EDISON

Illumination: Equity strategy and market outlook

May 2014

Published by Edison Investment Research

Global perspectives: Disturbing tranquility

- **Collapse in volatility makes us uneasy.** Since Q412, global measures of asset class volatility have fallen to levels not seen since 2007. This period of declining volatility coincides neatly with the ECB being prepared to do “whatever it takes” to save the euro; the Fed’s introduction of open-ended US QE and the Bank of Japan’s sizeable QE programme.
- **Lack of volatility driving risk premiums lower.** The lowering of volatility has increased investor’s willingness to seek out ever riskier securities to maintain returns in a global search for yield. This has been a difficult time, not only for active managers who are struggling to find value, but also for dealers contending with shrinking trading volumes.
- **A very traditional interest rate tightening cycle clearly in view.** Unemployment is declining in the US and UK to levels that in previous cycles prompted the Fed and Bank of England to tighten monetary policy. Policymakers are slowly realising that to have a smooth upward glide for interest rate policy, the first increases should start sooner rather than later. In our view, tightening monetary policy may be the trigger for rising volatility and increased risk premia.
- **No change to cautious portfolio strategy.** In a lower-growth/lower-inflation economic trajectory, investors looking to garner extra return from portfolios by moving out on the risk curve may be disappointed. Instead, having the patience to keep portfolio risk modest while interest rates are increased from emergency levels may be the route to medium-term outperformance. Within equity markets, we continue to strongly favour large caps over mid-caps, despite the recent underperformance of the latter. For corporate bonds it may be time to take some profits as credit spreads have continued to contract since end-2013.

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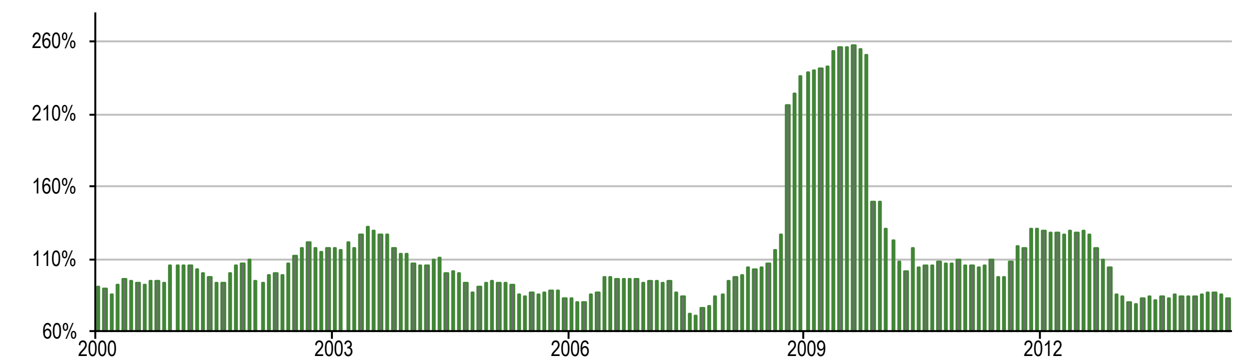
Disturbing tranquility

Since 2012, global market volatility has fallen to match the low recorded in 2007, just before the global financial crisis of 2008. This is therefore an unusually tranquil period for financial markets. Risk premia in both equity and credit markets have fallen in tandem with the decline in volatility. The perception of safety is well-known to encourage additional risk-taking to compensate.

However, we are uneasy. We have to question whether the change in the behaviour of investors and markets has been artificially induced by central bank policy; market volatility started its decline in September 2012, coincident with the Fed's indefinite QE programme and the ECB's "whatever it takes" plan to save the euro.

