Illumination: Equity strategy and market outlook

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Global perspectives: Markets fracture

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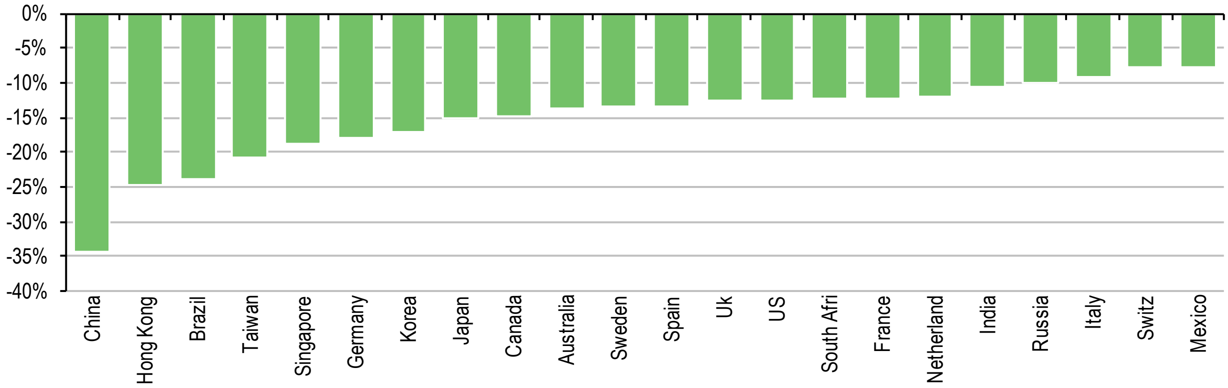
- **Out of nowhere, a correction.** Sudden and significant declines recorded during August have pushed many equity markets back to levels not seen for a number of years. We believe this reset of global equity valuations was long overdue and the volatility in China eventually woke investors up to valuations out of sync with declining profits momentum. While our cautious portfolio stance has been validated, the question now is what to do next.
- **We believe heightened market volatility is likely to persist absent a complete about turn on US monetary policy.** The market-implied probability of a US interest rate increase in September has fallen to 24% from 50% in at the end of July. However, although the People's Bank of China (PBOC) has eased policy, there has been a notable absence of commentary from officials at other major central banks. In addition to the question mark over global growth raised by emerging market volatility, investors are waiting for a cue from US Fed policymakers.
- **Developed markets are still not cheap.** Our universe of European large-cap growth stocks remains at a significant premium to long-run valuation levels. We also find that in the UK only energy and materials sectors are trading significantly above long-term run average dividend yields. Investors prepared for the long haul may wish to consider the lower-cost operators in the basic resources sector with balance sheets able to ride out a cycle.
- **Conclusion.** While we believe the basic resources sector may present some opportunities for value-focused investors, the unfortunate truth is that this correction was long overdue. As risks to growth have increased and equity valuations remain at a premium to long-run averages, we do not anticipate a rapid rebound to levels seen earlier in the year.

Markets fracture

In our view the sharp market declines during August, Exhibit 1, were a combination of coincident but loosely related factors that finally fractured investors' tolerance of a low-return/low-volatility global equity regime. First, increasing expectations that the first US interest rate hike would take place in September cast a shadow over the market, leading to a loss of momentum in US equity markets since Q2. At the fundamental level, the combination of declining profits and revenue growth sat uneasily with developed market equity valuations right at the top of historical ranges.

Exhibit 1: Market declines from 52-week high



Source: Thomson Reuters Datastream. Note: As at close on 25 August 2015.

Second, the slowdown in China and other emerging markets, which was becoming increasingly obvious from softening commodity and energy prices (but possibly less evident in the official Chinese GDP data) finally cracked investor confidence globally as China devalued the yuan. The attempt by the Chinese authorities to stabilise their stock market and subsequent failure to do so, together with rumours of a split in the leadership, has certainly contributed to market volatility. In addition, the prospect of a steady devaluation of the yuan against the dollar has created capital flight from emerging markets as investors fear difficulties servicing a large US dollar-denominated debt burden borne by EM corporates, many of which are heavily exposed to China's supply chain.

