

Since the 1980s, there has been a very non-linear relationship between the growth of NYSE margin debt and the *subsequent* performance of the stock market. Exhibit 11 shows that as the growth in margin debt exceeds 0.5 standard deviations from the mean – the current level – the average performance of the S&P over the next 12 months declines substantially. Although a secondary factor relative to fundamentals, these data indicate an increased likelihood of a muted H2 S&P 500 performance.

Exhibit 11: Non-linear relationship between NYSE margin debt and *future* S&P performance



Source: Datastream, Edison calculations

Global bond yields closing in on economic danger point

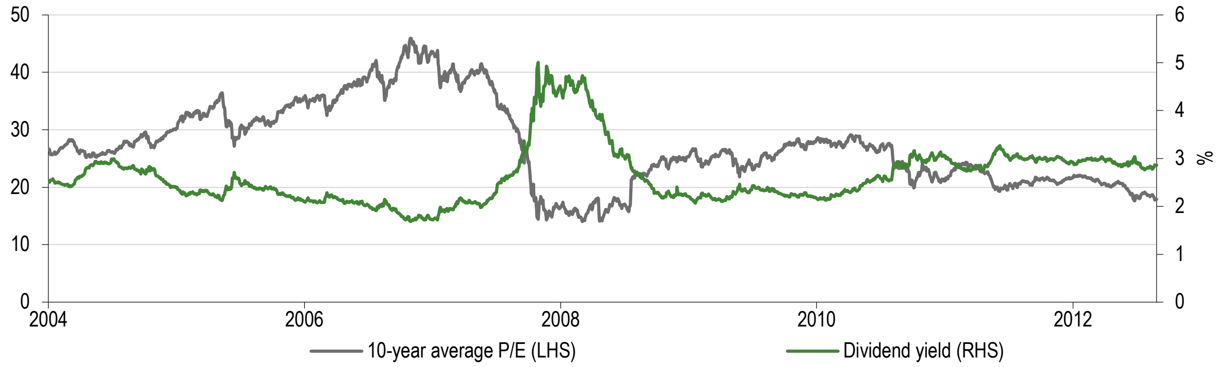
It is easy to forget that in aggregate there has been no meaningful deleveraging in developed markets since 2007. Government debt as a percentage of GDP has increased, as shown in Exhibit 2, as the private sector has deleveraged. Therefore, the world economy remains acutely sensitive to both short- and long-term borrowing costs. We have already seen US mortgage applications decline sharply as US government bond yields nearly doubled to a little less than 3% since February of this year. In our view, a further rise in real interest rates would risk choking off the nascent US economic recovery. An over-steep yield curve had exactly this effect in Japan in the 1990s. Although bond yields remain low in a historical context, an increase in US yields much over 3% would appear to be self-defeating. For this reason, we see less near-term risk in the bond market than in growth-exposed equities.

Finally, some exposure to emerging markets

The recent sell-off in emerging markets is presenting some valuation opportunities in both emerging market debt and equities. Although these markets are still some way from depressed, they would be the first to benefit from a delay to tapering. In the meantime, dividend yields are close to decade highs (excluding 2008) and the ratio of market value to 10-year average earnings has fallen close to decade lows, Exhibit 12.

The underperformance relative to developed market equities has also been severe as emerging market currencies have declined against the US dollar. While we have always wanted to add exposure to these faster-growing, better demographically positioned and less-indebted economies, the question has been price. As hot money seeks an exit, for patient investors it would seem to be a better time than average to be adding a modest allocation to emerging markets.

Exhibit 12: Emerging market non-financials – much better value following underperformance



Source: Datastream

Responding to challenging conditions

A period of tightening monetary conditions combined with relatively high market valuations is a challenging time in which to invest. It would have been relatively straightforward to have interpreted the incoming data much more negatively and suggest a wholesale reduction in portfolio risk was the only course of action. However, we have resisted this temptation for the following reasons.

Firstly, although the case for a cautious positioning can be clearly laid out – high valuations, slow growth, tightening monetary policy and potentially over-leveraged stock market investors, any short-term stock market prediction is in reality subject to a high degree of uncertainty. Statistical approaches to decision making under uncertainty indicate that in such circumstances extreme portfolio positioning is sub-optimal and would reflect over-confidence in our predictions.

Secondly, given the extraordinary level of sovereign debt to GDP worldwide, it is unclear that cash is still a risk-free asset in purchasing power terms. On the basis of the current economic outlook, it is not at all unreasonable to assume that cash will keep earning a negative real return in the US, UK and eurozone for at least the next two years. We note also the historical evidence that significant inflation outbreaks often follow a major debt crisis.

Thirdly, while we pay close attention to market developments in shaping the overall risk profile of the investment strategy, we are still finding specific situations that have a good risk/reward, especially among larger cap stocks and in Europe. Therefore, while we would suggest keeping equity risk at the lower end of the range by taking profits in mid-caps, we expect there would remain a number of holdings that are still highly likely to outperform cash over the medium term. In our view, sector exposures should be tilted toward those less geared to the economic cycle.

While retaining a significant amount of cash on hand, valuation signals are pointing to adding a modest allocation to emerging markets for those investors who can bear the short-term volatility. We are more relaxed about US government bond yields now they are close to 3% and we also highlight niches within the credit markets where interest rate and credit risk is modest and yields of over 4% are on offer. A position in gold is appropriate as a partial hedge against inflation and geopolitical risk.

In short, even if focused on capital preservation, by accepting a modest level of volatility investors should be able to build portfolios that will perform adequately in a range of scenarios while waiting for more compelling macro opportunities.

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