Illumination: Equity strategy and market outlook

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Global perspectives: Thinking time

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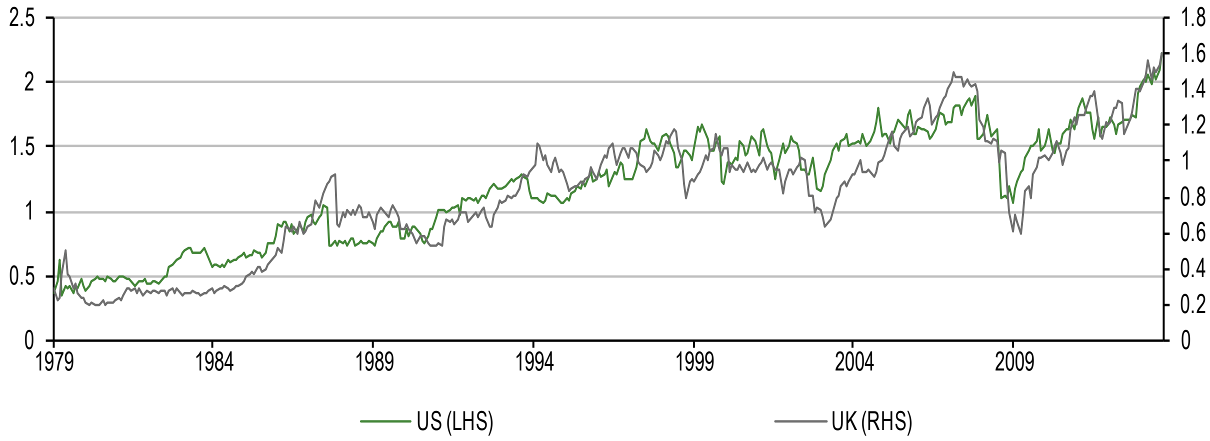
- **Equity valuations remain stretched.** We stick with our cautious equity view for Q114. Median dividend yields are at 30-year lows and price/sales ratios at record highs in the UK and US. Despite the market noise, we note that global equities in dollar terms are only up 3% since May and less in sterling and euro terms.
- **US QE tapering will be ongoing during 2014.** Bernanke has his Christmas wish and has fired the starting gun on the unwinding of the US Fed's QE programme, having firmly anchored short-term interest rate expectations through forward guidance. The initial positive market reaction may be reflective of bearish market positioning and does not change our medium-term view.
- **Economic and earnings momentum remains muted.** Despite the improvement in survey data, both economic and earnings momentum remain muted. Economic forecasts in 2013 started low and finished lower in both the US and eurozone. Consensus 12-month forward earnings forecasts are being revised lower and at an accelerating rate into the end of the year.
- **Warming to government bonds.** Even though 10-year US government bond yields remain low in a historical context, the near doubling of yields in the past six months leaves US real yields (nominal yield less core inflation) sufficiently close to long-term averages to open the debate on whether now is the time to be adding high-quality government bonds to portfolios.
- **A complete investment strategy cycle during the last two years.** In 2011, we highlighted that European equities were discounting all but the worst scenarios for the euro, while highly rated government bonds, which at the time were offering negative real yields, were expensive. During the last two years the relative valuations of each asset class have turned 180 degrees and we believe portfolio managers should consider shifting allocations accordingly.

Equity valuations remain stretched

A modest decline in world equities since October has not fundamentally changed the picture of overvalued US and UK markets on a price/sales basis, Exhibit 1. The chart may look benign, but in the last 12 months there has been a near 40% increase in median price/sales ratios, taking the series for both the UK and the US beyond the levels recorded in 2007 and onto a 35-year record high. This simple measure has been mean reverting since 1994 – and reversion just back to the mean from here would imply significant losses in equity portfolios.