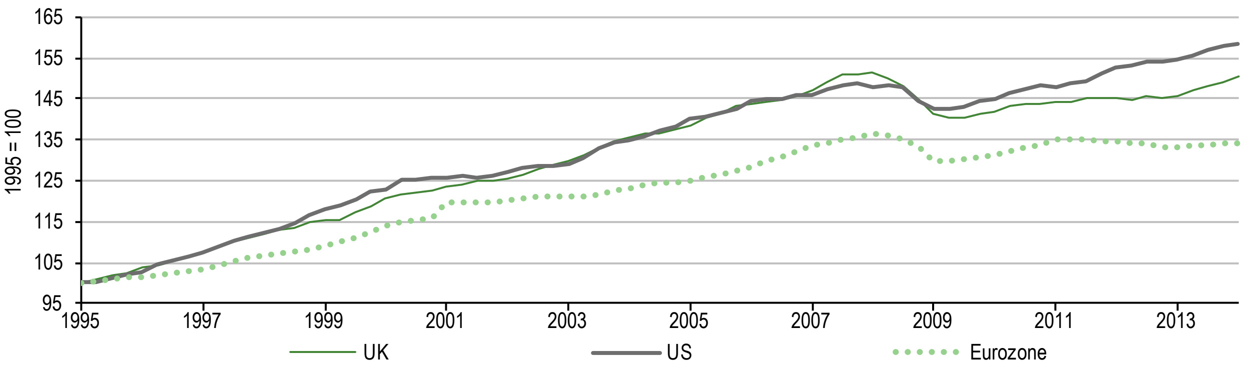
Exhibit 1: Global volatility* decline of major asset classes (equities, bonds, FX, commodities)



Source: Thomson Reuters Datastream, Edison calculations. Note: *Average 12-month volatility relative to 15-year median.

During the last 12 months, we have highlighted exceptionally high valuations among mid-caps, unusually narrow corporate credit spreads and a significant slowing of corporate revenue growth. However, with the exception of recent underperformance in mid-caps, this analysis has been of limited benefit as markets continue to set new highs. We sense that investors feel they have no choice but to remain invested as the alternative is to own low-yielding cash. Memories of the crisis of 2008 are institutionally fading as a new generation of finance professionals with no direct experience of a liquidity crisis – or even a typical tightening of monetary policy – progress into more senior positions.

Exhibit 2: Real GDP remains below historical trends in the US and Europe



Source: Thomson Reuters Datastream

Unconventional monetary policy has given developed markets something of a recovery, but not one that investors in previous eras would recognise. The level of real GDP in developed economies remains well below previous historical trends, Exhibit 2. As a consequence the total debt burden remains high. In Europe, it would seem logical that the recent swing to popular parties of protest may be a belated reaction to the boom/bust cycle of the last 14 years, which resulted in high levels of unemployment and weak wage growth.

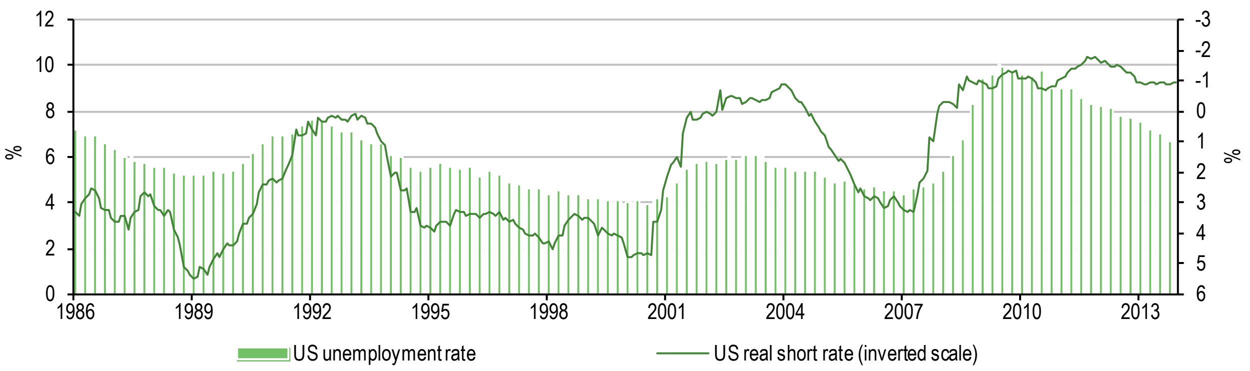
Despite the large notional output gap, unemployment has fallen much faster than expected in the US and UK, leading to the Fed and Bank of England distancing themselves from unemployment-based forward guidance and replacing it with more informal and qualitative measures to justify keeping interest rates lower for longer.

In turn, the faster decline in unemployment may have been for the wrong reasons – falling participation rates and sluggish productivity growth. What is most disturbing about the market's current tranquility is that growth in many economies remains modest and the US Federal Reserve may be running out of runway.

US and UK interest rate policy on the turn

Since the 1980s there has been a strong link between US unemployment and the level of real interest rates, where the correlation is over 70%, Exhibit 3. Previously, interest rates have started to rise when unemployment was between 5.4-6.5%. During the periods of tightening the total increase in real interest rates was between 2-4%.

