Illumination: Equity strategy and market outlook

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Global perspectives: Refining the view

- **Global markets have made little progress in Q114.** The standout asset class in US dollar terms so far this year is gold, followed by agricultural commodities, both of which have benefited from geopolitical tension in the Ukraine. Most asset classes, including equities and bonds, have moved within a range of +/- 5%, with the notable exception of copper and the Japanese equity market.
- **Recent events add weight to our view that the 'peak' in monetary accommodation may be behind us.** Formally, both the ECB's and US Federal Reserve's policy outlooks appear little changed. But at press conferences following the policy decisions the nuances became clearer, with both the ECB and US Federal Reserve disappointing markets with a more hawkish tone.
- **Refining the view.** This month we present a new market valuation method based on aggregating return forecasts for individual stocks. The model shows that in each of the US, UK and Europe, forecast returns have dropped significantly in the last two years as improvements in fundamentals have failed to keep pace with rising equity prices.
- **Events in the Ukraine not yet systemic.** Our central case is that it is in no one's economic interest to escalate the dispute further in the short-term and the current level of sanctions will not have a material economic effect. We believe the increased risk premium for Russian assets is appropriate, but also see some medium-term benefits for the European defence sector. We would need to see further escalation to move to an even more cautious portfolio positioning.
- **A modest tightening in the monetary outlook, a richly valued equity market and the emergence of new risks keep us cautiously positioned.** Equity exposure should be limited to situations where the long-term upside is sufficient to compensate for near-term market volatility. With the primary risk in 2014 being valuation risk, we would also be weighting equity portfolios towards segments of the market that still trade at levels in line with historical averages, and in particular quality large caps over small and medium-cap names.

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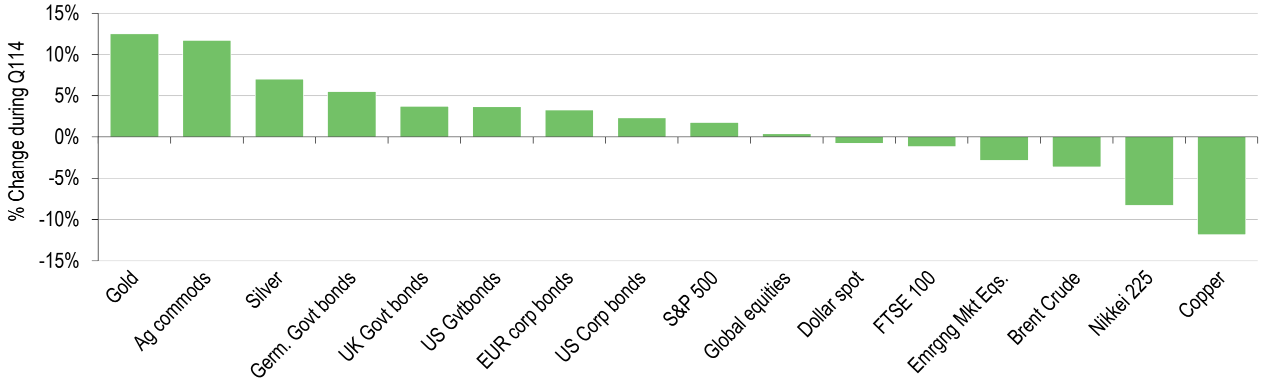
Refining the view

Global markets have made little headway in Q114, Exhibit 1. Relative to normal market volatility most major asset classes are effectively flat year to date in US dollar terms. The standout performers have been gold and agricultural commodities, which have most recently benefited from heightened geopolitical risk. The laggards are the Nikkei and industrial metals such as copper, which have suffered from the continued slowdown in China.

