# Illumination: Equity strategy and market outlook

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# Global perspectives: Jumping to conclusions

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- **Optimisim on a deal for Greece is ebbing.** European leaders were delighted to discuss new Greek concessions on Monday, but it appears the changes were symbolic and have since been largely rejected by the IMF. A modest shift in the Greek position on pension reform worth less than 1% of GDP was intended to open the door to avoiding default and the possibility of debt relief. Markets initially assumed this was a done deal with the Eurostoxx rallying by close to 4% on the day. Since then, the reality that the sides may be as far apart as ever has been sinking in.
- **FOMC meeting confirms our thesis**. While we were a little surprised by the mismatch between the largely unchanged FOMC statement and significantly lowered rate expectations by Fed policymakers, the data are in line with our earlier views. We do not believe US rate increases in 2015 will be sufficiently rapid to power a market-unfriendly rise in the US dollar, which will be beneficial for emerging markets and commodities.
- **We continue to view equity markets as very highly valued.** Our review of 450 of the faster-growing European companies shows a significant premium to long-term valuation levels, well in excess of those prevailing in 2007. The modest recovery of the European economy in 2015 appears fully embedded in equity prices.
- **Bond yields likely to drift higher.** We are not entirely sure what drove bond yields to such low levels at the start of the year, but with rising headline inflation into H215 and wage inflation picking up in the US and UK, bond yields are likely to drift higher still.

## Jumping to conclusions

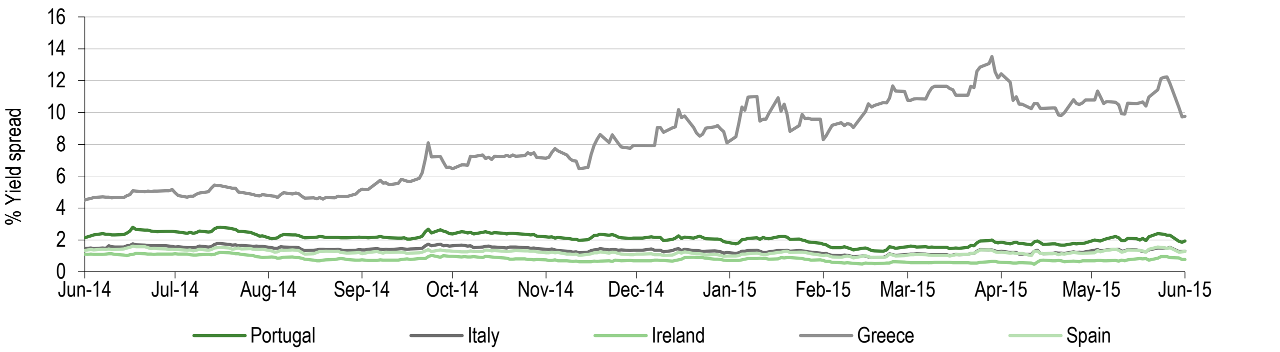
For a short while, markets were operating under the assumption that Greece was a done deal and a near-term default unlikely. Given the symbolic rather than substantive nature of the most recent Greek proposals, we always thought it was a little early to be celebrating and that investors should pay close attention to the various parties on either side, such as factions in Syriza or the IMF, both of which have now raised objections to the current proposals.

While some have characterised a deal on these terms as a victory for creditors such as Germany and the ECB, we would have seen this as a big victory for the Syriza administration. By holding out from any pension reform until the last minute, discussions on debt relief had been put on the table. Debt relief, if agreed, could arguably benefit Greece by an order of magnitude more than the modest pension proposals that have been offered to date.

The Syriza administration's negotiating position was helped by the lack of fear shown in the polls by ordinary Greek citizens to a Grexit. Capital flight out of Greek banks demonstrated that Grexit was something many ordinary citizens were planning for. The ECB remains in a difficult position providing liquidity assistance to Greek banks – as withdrawal of support in effect creates the conditions for Grexit, which is in essence a political decision rather than monetary policy.

A Greek default, capital controls and Grexit still has the potential to be a significant market event as it would represent the first significant rupture in the eurozone currency union, even if the relatively small size of the Greek economy indicates the longer-term impact may be modest. Exhibit 1 shows that investors have arguably been too sanguine in recent weeks, showing little of the fear that pervaded markets in 2012 and perhaps believing that in the end a default will prove unlikely. However, the absence of meaningful declines in equity markets or peripheral bond prices means that for opportunity-driven investors, during 2015 Greece has been a frustrating non-event so far.