Exhibit 1: Traditional valuation metrics look extended – median price/sales for the UK, US



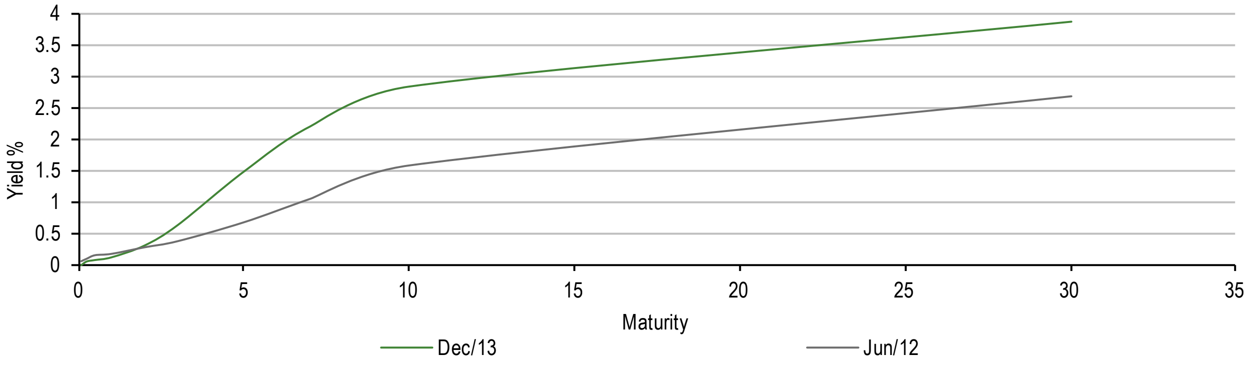
Source: Datastream, Edison calculations.

Exhaustive screening of UK non-financial stocks from the bottom up confirms the top-down picture; there are relatively few situations in the last 12 months where large share price increases can be explained by large upgrades to profits forecasts (with the notable exception of the housebuilding sector). Aggregate profit margins are close to cycle highs and the story of the last 12 months has been one of re-rating. It would appear this process has run its course and investors should at the very least expect a lower rate of return in future.

US QE tapering a feature of 2014

For global markets the key factor in the near term was always the timing and extent of the tapering of the US Federal Reserve's quantitative easing programme. With headline US unemployment dropping to 7% from 8.1% in Q212, the original endpoint of 6.5% for the 2012 QE programme was in sight. In addition, the US yield curve appears firmly anchored for maturities out to three years, Exhibit 2, reflecting the Fed's communication efforts to clearly separate the withdrawal from QE from any increases in interest rates.

Exhibit 2: US yield curve prices in both tapering and forward guidance



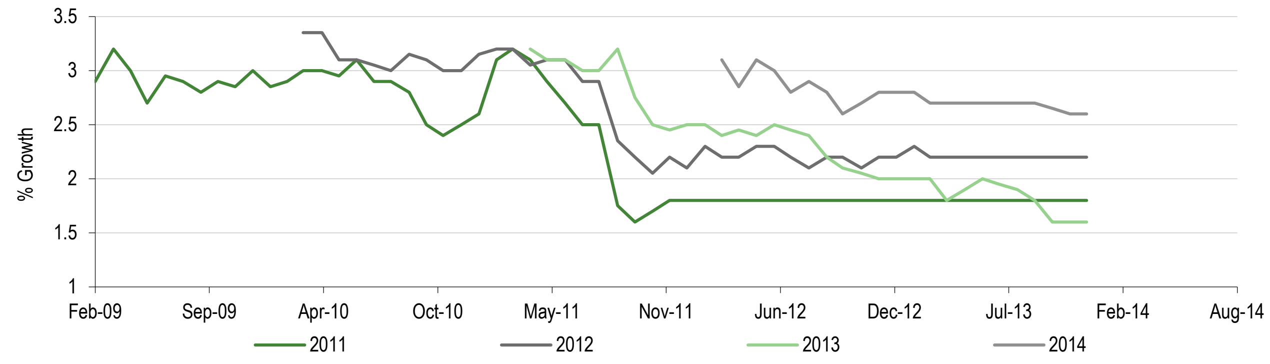
Source: Datastream

In addition to meeting the primary endpoint of a reduction in headline unemployment, the undesirable side effect of increased political scrutiny from the open-ended expansion of the Fed balance sheet and mounting evidence of froth in corporate credit means that the era of unconventional monetary policy is likely to be drawing to a close. In our view, it would take a material change in the economic outlook to justify changing course on QE, even if the rate at which QE is withdrawn is said to be data dependent.

