



Illumination: Equity strategy and market outlook

July 2014

Global perspectives: Markets unplugged

- **Global equity markets are failing to discount increasing growth, interest rate and geopolitical risks.** Economic forecasts have fallen in recent weeks, notably in the US but also in Europe. Expectations for interest rate increases in the US and UK have been brought forward as unemployment has continued to decline rapidly since the start of the year. Geopolitical risk has clearly jumped higher, due to renewed tension in both Ukraine and the Middle East.
- **In terms of US valuations, we note the US Federal Reserve is broadly in agreement with our earlier valuation analysis.** In the Fed's report to US Congress, small-cap equity valuations were described as stretched, while overall market valuations were "not far above their historical averages". The US Fed also noted aggressive pricing of higher-risk corporate credit such as high-yield bonds and leveraged loans. We have been highlighting these issues for some time.
- **The Bank for International Settlements' (BIS) annual report has created something of a stir in central bank circles.** BIS was early in identifying some of the risks building in the financial system before the 2008 sub-prime crisis and does not believe that macroprudential policies alone can choke off dangerous speculation in asset markets. Sharp retorts from both Fed Chair Yellen and the Bank of England's Mark Carney show a determination to keep emergency interest rate policy in place, even as unemployment and inflation are returning to normal levels.
- **Maintaining cautious position.** With global equity valuations either above or some distance above historical averages, it would be counterintuitive to be recommending overweight positions, given the lack of forecast growth in corporate revenues and profits. Within equities, we believe investors should focus on large-cap and M&A-focused investment ideas. Despite recent declines, mid-cap valuations have not fallen sufficiently to justify changing tack on this segment of the market. We are now cautious on corporate credit, with credit spreads as narrow as at any time in the last 15 years. In our view, UK and US government bond yields are close to the bottom of their fair value range, in the context of a likely peak in interest rates of 2.5-3% over this cycle.

Analyst

Alastair George

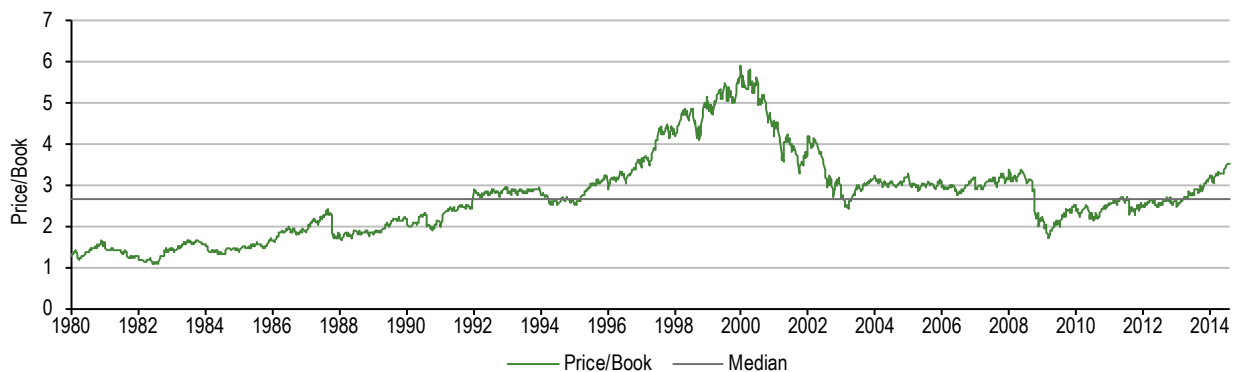
+44 (0)20 3077 5700

institutional@edisongroup.com

Markets unplugged

The ongoing divergence between the strong performance of riskier assets such as equities and corporate bonds on the one hand and rising uncertainties in the fundamental outlook on the other is of increasing concern. A cursory examination of US non-financial price/book multiples over the last 30 years suggests that for the third time in as many decades US equity markets may have been temporarily re-rated as a consequence of a long period of loose monetary policy, Exhibit 1. Institutional investors with memories of the 1998-2000 period may feel obliged to remain in the game to avoid short-term underperformance. However, current US valuations are indicative of lower than average returns over the medium term.

