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Illumination: Equity strategy and market outlook

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Global perspectives: A gentle risk reminder

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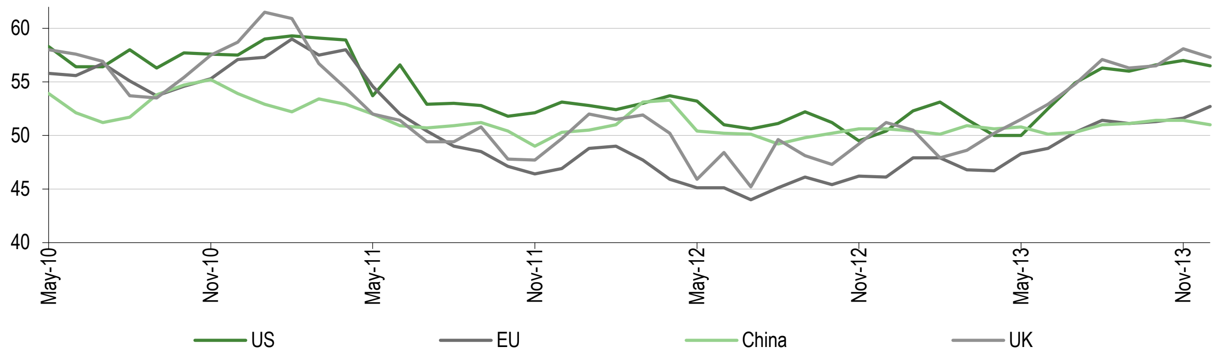
- **A gentle risk reminder.** The year-to-date declines in world equity markets do not surprise us given how far markets rose in 2013. Valuations remain extended as prices have risen, while profits forecasts stagnate or move lower. The temptation to make an ex-post rationalisation of the recent move lower should be resisted, as there was no single obvious trigger. However, the declines are so far insufficient to switch us from our cautious stance.
- **Global economic momentum has improved substantially during the last 12 months.** Survey data currently indicate the fastest rate of expansion seen during this decade. This will please policymakers, although investors should remain attentive to the shifting nature of risk. For much of the post-2009 period, equity valuations were relatively depressed, while economic uncertainty was high. This picture has now reversed as we believe it is valuation that is now the key risk for equities and ultra-low credit spreads the key risk in credit markets.
- **Central banks and investors have mutually benefited from rising asset prices.** Increased asset prices have been instrumental in allowing the bank sector to recapitalise and more leveraged entities to survive, if not prosper. With private sector appetite for assets such as peripheral European government bonds now strong, the case for normalising the level of support and by implication normalising market interest rates is much stronger.
- **Central bankers' interests now diverge from those of investors.** We see in the recent sell-off the hallmarks of tighter monetary conditions. Emerging market currencies have sold off aggressively, while mid-cap stocks have underperformed large caps and traditional safe havens such as the Swiss franc have risen. However, we do not expect a US policy response to the modest market declines seen to date as the US domestic economic outlook is little changed.
- **Still cautious and favouring large cap equities.** A diversified portfolio would have suffered little damage over recent days with losses in equity positions offset by gains in bonds and gold. We remain most concerned about the relatively high valuations and poor liquidity in mid-cap equities. Highly rated government bonds have outperformed recently, but we are still positive on the asset class at yields of over 3%.

Global economic momentum still strong...

It is clear that economic momentum going into 2014 is substantially stronger than in recent years as judged by survey data, Exhibit 1. Developed market GDP growth for 2014 is now forecast by the IMF to be 2.2% or nearly double the rates of 2011 and 2012, with world GDP growth at 3.7%. This recovery in confidence has contributed to improved trends in employment, both in the US and UK, and a dramatic reduction in the perceived risk of investing in the periphery of Europe. However, while any recovery may be welcome by society at large, investors should remain attentive to the shifting nature of the risks they face.

Exhibit 1: Global survey data



Source: Bloomberg

...but valuation at risk

While periods such as 2009 or 2011 were difficult in terms of the uncertainty over the direction of the economy, investors were amply compensated by discounted equity valuations. It was a reasonable bet to make that in the event of a meltdown scenario (such as a break-up of the eurozone) all the major central banks worldwide would be highly proactive in preventing a downward asset price spiral affecting either the banking sector or the real economy. Since then, owners of assets have been the prime beneficiaries of zero interest rate and unconventional monetary policy.

