Illumination: Equity strategy and market outlook

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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.

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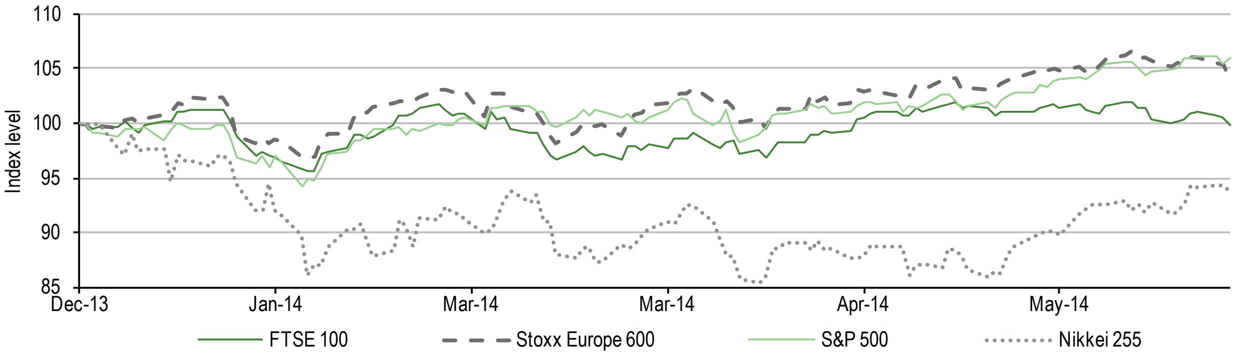
Maintain position

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 and terms of the economic cycle.

Exhibit 1: Global equity market performance – H114

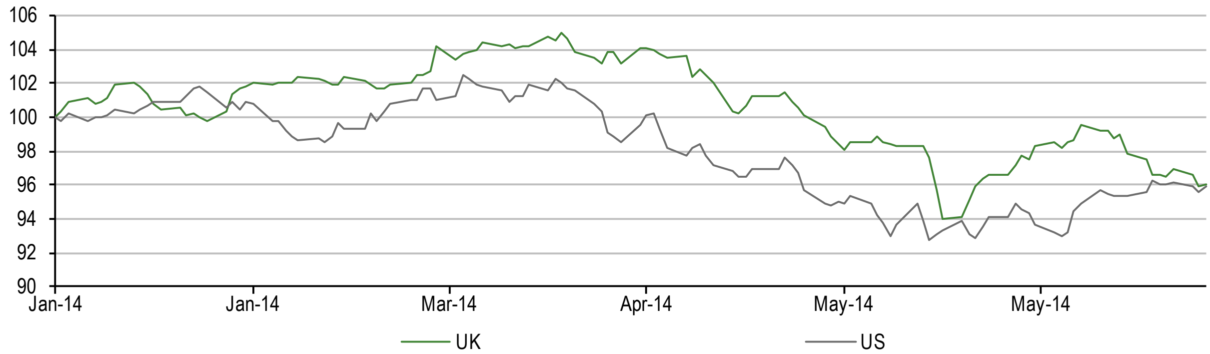


Source: Thomson Reuters Datastream. Note: Performance in local currency.

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.

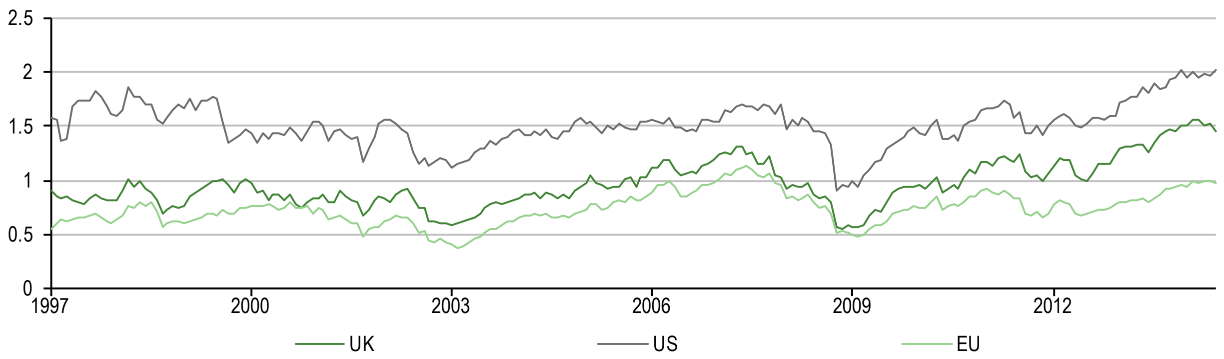
Exhibit 2: US and UK mid-cap vs large-cap performance



Source: Thomson Reuters Datastream

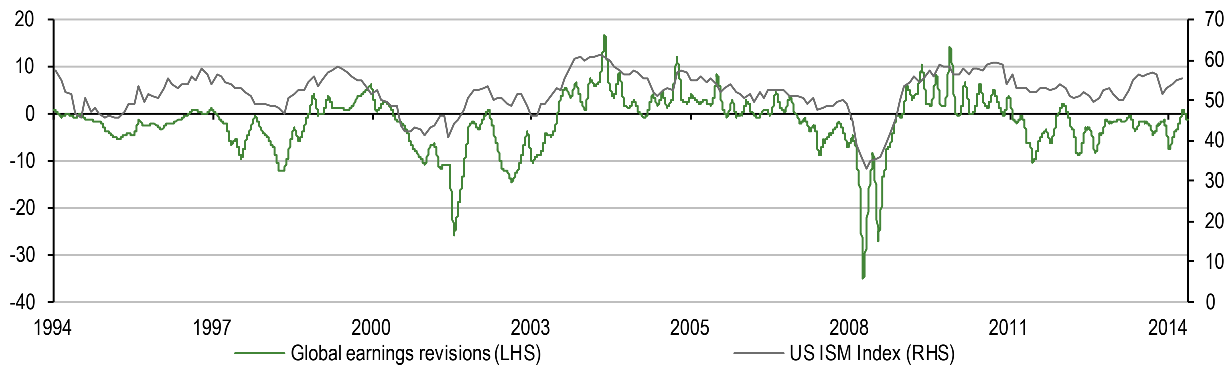
Median equity valuations remain at relatively high levels on a price-to-sales basis, Exhibit 3. We remain cautious on equities as we are finding little evidence of above average future profits growth to justify these high valuations as global earnings momentum remains weak, Exhibit 4. This is despite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

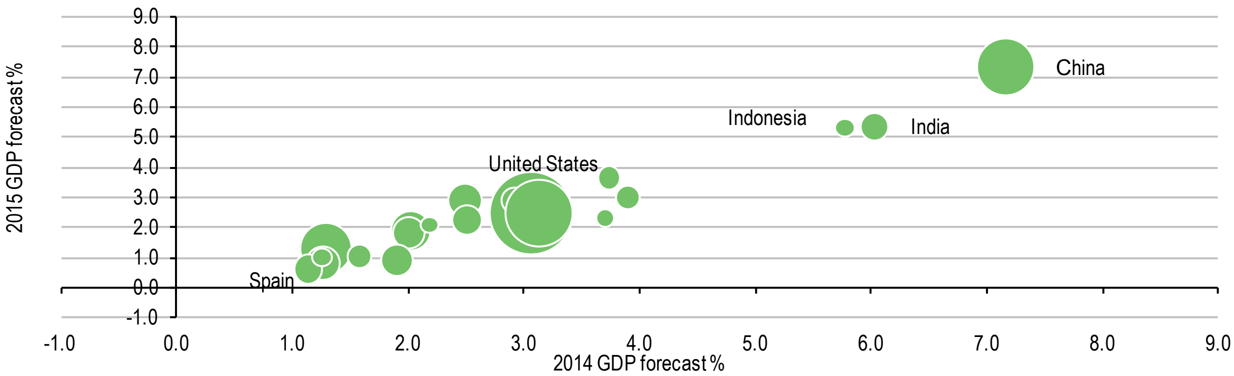


Source: Thomson Reuters Datastream

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.

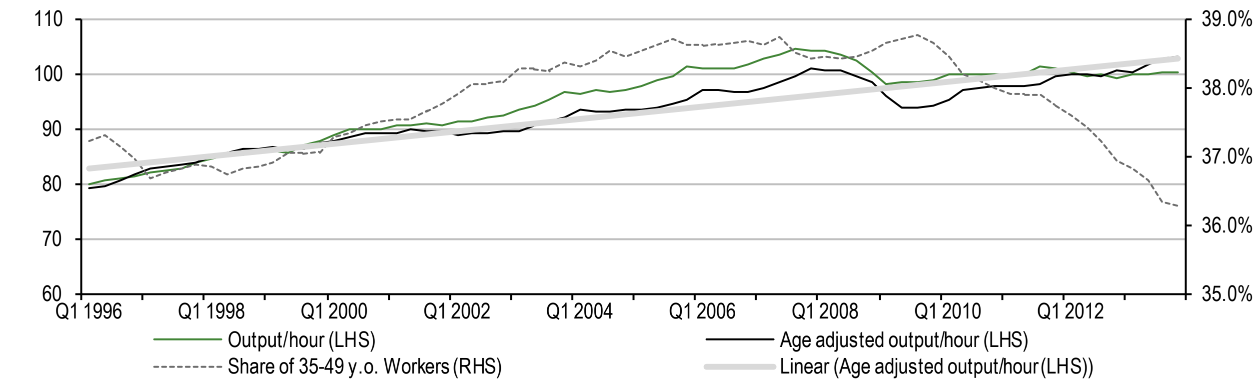
Exhibit 5: Consensus GDP forecasts



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

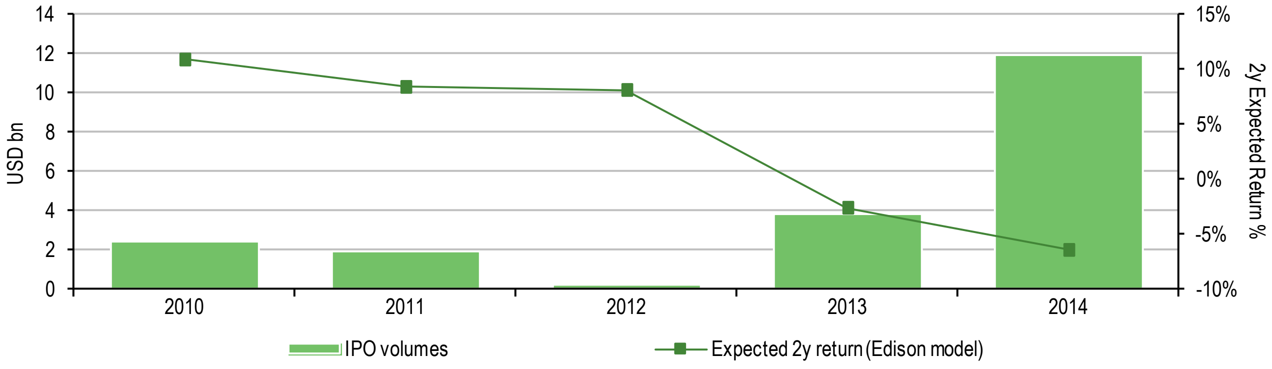
There is a similar pattern in the US data and the implication is that trend growth in both these economies may be lower than in the past due to the ageing of the workforce. Although there is a substantial degree of uncertainty in the academic research, those looking for a shift in UK productivity growth 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.

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