Exhibit 1: US non-financial price/book – 1998 or 2007?



Source: Thomson Reuters Datastream

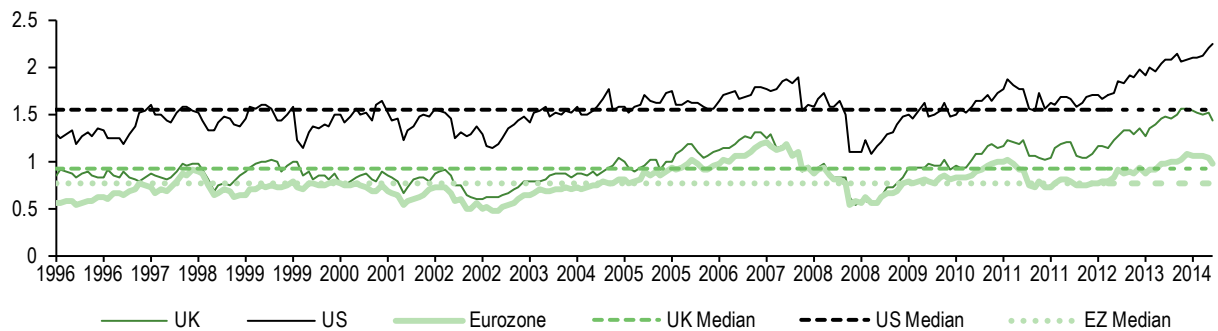
We recognise that over the last five years the corporate sector has been the prime beneficiary of weak labour markets, ultra-loose monetary policy and fiscal deficits. Furthermore, by starting the post-2008 period at relatively depressed valuation levels, corporate securities have been the standout outperformers. Major equity indices have risen close to record levels or are making new highs. Corporate credit markets have benefited from exceptionally low default rates and yield spread compression.

However, judging by current valuation levels for equities and corporate credit, we believe all of the good news is in the price while some unsettling incoming data are yet to be discounted. In this note we highlight the key risks in our view.

Valuation is unsupportive of strong gains

Exhibit 2 shows the median price/sales valuations for equities in the US, UK and the eurozone. These remain exceptionally high for the US and UK and above average in the case of the eurozone. Focusing on price/sales makes the valuation signals clearer as sales are significantly less volatile than earnings. Subject to the assumption that profit margins are mean reverting, price/sales therefore offer a more stable medium-term valuation signal. Unlike the data behind Exhibit 1, the median is an unweighted measure and therefore gives more insight into the valuation of the typical index constituent, as the market as a whole can be heavily influenced by only a few of the largest-cap stocks in the index.

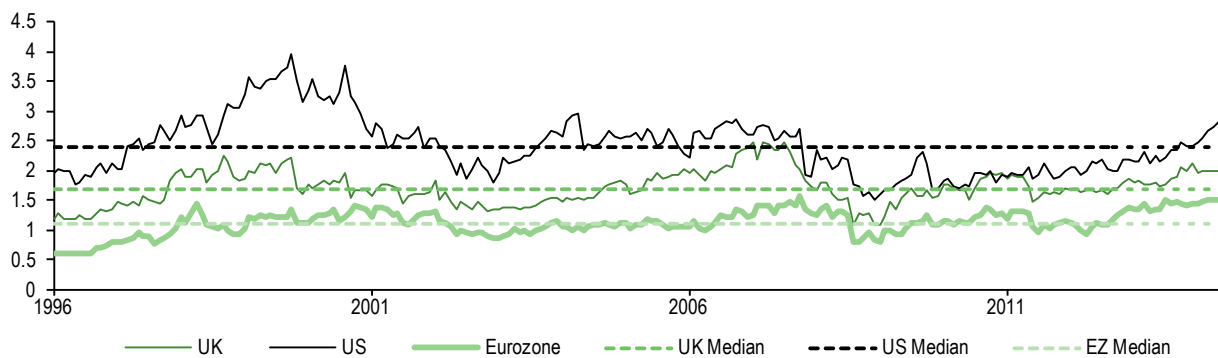
Exhibit 2: US, UK and eurozone – median price/sales



Source: Thomson Reuters Datastream, Edison calculations

Exhibit 2 highlights that the median equity security is currently significantly above normal price/sales levels, in both the US and UK. We would therefore concur with the US Federal Reserve's recent comments that valuations of mid-cap equities are stretched. If the calculations are repeated using just the largest 30 stocks in each index, while current valuations are still above historical levels, the divergence is less stark, Exhibit 3.