Economic and earnings momentum still weak

Despite being burned by forecasts over and over during the last two decades, investors are once again prepared to give the outlook precedence over historical experience. We would highlight that economic growth for 2013 has in fact surprised to the downside in both the eurozone and the US, even if momentum has improved in the UK. More importantly, the data show that consensus economic forecasts have surprisingly little predictive power, as shown in Exhibit 3. Forecasts would seem to be based on an initial estimate of growth in line with long-run averages, which is then adjusted (generally lower in recent years) as actual data come in.

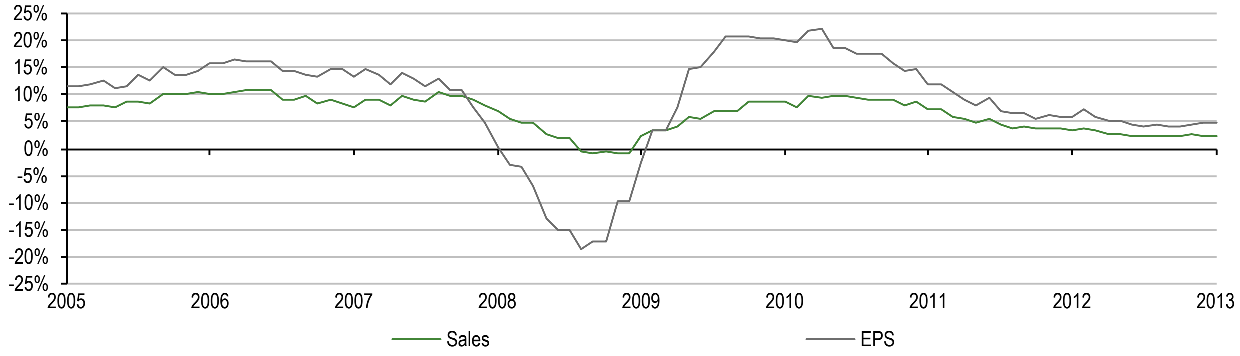
Exhibit 3: Time history of US consensus economic forecasts by year



Source: Datastream

Even as economic data have improved somewhat during the year, earnings remain stubbornly resistant to upgrades. As margins are relatively high, growth in sales is critical to driving earnings growth, but sales momentum has slowed significantly over the last 18 months in the UK, Exhibit 4.

Exhibit 4: 12-month forward sales and EPS growth for UK (median, non-financials)



Source: Datastream, Edison Investment Research calculations

Last month we highlighted the unusual divergence between survey data and earnings revisions. Although survey data have improved enormously during 2013, earnings revisions have not followed and within the last month there has been an acceleration in earnings downgrades globally. The reasons for this are unclear, but the corporate sector discloses its private beliefs in its actions; share buybacks are being favoured over M&A.

US share buybacks nearing 2007 levels

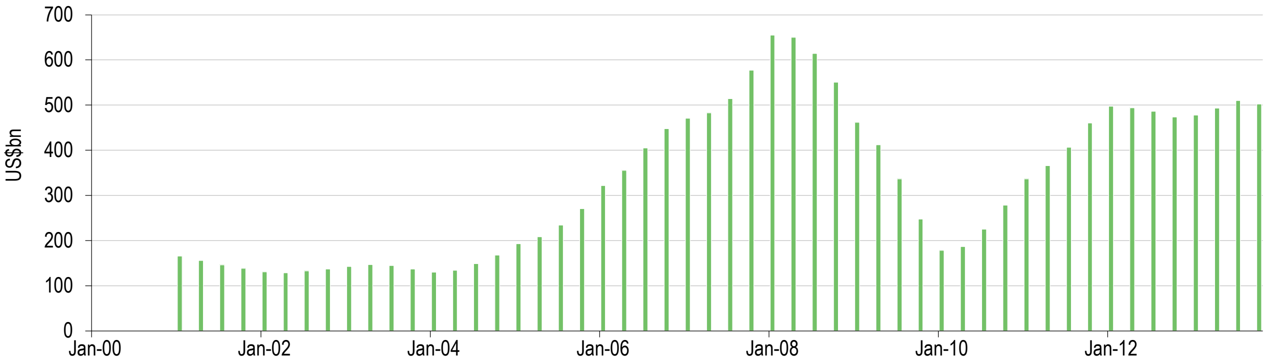
In the US, share buybacks now account for over 5% of daily trading volumes, which represents a significant prop for the equity market. The willingness to reduce equity capital would appear to indicate that larger businesses still see few opportunities for deploying capital at a sufficiently high rate of return.

