



Illumination: Equity strategy and market outlook

June 2014

Global perspectives: Maintain position

- **A cautious strategy has been the right call for H114 and we see no reason to adjust our view for H2.** Gains in global equities have been modest year to date. The underperformance of mid-caps compared to large caps is also notable.
- **US and UK equity market valuations remain relatively high and there has been little change to the growth outlook.** High valuations can be justified by a strong outlook for profits growth, but we see no evidence of this. In reality earnings momentum continues to be subdued and we believe investors only continue to stay out on the risk curve in response to ultra-low interest rates.
- **Maintaining our position.** A large-cap and M&A-focused investment strategy would have performed well so far this year. Despite recent declines, mid-cap valuations have not fallen sufficiently to justify changing tack. We are now cautious on corporate credit with credit spreads as narrow as at any time in the last 15 years, but view UK and US government bonds as fairly valued in the context of a likely peak in interest rates of 2.5-3% over this cycle.

Analyst

Alastair George

+44 (0)20 3077 5700

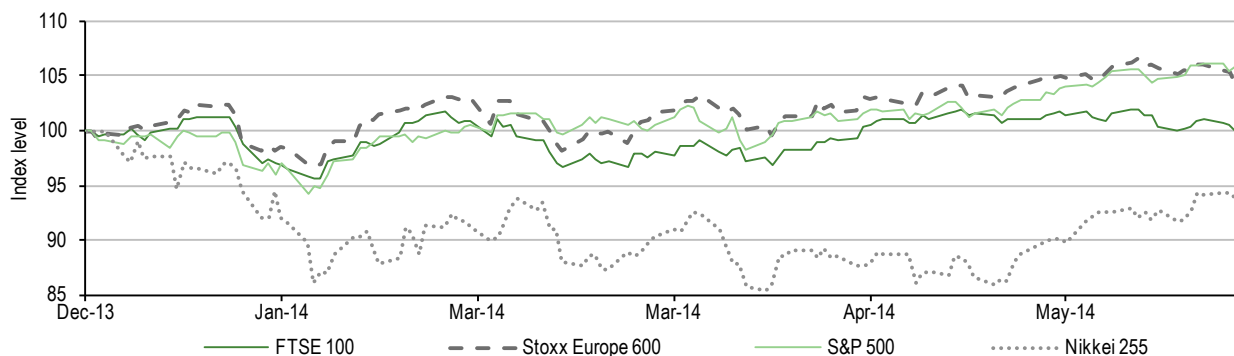
institutional@edisongroup.com

Maintain position

Global equity markets have risen in H114, but gains have been modest. Outside the eurozone investors are no longer able to rely on the prospect of ever looser monetary policy to drive asset prices. In the UK the debate has clearly shifted to when interest rates will be increased and Mark Carney has effectively confirmed in recent speeches that forward guidance is a policy tool rather than a real commitment. In the US, Fed chair Yellen's most recent comments clearly indicate that future policy moves will be data dependent, even if there remains a bias to more accommodative policy than would be considered normal at this point in the US economy.

In the eurozone the situation is rather different as unemployment and inflation readings offer policymakers ample justification for further monetary stimulus and local currency equity market gains have outstripped those achieved in the UK in 2014, Exhibit 1. The introduction of negative deposit rates and credit-easing policies during June shows just how far the eurozone lags behind both the US and UK in terms of the economic cycle.

Exhibit 1: Global equity market performance – H114

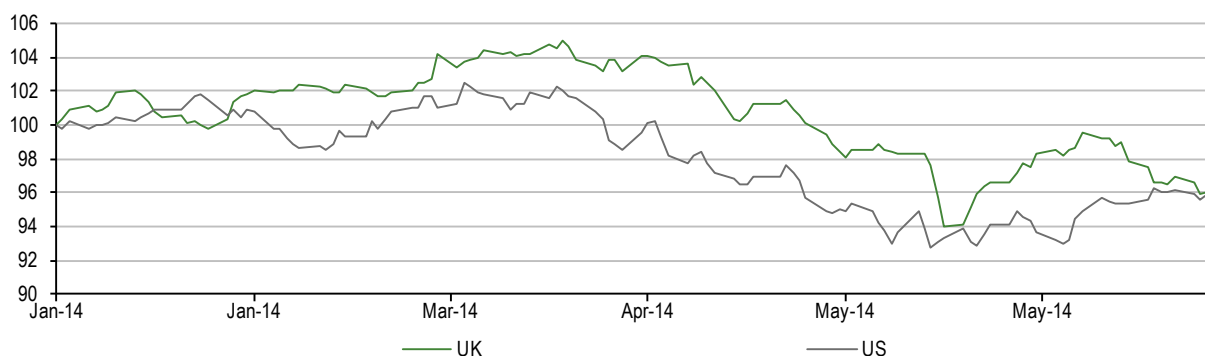


Source: Thomson Reuters Datastream. Note: Performance in local currency.