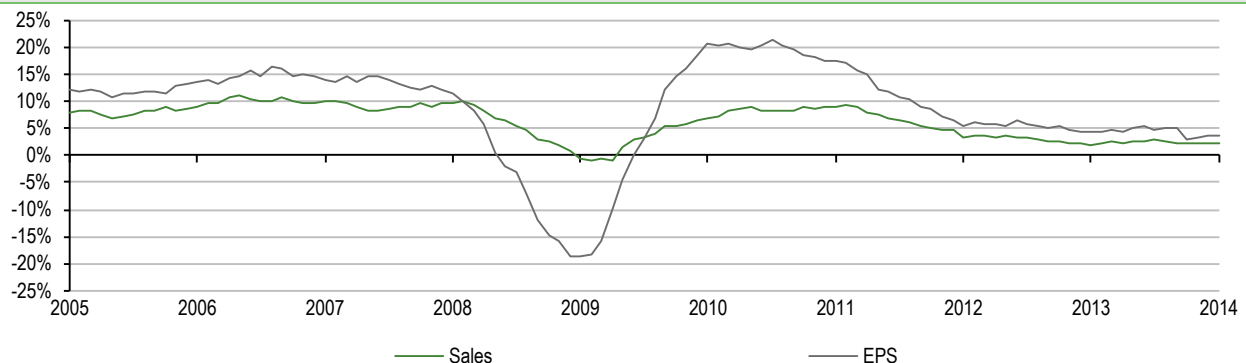
Exhibit 3: US, UK and eurozone – median price/sales for 30 largest stocks in index



Source: Thomson Reuters Datastream, Edison calculations

We believe long-term investors need good reasons to buy assets above historical average valuations, such as above-average growth prospects. By contrast, UK forecast corporate revenue and profits growth rates are still significantly lower than the pre-2008 period, Exhibit 4.

Exhibit 4: UK – median forecast revenue & EPS growth significantly below pre-2008 trends

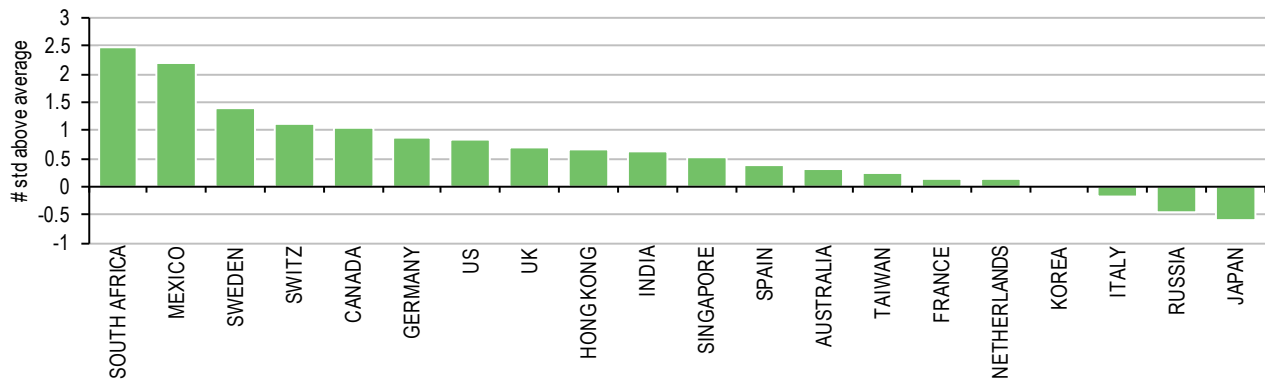


Source: Thomson Reuters Datastream, Edison calculations

Price/book multiples also confirm an extended valuation picture for many of the world's largest equity markets, as shown in Exhibit 5. The clear majority of these markets are now trading

significantly above long-term average price/book levels. We highlight that the US is now trading at 3.5x book value, a higher multiple than at any time outside the original dot-com bubble at the turn of the century. In the last 12 months the expansion in price/book has also been as rapid as the initial phases of that market, which is all the more remarkable given the subdued outlook for profits growth.

Exhibit 5: Global non-financials – price/book multiples extended



Source: Edison calculations. Note: Chart shows number of standard deviations current price/book above long-term average.

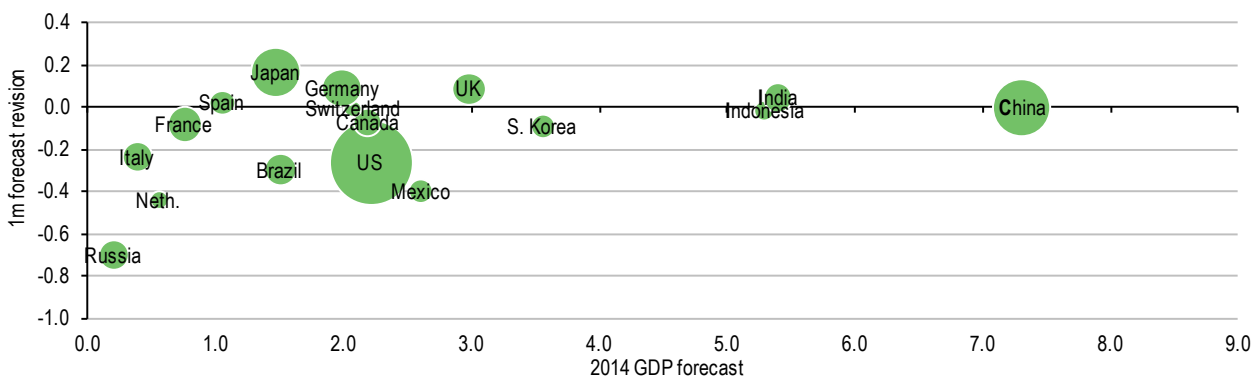
In corporate credit, the evidence is mounting that both pricing and investor behaviour is consistent with relatively speculative conditions. Yields compared to equivalent maturity government bonds are exceptionally low, while the quality of issuance has also declined. With over US\$200bn issued so far during 2014, this is the strongest period of US junk bond issuance since 2000. US corporate debt outstanding has now exceeded that outstanding on residential and commercial US mortgages. Buoyant credit markets have contributed to the renaissance in large-cap M&A, where global deal volumes have doubled in the first half of 2014, compared to the previous year.

When markets are in a bullish mode, the temptation is to downplay the longer-term risks. However, if price momentum ebbs (as it has this year in the UK for example), we believe the size of the potential decline to reach even average valuation levels is the forest-fire fuel that can trigger significant de-risking and abrupt market declines. For example, in the event that mid-cap equities returned to their average price/sales ratio of the last 30 years, the fall in market price would be substantial in both the US and the UK. History shows that markets also have a tendency to overshoot to the downside in such circumstances.

Risks are rising – risks to growth

Economic momentum has recently slowed in a number of economic regions as consensus forecasts for 2014 GDP decline, most notably in the US as shown in Exhibit 6.