Exhibit 1: Q114 asset class performance



Source: Thomson Reuters Datastream

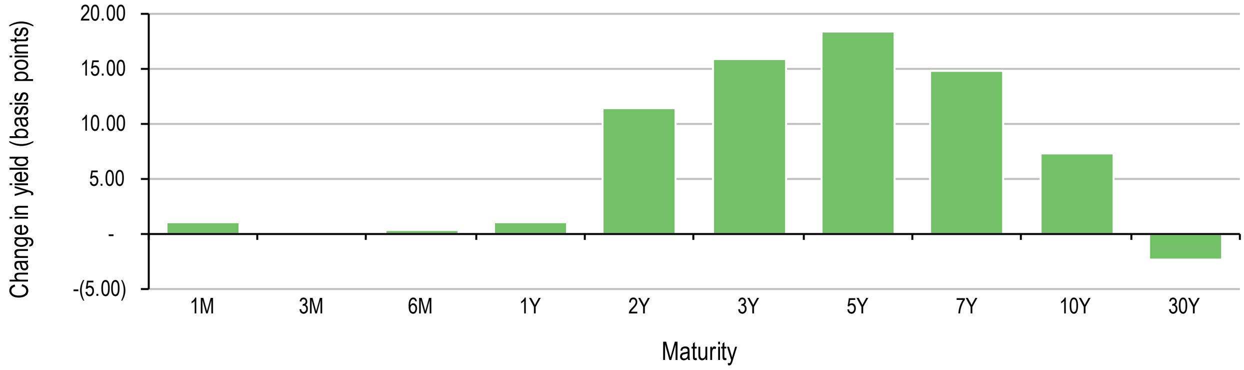
ECB and Federal Reserve – leaning to tighter policy

Although the formal policies of the ECB and US Federal Reserve are in essence unchanged from the previous statements, which envisage a long period of loose monetary policy even as growth recovers, investors are right to be focusing on more hawkish commentary from both the ECB and US Federal Reserve in recent weeks.

In Europe, the signals are confused. Draghi's press conference disappointed those looking for more progress towards the introduction of QE or even credit easing policies. Instead of discussing further policy initiatives, Draghi highlighted the improvement in PMI survey data, convergence in credit conditions across the eurozone and well-anchored inflation expectations. We were surprised, given the significantly below-target inflation outlook within the eurozone, but the message seemed to be that the ECB would wait and see how much progress is made with the current low levels of interest rates and forward guidance before attempting more radical policies.

In this context, the timing of recent comments by Bundesbank head Jens Weidmann, indicating a newly found willingness to consider full-blown QE and confirmation from people close to the situation that active work is being undertaken on credit easing policies appears odd. There may have been a subtle attempt to reassure the markets that all the ECB's options remain on the table, even if no action is contemplated in the short term to prevent the euro exchange rate rising too far, which is clearly hindering the battle against deflation.

Exhibit 2: Shift in US government yield curve pre/post FOMC



Source: Thomson Reuters Datastream

In the US, formal policy was also effectively unchanged following the most recent FOMC meeting. However, in our view markets are correctly interpreting the FOMC participants' interest rate expectations data as more hawkish, Exhibit 2. In our view, Fed Chair Yellen's press conference comments clearly implied a strong likelihood of an interest rate increase in H115, which briefly jolted the equity market lower by 0.75% and has led to an increase in short-term market interest rates.

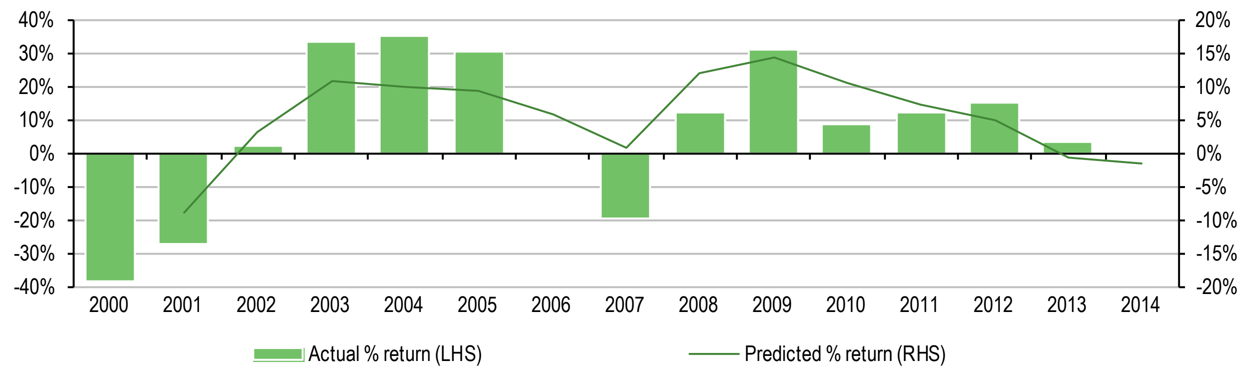
In the UK, there has been little recent shift in expectations, but the first interest rate increase is still expected in H115. Even if the rate of increase will be gradual, the situation is very different from only 18 months ago when forward guidance flattened the short end of the yield curve. Absent a material downward shift in growth expectations, UK monetary policy is on a tightening path, even if only moving slowly.