Within US and UK equity markets, mid-caps have struggled, Exhibit 2. This is not entirely surprising given the relatively extended valuations for all but the largest stocks in these markets. The modest level of underperformance this year does not fully address what is in our view a still-wide valuation gap between mid- and large-cap equities.

Relative underperformance is also being emphasised by the number of M&A deals now being struck or rumoured in the large-cap space. In many cases the potential acquirers are US corporations looking to tax-efficiently deploy cash held overseas in so-called inversion deals. We do not see this activity slowing down in the near term, absent a change to US tax law or a material increase in corporate borrowing costs.

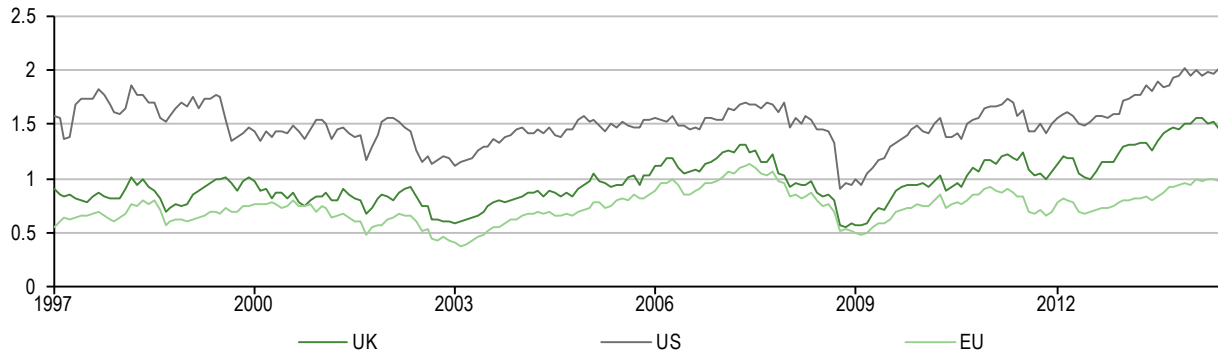
Exhibit 2: US and UK mid-cap vs large-cap performance



Source: Thomson Reuters Datastream

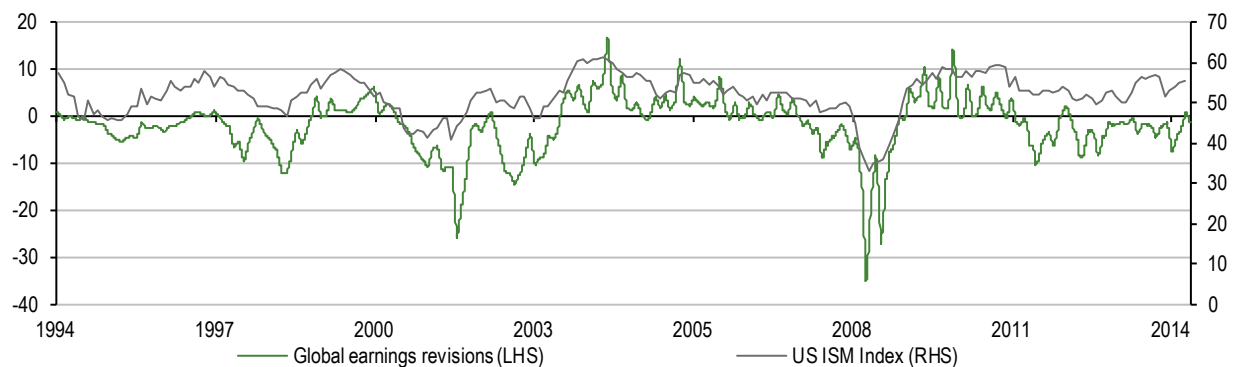
Median equity valuations remain at relatively high levels on a price-to-sales basis, Exhibit 3. We remain cautious on equities as we are finding little evidence of above average future profits growth to justify these high valuations as global earnings momentum remains weak, Exhibit 4. This is despite a generally improving trend in developed market survey data.

