# Illumination: Equity strategy and market outlook

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# Global perspectives: Bumpy road ahead

- **Neither bull nor bear markets move in a straight line.** A collapse in commodity prices, a rising US dollar and sharply declining global bond yields seem to imply a major slowdown is at hand in 2015. But investors may be turning the pages of the story too quickly. A contrarian bounce in economic activity cannot be excluded as consumers respond to lower financing costs and energy prices, especially in Europe.
- **ECB QE – not ideal, not sufficient, but clearly necessary.** Returning the ECB's balance sheet to the size it was in 2012 is in our view a necessary step given the weight of expectations created by Draghi since last August and rising real yields in the periphery. In addition, as bond yields and the euro moved swiftly to discount the possibility of QE last year, we believe the economic benefits have been brought forward and highlight the improved economic surprise indicators for the eurozone.
- **Grexit back on the agenda.** A high-stakes game of poker is being played as German politicians make it clear that the price of changing the Greek bailout terms may be an exit from the euro, a currency they know remains popular among Greek voters. With Spanish elections due this year, the eurozone continues to face significant political risks.
- **US equities suffering earnings downgrades.** The combination of dollar strength and oil price weakness has led to a sharp decrease in US earnings momentum with downgrades currently accounting for 70% of analysts' earnings forecast revisions. We believe US equities now face triple headwinds – declining earnings momentum, high valuations and the likelihood of the 'lift off' in US interest rates by the end of 2015.
- **It just gets more challenging and our strategic views are unchanged.** At current yields, fixed income investors are being asked to bet against the ability of central banks to create inflation. This is not an appealing proposition over the medium term, given historical precedents. Yet in equities, current valuations would seem to imply investors are betting on the ability of central banks to create real economic growth – an equally unappealing prospect from our perspective. We maintain a cautious positioning, but are warming to the energy sector and believe that in a negative interest rate environment gold will continue to find favour as a store of value.

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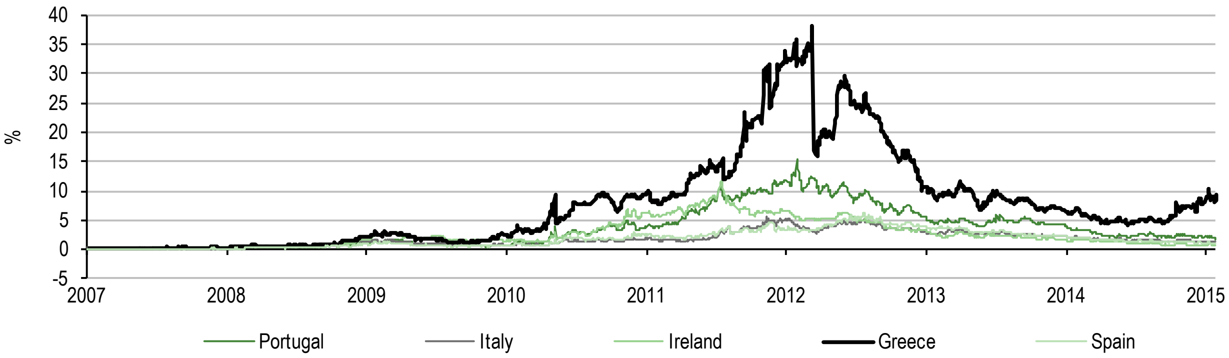
## ECB QE – expectations speak louder than actions

Over the last six months, ECB President Mario Draghi has steadily built support within the eurozone for a form of sovereign QE. The ECB is now aiming to return its balance sheet to levels last seen in 2012 via a combination of asset purchase programmes targeting private and public sector assets. The programme is open-ended, but currently expected to draw to a close over 18 months, subject to inflation targets being met.

Our view is that there will be limited economic stimulus arising from this policy, but only because it is in effect the deeds behind the words of "whatever it takes" expressed at the peak of the eurozone sovereign debt crisis of 2012. Since then, speculative attacks on the integrity of the eurozone have been punished through a steady narrowing of yield spreads across the region, with the notable exception of Greece, Exhibit 1.

