Illumination: Equity strategy and market outlook

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Global perspectives: Dollar dominates

- **Adjusting the view.** At the start of the year we expected a revival in markets during H1 and our original thinking was that H2 would be more difficult, based on a stronger dollar and increased US interest rates, possibly as soon as June. The recent weakness in the US economy has shifted the goalposts; notwithstanding the most recent FOMC statement, US interest rate increases may now come as late as Q415. The importance of this shift for global markets lies in the outlook for the US dollar.
- **Easier US dollar funding conditions should be beneficial for emerging market performance.** On the basis of relative valuations we would suggest taking profits in European and US equities to increase weightings in emerging markets, even if on an absolute basis emerging market valuations are only in line with long-term averages.
- **We maintain a cautious outlook on the basis of relatively high valuations in developed markets, which still account for over 80% of global market value.** While we cannot identify a specific trigger for a large downward move, this does not mean that one does not exist; adjusting portfolio allocations based on the known valuation signals to account for the unknown risks is why value investing is psychologically difficult.
- **For return-focused investors, current yields on eurozone government bonds look unattractive.** Over the medium term longer-dated bond yields are now inconsistent with the ECB's inflation expectations and the likely path of interest rates.

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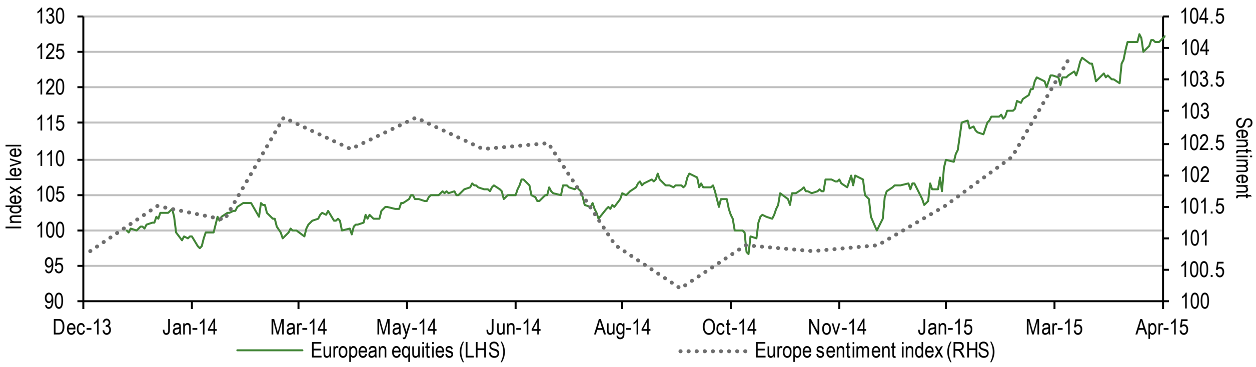
Europe: Improving activity and Greece contagion-free

So far, 2015 has been kind to investors. A turn in European economic sentiment at the start of the year has underwritten a strong rally in eurozone equities, Exhibit 1. The posssibility of a Greek default or exit from the eurozone is no longer viewed as a major market event by investors now confident in the ECB's ability to handle any potential contagion with the tools of QE and Outright Monetary Transactions (OMT). In turn, the absence of market panic has weakened Greece's negotiating position and increased the probability of compromise.

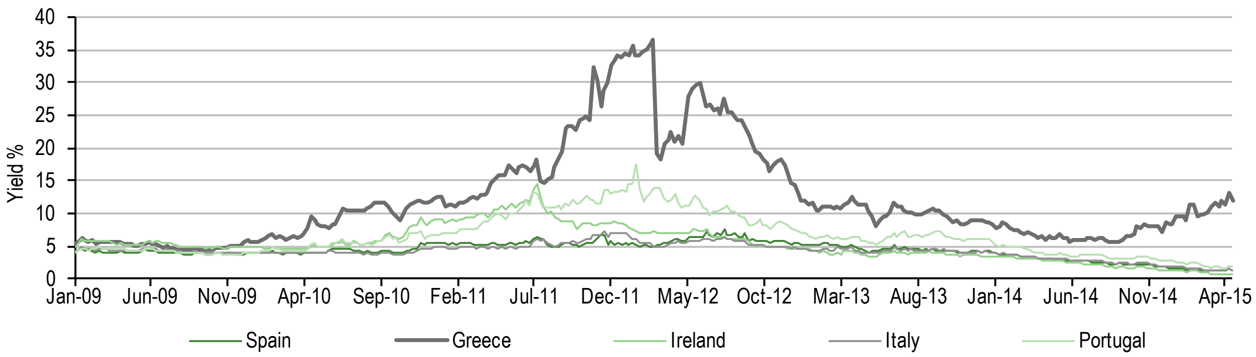
Exhibit 1: Eurozone – economic sentiment and equity performance



