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Illumination: Equity strategy and market outlook

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Global perspectives: Divergence

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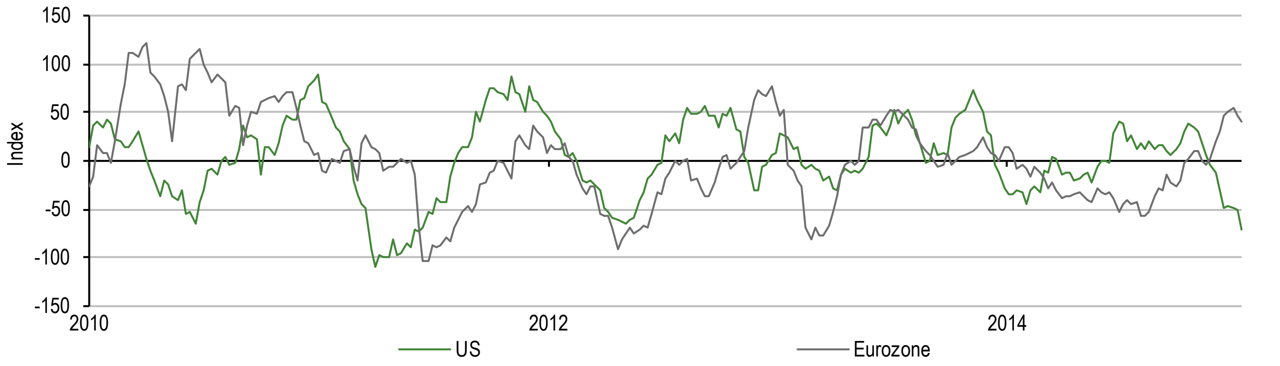
- **Economic prospects in Europe have been improving in Q115.** This is in line with our thoughts in January when we believed that the combined effect of falling oil prices, a weaker euro and a flattening yield curve had the potential to surprise to the upside. Since then, positive eurozone economic surprises have been feeding into profit forecasts, which are showing the strongest momentum compared to any time in the last three years.
- **US corporate profits suffering from a strong dollar and lower oil prices.** In the US, analyst's earnings downgrades are now exceeding upgrades by the widest margin since 2008. The continued upward re-rating of of the US equity market places it on a forward P/E ratio of 18x, a level exceeded only during the globalisation and dot-com boom of the late 1990s.
- **But mind the valuation gap.** Improving sentiment in the eurozone has led to something close to euphoria in German equities. German non-financials are now trading at 2.5x book value, a level seen only in the late 1990s and briefly in 2008. To extrapolate the recent cyclical upturn into a justification for structurally higher valuations is too much of a stretch for us. Instead we remain focused on the scope for a more challenging H2 as the Fed increases interest rates, albeit slowly and in small steps.
- **Last week's FOMC meeting highlighted the strong grip of the US Federal Reserve on global markets.** Bond markets, equity markets and currency markets danced to the tune of Yellen's press testimony and the lowered dot plots of Fed policymakers' interest rate expectations. However, looking through the day's volatility the basic Fed message of slow, steady but data dependent increases in interest rates remains unchanged**.**
- **Desperately seeking value.** We maintain a cautious overall outlook, due to what are in our view lower than average prospective returns on both government bonds and equities. However we do see pockets of value. The global mining and energy sectors are currently trading below long-run valuation levels, in stark contrast to the remainder of the market. In addition, country-specific risk may be overplayed in Russia. However, the harsh reality is that we are highlighting the few valuation exceptions rather than the rule.
- **Still no desire to move 'out on the risk curve'.** The pain the active investment management community feels with valuations stretched, but prices still rising, is palpable. We believe the appropriate response to aggressive and experimental central bank policy is caution and investment discipline, even if it is only when the monetary tide goes out that the benefits of such a strategy become clearer.

Europe bounces off QE and a lower euro

The combination of the flattening of eurozone yield curves, a sharply declining euro and lower energy prices has led to a surprise bounce in European economic activity during 2015 to date, Exhibit 1. The re-convergence in eurozone interest rates and easing of financial stress is finally having a beneficial effect on the periphery; we note for example that Spanish business sentiment has improved markedly over the last 6 months.