**Exhibit 1: "Whatever it takes" – reconvergence in sovereign bond yields to bunds (ex-Greece)**




Source: Thomson Reuters Datastream

However, we believe disincentivising speculative attacks is only a necessary, rather than sufficient, condition for maintaining the integrity of the eurozone. The combination of high unemployment and fiscal austerity has led to a substantial decline in inflation and inflation expectations that has been exacerbated by falling energy prices. This phenomenon is more severe in the periphery of Europe where deflation has taken hold – largely a result of the internal devaluations these nations have been required to undertake to restore competitiveness. Since last summer, the ECB has increasingly feared that rising real yields and widening output gaps would lead to a deflationary spiral, which would only increase the financial stress on sovereign bond markets, thereby neutralising the ECB's efforts to date.

In terms of the implementation of eurozone QE, national central banks will bear the bulk of any losses arising from the purchases of sovereign bonds. We believe that Draghi may be correct in stating that the absence of a significant degree of risk sharing is not relevant, but only from a strict monetary perspective. Subsequent press reports indicate limited risk sharing was a compromise to ensure a working majority of ECB governing council members would support the QE package at this time.

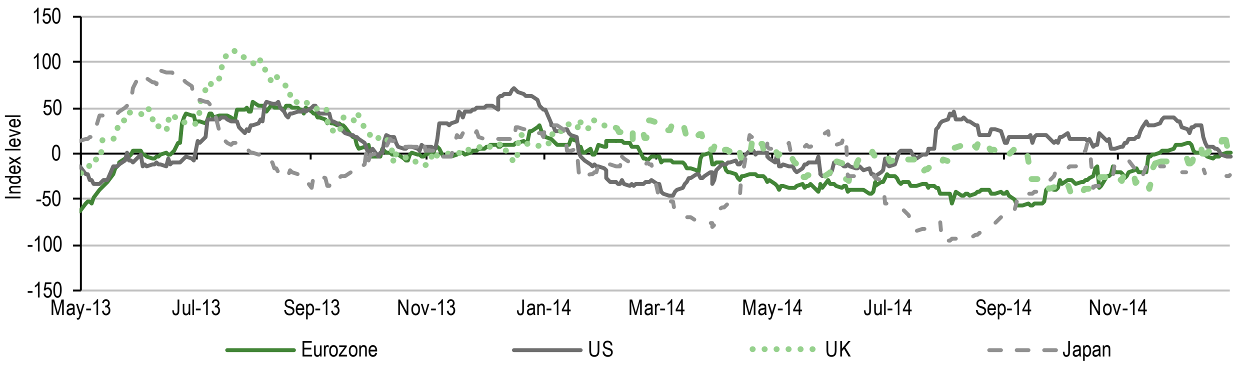
Unlike Draghi, we believe the lack of risk sharing will reduce the effectiveness of ECB QE. Full risk sharing would have been a very strong statement that would have contributed to the irreversibility of the eurozone project and would have incentivised further investment and activity in the eurozone periphery. As it stands, investors will rightly consider this to be multiple national QE programmes, which make no contribution to eurozone integration or the development of a 'eurozone' sovereign bond market.

Furthermore, we fail to see how investors who have been pushed out on the risk curve by unconventional central bank policy feel wealthier and therefore question the effectiveness of the 'portfolio balance channel' which is supposed to stimulate growth as a result of the ECB's QE policy. Variable dividend income from riskier assets such as equities is a poor substitute for the risk-free real yields that were available on high-quality government bonds for many years before the 2008 financial crisis. In essence, options always have value; taking away the option to invest in risk-free assets – this is the essence of the 'portfolio balance channel' referred to by Mario Draghi – is in our view a negative for savers who may respond by increasing their savings to compensate for lost future income, rather than by increasing their spending. For example, in the US in recent years, the response by corporates to weak demand, ultra low interest rates and a flattening of the yield curve was to issue debt and buy back shares rather than increase capital expenditure.

The immediate reaction to the QE announcement has been to push the euro and eurozone bond yields lower and equities higher. But we would be reluctant to view this as a sustainable investment theme given how far on this road markets have already travelled. Instead, we believe the ECB's action is merely sufficient to fulfil its own self-created expectations.