**Exhibit 1: Peripheral bond spread to bunds well contained ex Greece**



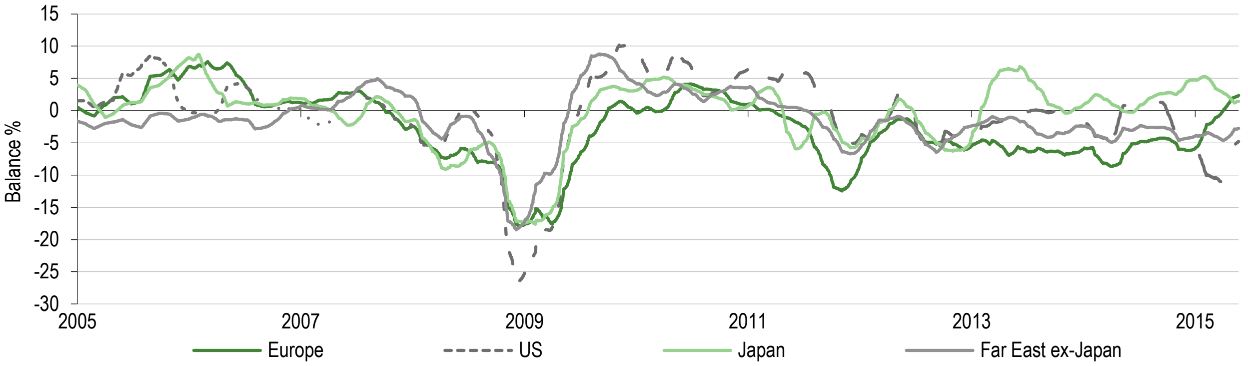

Source: Thomson Reuters Datastream

## European economic momentum continues

Greece has also distracted attention from the continued recovery in the eurozone economy. PMI indices are now indicating that Q2 will have been the strongest for GDP growth since 2012. Even if new orders data are now indicating something of an easing of the pace of expansion, this is clearly a much better outcome than expected at the start of 2015.

In turn, Europe remains the strongest economic region in terms of earnings momentum, Exhibit 2. US earnings have proved stubbornly resistant to upgrades, even after the recovery in the oil price.

**Exhibit 2: Global earnings momentum – Europe now strongest**




Source: Thomson Reuters Datastream

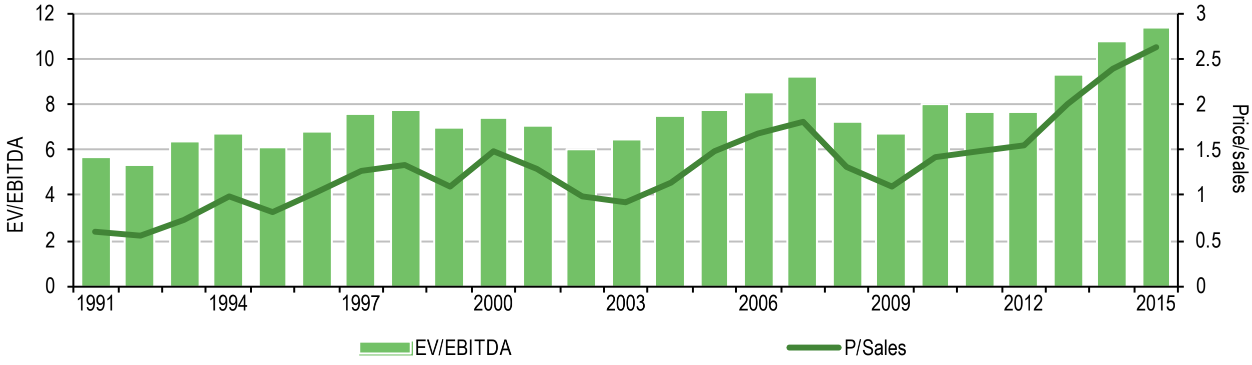
While the economic climate has improved in Europe we are not so enamoured of European equity valuations, which on our estimates look highly stretched, even before we factor in the current forecasts for relatively low sales growth over the next two years, Exhibit 3. We are aware of the risk that lower sales growth understates the extent of the overvaluation of the equity market and have therefore approximated a like-for-like valuation comparison by creating a subsample of European equities, which are forecast to deliver at least 7% sales growth over the next two years, in line with the pre-2008 market average.

**Exhibit 3: Global revenue growth in decline**


Source: Thomson Reuters Datastream

The valuation of this group of equities is substantially above its historical average and well above the previous peak recorded in 2007. Specifically, the median price/sales multiple of 2.6x is 44% above the 2007 peak and the median EV/EBITDA multiple of 11.4x is 23% above the 2007 peak. This highlights the conundrum faced by investors: is the correct response to ultra-low cash rates and bond yields to invest in equities at such high valuations? Investors may only have to look as far as this year's bond market reversal to find an answer – while the timing may be uncertain, chasing yield, however small and regardless of fundamentals, can result in sudden and significant loss of capital.

**Exhibit 4: Growth equity subsample EV/EBITDA and Price/sales valuation**




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

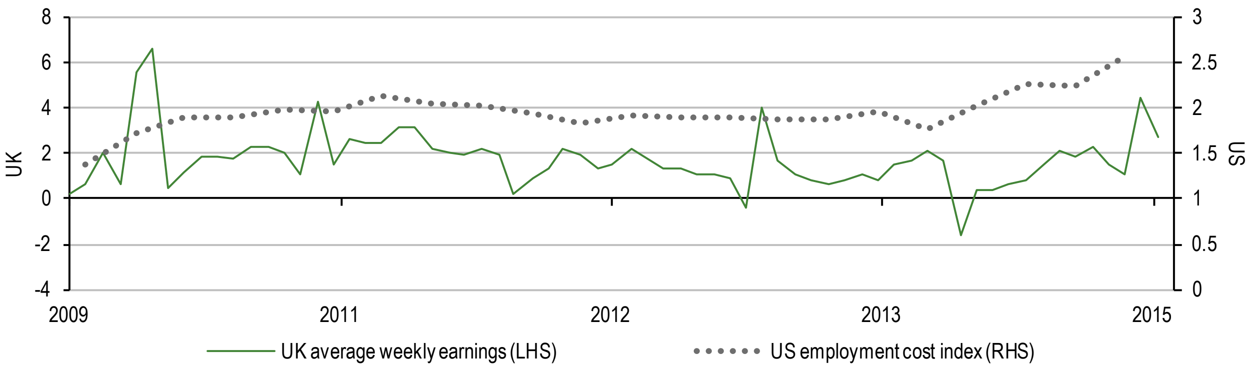
## US FOMC – mixed messages

The most recent FOMC statement confirmed the Fed's view that the weakness in Q115 was transient and indicated that it believes the US economy is now expanding at a moderate pace. The Fed also noted a declining level of slack in the labour market on its broader range of measures in a statement little changed from April. This statement therefore did not contain any surprises.

By contrast, the average of the 'dot plots' of individual FOMC participants' forecasts for US monetary policy, eased by around 25bp for both 2015 and 2016. This was accompanied by a 0.6% reduction in the forecast for 2015 GDP. For 2016, the midpoint of the GDP growth forecast was raised by only 0.1% to 2.5%, reflecting an FOMC view that only a small part of the shortfall in 2015 GDP will be recovered in 2016. As a result, the central forecast for the unemployment rate by the end of 2015 has also shifted marginally higher.

Given the recent generally positive public commentary from Fed policymakers (including Fed Chair Yellen), this was a surprisingly doveish change in forecasts from the US Fed and on the day was positive for US bonds, negative for the dollar and supportive of US equities. Therefore, for the next quarter at least this new outlook allows us to reaffirm our view that an over-rapid tightening of US monetary policy (and upward pressure on the US dollar) is unlikely to be among the primary risks for global securities markets. However, notwithstanding the views of the FOMC, investors should also take note of the recent rise in the US employment cost index, Exhibit 5. If this trend continues, lower-for-longer rates during 2015 may risk a more rapid trajectory of rate increases in 2016.

**Exhibit 5: US employment cost index and UK wage growth**




Source: Thomson Reuters Datastream

## UK rates – excuses for delay wearing thin?

The UK is rapidly reaching the point where the excuses for keeping interest rates at emergency low levels are wearing thin. Wage growth has moved up sharply over the last six months, consistent with a tightening of the labour market. The MPC noted in the most recent minutes that energy, food and wage costs accounted for the majority of the deviation from the 2% inflation target and we would highlight that each of these factors will have reversed course by H215.

Recent comments by a BoE policymaker indicate that possibly two members of the MPC may be voting for a rate rise as soon as August. Therefore, by coincidence, both the BoE and US Fed may be raising rates during the autumn. With both inflation and interest rates on a rising track, we believe both US and UK 10-year bond yields may have further to rise from current levels.

## Conclusion

Despite the high-level desire for a deal, it would appear that the lack of substance in the most recent Greek proposals is a no-go for the IMF and preventing a staff-level agreement. We would also not underestimate the difficulties of approving any new agreement in the Greek Parliament if it contains further concessions. While we certainly cannot rule out a last-minute deal, it is frustrating to see so much time wasted on such little real progress. The lack of contagion leading up to the most recent eurozone summit earlier this week has provided relatively few tactical opportunities for investors.

Global equity investors should however remain attentive to the prospect of interest rate increases in the US and UK later this year in the context of highly valued equity markets. We continue to believe US and European markets will trade in a range for the remainder of the summer as valuations – especially of European equities with growth prospects matching pre-2008 trends – would seem to fully discount the recovery in economic prospects in Europe.

For US and UK government bond markets there is a notable pick-up in wage inflation in both nations. It is possible the six-year period of ultra-low interest rates may have led to investors overlooking the natural anchor for bond yields of nominal GDP growth. With headline inflation set to continue increasing, in part due to the impact of rising energy prices on a year-on-year basis by Q4, we believe US and UK bond yields may have further to rise, potentially increasing the competition for investors' capital away from equities.

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