Refining the view

Thus far we have relied on top-down valuation measures of equity markets to highlight what we believe is a relatively elevated level for market valuations, especially in the US or UK. In our view, it is too easy for strategists to hide behind top-down numbers without considering the data at the company level. This month we have extended our research in this area by building market valuation models from the bottom up, or in other words by appraising the return outlook for each constituent stock in market indices using a statistical modelling process.

The advantage of doing this is that it allows a much more detailed view of sector, region and relative size valuations. In addition, it allows us to cross-check our earlier top-down valuation estimates, which can be distorted due to outliers among larger capitalisation issues.

Exhibit 3: UK 24-month non-financial market return forecasting model versus outturn



Source: Edison analysis, Thomson Reuters Datastream. Note: Actual returns based on year-average index levels.

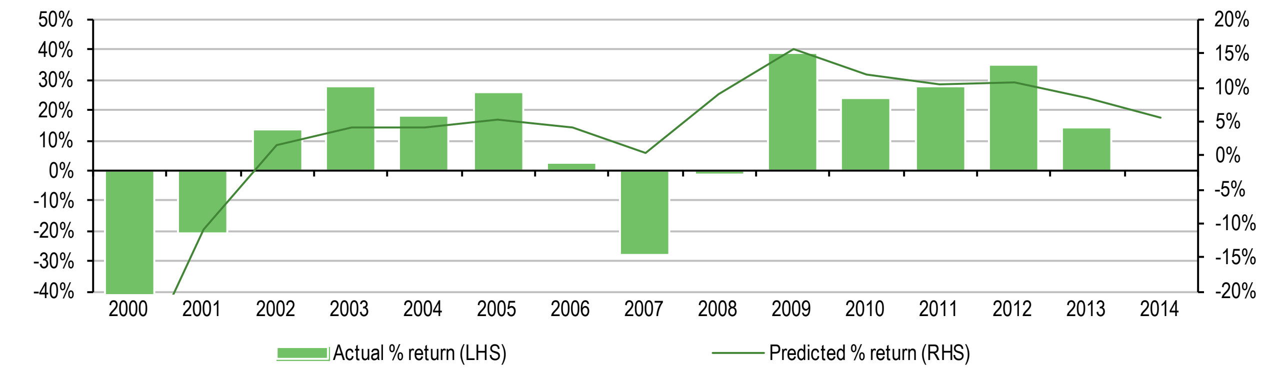
The results for the UK are shown in Exhibit 3, where the forecast return on a two-year time horizon is compared to the actual outcome for the non-financial Datastream index since 2001. The fit is relatively good, with the model explaining approximately 70% of the deviation from the mean over the previous two market cycles. Investors may wish to note that at present this model is suggesting that non-financial UK equities are currently offering returns lower than at any time since the dot-com bubble, confirming our original top-down thesis of a relatively expensive equity market.

Exhibit 4: UK – 24-month return forecast by size quintile

Source: Edison analysis, Thomson Reuters Datastream

While we were not looking for this result, the model also confirms our sense that the market has a relative opportunity set similar to that prevailing in 2007. Namely, large-cap equities currently offer the best returns, compared to mid and small caps, Exhibit 4. This is of course very different from the dot-com era when large cap equities accounted for the bulk of the market overvaluation with many mid- and small-cap equities overlooked by investors.

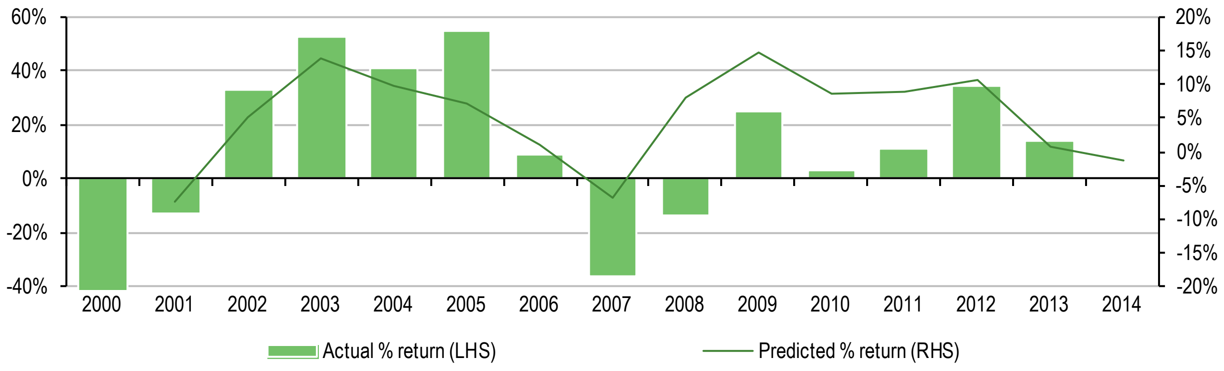
Exhibit 5: US 24-month non-financial market return forecasting model versus outturn



Source: Edison analysis, Thomson Reuters Datastream. Note: Actual returns based on year-average index levels.

