EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: When the facts change…

- **When the facts change, the US Federal Reserve changes its mind.** The decision not to taper the US quantitative easing (QE) programme in September surprised markets as recent Fed communications indicated a strong likelihood of tapering. However, on closer examination the Fed is clearly concerned that the sharp increase in bond yields may yet put the US recovery off track.
- **Outlook for markets unchanged.** 2013 US GDP growth is likely to come in rather lower than earlier projections and consensus GDP forecasts remain on a downward path. Slower growth and the delay to tapering are clearly beneficial to global bond markets. However, these factors are offsetting for global equities and there is no change to our cautious view on developed markets.
- **Valuation – context is everything**. Outside the largest global equities, valuations on a dividend-yield basis have moved towards the highest levels seen in the last 20 years. The case for a cautious portfolio positioning is easily made, even if it is said a bell never rings at the top of the market. Prices have risen, valuation multiples have stretched but sales growth remains muted. Finally, margins are high and showing signs of peaking. We would not be aggressively adding equity risk at present.
- **Triggers for downside.** With the delay to US QE tapering, the near-term risks to equity markets have clearly diminished. Though one could point to the current round of negotiations on the debt limit as a source of market turmoil, an awkward compromise remains the most likely solution over a formal default. Absent a trigger, we believe markets are likely to drift into the year end.
- **Where to look for value**. Our suggestion of adding emerging market exposure has quickly paid off and the gains may be less rapid from here. With little premium being paid for liquidity we would focus on largest capitalisation companies. This segment of the market has underperformed notably over the last 12 months and is now one of the few remaining pockets of value in the equity market.

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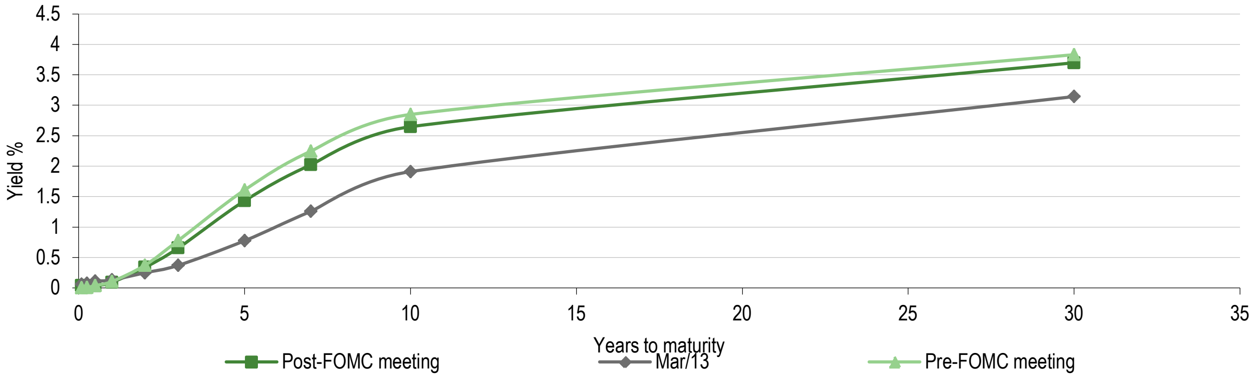
When the facts change…

The US Federal Reserve's surprise decision maintain its quantitative easing programme at US$85bn a month created several days of volatility in global markets during September. The primary reason for the abrupt reversal in monetary policy seems to have been that a rapidly steepening yield curve would quickly choke US economic growth, as it did in Japan in the 1990s, Exhibit 1.

Exhibit 1: Steepening of US yield curve



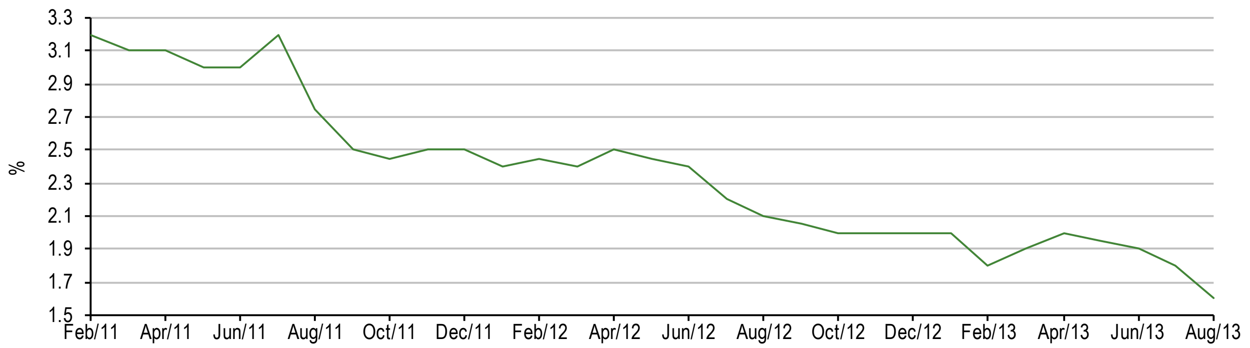
Source: Thomson Reuters Datastream

The decision not to taper at all surprised us and may prove costly for policymakers who are relying on markets to take forward guidance at face value in future. In our view, a firm statement in terms of forward guidance at the same time as very modest reduction in the size of the QE programme would have achieved a similar lowering of yields in credit markets as the 'no taper'. The Fed may yet regret confounding the market in view of the credibility required for forward guidance policy to be effective.