Exhibit 1: Eurozone and US economic surprise indices

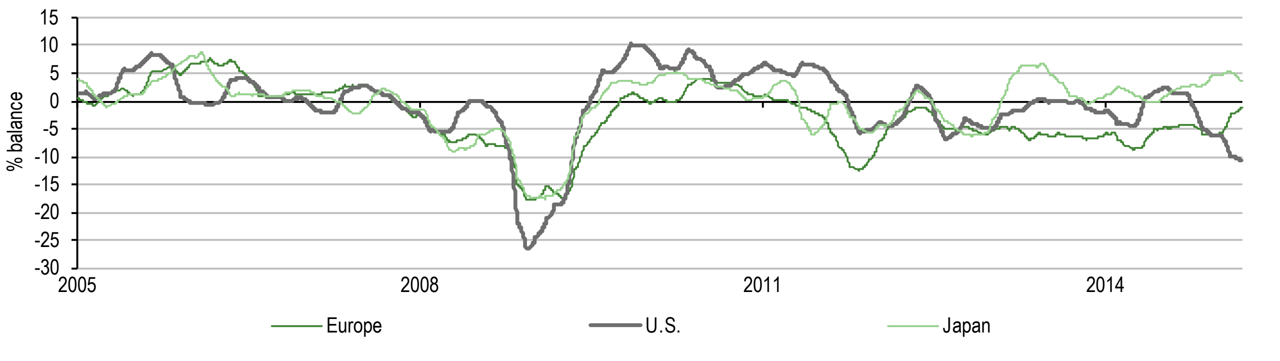


Source: Thomson Reuters Datastream

But US corporate profits stalling as Europe improves

In terms of profits expectations, earnings momentum is as strong in the eurozone as at any time in the last 3 years, Exhibit 2. This has given investors increased confidence in the outlook, especially in export-led Germany, even if this was not the primary target for additional ECB monetary stimulus. The DAX index has risen over 20% in local currency terms in the year to date.

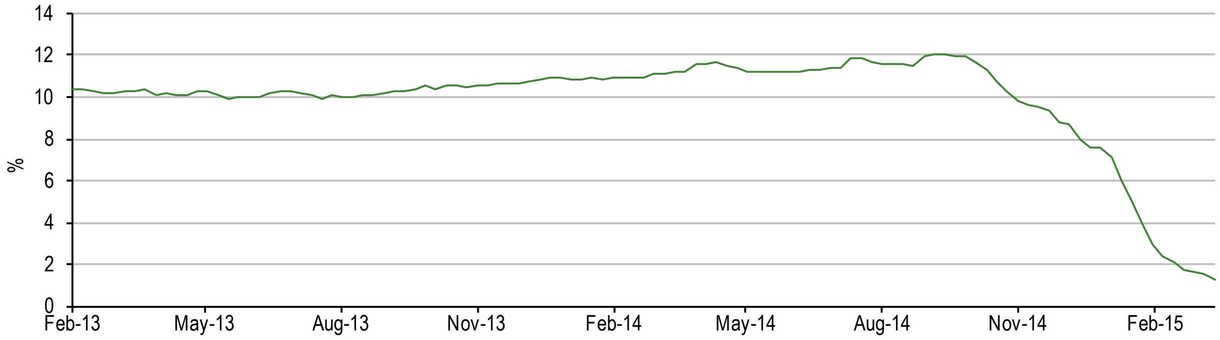
Exhibit 2: Global earnings momentum



Source: Thomson Reuters Datastream, I/B/E/S analyst EPS revisions balance

For the US, the earnings picture is very different; the loss of momentum in terms of the increasing prevalence of downgrades has no parallel outside 2008. Since October, consensus forecasts for 2015 earnings growth for the S&P500 have fallen from 12% to 2%, Exhibit 3. Downgrades are especially severe in the energy sector but also in global sectors exposed to the movements in the US dollar. In other sectors there has been a notable loss of momentum which may reflect a slowing of domestic US activity. We are surprised that US equities have continued to make strong progress this year in light of the likelihood of even modest increases in US interest rates during H2 and significant downgrades to earnings forecasts.