In the US, the bottom-up model also fits the data well and shows a significant reduction in the prospective return. However, the forecast is still well above zero, due to the better forecast growth prospects for US corporates arising from a fundamentally faster growing US economy compared to Europe and the UK. The surprise during the modelling exercise was continental Europe, Exhibit 6. Despite trading some way from peak price/sales in aggregate, the bottom-up model indicates that valuations are as extended as at any time during the last 10 years. We believe European equities are suffering from a lack of profits momentum, which unless reversed during 2014 may prove to be an increasing headwind for European equity markets.

Exhibit 6: Europe ex UK 24-month return forecasting model versus outturn



Source: Edison analysis, Thomson Reuters Datastream. Note: Actual returns based on year-average index levels.

Institutional clients who wish to see the full results of the bottom-up analysis down to security level should contact their Edison representative.

Ukraine – another risk, but not systemic yet

Since the global financial crisis, investors have been focused almost exclusively on economics. Specifically, the interplay of the fragility of the financial system, the monetary policy response and the resulting impact on sustainable economic growth were the dominant investment factors.

Geopolitical risk has been off the radar, and up until the events of February 2014 there have been no international disputes with significant market or systemic economic repercussions. Both investors and policy makers have enjoyed the luxury of being focused on rebuilding the economy, unconstrained by a foreign policy agenda.

The issues surrounding the Ukraine are a complex overlay of defence and energy politics combined with a failing Ukrainian economy. Had the Ukrainian government not needed a bailout, it is likely this episode of political instability would have been avoided. It is also easy to forget that the size of the Ukrainian economy (2013 GDP of US$170bn) is minimal compared to the potential systemic nature of the fallout from the Russian incursion into Crimea.

Russia has proved to have been very sensitive to the encroachment of Western-leaning governments on its borders, regarding the fall of the Russian-leaning Ukrainian President Yanukovich as unconstitutional. However, it is not at present clear why the annexation of Crimea was so important to Russia. Russia's control of the gas supply has historically provided effective control of the Ukrainian nation (including relatively recently, for example, during the lease negotiations for the military bases in Crimea). In turn, this control of the gas supply has wielded significant influence over much of Europe, regardless of which Ukrainian administration was currently in power.

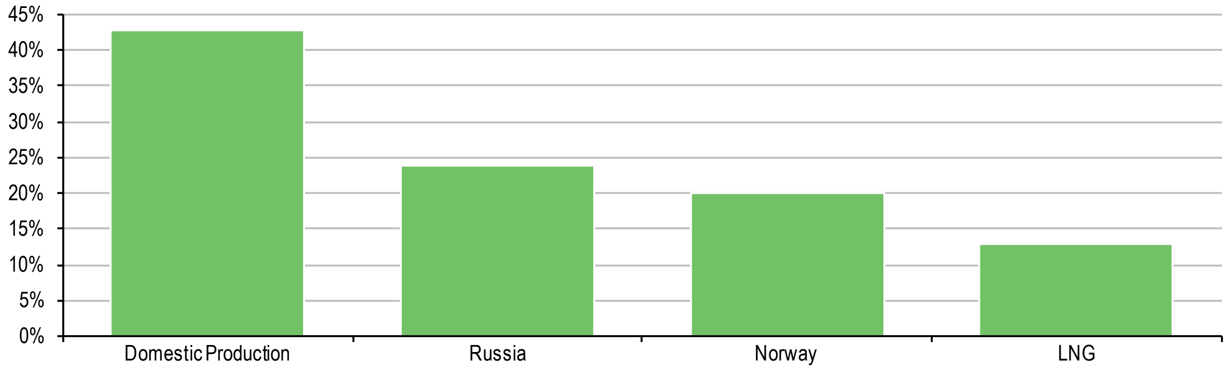
Uneasy stalemate now in place

Russia would have known that a military incursion would run the risk of sanctions, but as importantly bring its behind-the-scenes power in European energy markets into sharp relief. Crimea seems an insufficient prize given such costs and Russia's next steps are therefore unclear, including whether an annexation of the eastern part of the Ukraine could be planned, for example.