In 2014 we see the same arguments, but in reverse. Equity market valuations are much higher than historical averages, with the exception of some of the largest cap stocks. The tide of monetary policy has turned and we suspect that even if the global economy fulfils current growth expectations, a modest tightening of monetary conditions may lead investors to question equity valuations during 2014.

Past the point of 'peak money'?

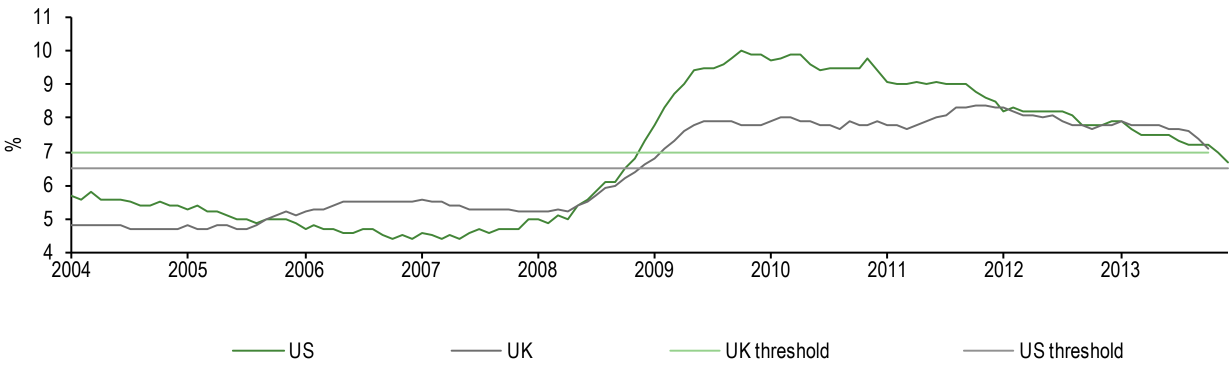
Recent days have seen higher beta segments of the market (such as mid-caps and emerging markets) underperform and a modest flight to safety in terms of a stronger bid for traditional safe havens such as US treasuries and the Swiss franc. This has all the hallmarks of a tightening of US dollar funding.

Both the US Federal Reserve and the Bank of England have been at pains to stress that interest rates will be maintained at low levels for both an extended period of time and for as long as it takes to ensure a self-sustaining recovery. However, both central banks have also stepped back from quantitative easing. In the US, provided current economic expectations are met, the trajectory of tapering means that QE will end during 2014, while in the UK the Bank of England's balance sheet has remained unchanged at £375bn since mid-2012.

Official measures of unemployment have declined more sharply than anticipated earlier in 2013, as shown in Exhibit 2. Both the US Federal Reserve and the Bank of England have been careful to refocus attention on still well-anchored inflation expectations, to avoid a situation where forward guidance is compromised by rising market interest rates. However, it is clear that initial forecasts of the trajectory of unemployment were too pessimistic. Although highly unlikely in 2014, if UK economic momentum is maintained the first rise in interest rates may only be just over a year away.

In the eurozone, growth prospects remain weak and the risk of outright deflation is much higher than in the US or UK, although there are significant political difficulties in introducing QE. Draghi's most recent comments also show he is sceptical that government bond purchases will address the eurozone's difficulties. Instead, the ECB is in the preliminary stages of considering a form of credit easing targeted at supporting private sector credit creation. While this would be a welcome development that would improve credit availability and narrow corporate interest rate differentials across the eurozone, it would also be unlikely to have as large an effect as full-blown QE on financial markets.

Exhibit 2: US and UK unemployment and central bank target



Source: Thomson Reuters Datastream

As we have written previously, we view forward guidance as a more appropriate economic policy at this stage as it creates fewer market distortions. The second advantage is that this policy carries less risk for central banks, as it does not result in ever-increasing central bank balance sheets. The policy can therefore be continued for much longer, subject to inflation expectations remaining well anchored, and is easily reversed if required.