Exhibit 3: US – 2015 consensus earnings growth forecasts



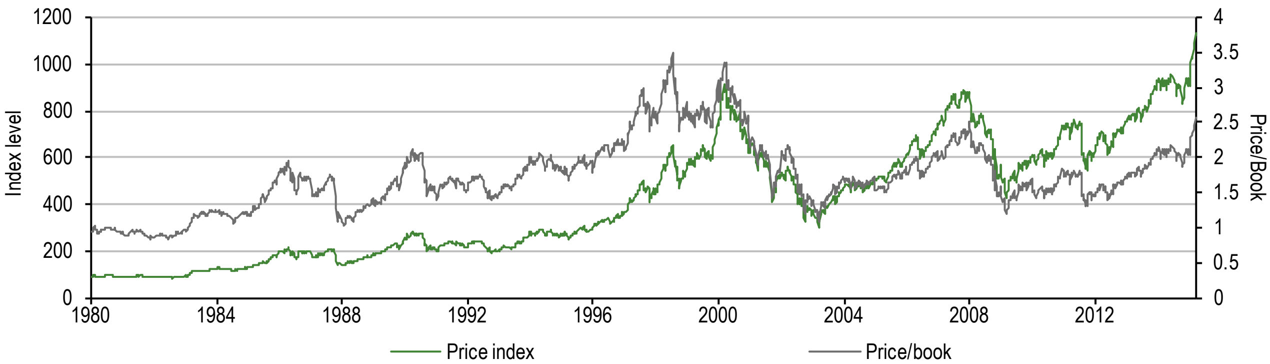
Source: Thomson Reuters Datastream, I/B/E/S

Mind the valuation gap – even in Europe

We can see the logic in the argument that European equities may continue to outperform the US for as long as relative earnings momentum is stronger and the ECB runs a comparatively looser monetary policy to the US Fed. But on an absolute basis, European equities now look as expensive as at any time since 2008. We remain convinced that valuation is as important as ever over the long run and for this reason while overweight positions in rapidly rising equities may have speculative appeal in the short run, in our view, returns from current levels may ultimately disappoint.

For example, German non-financials are now trading at 2.5x book value, Exhibit 4, a level only briefly reached during the late 1990s and momentarily in 2008. To extrapolate the recent cyclical upturn into a justification for structurally higher valuations is too much of a stretch for us. On the contrary, there is in our view, a glaring logical inconsistency in market expectations for permanently lower interest rates but without similarly lowered expectations for long-run profits growth.

Exhibit 4: German non-financials price/book

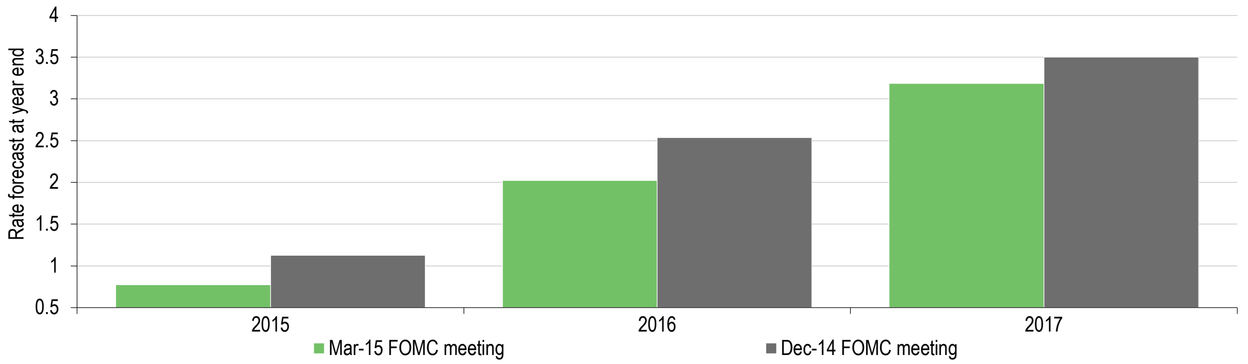


Source: Thomson Reuters Datastream, I/B/E/S

US Fed decision: Read my dot plots

We interpret the US Fed's most recent statement as confirming that policymakers are attuned to the slowing of the US economy over Q115. However, with US unemployment now closer to 5% and 2015 US GDP growth still forecast to remain above trend, US monetary policy currently remains very accommodative. By removing the commitment to be patient in raising interest rates, the Fed is giving itself more room to act on the incoming data in the short run. It was highly convenient for markets that at the same meeting, policymaker's expectations for the trajectory of interest rate increases (given in a dot plot format) through to 2017 have been lowered towards market expectations, Exhibit 5. The reasons given for this change in policymaker's expectations not only included the drag on net exports from a stronger dollar but also a lower longer-run unemployment assumption. Our fears of a mismatch between the market and more hawkish Fed expectations have therefore been allayed to an extent. Global markets responded with a flattening of the yield curve and the euro has stopped its near daily decline as a steady ramp in US interest rates is no longer a foregone conclusion. We would also highlight that emerging markets dependent on dollar funding may benefit from a more dovish Fed.