Exhibit 3: Peak levels for median price/sales



Source: Thomson Reuters Datastream, Edison calculations for non-financials

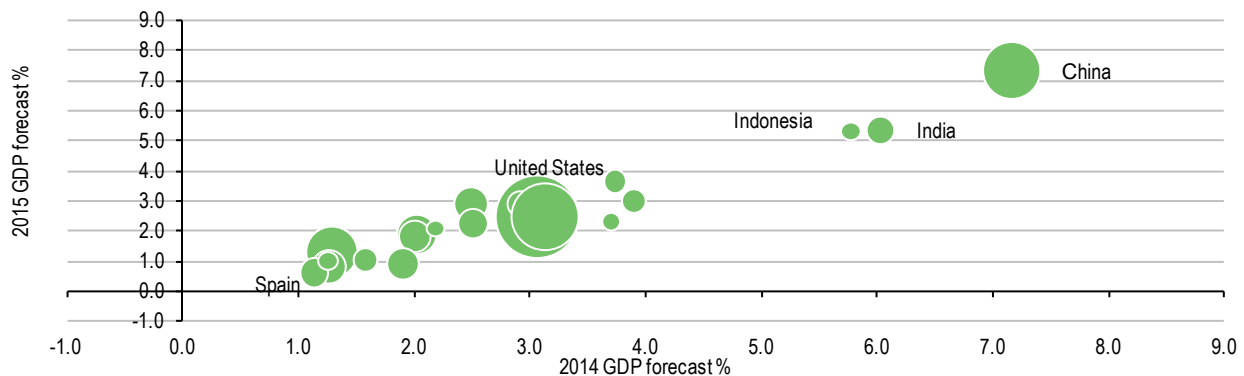
Exhibit 4: Global earnings momentum and US ISM index



Source: Thomson Reuters Datastream

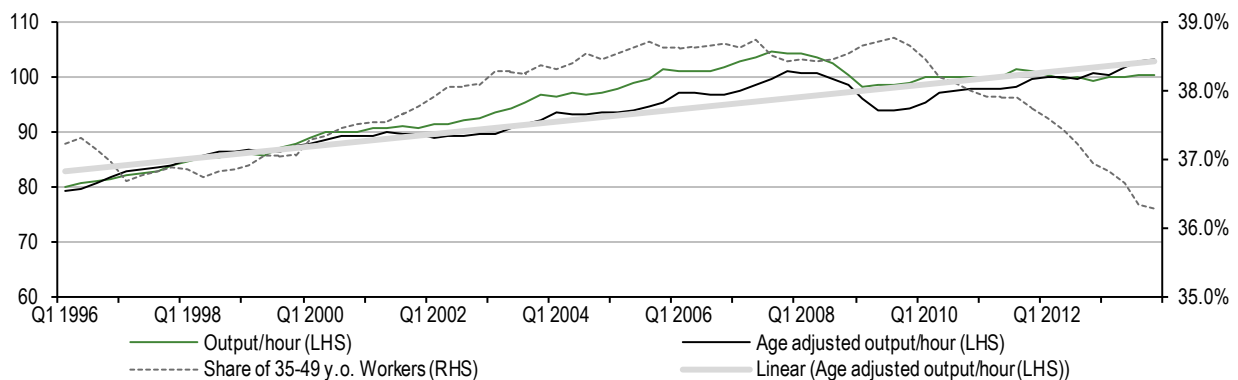
Strong growth remains elusive

For all the talk of recovery, consensus forecasts for world GDP growth call for only 3.0% in the 2014-15 period and just 2.2% ex-China. This compares to an average of 3.5% over the last 40 years. Exhibit 5 also shows that world growth is strongly weighted to emerging markets, while the weakest growth outlook remains in the periphery of Europe. The sluggish developed market recovery means that US and UK GDP still tracks well below the pre-2008 growth trend. Yet unemployment is falling relatively quickly in the circumstances. We believe demographic change may be behind at least some of the lack of productivity growth (and indirectly real wage growth) during this recovery - and this is likely to be a continued drag on growth in future.

Exhibit 5: Consensus GDP forecasts


Source: Thomson Reuters Datastream. Note: Bubble size is proportional to GDP.

UK productivity growth has been anaemic since 2008, but we are intrigued to observe the 35-49-year-old share of the workforce has also been shrinking over this time period. It is in this age range where productivity growth is strongest as workers gain the skills and experience to maximise their potential. Using coefficients from academic studies, Exhibit 6 shows that UK productivity growth, if adjusted for demographic changes, is remarkably close to expected long-term trends, after recovering from a sharp cyclical downturn in period 2009-10.

Exhibit 6: UK – Is weak productivity growth related to demographic trends?


