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Illumination: Equity strategy and market outlook

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Global perspectives: The grow-slow years

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **Fed flips, market flops.** Fed policymakers have reinforced October's FOMC message with a number of speeches in recent weeks which highlight the high probability of a US interest rate increase in December. The more hawkish Fed tone has put renewed upward pressure on the dollar and downward pressure on risk assets.
- **The grow-slow years.** We highlight the remarkably slow pace of corporate revenue growth compared to the pre-2008 period. With profit margins high and dividend cover already relatively tight, the outlook for dividend growth is inconsistent with high equity market valuations. Slowing dividend growth cuts into the heart of the argument for substituting equities in place of low-yielding debt and, in our view, is the biggest threat to long-term equity performance.
- **Conclusion.** While desirous of becoming more positive on the outlook, we are not desirous of losing money. Therefore, we remain cautious on developed market equity indices based on our growth and valuation concerns. In 2016, we believe investors will have to focus on company-specific return generating opportunities rather than relying on market gains to drive portfolio performance.

Fed flips, market flops

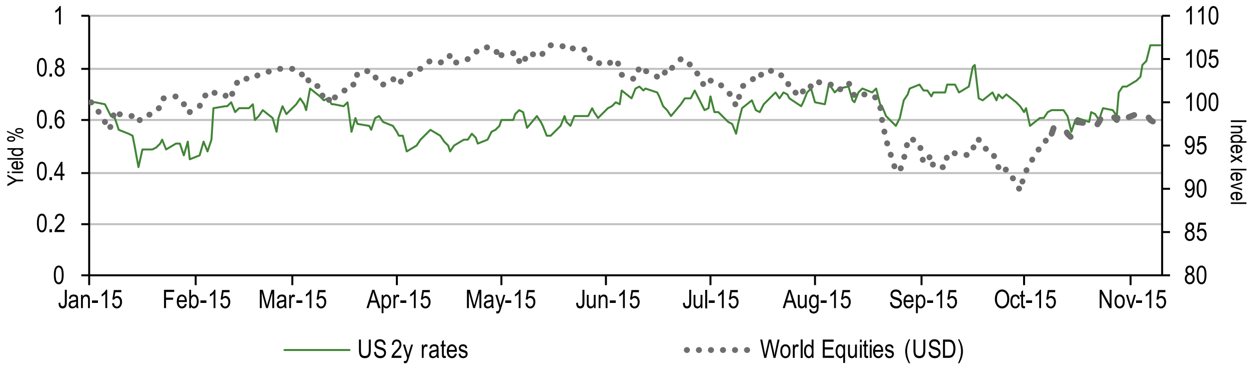
In recent months investors could be forgiven for sitting on their hands. By guiding markets to expect a US interest rate increase in Q315, US Fed policymakers predictably added to upward pressure on the US dollar, Exhibit 1, and created the conditions for capital flight out of China and other emerging markets.

Exhibit 1: Q1 reprise – policy divergence drives euro/US$ lower

Source: Thomson Reuters Datastream

Perhaps spooked by the negative market reaction in global markets over the summer, Fed policymakers initially confirmed investors' much reduced US interest rate expectations in September, Exhibit 2, which resulted in a powerful rally in global equities during October. Therefore, October's Fed statement was an unpleasantly hawkish surprise; interest rate expectations once again shifted rapidly higher as the US policy focus returned to domestic data such as strong payrolls growth. The yield on two-year US Treasury notes has risen by nearly 30bps since the end of October.

Exhibit 2: US interest rate expectations soar following October FOMC statement



Source: Thomson Reuters Datastream

In addition to October's FOMC statement, the publication of speeches from Fed Governors Bullard, Evans, Fischer and Lacker earlier in November provided a useful real-time sample of the current thinking at the FOMC. In our view, despite a clearly dovish speech from Charles Evans, the more hawkish tone of the most recent FOMC statement was only reinforced. We do not believe that the Fed is bluffing on a rate increase in December, absent a major market decline.

James Bullard, who is not a voting member of the FOMC, spoke of a stylised model which showed the US economy would appear to be well past the 2-1/2 year period where ultra-low rates would be expected to stimulate the economy; instead, they may be contributing to the absence of inflationary pressure. While we do not necessarily share his views on the mechanism, we would concur that the extended period of low rates may now be contributing to deflationary pressures. The example of the mining and energy sectors, where additional debt-financed and high-cost capacity has contributed to a deflationary commodity price environment would seem clear enough. There was little for the doves in Bullard’s speech; this was a call not only to raise rates now, but also to think more conceptually about whether low rates are in fact causing the observed low inflation.