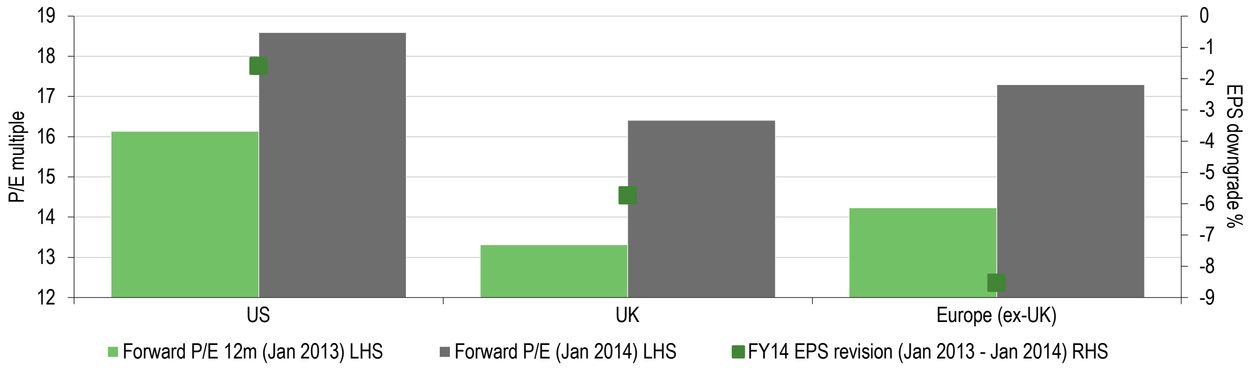
However, the move towards forward guidance does represent a shift along the spectrum of policy tools away from fire-fighting and back to more conventional monetary policy. The modest reduction in the rate of US quantitative easing has been associated with a near doubling in US and UK 10-year government bond yields and something of a 'stepped' yield curve, which has for example sharply curtailed the number of US mortgage applications since early 2013.

It is therefore entirely possible we have passed the point of peak monetary accommodation in this cycle. This is good news for value-driven investors, as it means the era of quantitative easing may be drawing to a close; for many pension funds the urge to switch out of equities that have outperformed and into bonds to de-risk pension liabilities must be strong now yields have risen. Investors should now consider whether central banks still have their interests at heart, or whether their affair with rising asset prices has come to an end.

Profits growth continues to be elusive

While survey data have become much more optimistic, there has been no corresponding increase in profits expectations for the non-financial sector. We believe the equity rally of 2013 was remarkable as the lack of profits momentum meant the market was wholly driven by an expansion of P/E multiples. Exhibit 3 shows that for the US, UK and Europe how P/E multiples have expanded, while 2014 EPS forecasts for each market have contracted, most notably in Europe.

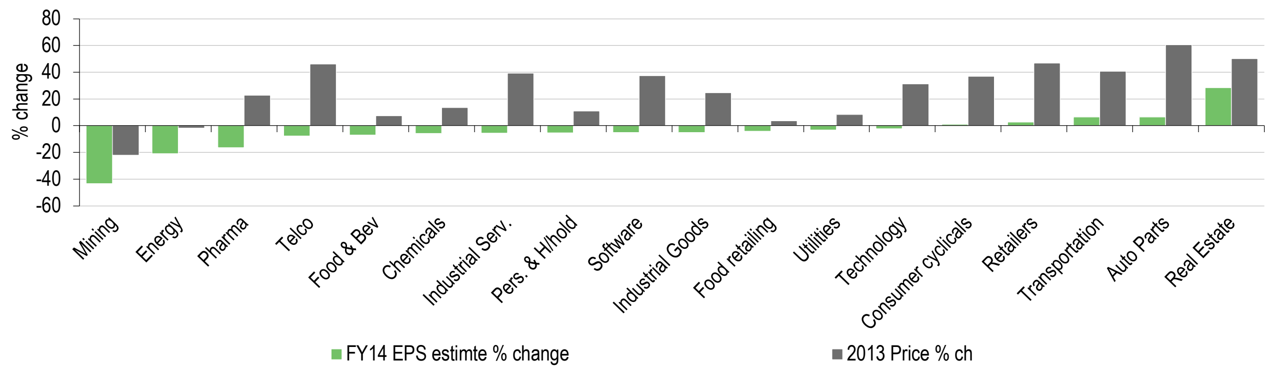
Exhibit 3: 2013 – US, UK and Europe: the 'great re-rating'



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

Although there has been some correlation in the UK between upgrades during 2013 and sector performance, Exhibit 4, this is not evident in either the US or continental Europe, where all sectors rose sharply irrespective of earnings momentum that was on average negative. Exhibit 4 also highlights the contrast between the sharp rise in the market versus the underlying weakness of profits momentum, even in the UK. Globally, downward revisions continue to outpace upgrades.