Exhibit 5: US Fed interest rate expectations lowered towards market-implied levels

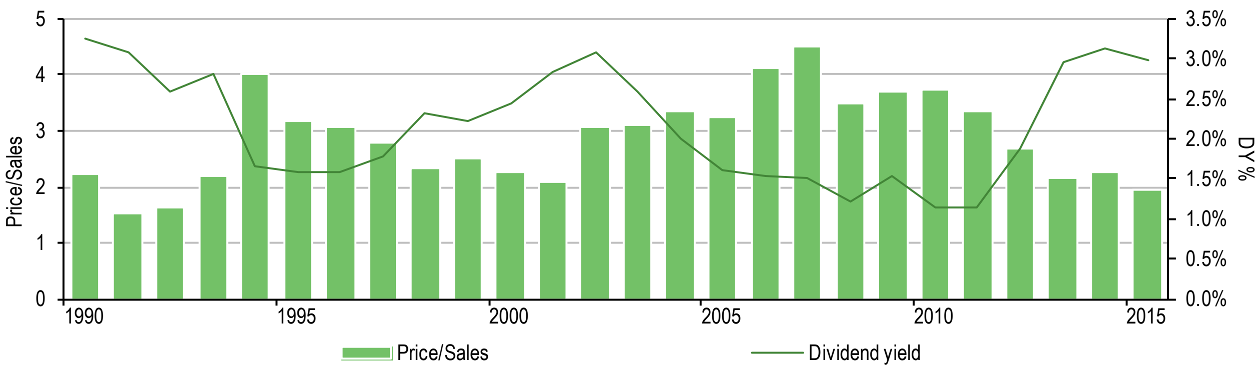


Source: Thomson Reuters Datastream, Edison calculations

Desperately seeking value

In a global securities market where many asset classes are trading well above long-run average valuation levels we are intrigued by below-average valuations in the energy and mining sectors. Russia is also a special case, being at the intersection of resource and geopolitical risks. While both energy and industrial commodity markets are currently in a state of over-supply with spot prices well below the marginal cost of production, from an investment strategy view this would appear to be incorporated in the price, Exhibit 6. In essence, stock market investors are currently ascribing little probability to any rebound in energy and commodity prices to levels consistent with growth expectations embedded in the remainder of the equity market.

Exhibit 6: Mining sector valuation history



Source: Thomson Reuters Datastream, Edison calculations. Note: Chart shows median stock in global mining index.

Conclusion

The outlook for the medium term remains one of only modest expected returns across asset classes as a result of the continued ultra-loose monetary policies pursued by the world's major central banks. While we can find pockets of value in commodity-related sectors and politically troubled regions such as Russia, these situations are the exception rather than the rule.

The economic recovery in Europe has improved investor confidence to the point where market indices look extended on traditional valuations metrics. With profits momentum as strong as at any time in the last three years, this enthusiasm is perhaps understandable, but also in our view misplaced. The stimulus effects of the decline in the currency, bond yields and energy prices will ebb from H215 and we would not chase eurozone equities at these levels.

In contrast, in the US where profit forecasts are falling faster than at anytime except the lead up to the financial crisis of 2008, we struggle to see why US markets continue to trade close to their highs. We remain of the view that the US Fed will be raising rates in the second half of 2015. This will be a clear challenge to currently highly valued US equities.

Navigating the investment landscape is especially difficult at present as the direction of central bank policy dominates, rather than influences, the direction of markets. A significant proportion of the world's shorter-dated, high-quality fixed income securities trade at yields close to 0%. We believe the appropriate response to aggressive and experimental central bank policy is caution and investment discipline, even if it is only when the monetary tide goes out that the benefits of such a strategy become clearer.

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