Stanley Fischer's speech outlined his view that the US had weathered the US dollar appreciation well, at least in part due to the FOMC's prior decision to defer raising rates during 2015. By highlighting the FOMC’s upcoming discussion on raising US rates due to take place in December – and avoiding any discussion on how dislocations in emerging markets may slow the US economy (due to US dollar appreciation) – we would suggest Fischer's bias now is to tighten, even if he voted for no rate increase during October.

As expected, Charles Evans took a wholly different tack to James Bullard. While acknowledging the recent declines in the unemployment rate to 5.0% (the Fed's estimate of the long-run sustainable rate is 4.9%), he highlighted other measures of labour market slack such as the rise in part-time jobs, weak wage growth and the low labour force participation rate. In his view, the lack of evidence of inflationary pressures mean a later liftoff and slower pace of monetary tightening would best position the US economy. This voting member of the FOMC seems unlikely to vote for a rate increase in December and is also likely to push hard for communications which emphasise a measured pace of rate increases once lift-off occurs.

Jeffrey Lacker, who at the most recent FOMC meeting voted for a rate increase, took a surprisingly strong position on the limitations of monetary policy. In his view, monetary policy can effectively control the rate of inflation, but cannot change medium-term economic outcomes as population and productivity growth are the dominant factors. Furthermore, he believes central banks should be even more cautious about using monetary policy to achieve financial stability. With comments suggesting that today's low inflation rate could even be a largely random event which should not imply a longer-term deviation from target, as expected this was a very hawkish set of comments.

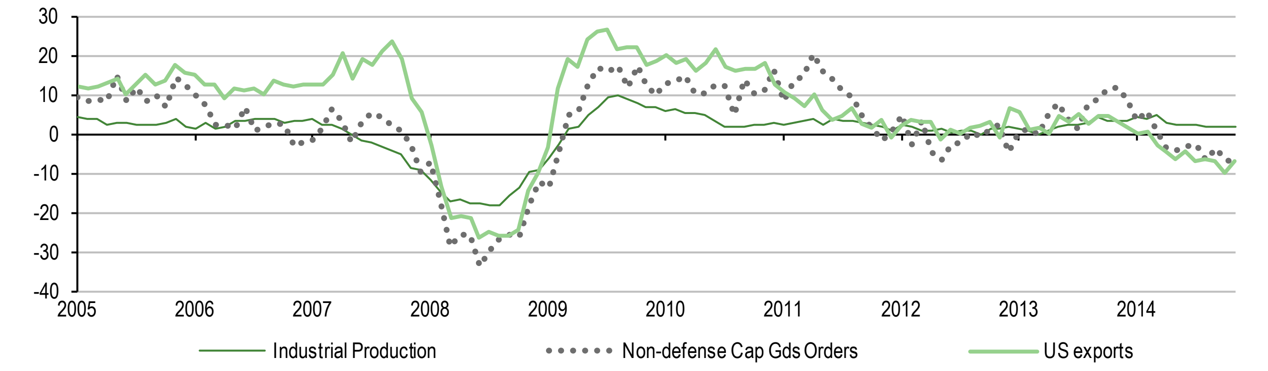
In our view, what was left out of these speeches was any meaningful discussion on the second-order effects on the US of a slowdown in global activity during a period of increasing US interest rates. Focusing on the US in isolation will naturally lead the FOMC to a more hawkish conclusion. Our key takeaway is that if we consider these speeches a sample of current FOMC thinking, only one out of the four speakers said anything in favour of not raising rates at December's meeting.

Fed and ECB policy diverges again

As a result of the recent shifts in Fed/ECB policy, the divergence between the world's two most influential central banks has widened considerably. Comments from ECB President Mario Draghi indicate that the weakness in emerging markets is still being taken much more seriously than at the Fed. This is somewhat ironic as the near-term economic momentum is arguably in Europe’s favour. Even if US employment data remain robust (notwithstanding this week’s employment-related decline in consumer confidence), Exhibit 3 shows that US exports and durable goods orders momentum has fallen considerably over the year while industrial production growth remains modest.

With the ECB emphasising that its asset purchase programme is "considered to be a particularly powerful and flexible instrument," the announcement of additional QE in December is for all practical purposes a given in our view. In addition, in the UK the BOE has indicated that it may tolerate a modest overshoot of the inflation target, a further dovish signal. Unsurprisingly, the re-emergence of the policy divergence theme has renewed the upward pressure on the dollar, notably against the euro which has fallen by over 5% since the end of October, Exhibit 1.