Exhibit 4: UK 2013 sector performance v 2014 earnings revision (January to December 2013)



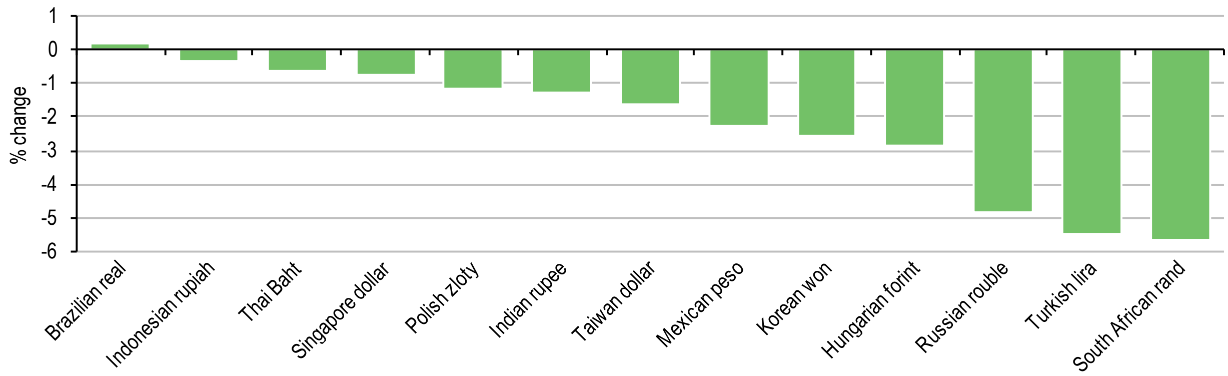
Source: Thomson Reuters Datastream, Edison calculations

We are not sure how long investors will be prepared to ignore the profits downgrades. Either estimates will have to start to rise, reflecting improved economic conditions, or market valuations will become vulnerable to declining profits expectations. Companies that have disappointed with even modest deviations from previous guidance are being punished aggressively and we note that UK profit warnings for the final quarter of 2013 have risen sharply, with nearly 10% of the FTSE 350 warning in recent weeks.

Emerging market currencies hit by tapering

During January, the sell-off in emerging market currencies has accelerated, Exhibit 5. There are certainly weaknesses in the current account positions of many emerging market nations, but there seems to be no single trigger for the market declines, with observers attributing the moves to political instability in Turkey and the Ukraine, weakness in China's PMIs or the potential for a mishap in China's shadow banking system. It is as likely the prospect of tightening dollar liquidity and relative underperformance of equity markets in US dollar terms that has triggered a degree of capital flight.

Exhibit 5: Emerging market currency weakness 1 to 28 January 2014



Source: Thomson Reuters Datastream

We note that for emerging market equities, valuations do not look expensive. Comparing developed market non-financials with emerging peers shows that EM dividend yields are higher and forecast sales growth rates substantially higher than developed markets, Exhibit 6.

Exhibit 6: Emerging market valuations compared to developed markets (non-financials)

	P/E (trailing)	Div. yield	P/Sales	Sales growth	EV/EBITDA	Net debt/EBITDA
UK	17.8	1.9	1.8	5.3%	8.7	0.7
US	21.4	1.7	2.2	5.7%	9.4	0.9
Europe (ex-UK)	19.4	2.0	1.0	4.3%	7.6	0.7
Emerging markets	18.1	2.2	1.9	8.9%	8.3	0.8

Source: Thomson Reuters Datastream, Edison calculations

If the question is one of currency devaluation, many EM-located firms will benefit from an improved competitive position in terms of global trade. Once the market volatility has subsided, potentially through central bank intervention to stabilise currencies at a lower level, valuations are likely to recover.

Conclusion

We believe the recent market declines are a gentle reminder that equity markets do not necessarily move in the same direction as economic momentum, especially when valuations are extended. If we have passed the point of 'peak' monetary accommodation, there is every possibility that equities have already entered a soft patch, and we note that the FTSE 100 has only moved sideways in the last eight months. In the face of even a gradual tightening of monetary conditions, the global re-rating of 2013 can only be sustained if the corporate sector can deliver profits upgrades to match the recovery in economic confidence.

From a strategic perspective, we therefore remain cautiously positioned and favour going to where we still find value and liquidity, which is in the large-cap segment of the market. We continue to suggest tactically increasing exposure to highly rated government bonds at yields above 3%.

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