However, the most likely scenario is that an uneasy stalemate has already developed, in our view. Crimea has strong historical ties and is of more consequence to Russia than to the West. In terms of sanctions to date, the recent actions taken by the West are carefully targeted at individuals to avoid damage to broader trade volumes. Provided Russia can resist the temptation to escalate a sanctions war, the world could return to relative calm in the short term.

In this most likely scenario, the annexation of Crimea becomes a longstanding geopolitical dispute. In terms of Europe's gas supply, Exhibit 7, Europe should have little to fear as cutting the flow of gas would eliminate approximately one-quarter of Russia's government revenues and would be clearly unsustainable. In the medium term, both Russia and Europe will look to diversify energy supply relationships, which would be a net positive for both economic regions and reduce the strategic importance of transit nations such as the Ukraine.

Exhibit 7: Where does Europe get its gas?



Source: BP statistical review

However, the most likely scenario is not the whole story. The increased risk of Russian military incursions will have an impact on defence policies, particularly in regions formerly part of the Soviet Union. The US has for some time encouraged Europe to spend more on defence and take a bigger role in foreign policy interventions.

Positive impact on defence sector

It would be rash to think that Western European states might reverse over 20 years of defence cutting overnight. But we think it a real possibility that the current situation might rapidly affect defence policy thinking: for example, there are some indications that the situation in the Ukraine is already affecting some of the preparatory thinking ahead of the UK's forthcoming Strategic Defence & Security Review (SDSR), due to be published after the 2015 general election. Our view is that under the circumstances future defence cuts become much harder to justify.

We would also highlight the imperative to demonstrate EU (and, arguably more importantly, NATO) solidarity with those Eastern European members, especially the Baltic States, which have significant Russian-speaking populations. There is therefore likely to be a discernable upward pressure on some areas of defence spending as Western European NATO members commit forces to deploy to the east as a deterrent.

Finally, we are impressed by the degree to which the Ukrainian crisis has accelerated the change of the long-term political consensus in Scandinavia. Recent reports indicate that both Sweden and Finland are now very actively considering applying for NATO membership. This could clearly be construed as provocative by Putin's Russia, but it highlights to us the degree to which the glasnost/neutrality/budgetary disarmament trend of Europe since 1992 has been utterly punctured.

Increased risk premia for Russian investments

The risk of sanction escalation will place a much higher risk premium on Russian investments such as equities, which may have a more chilling effect on Russian economic growth than the initial capital outflows, estimated by Russia at US$70bn. Projects that require significant foreign investment in fixed investments are the most at risk. Companies with significant exposure to Russia, including oil majors such as BP, would have much to lose and there are clear precedents for Russian authorities to act, in the eyes of western investors at least, in an arbitrary manner in such cases.

Ukraine has limited effect on total portfolio risk at present

Although low probability, in the event of a full-scale economic escalation there would be a major economic impact on both Europe and the rest of the world. We believe such an escalation remains unlikely and therefore does not meaningfully increase overall portfolio risk when placed in the context of many other more mainstream concerns, the chief one being the effects of monetary policy re-normalisation.

Therefore, in terms of investment strategy, in our view the recent decline in the value of Russian equities correctly reflects an increase in the Russian equity risk premium, as Russia elected to pursue a foreign policy path that it knew would run the risk of sanctions from the US and Europe. This risk premium is likely to be sustained at least until Russia's intentions are clear, which could be some time from now.

Should there be no further escalation, we see little additional risk to the outlook for the European or global economy at present, as the current sanctions will not interrupt the flow of Russian energy onto world markets. For the medium term, we see increased pressure for defence spending in Europe, to the benefit of European defence companies.

For the Ukraine, no matter what government is ultimately elected, the first job will be to secure medium-term financing from international lenders and a path to fiscal sustainability. These negotiations are likely to be difficult but, given the relatively small size of any bailout, unlikely to have systemic implications.

Conclusion

A modest tightening in the monetary outlook, a richly valued equity market and the emergence of new risks keep our investment strategy cautiously positioned.

We believe markets are struggling to make headway as investors realise the point of peak monetary accommodation has passed and the first interest rate increases for many years move into view in Q115. Our cautious strategy is also supported by our new bottom-up market forecasting models, which confirm the top-down valuation signals.

Geopolitical events in Eastern Europe will need to be carefully monitored, but we see scope for an uneasy truce as both sides have much to lose from any sanction escalation that would cut off Russian energy from world markets. However, Russian markets are likely to suffer from an increased discount until the uncertainty over Russia's ultimate geopolitical ambition has dissipated.

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