There is also a mechanism here that may explain some of the recent strength of the US equity market. Demand for corporate debt is so strong that the corporate sector is retiring equity (which is perceived as expensive and dividends not a tax-deductible expense) with the proceeds from issuance of low coupon debt.

This may sound logical, just as it did during the previous peak in buyback activity in 2007. At one extreme, the private equity business has been a key beneficiary of ultra-low interest rate policy, as low-cost debt has facilitated dividend payments to sponsors and the re-financing of highly leveraged structures.

The danger in inappropriately timed share buybacks is only in hindsight, when the shareholder value destruction realised through buying stock at all-time highs only to announce a rights issue during a recession becomes apparent. We are not so sure we have sufficient evidence to prove that central banks have abolished boom and bust, and the short-term financial incentive to issue debt and retire equity may be another undesirable side effect of ultra-low interest rate policy.

Exhibit 5: S&P500 annualised share buyback activity

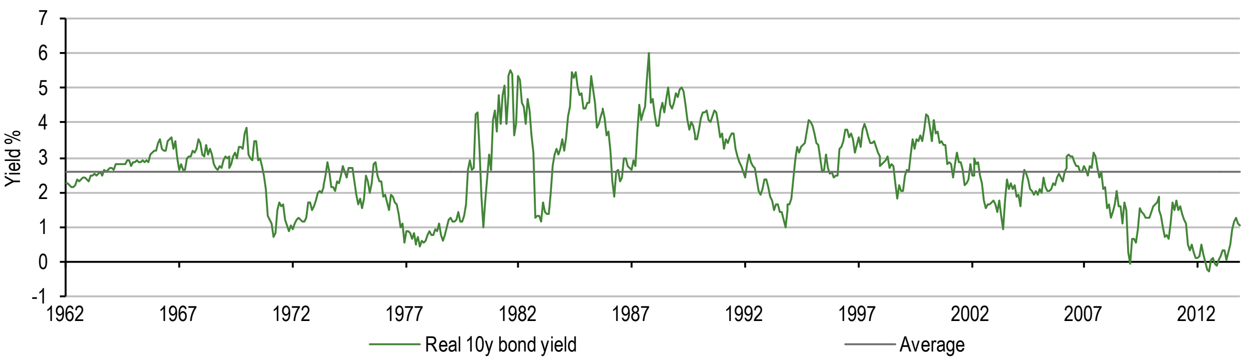


Source: Thomson Reuters

A valid debate on bond yields, inflation and interest rates

The prospect of QE tapering has created a sharp steepening of the yield curve during 2013 through an increase in 10-year bond yields and the impact of forward guidance flattening the front end of the curve. At 1.7% in real terms (ie after subtracting core inflation from the nominal rate), 10-year US bond yields are still somewhat lower than their long-term average of 2.5%, Exhibit 6, but the move upwards from zero real rates earlier this year is significant. The investment case for avoiding bonds is clearly now less clear cut.