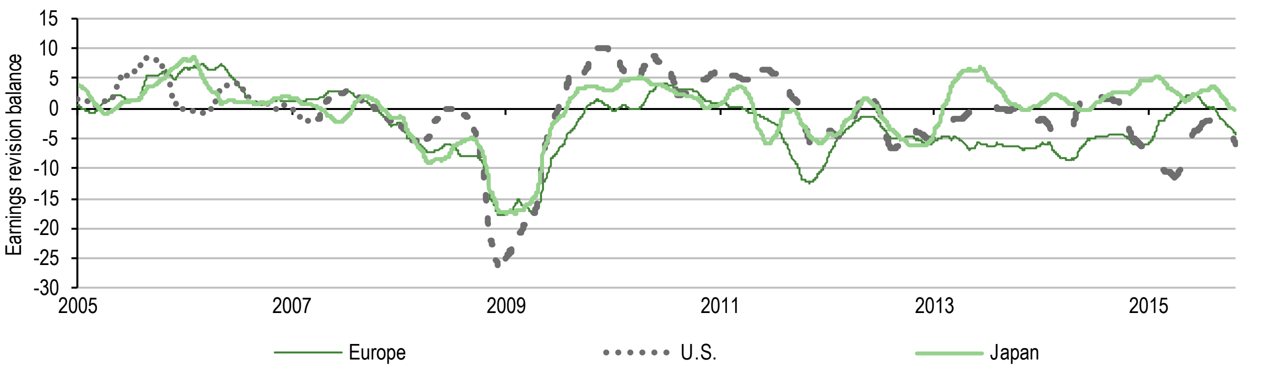
Exhibit 3: US: Loss of economic momentum, despite employment data?



Source: Thomson Reuters Datastream

Outside the FX markets, the equity rally has been all but snuffed out following the Fed's October statement. Investors are not only re-evaluating interest rate forecasts, Exhibit 2, but are also contending with a sharp loss of earnings momentum across all regions, Exhibit 4.

Exhibit 4: Global declines in earnings momentum



Source: Thomson Reuters Datastream

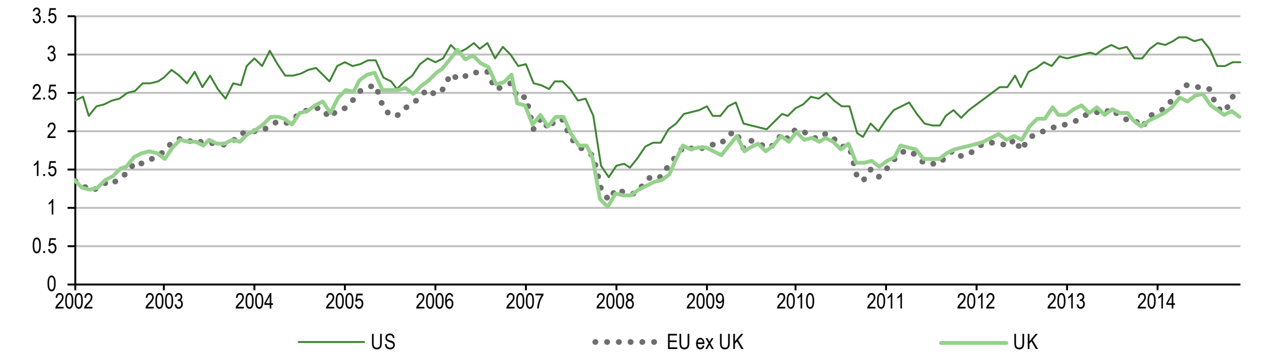
Our caution in terms of equities stems from the combination of relatively high median valuations and distinctly modest forecast sales growth on a global basis. The downward profits revisions which are coming through as world GDP growth expectations ebb may not be unexpected, but they highlight the relatively low expected returns on offer in equity markets. The recent high-profile profit warning for Rolls-Royce (RR.) may have been at least partly self-inflicted, but is also due to the distress in the energy services sector. In addition, there have been an increasing number of companies guiding to results towards the lower end of previously announced ranges, accompanied by relatively sharp share price reactions.

The grow-slow years

For the past three years in the US and Europe, the bulk of equity returns have come from a re-rating to higher valuation levels rather than sales-led profits growth. In an environment where returns on cash and high quality government bonds are likely to remain low, investors continue to look to equities to deliver the returns required to cover long-term liabilities.