Source: Thomson Reuters Datastream

Only Greece's sovereign bonds have been affected by the continuing impasse over the release of bailout funds, Exhibit 2. The recent reshuffle in the Greek negotiation team is also suggestive of a more conciliatory approach with the increasing realisation that the impact of a failure in the negotiations would primarily fall on Greek voters. We expect a compromise will be reached that will at least defer a default, even if a Greek referendum is required to approve the agreement.

Exhibit 2: Greek bond yields – no evidence of contagion to date

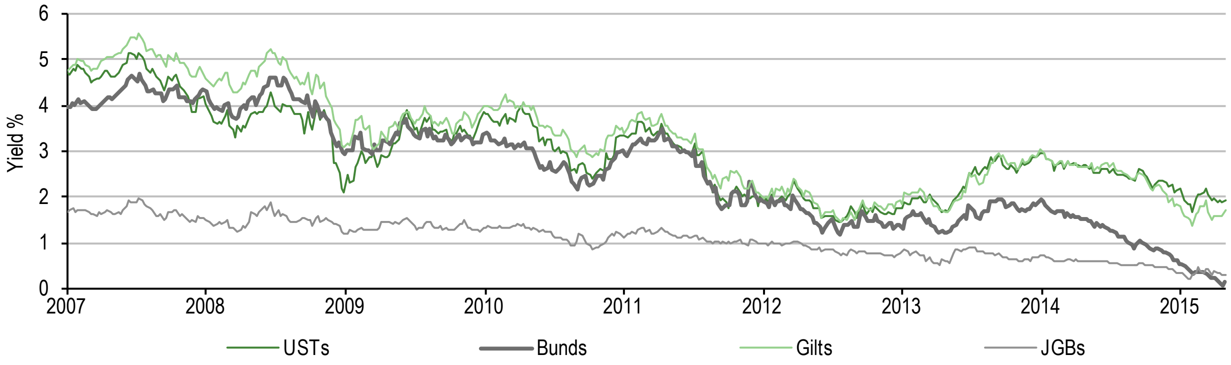


Source: Thomson Reuters Datastream

Eurozone bond yields unattractive for investors

The combination of the ECB's quantitative easing and the declining stock of government debt forecast in nations such as Switzerland and Germany has led to a dramatic decline in government bond yields, Exhibit 3, which are now negative in Switzerland for 10-year maturities and close to zero in Germany. We believe these represent unattractive returns for investors. In our view, the decline in bond yields has been driven in part by scarcity rather than expectations for real interest rates and inflation over the medium term, despite the ECB's protestations to the contrary. We suspect the shortage of high-quality collateral for financing transactions is likely to be playing a role in the exceptionally low yields on offer for German bunds.

Exhibit 3: Global bond yields – eurozone QE meets shortage of supply for bunds



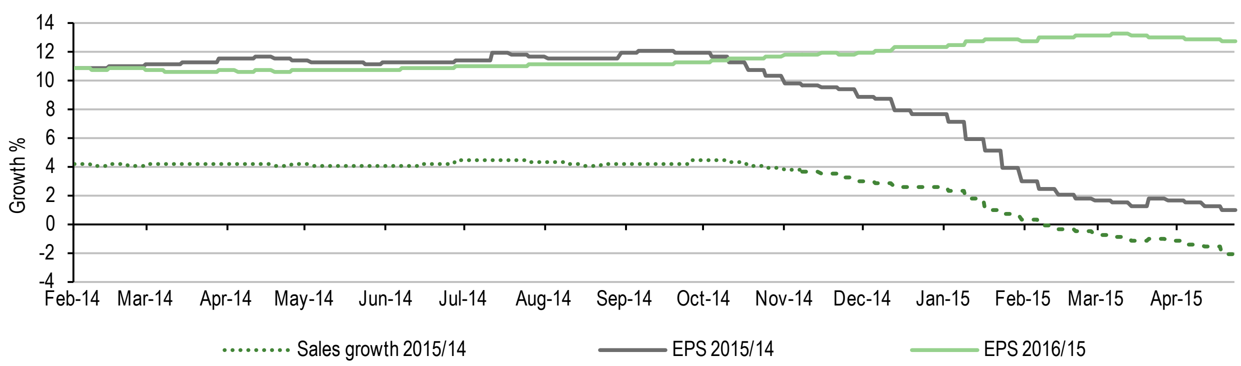
Source: Thomson Reuters Datastream

Furthermore, while it may be possible to hold modest amounts of physical cash outside the banking system as a practical matter the infrastructure is not in place for wholesale size deposits. Such wholesale deposits attract negative interest rates in both Switzerland and the eurozone. Banks and insurers therefore have a good incentive to mitigate this cost by purchasing and driving up the price of the nearest available substitute for cash – high-quality government bonds. This is a part of the "portfolio balance channel" referred to by the ECB. Although a decline in yields is therefore consistent with eurozone QE in principle, current 10-year bund yields look unsustainably low in practice, given the ECB's medium-term target for inflation of below but close to 2%.

We would therefore expect the impact of ultra-low or negative bond yields to be return-focused asset managers lowering bond allocations in favour of buyers such as pension funds with regulatory or hedging requirements. In terms of the outlook, further strong gains in government bonds appear less likely from here as they strongly imply further cuts to interest rates, which the ECB appears reluctant to implement at present. We also note that in only the past few days, yields on bunds have surged to 28bp, following the data showing positive lending growth in the eurozone. In our view this remains an exceptionally low level of yield.

The most recent ECB press conference emphasised that the risks to the economic outlook are now more balanced. Even as the pace of QE is maintained through to September 2016, in our view bond investors are unlikely to see further positive surprises in terms of the ECB's monetary policy during 2015. For the medium term we are mindful that 2% inflation and only 1-1.5% real growth would theoretically imply 3-3.5% as the fair range for bond yields so the bear case is easily made, even if unlikely to fully materialise in the near term.

Exhibit 4: 2015 consensus sales and profits forecasts for S&P 500



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

US – still suffering from the strong US dollar

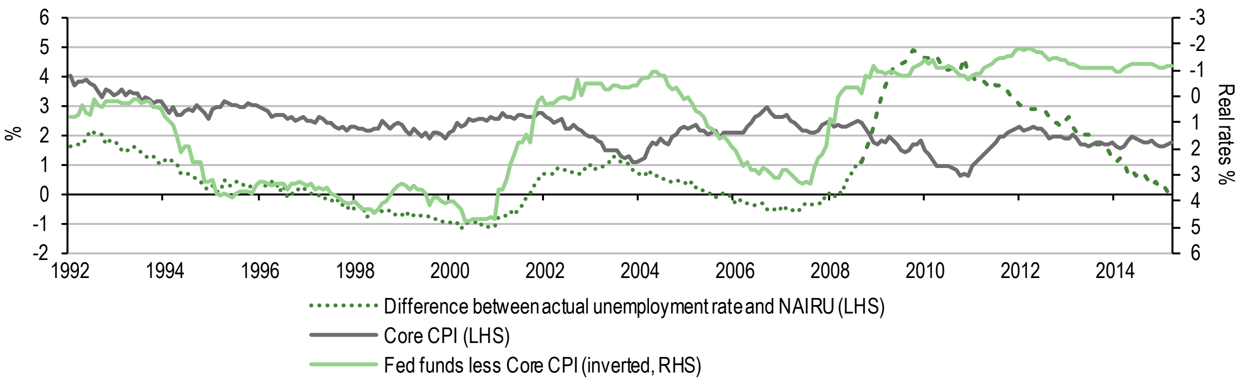
The US corporate sector continues to suffer from the strong dollar and declining expectations for the US economy. The decline in the oil price was always expected to hurt the energy sector, but the hoped for oil-related increase in consumer expenditure has failed to materialise, at least so far.

Year-on-year sales growth expectations for the S&P 500 for 2015 have now fallen to close to -2% in recent weeks from as much as 4% during 2014, Exhibit 4. Despite record quantities of share buybacks, earnings per share growth forecasts for 2015 have fallen to 1% from as much as 10%, according to I/B/E/S. We also note that analysts' earnings forecasts for 2016 have been for the most part taken down in tandem with 2015's numbers, as there has been little uplift to the growth outlook for 2016. In the circumstances, the year to date performance of the US equity market is in our view surprisingly robust and, like other developed markets, remains well above its long-run average price/sales multiple despite the negative momentum in profits forecasts. As a result of this slowing US economic momentum and the Fed's previous tendency to back away from tightening talk as growth ebbs, we believe the chances of a US interest rate increase in the near term have receded signficantly, even if US unemployment and core inflation are close to the Fed's targeted levels, Exhibit 5.

The most recent FOMC statement was admittedly slightly more hawkish than we expected, as it emphasised the role of transient factors in depressing US GDP growth and stated the risks to the outlook remained nearly balanced. We suspect the FOMC was aiming to keep interest rate expectations unchanged until the incoming data reveal whether it really is a transitory GDP slowdown or something more sinister.

At current extended valuation levels US equities would not be the way we would choose to play any decline in interest rate expectations. Instead, we believe the strong dollar rally, which started in mid-2014, is likely to at least take a pause after a year of exceptional gains, Exhibit 6. The prime beneficiaries of easier US dollar funding conditions are likely to be emerging markets, which have outperformed the S&P 500 by 3.6% year to date.

Exhibit 5: US unemployment, core inflation and real interest rates



Source: Thomson Reuters Datastream

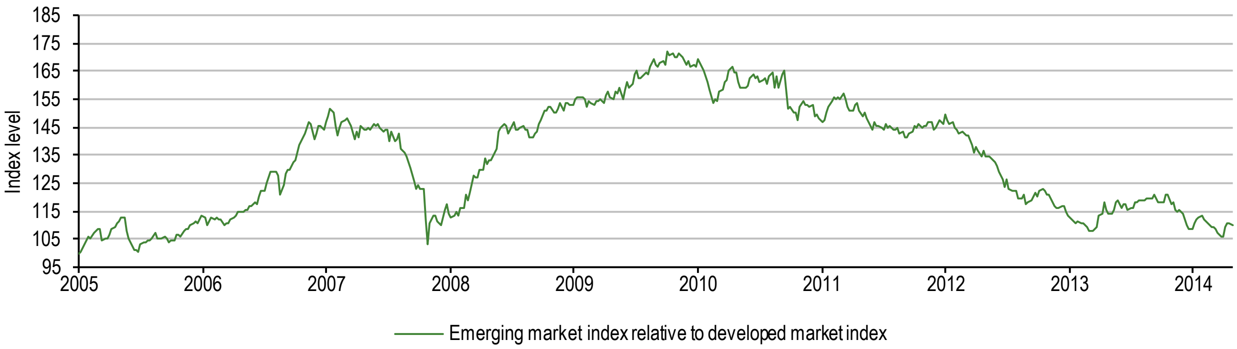
Exhibit 6: Trade-weighted US dollar index – rally stalls in 2015

Source: Thomson Reuters Datastream

Emerging markets

Emerging markets have been the serial disappointment since 2010, Exhibit 7, in part due to the widely held belief at the start of this period that stronger emerging market economic growth would invariably lead to investment outperformance, almost regardless of the valuation starting point. The combination of a valuation differential in favour of developed markets in 2010, extensive utilisation of QE by developed market central banks and disappointing growth from China have all contributed to a significant underperformance of emerging markets over the last five years.

Exhibit 7: Emerging markets have underperformed for five years



Source: Thomson Reuters Datastream

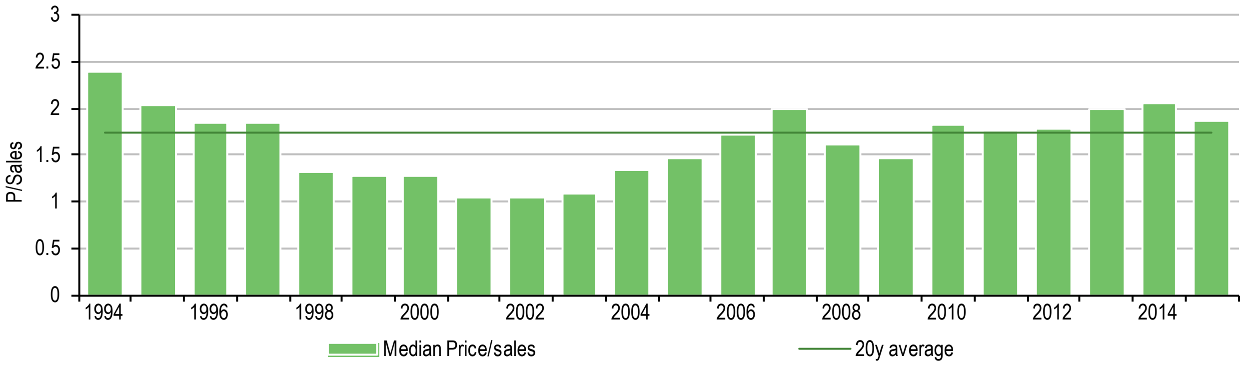
We started to notice the shift in the relative valuation position last year. In absolute terms, median valuation multiples for emerging markets are close to fair value and we are not suggesting that they represent a once-in-a-lifetime opportunity. But on a relative basis the comparison to overvalued developed markets is now striking, Exhibits 8 and 9. However, the strength of the US dollar and exposure of emerging markets to US dollar-denominated funding are a key concern and therefore our initial call proved a little early. This year emerging markets have started to outperform, helped by a stabilisation of the commodity and energy sectors. Should the US economy continue to endure sub-par growth, there is ample valuation room for emerging markets to continue to benefit if as a result US dollar funding costs remain low.

For China specifically there is currently a striking disconnect between the official GDP data and other measures of activity such as rail freight volumes and electricity consumption, which are now showing year-on-year declines. It is more than plausible that these unofficial data are being monitored by policymakers. If so, we can more easily understand the recent cut to China's reserve requirement ratio. We also note leaked details of an ECB-style term refinancing facility to take local government bonds off banks' balance sheets in return for long-term funding. The aim appears to be to centralise credit risk through the use of government guarantees on local government debt and to free up bank liquidity for loans to the private sector.

Exhibit 8: Developed market non-financials price/sales

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

Exhibit 9: Emerging market non-financials price/sales



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

This refinancing facility remains the subject of press speculation, but investors in the Shanghai Composite Index would appear to be counting on an impact not dissimilar to that of QE in the US, Japan or eurozone as the index has risen by close to 70% since Q414. We take no view on Chinese equities here; price/book multiples have rapidly moved towards the higher end of the 20-year range and the details of any formal credit easing or QE package from the PBOC remain speculation at this stage. However, any shift to an easing stance by the PBOC would clearly be supportive of further emerging market outperformance.

Conclusion

At the start of the year we expected a revival in markets during H1 and our original thinking was that H2 would be more difficult, based on a stronger dollar and increased US interest rates, possibly as soon as June. The recent weakness in the US economy has shifted the goalposts; the first increase in US rates could come as late as Q415. Easier US dollar funding conditions would be beneficial for emerging market performance. On the basis of relative valuations, we would suggest taking profits in European and US equities to increase weightings in emerging markets, even if on an absolute basis emerging market valuations are only in line with long-term averages.

More generally, we remain of the view that expected returns in US and European equities are currently at very low levels in a historical context and would maintain a cautious overall portfolio positioning. While we cannot identify a specific trigger for a large downward move, this does not mean that one does not exist; adjusting portfolio allocations based on the known valuation signals to account for the unknown risks is why value investing is psychologically difficult.

We struggle to see the merit in owning eurozone bonds at current low yields. While there may be a technical bid for these securities, longer-dated bond yields are now inconsistent with the ECB's inflation expectations and the likely path of interest rates.

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