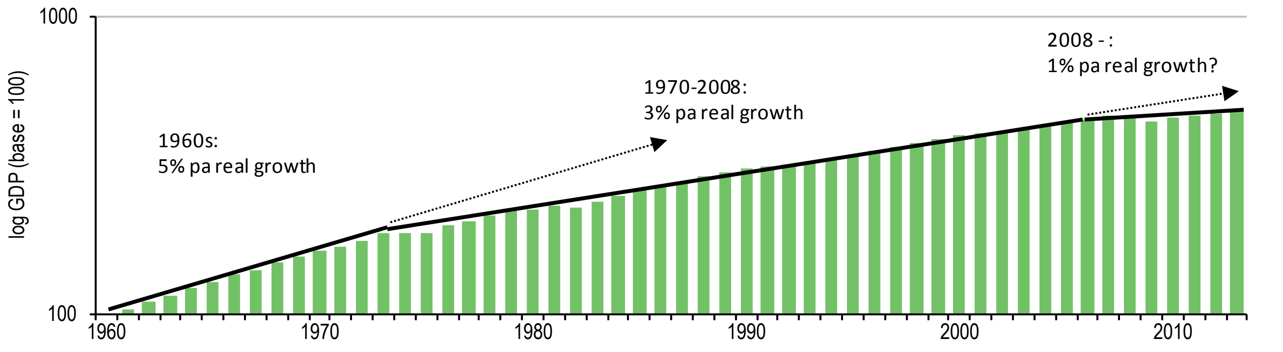
Exhibit 6: US real bond yields



Source: IMF

We believe the arguments for US bonds, and by implication other global bond markets, are now more balanced. Should, as we expect, developed markets grow more slowly than in the past (ie 1-2% real rather than 3% real, Exhibit 7), then bonds look closer to fair value than their nominal yields may imply. Certainly the recent disinflation in developed markets supports this view.

Exhibit 7: G7 GDP growth rates



Source: IMF

From a portfolio perspective, the steady withdrawal of the US Federal Reserve from the US bond market also points to the re-establishment of the traditional negative correlations between equities and government bonds, thus increasing the attraction of government bonds in terms of portfolio diversification.

A new allocation to bonds should not be at the expense of precious metals. Gold is trading much closer to industry cash costs than earlier in 2014. Gold remains an important hedge against the tail-risk outcome that central banks continue to hold monetary policy too loose for too long, in fear of the effects of another recession.

For corporate bonds, yields relative to risk-free government securities have continued to tighten to levels not seen since before 2008. Exhibit 8 shows how the cost of insuring credit risk has fallen during 2013. Investor's willingness to gain exposure to corporate credit risk at ever lower yields and in the case of loans with fewer or no covenants has in the short run reduced the risk of defaults. Corporate defaults have been so low for so long that some credit analysts openly question if a no-default model would be a better working assumption.

Exhibit 8: iTraxx crossover CDS spread

Source: Markit, Bloomberg

Financial history suggests that when risk is hidden it does not disappear but compounds; credit events in a covenant-lite world may be less frequent, but when they occur recoveries are likely to be lower. In addition, in a difficult market corporate bonds behave very differently from government securities and can prove illiquid. With spreads at such low levels, we see little reason to chase this asset class at present.

Conclusion

In the space of only two years our asset allocation has come nearly full circle. During the second half of 2011, with the eurozone debt crisis in full flow, we found that equity valuations in the core of

Europe discounted all but the worst possible outcome for the euro. Since then, the total return on the DAX has exceeded 70%, while government bond yields have doubled.

For government bonds where we were once bearish, we believe there is now a valid debate in terms of the current yields and the probable trajectories of inflation and real growth. A slowing in the growth of working age populations combined with high debt/GDP ratios across developed markets points to a slowing in the medium-term growth rate and may be factored into US and UK real bond yields. The steady withdrawal of QE should also mean in due course that government bonds are restored to their role as stabilisers within a portfolio. We would continue to look to add to positions at 10-year yields close to 3% in the US and UK.

Many of the fundamental arguments in relation to business quality, balance sheets and profitability that we used in 2011 to justify a position in equities remain valid today, but there is a key exception – valuation. No matter how good the company, if the shares are overpriced the returns are likely to disappoint. In only 24 months many shares in Europe and the US appear to us to have swung from undervalued to overvalued. The most extreme outperformance is in mid-caps, illustrated by the outperformance of the FTSE 250 and Russell 2000 indices. We have warned of the risks of a dash for the exits on a number of occasions in 2013, but clearly thus far have been too early (or wrong), as during H2 mid-cap indices continued to move slowly higher.

With corporate performance still strong and low interest rates likely to persist through 2014, it may seem counterintuitive to be focused on the scope for a market correction. However, we believe the past 12 months have caused investors to lose sight of the very normal levels of economic and market volatility that have been experienced in the past. Like off-piste skiers who ignore avalanche warnings, investors who have downplayed measures of risk/reward have been having more fun. But after any correction the question could easily be: What were they thinking?

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