Exhibit 3: US real interest rates and unemployment



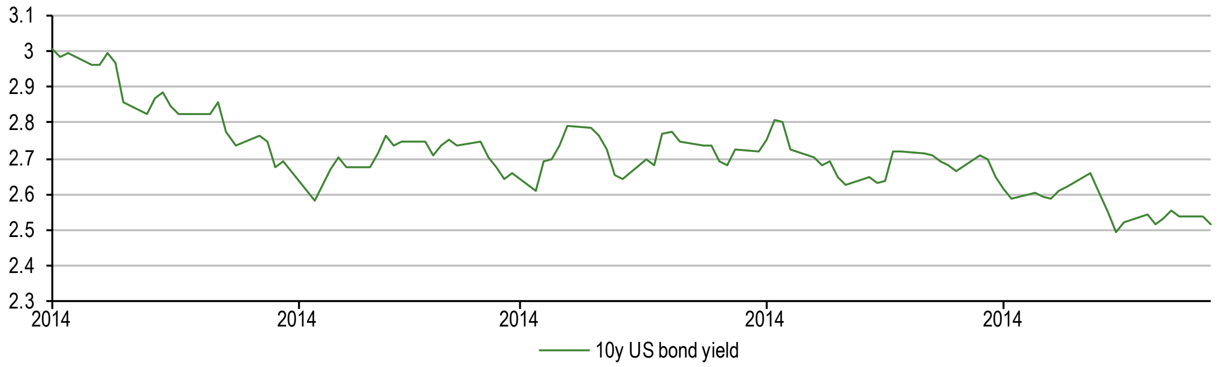
Source: Thomson Reuters Datastream

Currently US unemployment is at 6.3% and the series has rapidly moved into the zone where if this were a normal cycle rate hikes would be expected. However, in recent months, Fed chair Yellen has highlighted a wider range of measures of slack in the economy other than the official unemployment rate. The most important of these are the declines in the US participation rate and historically high numbers of part-time workers, potentially indicating a larger degree of slack in the economy than the headline unemployment figure.

However, while there may be a modest delay in US interest rate increases based on these qualitative arguments, we would prefer to err on the side of caution; ultimately we do not expect the existing statistical relationship between official measures of unemployment and interest rates to break down, even if the initial increase is delayed. Policymakers are fully aware that delaying tightening risks a sharper rate shock later. More recent commentary from Fed policymakers hints at maintaining purchases of mortgage-backed securities even after raising US interest rates, as fears of risks to financial stability grow stronger.

Given record levels of total US debt as a percentage of GDP, significantly lower inflation pressures and the relative weakness of the current US recovery, it would seem logical that interest rates may peak at a lower level compared to previous cycles. A 2-4% increase in real rates in this cycle implies that nominal interest rates will peak in the range of 2-3%. This is consistent with recent moves in US bond markets, Exhibit 4. To the surprise of the consensus, US 10-year bond yields have moved lower by 50bp to 2.5% during H114, even as the recovery was supposed to be gathering speed.

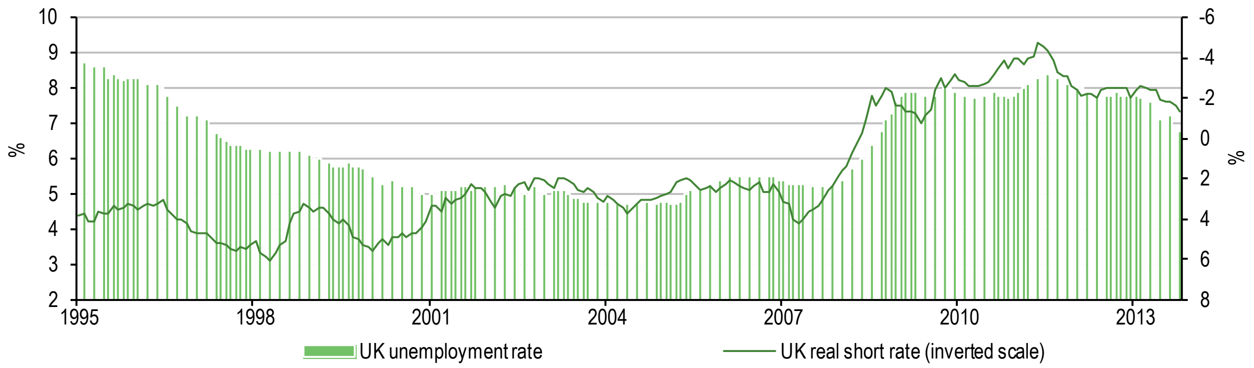
Exhibit 4: US 10-year bond yields declining