For developed markets, further deflationary pressure from emerging markets and a shortfall in world growth are unwelcome developments at this stage and have already renewed calls for not only delaying the first US interest rate increase, but also initiating a fourth round of US quantitative easing. We believe more QE cannot be excluded if emerging market central banks sell sufficient FX reserves to place upward pressure on US bond yields, even as deflationary pressures build. Exhibit 2 shows that real yields have not fallen significantly during this growth shock. However, while ultimately possible, QE appears a long way from the current thinking of the US Federal Reserve, at least if judged by the most recent Fed minutes, which were preoccupied with fine-tuning the US interest rate lift-off date.

Policymakers are likely to need time to discern how changing investor expectations and global capital flows have changed the fundamental economic parameters of growth and inflation. These parameters are likely to be considered more important than any correction in equity valuations, which thus far do not appear to be a risk to financial stability.

For the remainder of 2015 at least, the risk in our view is that the US Fed has set itself on a path to reducing monetary accommodation and will be reluctant to change course, even if a September rate rise is now unlikely. The absence of any comforting media commentary from policymakers in recent weeks stands in stark contrast to earlier periods of turbulence such as during October 2014. This may signal a subtle change of view in terms of the economic benefits of keeping asset prices high and volatility low.

Exhibit 2: US real bond yields

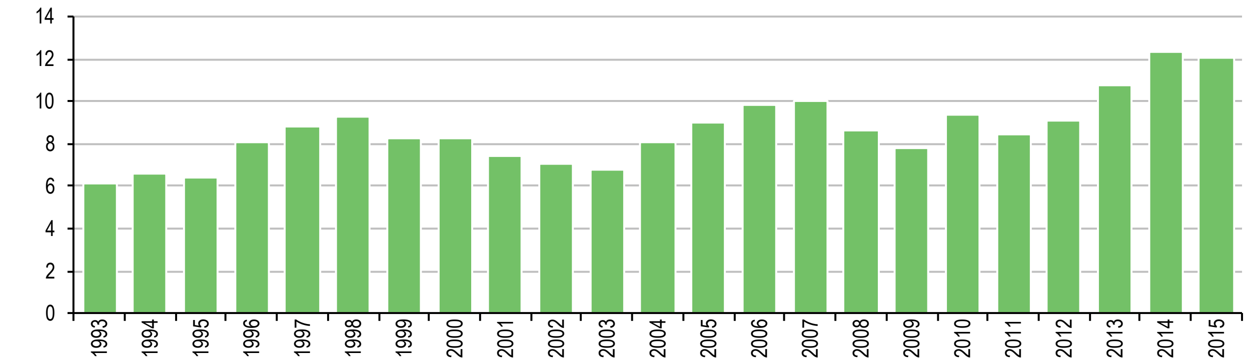
Source: Thomson Reuters Datastream

As policymakers wait for clear evidence of a sustained fall in US growth and inflation expectations, global markets may in the meantime be volatile and struggle for direction as recent declines appear insufficient to bring in value buyers in large numbers. We believe any further large-scale expansion of the Fed's balance sheet is likely to be a 2016 story, in addition to being contingent on rising real bond yields.

Valuations – still not cheap outside energy and mining

Nothing would give us greater pleasure than to say that following a 10-15% market decline valuations were now discounted, but such a statement unfortunately does not concur with our analysis. This is especially true in our European 'growth' universe of stocks, which are forecast to generate at least 5% revenue growth the over coming years, Exhibit 3.

Exhibit 3: European 'growth' universe median EV/EBITDA multiple

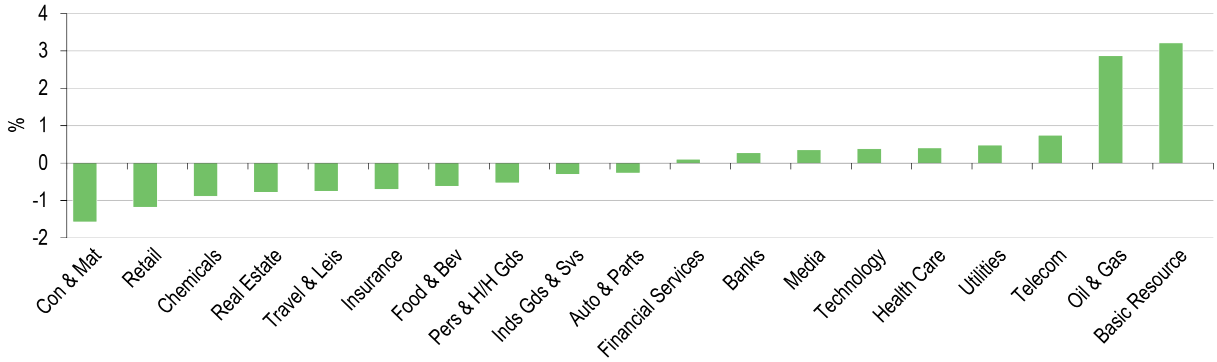


Source: Thomson Reuters Datastream

Valuations for this group of shares remain stubbornly and significantly above long-run averages and thus do not appear to us to represent a compelling buying opportunity. In terms of UK sector valuations, Exhibit 4, with the clear exception of energy and basic industries, the remainder of the market is still no bargain on a dividend yield basis. Due to their large weighting in the UK, the dividend yield for the FTSE 100 may be close to the upper end of the post-2009 period, but investors in the market as a whole should understand the relative cheapness is a result of the exposure to these two sectors.

With the price of iron ore well below industry marginal costs, yet with large low-cost producers still generating substantial positive cash flow, dividends yields in this sector are attractive in our view. Iron ore prices of more than US$100/t several years ago looked unsustainable when substantial low-cost industry capacity was being added. However, at present the market is slowly being brought into balance as high-cost producers are squeezed out. In addition, from a demand perspective we note that Chinese iron ore volumes have not been affected by recent market events, at least thus far. We believe this is a sector that value investors should be looking at.

Exhibit 4: UK sector dividend yield spread from 20-year average



Source: Thomson Reuters Datastream

Conclusion

The sharp decline in global equity markets and falling inflation expectations are likely to give the Fed reason to hold off raising rates until December at the earliest. A September lift-off would be inconsistent with the most recent Fed minutes which indicated that further improvements in the outlook were required before making a move. Since then, the global economic outlook has clearly darkened.

However, investors hoping for a quick about turn in US monetary policy in favour of QE may be disappointed. Unless bond yields rise to levels wholly inconsistent with the economic outlook, we believe the Fed will be reluctant to reintroduce the idea of more QE. As we have previously argued, this long period of ultra-low rates and extensive intervention in sovereign bond markets has created distortions in both asset prices and the real economy, which policymakers will be hesitant to incentivise further.

We have long held the view that equity markets were complacent in terms of the mounting risks to profits growth and that a cautious portfolio positioning was appropriate. Following the equity correction some of the more obvious value risk has been extinguished. However, given the sheer extent of the overvaluation earlier in the year, in our view this move lower is fully justified by fundamentals. In this context, it represents a move towards fair value rather than a value opportunity. Even if the mining and energy sectors are now tempting value investors, our universe of European stocks growing revenues at more than 5% pa is still trading well above long-term valuation multiples.

With valuations closer to fair value and a reappraisal of the world growth prospects underway, we believe markets are likely to move sideways until there is a clearer idea on the monetary policy prescription in both emerging and developed markets.

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