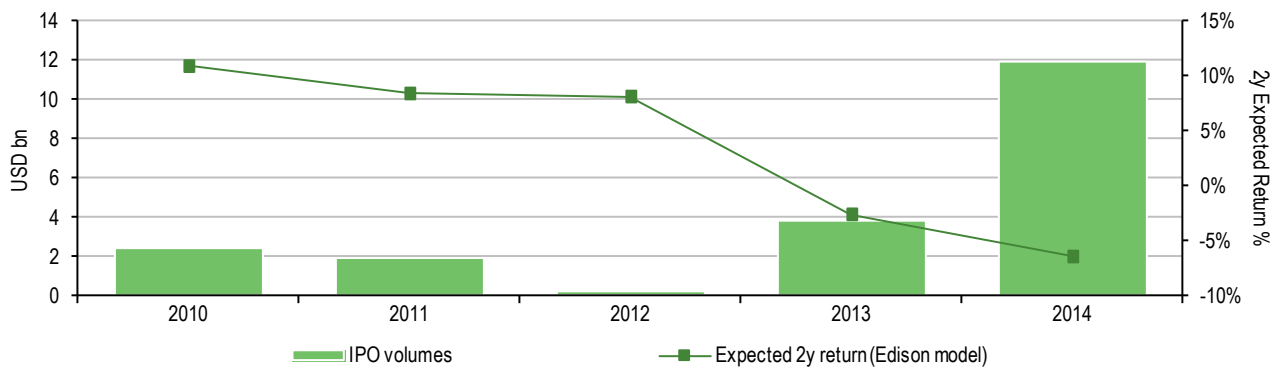
Source: Thomson Reuters Datastream

There is a similar pattern in the US data and the implication is that trend growth in both these economies may be lower than in the past due to the ageing of the workforce. Although there is a substantial degree of uncertainty in the academic research, those looking for a shift in UK productivity growth to pre-2008 levels (and hence evidence of further slack in the economy) may be disappointed.

Smart money selling

Edison's bottom-up market forecasting model has been indicating sharply reduced expected returns for UK equities since year-end 2013. Before 2013, the volatility of 2008/09 and uncertain outlook for the economy meant investors required above-average returns to invest in equities – or in other words equities looked cheap on a valuation basis.

Investors' recovering enthusiasm for UK equities has led to a 10-fold increase in the rate of new issuance via IPOs during 2014. In just the first half of 2014, issuance has exceeded the total for the previous four years, Exhibit 7. We believe sellers are taking advantage of investor demand to exit holdings; in what is in our view a highly valued market, buyers should pay close attention to the quality and pricing of new issues.

Exhibit 7: Edison two-year UK market return forecast and IPO volumes


Source: Thomson Reuters Datastream. Note: 2014 IPO volumes year to date.

Conclusion

Our investment strategy maintains its current position, even if we are somewhat frustrated to be locked into this cautious outlook for so long. The low level of market volatility has offered few opportunities to make tactical switches. We would maintain a focus on large-cap stocks over mid-caps as valuations remain in favour of the former. In credit markets we are becoming increasingly concerned that spreads for corporate bonds have compressed to levels that are unlikely to be sustained in the medium term.

While we cannot see a trigger for a sharp fall in markets (but should caution that historically such triggers are in general only identified after the fact), in our view equities are likely to continue to make only modest progress given the combination of weak growth trends and high valuations.

In terms of interest rates, the Bank of England has proved a useful test case of what happens to forward guidance when central banks hit traditional triggers for raising interest rates. Investors should note carefully that forward guidance does not seem to represent a meaningful constraint on future policy.

Edison, the investment intelligence firm, is the future of investor interaction with corporates. Our team of over 100 analysts and investment professionals work with leading companies, fund managers and investment banks worldwide to support their capital markets activity. We provide services to more than 400 retained corporate and investor clients from our offices in London, New York, Frankfurt, Sydney and Wellington. Edison is authorised and regulated by the Financial Conduct Authority (www.fsa.gov.uk/register/firmBasicDetails.do?sid=181584). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison and is not regulated by the Australian Securities and Investment Commission. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

DISCLAIMER

Copyright 2014 Edison Investment Research Limited. All rights reserved. This report has been prepared and issued by Edison for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. This research is issued in Australia by Edison Aus and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. The Investment Research is distributed in the United States by Edison US to major US institutional investors only. Edison US is registered as an investment adviser with the Securities and Exchange Commission. Edison US relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. As such, Edison does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison has a restrictive policy relating to personal dealing. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report. Edison or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Edison, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication. FTSE International Limited ("FTSE") © FTSE 2014. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
United States

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place
88 Phillip Street, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand