Illumination: Equity strategy and market outlook

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Global perspectives: Tough spot

- **We see few reasons at present to become more positive on global equities.** Greece may have been the primary source of 'headline' risk in recent weeks but, in our view, equity declines from the peak levels of Q215 have been driven by several other factors such as a collapsing equity bubble in China and sharply declining commodity prices inconsistent with a strong global growth narrative.
- **US Fed on track to raise rates as soon as September.** Subtle changes in July's FOMC statement compared to June suggest to us that the day US interest rates 'lift-off' is drawing closer. Now only 'some' improvement in the labour market needs to be seen before the committee believes it will be appropriate to raise rates. Combined with high equity valuations, this points to a challenging investment outlook.
- **Conclusion.** Once again we maintain the view that a cautious portfolio positioning is appropriate. At the heart of our cautious investment stance is a valuation argument; while we can find challenged business models at inexpensive valuations, the premium being paid for quality business franchises and ever-scarcer profits growth remains at a substantial premium to previous market peaks in the US, UK and Europe.

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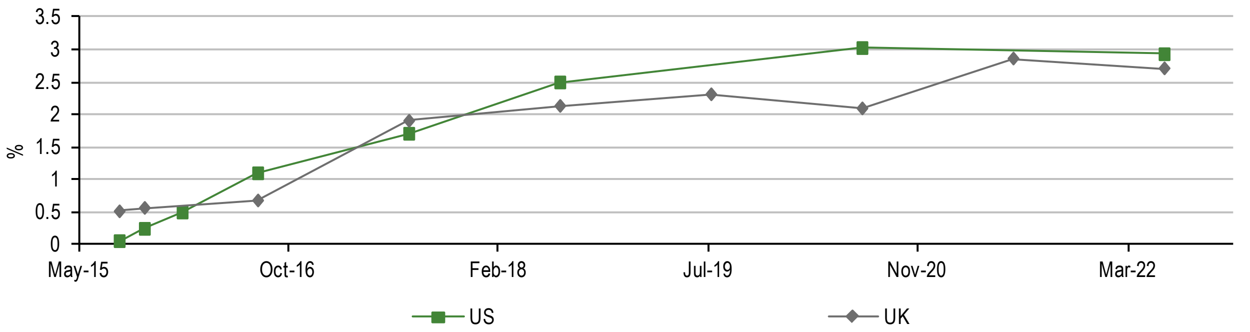
Tough spot

Despite the recent weakness in global markets, significant headwinds for equities are clearly in view for H215. First, the period of ultra-loose monetary policy is drawing to a close. We believe both US and UK interest rates will have risen either before or shortly after the start of 2016. Exhibit 1 shows that the trajectory of rate increases and the peak in rates will be much slower than in previous cycles, reflecting weak inflationary pressures and high levels of total debt outstanding. However, the fact remains that the rate re-normalisation period is unknown territory for investors.

How markets respond to a higher cost of money cannot be predicted with certainty, but we would be surprised if expected returns on risk assets did not rise during this period. With limited evidence of improving profits momentum this year, with the exception of the eurozone, this may mean equities globally struggle to make headway.

Exhibit 1: Market-implied trajectory of interest rates

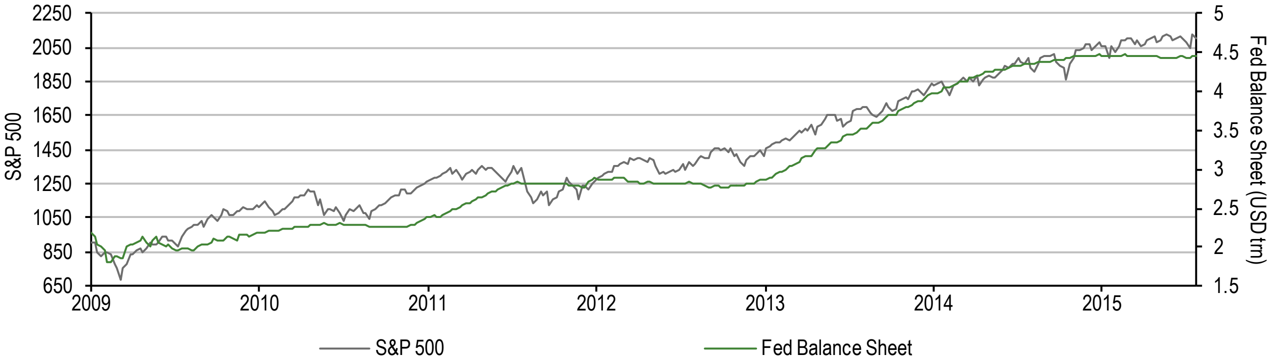


Source: Thomson Reuters Datastream

We may appear stuck recommending an ever-cautious portfolio positioning. However, our strategic view is simply driven by the valuation data combined with an outlook for relatively modest economic and profits growth in future. Even as economies have healed, the extensive use of unconventional monetary policy brought forward the asset price gains associated with reduced risk premia and improved profits forecasts.

For example, we note that in the UK – currently the fastest growing G7 economy – the FTSE 100 has remained unchanged for more than two years. In the US, the strong correlation of the S&P 500 with Federal Reserve asset purchases (rather than weaker than expected GDP growth) has only strengthened this year. As incremental securities purchases under the Fed's QE programme have halted, so has the S&P 500, which is now only fractionally higher year to date. The introduction, implementation and withdrawal of the Fed's most recent QE programme conincides almost perfectly with the performance of the S&P 500 over the period, Exhibit 2.

Exhibit 2: S&P 500 performance and Fed balance sheet

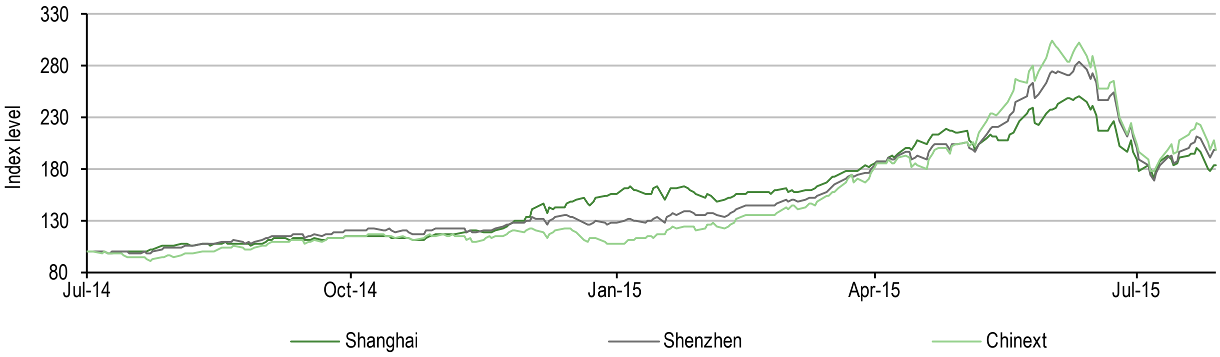


Source: Thomson Reuters Datastream

China's equity market bubble bursts

The inflation and bursting of China's equity market bubble, Exhibit 3, may become a textbook classic. The rapid growth in asset prices despite deteriorating economic fundamentals, rapid growth in margin debt and participation of the retail investor will be familiar to any readers of Kindleberger's classic *Manias, Panics and Crashes*.

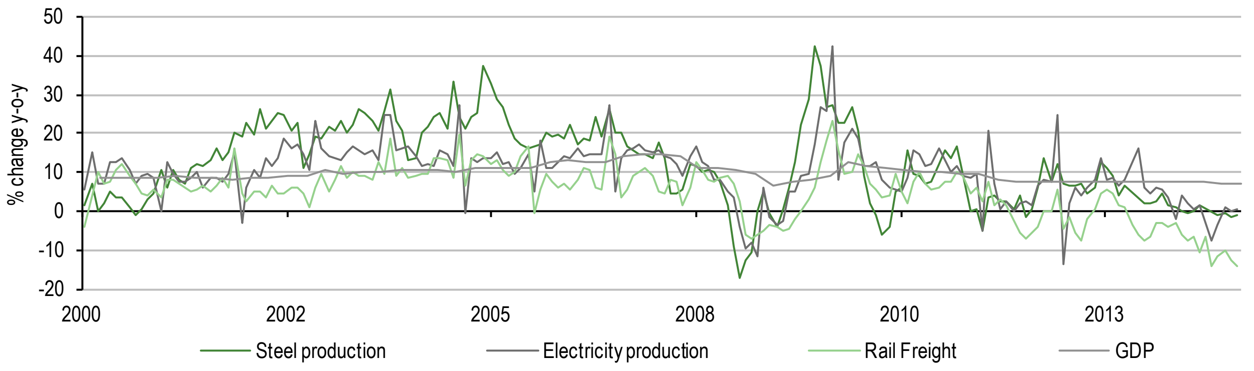
Exhibit 3: China's equity bubble bursts



Source: Thomson Reuters Datastream

We have long been cautious on China's growth profile as a result of what appeared to be an overreliance on fixed-asset investment to generate GDP growth and evidence of overcapacity in China's industrial and housing sectors. However, more recently we have also highlighted the significant divergence between the official GDP figures and unofficial proxies such as electricity production and rail freight volumes, Exhibit 4.These warning signals, in addition to sharp declines in industrial commodities such as iron ore, would appear to have been ignored by China's stock market investors.

Exhibit 4: China – proxies for GDP slowing sharply



Source: Thomson Reuters Datastream

The response to the to the decline in market prices over the past month has been equally predictable. Asset prices have not been allowed to fall to market-clearing levels; we have seen the introduction of trading halts, penalties for short sellers and, most importantly, large-scale purchases by state financial institutions, which as a result are now among the largest holders of Chinese equities.

There may have been a time when China would have been strongly criticised for interfering with market prices in this way. However, during the last 10 years this type of official intervention has become viewed as normal part of the monetary policy or toolkit. We would highlight that by removing the penalty for overinvestment, whether in the stock market or the real economy, central banks risk creating the conditions for the deflation they wish to avoid.

US Fed on course for rate increase in September

Subtle changes in July's FOMC statement compared to June suggest to us that the day US interest rates 'lift off' is drawing closer. Now only 'some' improvement in the labour market needs to be seen before the committee believes it will be appropriate to raise rates. Although there is a spread of opinion in the market on how to interpret this change, the statement in our view raises the probability of a September hike.

While the US Fed may sound reassuringly confident in its ability to fine-tune demand in the US economy, at this point the long period of ultra-low interest rates and very easy credit conditions could even be working against the Fed's own objectives of bringing inflation to target and lowering unemployment.

In previous cycles a short-term drop in the cost of funding has been associated with a recovery in demand for credit, consumer spending and business investment, thus dampening economic volatility. However, since 2009, lower interest rates have had a much weaker than expected positive impact on growth, leading to a much longer than anticipated period of low rates.

It could even be argued that the extended period of very low real interest rates on a global basis could be incentivising overcapacity and a substitution of capital for labour. The net result – over-indebtedness, persistent goods deflation and weak employment growth is certainly consistent with the economic experience of the past few years. In this context, easy credit conditions have also contributed to a relative absence of corporate failures, which has frustrated both corporate and financial buyers of distressed assets.

In addition, according to the Fed's own research, US equity valuations remain somewhat higher than historical averages and in our view the increasing and damaging distortions introduced by central bank policy are a further incentive to attempt to get rates above the zero lower bound – and certainly before an unanticipated shock to world economic growth.

Greece highlights the division in Europe

Once again we await the start of negotiations over a new funding package for Greece. Despite months of talks, the duration and outcome of these negotiations is still uncertain in our view, as there seems to be a difference of opinion between the the IMF and Germany about the need for further debt relief, with the latter opposed at this point. The possibility of an impasse if Germany will not sign off on a deal without IMF involvement – as the IMF seems an unlikely participant in a deal without debt relief – cannot be excluded.

What would appear to be missing from the debate is any meaningful discussion on how Greece will return to growth. Cutting government expenditure and improving tax collection may improve the fiscal position, but both are contractionary forces on the Greek economy, which has also suffered from the highly damaging imposition of capital controls and restrictions on withdrawals.

The significance of a deal for Greece lies in the parallels and precedents set for other nations. In terms of parallel, Greece may be the most extreme example, but is hardly alone in having a rather extended government debt/GDP ratio and very subdued long-run growth prospects. Also, in terms of precedent, the eurozone has now shown itself willing to impose significant hardship on less powerful nations in the currency union to protect the integrity of the euro for the benefit of the core. The reality is that for much of the 21st century Europe has arguably only delivered economic divergence rather than the hoped for, ever-closer union. We ascribe a high probability to the signing of a new bailout deal for Greece, even if it is a scrap of paper in which neither side believes, thus easing market concerns over a near-term Grexit. The moment that could have led to an immediate Grexit may have passed at 6am on the morning of Monday 13 July with the capitulation of the Greek administration to effectively all of the original creditor demands plus some new ones. However, we would caution that a deal which offers only further austerity wihout significant debt relief is likely to have the same effect of shrinking the Greek economy, leaving the nation under semi-permanent control by a committee of eurozone finance ministers.

In this regard, unless there is a reinvention of the EU as a union for growth and prosperity, investors can only look forward to further political challenges and risks emanating from Europe – including the UK’s referendum on membership due in 2017.

Conclusion

At the heart of our catious investment stance is a valuation argument. While we can find challenged business models at inexpensive valuations, the premium being paid for quality business franchises and ever-scarcer profits growth remains at a substantial premium to previous market peaks in the US, UK and Europe.

In addition to our valuation concerns we believe there are some good but so far little-discussed reasons why the US Federal Reserve may wish to press ahead with raising US interest rates this year, as a result of the growing economic distortions resulting from such a long period of ultra-low rates, even if inflation remains subdued.

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