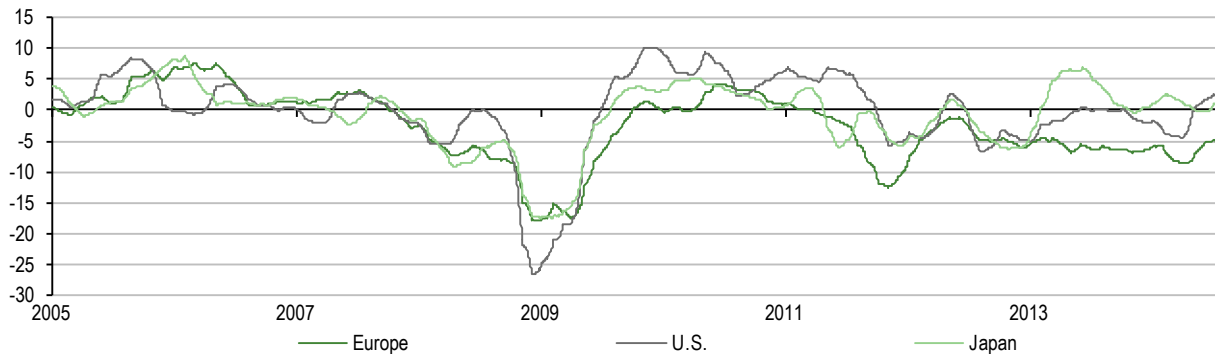
Exhibit 6: One-month change in GDP forecasts



Source: Thomson Reuters Datastream. Note: Bubble size is proportional to GDP in US\$.

We also note survey data are pointing to a slowing of Germany's economic expansion, while in Italy industrial production recently came in well below expectations. Slower economic growth is in turn likely to make profits growth harder to achieve during H2 even if the most recent earnings season has been largely in line to date, leading to a near-term reduction in the pace of European earnings downgrades, Exhibit 7.

Exhibit 7: Regional earnings momentum shows near-term improvement



Source: Thomson Reuters Datastream

Risks are rising – tighter monetary policy

During the last 12 months, the US Federal Reserve has faced increasing criticism for keeping emergency monetary policy in place long after the systemic emergency has passed, encouraging investors to price assets at much higher levels than might be justified by current fundamentals. The return of much more aggressive financial behaviours over the last 18 months cannot be disputed; recent official publications from the US Federal Reserve and BIS show there is no monopoly on highlighting the moderate to high overvaluation of many financial assets.

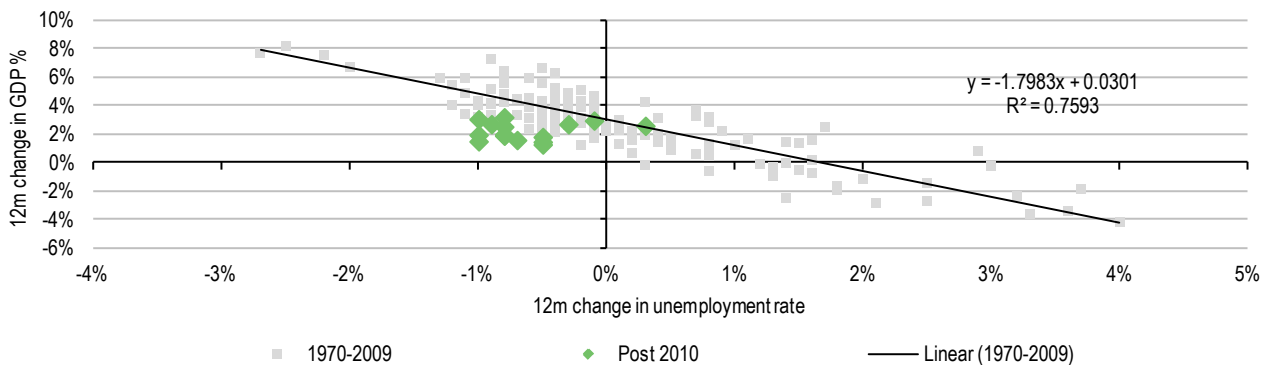
The glaring anomaly in our view is not the strong performance of risk assets; it is the strong performance of risk assets given the weak underlying economic growth in developed markets during the post-2008 period. This divergence is showing few signs of being closed the benign way, as profits and revenue growth remain crimped by only modest economic growth.

Given the incoming economic data, a more rational signal is coming from the bond market. US and UK yields have declined by 30-50bp this year even as the first increases in US and UK interest rates draw closer, the US QE programme gradually unwinds and inflation is moving closer to target. Interest rates are likely to peak at rates well below previous cycles simply because of the increased quantity of debt in developed markets.

The obvious trigger for a reversal in global market sentiment is in our view the tightening (even if modest) of US monetary policy expected over the next 12 months. The US Fed, according to Yellen's most recent comments, will have stopped expanding its balance sheet by October of this year. US unemployment continues to decline and based on current trends would be at close to 5.5% by year end, thus potentially bringing the first US interest rate increase forward to Q115. (In the UK similarly rapid declines in unemployment have brought forward expectations for the first interest rate increase to later this year.)

It is natural to assume that the return of declining unemployment and inflation to target levels is a proxy for stronger growth. Over the long run there is a good statistical link between positive GDP growth and declines in unemployment, as would be expected. However, we are struck by the sequential bias to the downside, in terms of growth, over the last four years, as shown in Exhibit 8. Based on long-run trends, growth in US GDP is picking up much more slowly than the sharp declines in unemployment would normally imply. We believe this is a result of the weak productivity growth trends observed over the last five years.

Exhibit 8: US change in GDP against change in unemployment rate



Source: Thomson Reuters Datastream, Edison calculations.

We believe investors should stay focused on the possibility that central banks are running out of room to keep ultra-loose monetary policy in place while evidence of a strong recovery remains elusive. Should interest rates return over time to levels of even 2.5-3% without stronger levels of profits growth, the relatively rich pricing of many equities would be confirmed.

Investors have taken Yellen's insistence that it is not the Fed's job to prick asset bubbles as a green light to chase equities higher. Perhaps an equally valid interpretation is that the Fed is looking to distance itself from any market declines to prevent them becoming a constraint on monetary policy. In the event that market valuations return to more normal levels, investors cannot claim they have not been forewarned. Officials from the IMF, BIS and Fed have all raised concerns that asset prices are racing ahead of fundamental improvements in the economic outlook over the past month.

Risks are rising – geopolitical tensions rising

2014 has been the year of sharply rising political tensions. Even if financial markets have thus far paid little attention to these developments, we believe investors should pay close attention to the apparent decline in the power projected by the US and EU.

Most obviously, the tragic shooting down of a civilian airliner over Ukraine only hours after further sanctions were imposed on Russia by the US and Europe has brought tensions between Russia and the West to a new high. The US and Russia would appear to be as far away from a resolution to this particular crisis as at any time, as reports arise of renewed bombardment of Donetsk as international investigators wait there for permission to visit the primary crash site.

Syria remains in a civil war and no progress has been made in re-establishing state control over northern Iraq and eastern Syria. Within the last week Israel has launched a new ground offensive into Gaza. In the circumstances the oil price has remained remarkably subdued.

We have been astonished by the resilience of financial markets to these events, given the common theme of the declining US influence on Russia, the Middle East and China. Though in its infancy, we would also highlight the willingness of emerging market nations to create their own supra-national financial institution to reduce reliance on US dollar funding and recourse to the IMF in times of financial stress.

Conclusion

In the face of the valuation evidence, to be aggressively invested at present requires a belief in a permanently high plateau for equity valuations. In turn, this requires faith in slow but stable world economic growth; permanently lower long-run economic volatility; continued loose monetary policy and structurally stronger profit margins. This is quite a long list – and only one of these factors need be invalidated for the argument to fail.

Our investment strategy maintains its current cautious positioning. We remain focused on large-cap equities, which in Europe can still be obtained closer to long-run valuation averages than mid-caps, and believe the current level of interest in European targets by US acquirers may have further to run. However, we believe that in developed markets valuation risk has increased sharply. Rising US interest rates represent a clear danger, as unemployment declines but growth remains below previous trend levels.

While the course of geopolitics is unpredictable, the lack of market response to events in Ukraine and other conflict regions is complacent in our view. Despite the tragic recent loss of a civilian airliner, the past week has seen no substantive political change in Ukraine.

For credit, while this may be an opportune time to be issuing debt for M&A transactions, investors are being given the short straw in terms of yield and credit quality. We believe it is time to reduce exposure to this asset class, especially as liquidity in individual bonds declines.

For government bonds, US and UK yields have declined to the lower end of our targeted range of 2.5-3%. If labour market slack continues to be taken up and inflation remains at current levels, we believe central banks will not delay raising rates and would suggest taking profits on overweight positions.

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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