We do, however, acknowledge that the eurozone has recently received three separate and significant shocks; firstly, the euro has depreciated significantly over the last 12 months. Secondly, the eurozone is a significant energy importer and will have benefited from the recent collapse in oil prices. Thirdly, the decline in borrowing costs over the last 12 months has been significant and would normally be expected to stimulate activity. The combined effect of these impulses may be sufficient to create at least a short-term improvement in eurozone economic activity during H1, even if the long-term prognosis, based on working-age population and productivity trends looks more challenging.

**Exhibit 2: Economic surprise indices**



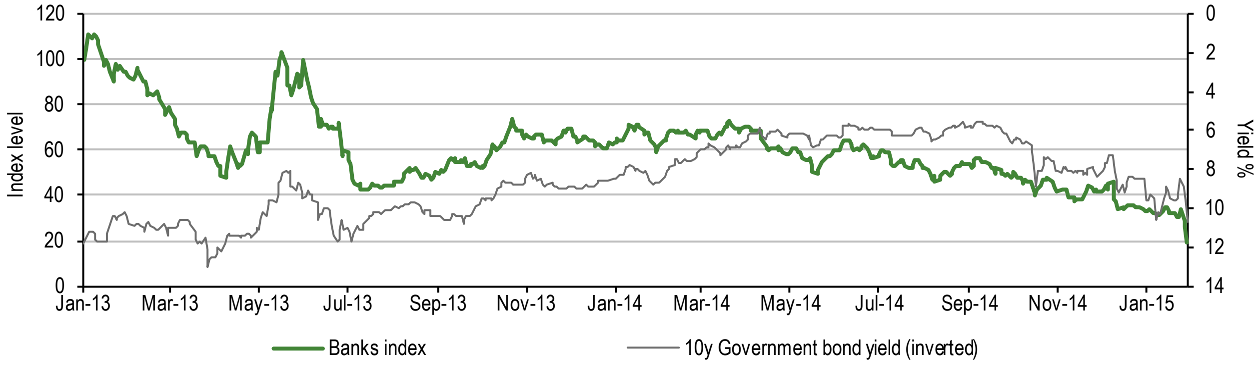

Source: Thomson Reuters Datastream

Recent economic surprise data show a significant improvement in the eurozone compared to a deterioration in the US, Exhibit 2, and a similar divergence in earnings momentum, Exhibit 4. In the circumstances, it is not obvious to us that the long dollar/short euro trade remains a one-way bet.

## Greece still has the power to shock

In recent months, we have highlighted the rising popularity of alternative political parties in Europe. Years of austerity have led to Greece's far-left Syriza party becoming elected on a mandate to renegotiate Greece's bailout package. So far markets have reacted calmly to the news, even if Greek bank shares and government bonds, Exhibit 3, have sold off sharply and a degree of deposit flight is taking hold within the banking system. In the circumstances, the avoidance of a Cyprus-style outcome is far from assured and the reaction of depositors to the Syriza victory is not wholly irrational. We note also the foreign policy implications; the new administration in Greece recently distanced itself from calls for further sanctions on Russia. The real fear for eurozone policymakers is that Greece provides a compelling template for successfully exiting the eurozone, which might be followed by other nations.