Consensus economic forecasts for the US are indicative of a softening growth trend, Exhibit 2. Although the first market reaction to the 'no-taper' news was higher market prices of equities, bonds and commodities, market prices have – correctly in our view – now started to price in a period of lower US growth in combination with easier economic policy.

US equities have now given back their post-Fed announcement gains while government bond yields have contracted sharply and remain lower. In contrast, emerging markets have staged something of a relief rally from their recent lows as easier US monetary policy is likely to slow the pace of capital outflows from these regions.

Exhibit 2: US consensus GDP forecasts



Source: Bloomberg

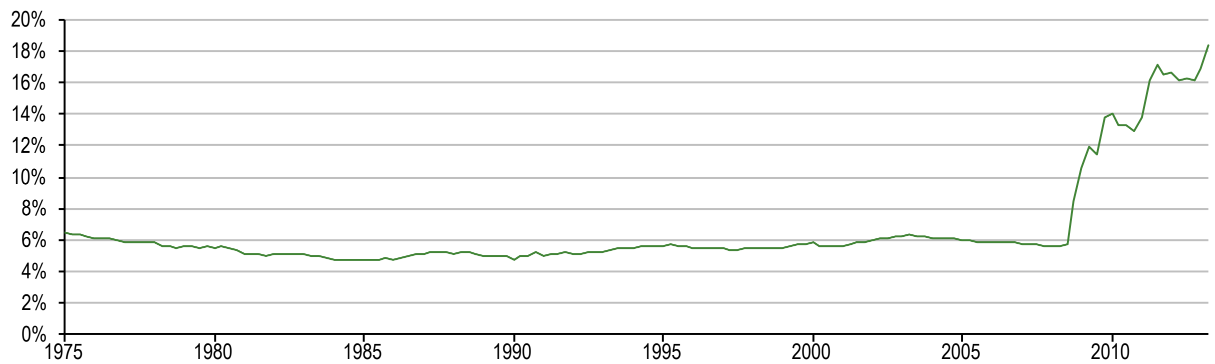
In the short run, the risks in global markets are clearly lower as markets will not need to worry about a reduction in the QE programme over the autumn. However, the aggressive and continued expansion of the US monetary base (M0) at a time of no obvious stress in the financial system makes it clear this is no ordinary recovery. The unwillingness of the Fed to allow the economy to find its feet without QE points to one of two possibilities.

The first is that the US Fed has overestimated the economic impact of QE, especially to the downside. In this scenario the Fed may fear that a sharp relapse in activity is almost certain if QE is withdrawn. This will make it very hard to justify winding the programme down. In contrast, we believe QE has only had a limited impact on the real economy and the costs are now exceeding the benefits. It is notable that the current Bank Of England governor Mark Carney has recently stated that he sees no need for further QE in the UK.

The second possibility is that the Fed no longer believes forward guidance will be effective on its own in keeping the long end of the yield curve sufficiently depressed to continue to support economic activity. The near-doubling of US 10-year bond yields over the last six months is largely attributable to market expectations of a withdrawal of the QE programme over 2014. If forward guidance has been deemed to be an insufficiently powerful policy instrument, QE will be a feature of the US monetary landscape until well after a period of robust economic growth.

We can see the objective but question the stakes. The monetary base (M0) in the US is growing enormously under the current Fed policies, Exhibit 3. The Fed may be risking the 50-year benefits of having the world's reserve currency to micromanage the volatility of the US economy – and with no guarantee of success.

Exhibit 3: US monetary base (M0)