Source: Thomson Reuters Datastream

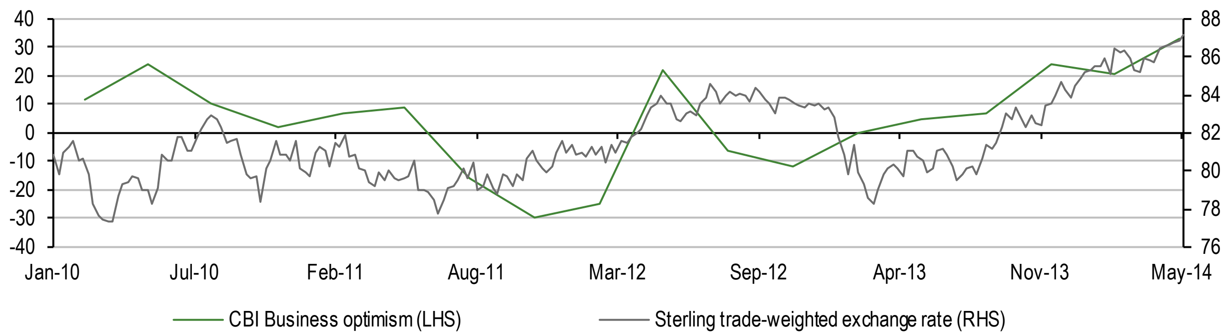
The outlook for monetary policy in the UK is similar to that of the US, in terms of the rapid shrinkage of official unemployment, Exhibit 5. A wide variety of measures, from industrial production to retail sales and consumer survey data, attest to the sharp rebound in confidence and economic activity. Sterling is clearly anticipating tighter monetary policy, having appreciated by close to 10% over the past year on a trade-weighted basis, Exhibit 6.

Exhibit 5: UK unemployment and real interest rates



Source: Thomson Reuters Datastream

Exhibit 6: UK CBI business optimism and trade-weighted sterling



Source: Thomson Reuters Datastream

As in the US, there is a clear policy bias to keep rates lower than would normally be warranted given the incoming data. In this regard, the appreciation of sterling will have been helpful, but delaying the first move higher in rates brings increased risks to financial stability and therefore cannot be postponed indefinitely.

If the coming interest rate cycles prove to be slow and gradual, we believe the greatest impact will be on financial markets, while the real economy continues to make modest progress regardless.

In our view, the effect on the real economy of the first increases in rates may be less than policymakers fear. In addition to direct funding costs, lenders have to cover other operating expenses in loan pricing for SME loans or individual mortgages, for example. Modest increases in interest rates may have proportionately less impact on borrowers' total loan costs in these markets, especially if the longer end of the yield curve remains lower in response to rising rates. In effect, the lack of positive economic response to cutting rates to very low levels in the post-2009 period may also be seen in reverse as rates increase in the first phase of a tightening cycle.

We therefore see no reason to rush out of reasonably priced and conservatively financed large-cap equities able to grow dividends and earnings, albeit at slower rates than in the past. In our view the greatest impact will be in more speculative and riskier corners of the equity markets. Expected returns here have been compressed by risk-averse investors incentivised to enter these markets by nearly seven years of ultra-low interest rates.

A positive real return on low-risk assets such as short-dated government bonds will be highly attractive to many institutions and individuals who have for an extended period of time been starved of income. In a similar manner to equities, in our view credit investors are likely to pull back from riskier and more esoteric areas of the lending markets as interest rates rise, raising risk premia in the process. For this reason we remain cautious about corporate credit, which is trading at very low spreads to equivalent maturity government securities.

Conclusion

Yet again, we see no reason to shift from a cautious portfolio strategy. The primary reason for caution is not the economy, which in the US and UK is now growing at, or close to, its sustainable long-term rate, even if China continues to slow. Rather, it is valuation risk that is the primary concern. We believe investors are prepared to accept low returns on riskier assets such as equities and high-yield corporate credit, but only for as long as market volatility remains at very low levels and risk-free rates are held close to zero.

Volatility is historically mean-reverting and the trigger for an increase is in plain view. Declines in unemployment and improving growth prospects mean both the US and UK may be raising interest rates within a relatively short time span, if previous cycles are a guide.

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