**Exhibit 3: Greece – financial stress rising again**

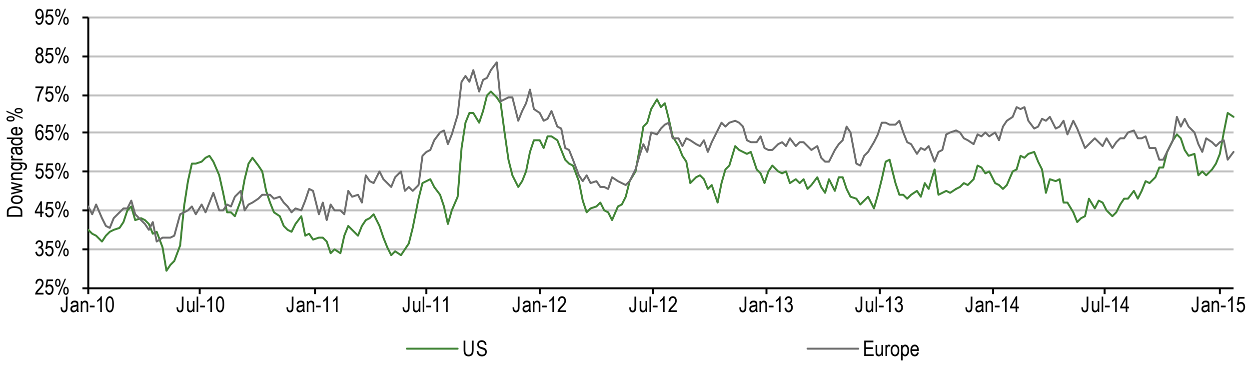



Source: Thomson Reuters Datastream

## Declining oil prices and strong dollar pressure US earnings

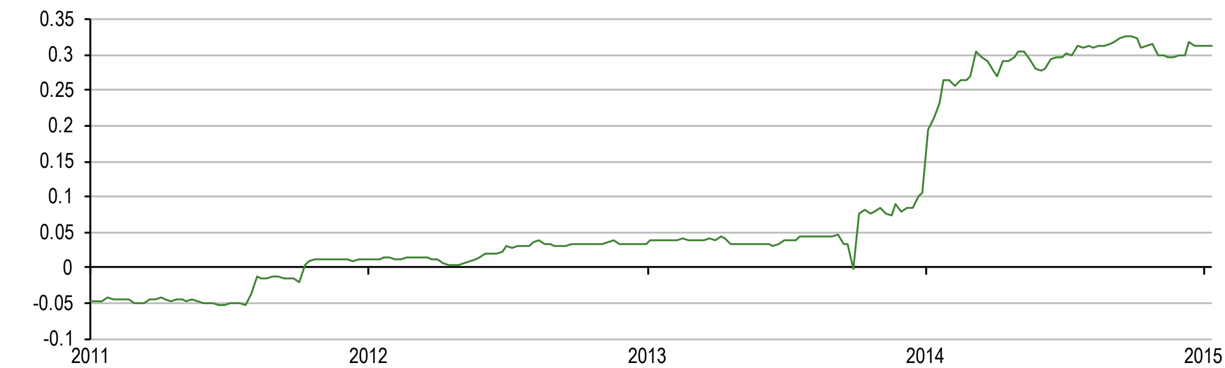
The impact of the decline in the oil price and strong dollar on US corporate performance is now becoming felt in earnings forecasts, Exhibit 4. In recent years, the positive correlation between US earnings revisions and the oil price has risen markedly, Exhibit 5. While the decline in the oil price and rising dollar is clearly beneficial for the US consumer in the medium term, this is at the expense of the US corporate sector in the short run. In our view, the near-term scope for improved earnings momentum remains centred on Europe.

**Exhibit 4: US earnings downgrades now outpace eurozone**




Source: Thomson Reuters Datastream

**Exhibit 5: US earnings forecasts – increasing correlation to oil prices**




Source: Thomson Reuters Datastream, Edison calculations

## Conclusion

We believe that the ECB's QE programme is a necessary policy to avoid an undesirable increase in real yields across the eurozone, but has been widely anticipated by markets during the second half of 2014. The economic impact has therefore been brought forward, and we see an increasing probability of a positive economic surprises in Europe in H115, due to the recent declines in bond yields, the euro and the oil price.

However our medium-term concerns remain in place; political risk is rising in Europe and the combination of declining working-age populations and slow productivity growth means that the medium-term expectation should be that Europe will remain a slow-growth economic region. Although European equity valuations are still at relatively high levels on a price/sales basis, they are less extended than in the US; there may therefore be scope for outperformance of European equities over US peers on the basis of recent trends in economic and earnings momentum.

More generally, the outlook remains challenging for investors. The large decline in inflation expectations has flattened yield curves and led to a rapidly growing universe of high-quality fixed income assets trading at negative yields. We continue to see risks that are not priced into equities; in addition to rising political risks in Europe there is an increasing probability of a major US/Russia confrontation over Ukraine.

In our view at current yields fixed income investors are now being asked to bet against the ability of central banks to create inflation. This is not an appealing proposition over the medium term given historical precedents. Yet in equities, current valuations imply investors are betting on the ability of central banks to create real economic growth – an equally unappealing prospect.

We maintain a cautious positioning, but are warming to the energy sector and believe that in a negative interest rate environment gold will continue to find favour as a store of value. But with rates effectively at zero for much of the developed world and record global debt burdens, the key question remains – what would happen to asset prices if investors lost confidence in the effectiveness of unconventional monetary policy?

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