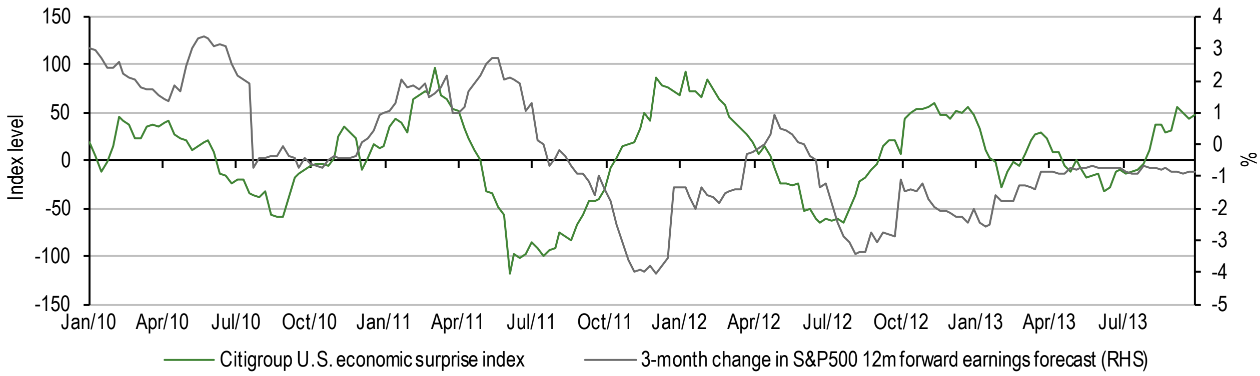


Source: Thomson Reuters Datastream

Staying cautiously positioned and diversified

In our view the sustained compression of yields across the yield curve has driven investors to value equities much more highly than would have otherwise been the case in such a weak macroeconomic environment. Global equity markets have risen strongly over the last 12 months but the fundamental support for this move in terms of sales or profits growth remains elusive, Exhibit 4. Positive economic surprises have not led to earnings upgrades in sharp contrast to other episodes.

Exhibit 4: Positive economic surprise has not fed into earnings forecasts



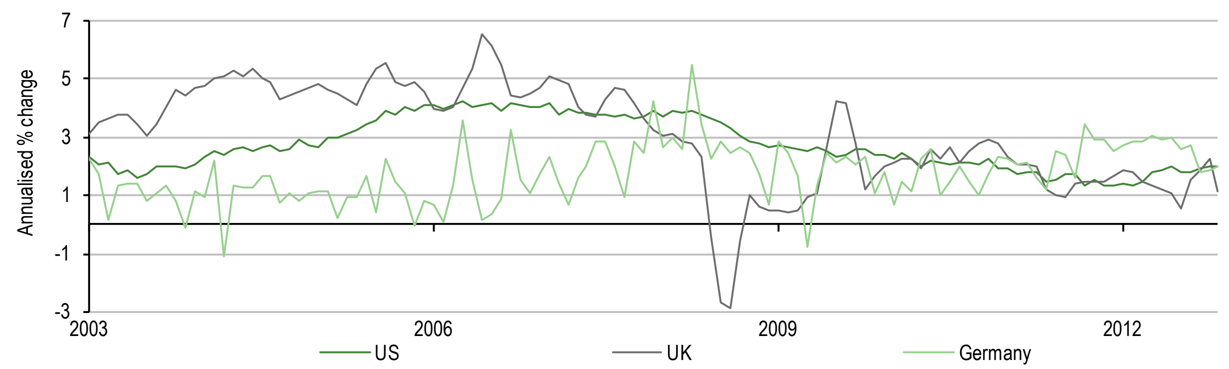
Source: I/B/E/S, Thomson Reuters Datastream

In terms of valuations there has been no change in the outlook over the past month. Dividend yields for all but the largest-cap stocks are close to multi-decade lows in the UK and US. European equities are less aggressively valued in aggregate and there remain situations where strong global organisations have been unfairly penalised in terms of valuation relative to peers by virtue of having European headquarters.

We remain concerned by the combination of high valuations and high profit margins as discussed in detail in last month's note. The corollary of high profit margins has been the suppression of wage growth and politically this is becoming a very visible issue in the UK. Ed Miliband, leader of the opposition party, has recently proposed price controls on energy, a populist move reminiscent of similar controls in emerging markets.

Clearly this policy has been designed with a political agenda in mind, perhaps even as a counter-offensive to the current government's house purchase subsidies. Investors should remain alert to populist initiatives that restrain profitability either by adding to costs (including corporate taxes, which remain at very low levels in a historical context) or supressing revenues.

Exhibit 5: US, UK, Germany wage growth



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

However, in the long run, an economy cannot be expected to grow quickly if nominal wage growth remains at 1%, such as is currently the case in the UK. It is by no means clear the corporate sector will be able to maintain the historically high level of profit margins as workers pricing power increases as an economic recovery takes hold.

Investors should at least consider that a period of P/E multiple expansion, driven by declining margins, may lie ahead even assuming the world's developed economies continue to heal. Should growth remain subdued margins may be less pressured but it is difficult to see how current valuations could be sustained if there is further decline in sales momentum.

Conclusion

Slightly slower growth combined with slightly looser monetary policy leaves our portfolio strategy unchanged. We continue to believe that over the next 12 months the upper bound for developed market bond yields is around 3% and the market is unlikely to test this level again (and by implication the resolve of the Fed) unless there is significant additional improvement in growth prospects.

For equities, there is no change to our cautious view. US and UK mid-cap stocks in particular have re-rated strongly in recent years as earnings have not kept pace with price appreciation. High valuations and cyclically strong margins point to an underweight – or no – exposure to this segment of the market from a top-down perspective. Where equity exposure is retained, we believe it should be focused on large-cap issuers trading at lower valuations. We remain positive on emerging market equities on the basis of valuation although we believe the gains may be slower from here given the sharp rally over the last few weeks.

In terms of tail risks, any further delay to QE tapering risks triggering speculation the US Fed is caught in a trap of its own making and cannot stop printing money for fear of a bond market rout. We would therefore also retain an allocation to precious metals as an insurance policy against this sequence of events.

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