The problem is as acute for the largest institutional investors as it is for private investors saving for retirement. There is the cliché that what a wise man does in the beginning, a fool does in the end; we would have had much less of an issue with raising equity allocations in pension portfolios to offset declining income from cash and bonds when equities were at or below long-run valuation averages (i.e. 2009-2012). At present, with median price/book ratios at the very high end of 10-year ranges, Exhibit 5, the reach for yield strategy has clear dangers.

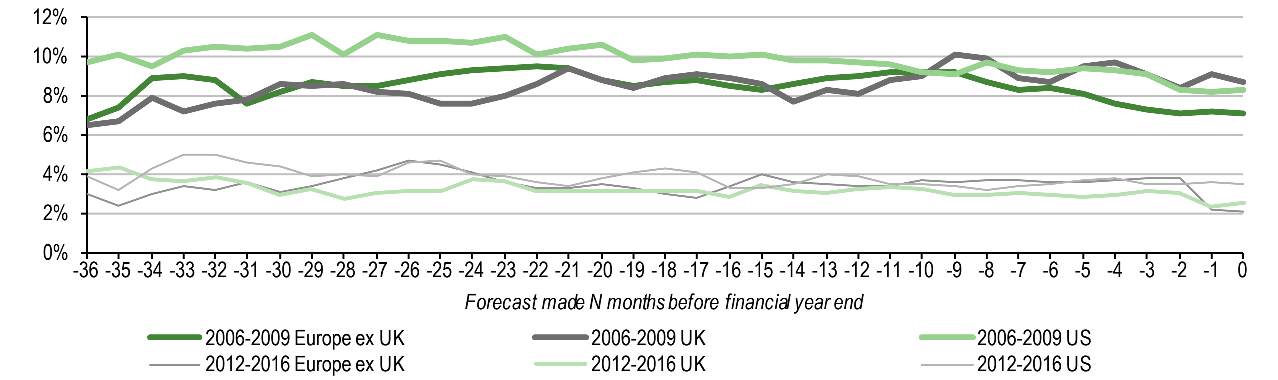
Exhibit 5: Median price/book ratios close to 10-year highs



Source: Thomson Reuters Datastream

The demand for income – and growing income – has not gone unnoticed by the corporate sector. In the post-2008 era, corporates have been criticised for favouring shareholder returns (whether by dividends or share buybacks) over investment in organic growth. In aggregate, US and European companies appear much more eager to invest in the relative certainty of cost-cutting rather than investment in organic growth. This has translated into a significant decline in corporate sales growth on a global basis, Exhibit 6.

Exhibit 6: Global shift in median sales growth rates (averages pre- & post- 2008)



Source: Thomson Reuters Datastream

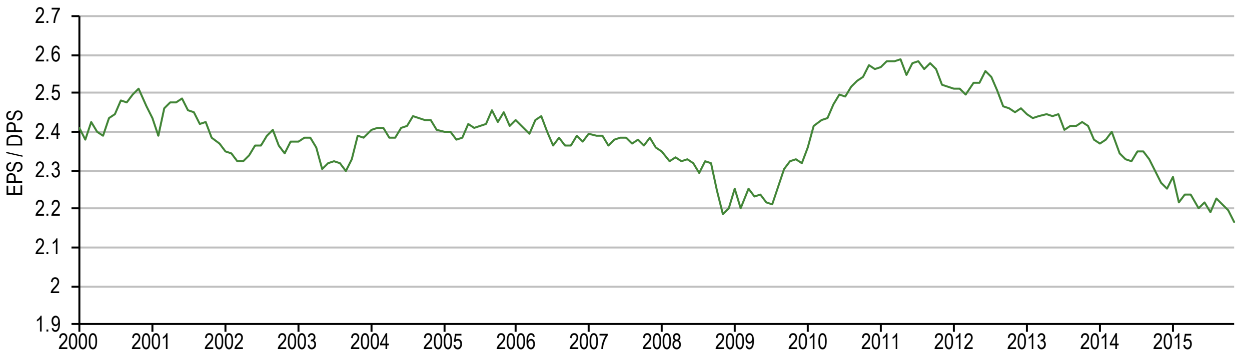
For investors, whether weak GDP growth is the cause – or effect – of weak growth in corporate revenues may be beside the point. The bare truth is that sales growth projections for equities in each of the UK, US and Europe are a fraction of the levels of earlier periods. For example, Exhibit 6 shows the average sales growth projection for the years 2006-09 by forecast date. Tracking this average expected growth over the forecasting period shows a relatively consistent level close to 8% pa, albeit with the traditional dip towards the right hand side of the chart when forecasts are trimmed to match reality. Exhibit 6 also shows the average sales growth for the period 2012-16. The stark difference is that forecast sales growth is one-half the pre-2008 period, at only 4%.

Why does this matter? First, we believe this may be a new normal due to slowing population and productivity growth trends. Consequently, these lower sales growth projections may be structural. Second, median equity valuations in the US and Europe have at the same time shifted significantly higher in recent years. In simplistic terms this may make sense, as dividend yields look more attractive as the yields on bonds move lower. However, this ignores the dividend growth factor, which is as important to the equity investor as the current yield because in the steady state, the equity return is equal to the current yield plus the growth rate of dividends.

For example, if the median growth rate of sales is only 3-4% and the median dividend yield is 2.5%, the long-run equity return from here would only be 5.5-6.5%, or levels achievable with lower-risk asset classes such as real estate.

There are of course two other levers that the corporate sector can use to increase cash returns to shareholders, even in the absence of revenue growth. Profit margins can be increased and payouts to shareholders made a greater proportion of net income. However, with both profit margins and dividend payouts close to the top of their historic ranges, the prospects for long-term dividend growth look rather discouraging for developed markets in the US, UK and Europe. We draw investors' attention to the decline in the median dividend cover ratio in the UK over the last three years, Exhibit 7.

Exhibit 7: UK – decline in dividend cover



Source: Thomson Reuters Datastream. Note: Unweighted average

We certainly do not claim in this analysis that all companies or equity investments will disappoint investors, but instead highlight the risk for a disappointment in aggregate over the long term. Buy and hold may be a good strategy for avoiding the ups and downs of the stock market. In contrast, the strategy of hold and hope is less appealing.

Geopolitical risks return to the headlines

The tragic events in Paris demonstrate again that in a global world, links between regions do not stop at trade. Across the south-east of Europe lies a region of conflict, which Europe's electorate and political classes have so far preferred to largely ignore. At least until the flow of refugees from Syria turned into a flood, Europe was preoccupied with its internal problems, such as the integrity of the eurozone and slow growth. The willingness of the world's major powers (France and Germany included) to allow a nation on Europe's borders, such as Syria, to turn into a failed state ravaged by a multi-year civil war would now seem to be a large mistake.

However, from an investment perspective, investors could not fail to have been aware of the pressure building in Syria and the increased risk of events such as these. The attack in Turkey in October also resulted in the loss of more than one hundred civilian lives. Therefore, we would not expect a major market reaction from this event alone. Experience from previous terror attacks on Western targets shows that any impact on economic activity is likely to be transient. Large cities have consistently demonstrated a remarkable ability to recover from terrorist atrocities.

We note the increased determination to attempt to resolve the situation in Syria and equally importantly, resolve the US-Russian disagreements on how this should be achieved. In this regard, the face-to-face meeting between Obama and Putin at the G20 meeting in Turkey, which resulted in an agreement to push for a Syria-led political transition and ceasefire, may be more significant than the step-up in the aerial bombing campaign. Turkey's decision to shoot down a Russian jet following the rapprochement between the US and Russia seems a strange turn of events in the circumstances.

In terms of our view that these are political rather than market events, we would also highlight that markets are now assuming that progress will be made in Syria in restoring peace. Otherwise, the European refugee crisis will become increasingly acute and could easily have many other knock-on effects in terms of European politics and the European project. Specifically for the defence sector, investors also have moved quickly to price-in upward pressure on defence budgets to secure Europe's national and regional interests over the medium term.

Conclusion

Approaching the end of 2015, we see a continuity of themes as we move into the new year. The spectre of US interest rate increases will continue to overhang markets, although the current FOMC average forecast for a 1.5% US Federal Funds rate in one year's time is only 30bps higher than that prevailing one year ago.

The combination of slowing corporate revenue growth and relatively high equity valuations in each of the US, UK and Europe should be a bigger cause for investor concern, in our view. The recent wave of earnings downgrades and severe market reaction to profit warnings in a number of individual cases highlight investors' limited appetite to put additional money to work when the outlook becomes less certain.

Slowing dividend growth cuts into the heart of the argument for substituting equities in place of low-yielding debt and in our view, is the biggest threat to long-term equity performance. While desirous of becoming more positive on the outlook, we are not desirous of losing money. Therefore, we remain cautious on developed market equity indices. In 2016, we believe investors will have to focus on company-specific return generating opportunities rather than relying on market gains to drive portfolio performance.

EDISON

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
United States

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place
88 Phillip Street, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand