Illumination: Equity strategy and market outlook

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Global perspectives: Bouncing off bad news

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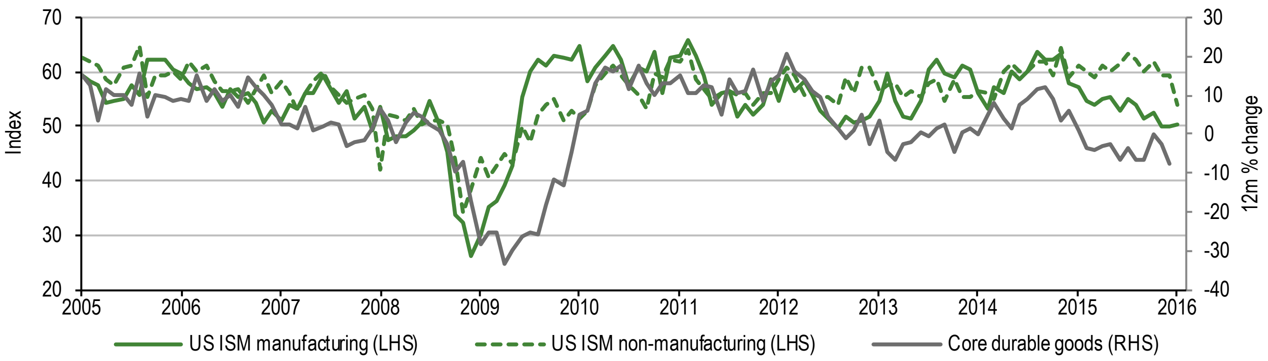
- **Financial sector mini-panic for now embraced as a positive market event.** Although leading indicators of economic activity continue to decline across developed markets, investors are anticipating that the recent sharp rise in financial sector risk is a prelude to yet more central bank stimulus.
- **Oil price stabilises following meetings between exporting nations.** We believe oil producing nations have a shared objective in prioritising fiscal revenues over foreign policy objectives and early attempts to build a consensus for limiting expansion of production shows the pressure from lower oil prices is building. Uncertainty remains high, but the willingness to even talk has stabilised the oil price in the US$30 range.
- **Weak bank sector performance highlights one of the risks of NIRP.** The flattening of the yield curve in 2016 has raised fears of an erosion of bank sector profitability, adding to concerns over rising default risks in energy loan books. Investors are also right to be concerned that negative interest rate policy may further adversely impact bank sector profits in the medium term.
- **Earnings estimates stabilise in the UK and US.** One of the more obvious pressures on equity markets has now abated as EPS estimates hold the same 2016 forecast level over the past month – for the first time since mid-2015. We believe analysts have at least caught up with economic events and short-covering may have contributed to the rally most recent rally. We still stick to the view that median equity valuations remain expensive given that risks to growth remain skewed to the downside.
- **Despite increased risks, high yield bonds now look attractive.** Yields on high yield bonds have doubled to close to 10% since mid-2014 even as risk-free rates have fallen. Absent a major financial crisis but allowing for a pick-up in actual defaults, we believe at current levels the high yield market is discounting a much more significant decline in corporate earnings than that implied by equity valuations. Investors seeking equity-like returns of over 5% may wish to consider adding to allocations.
- **Tempting to move, but investors should stay put for now.** Earnings estimates have stabilised and the US dollar's ascent is at least on pause, to the benefit of risk assets globally. But the IMF's call in the last few days for a multilateral G20 response merely highlights declining global economic momentum. Outside the high yield market where this is at least in part discounted, we see insufficient reasons for investors to move away from a cautious portfolio positioning at present.

Bouncing off bad news

Though leading indicators of global economic activity continue to decline and in the US notably so, Exhibit 1, global equity markets have bounced significantly off their lows for the year as February's sudden resurgence in bank credit stress receded. Year to date, the H215 dynamic of mining sector underperformance driving global markets lower has reversed, with the Datastream global mining index up over 15% on a relative basis. Miners have shown robust performance in recent weeks even as commodity prices have merely stabilised at lower levels.

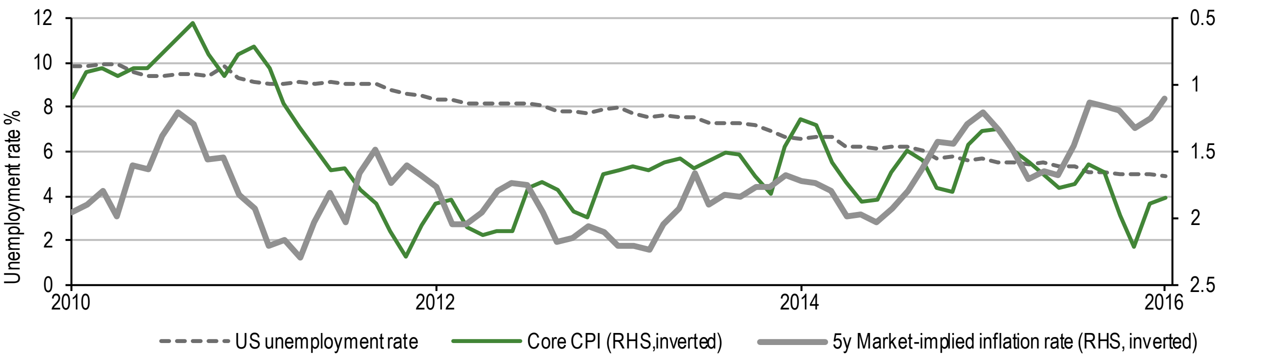
Exhibit 1: US economic activity weakening



Source: Thomson Reuters Datastream

It is as if the recent mini-panic in the financial sector has provided investors with increased confidence that central banks now have a renewed mandate to do "whatever it takes" to support economic activity through further monetary policy accommodation. In a sense, this is justified; globally, market-implied interest rate expectations have fallen sharply in the first six weeks of 2016 and in the US to levels which have in the past triggered action from the Federal Reserve.

Exhibit 2: US policymakers' dilemma: Divergence in actual inflation and US TIPS implied future inflation



Source: Thomson Reuters Datastream

However, the US Fed is not in our view in a position at present to consider policy options other than deferring rate increases; investors' expectations should remain anchored by the limited current level of slack in the US economy. US unemployment is at Fed policymakers' estimates of the long-run sustainable level of 4.8-5.0% and core CPI inflation is also now close to target at 1.9%, Exhibit 2. Complicating the picture for policymakers, US survey data continues to highlight a significant slowdown in the US economy. We believe the US Fed will have to balance this forward looking data with lagging indicators such as unemployment and inflation which offer a more sanguine perspective. But we concur with the market's view that in the circumstances, a US rate increase at the 16 March Fed meeting remains unlikely.

No such constraints apply to the ECB, however, as inflation remains well below target. While markets were initially disturbed by the recent sharp increase in market-implied credit risk within the bank sector, this is now being interpreted as arm-twisting the ECB into adding to its monetary policy accommodation. After disappointing markets in December, we would be very surprised if the ECB did not follow through on its strong hints of further policy easing on 10 March.

Oil talks – at an early stage in the process

In terms of the oil market, no analysis can be complete without taking into consideration that the world's largest oil-exporting nations are engaged on opposing sides in the Syrian war. Although progress in resolving this conflict is painfully slow, in our view it does not necessarily follow that the current policies of maintaining full production into soft world oil markets will continue indefinitely.

Fiscal pressures on the oil-exporting nations continue to build and the undesirability of drawing on sovereign wealth funds and austerity policies are still likely to be a higher priority for these nations than foreign policy, at least once the parties believe they have achieved an acceptable negotiating position over Syria.

Even as there may be wide differences in opinion over the Syrian question, all oil-exporting sides in the conflict stand to benefit from a perception of stability in energy markets. Recent comments from OPEC's secretary-general reconfirm that the oil price has declined by much more than was originally envisaged at the outset of Saudi Arabia's strategy to regain market share.

We would highlight that during February there has been a constructive engagement between Russia and Saudi Arabia to maintain oil production at current levels; an attempt by OPEC to reach out to Iran (even if unproductive for now); and more recently, statements from OPEC members seeking to bring other non-OPEC producers into talks to stabilise the oil price.

Sceptics would correctly point out that none of these talks have led to any meaningful agreements to cut production. But we view these developments as a first stage in a lengthy process to balance the market at structurally lower prices with a greater role for OPEC's lower cost producers.

The recent stabilisation in the oil price at around US$30, Exhibit 3, is in our view a response to evidence that oil producers are recognising that it is in their interest to cooperate despite differences in foreign policy objectives. Talks are the first step in that direction. By the time agreement has been reached, it will be time to take profits from any oil price rally.

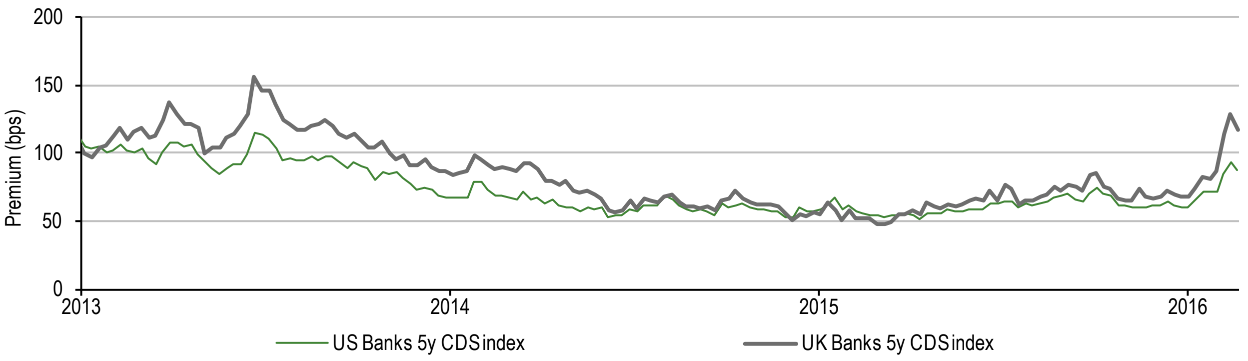
Exhibit 3: Oil – Early-stage talks stabilise prices around $30/bbl

Source: Thomson Reuters Datastream

NIRP needs work

The banks sector has caused significant and unanticipated pain for investors during 2016 with share price declines of close to 20% year-to-date in both Europe and the US. Investors who participated in the recapitalisation of the banking sector in recent years could have been forgiven for hoping 2016 would allow accelerating loan growth and widening net interest margins. Instead, credit spreads within the banking sector have widened significantly, notably in Europe and including systemically important institutions such as Deutsche Bank and Credit Suisse, Exhibit 4.

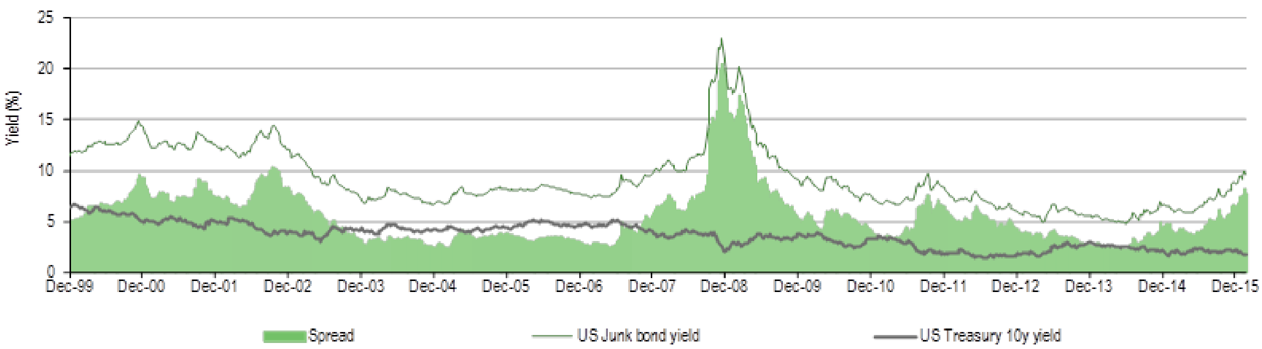
Exhibit 4: Credit default swap prices for US and UK bank sectors



Source: Thomson Reuters Datastream

We believe several factors are at play. First, the sell-off in the high yield and leveraged loan markets which we first observed in December last year has accelerated, Exhibit 5. We discuss below why we think this may now be overdone and could represent an opportunity for investors, but for the banks sector it raises the risk of an increase in loan loss provisions in coming quarters. We note JP Morgan's 60% increase in energy lending provisions (22 February) and also the footnote which indicated that provisions could reach 15% of oil and gas high yield exposure should oil prices remain at or below $25.

Exhibit 5: Junk bond yields discounting a sharp rise in defaults



Source: Thomson Reuters Datastream

The alarming sell-off in European bank debt may not be directly related to perceptions of increased counterparty risk. It is possible a lack of liquidity in single-name CDS has pushed hedging of individual corporate credit exposure towards credit default swaps written against the large banks, where CDS instruments are much more liquid. If true, this has unfortunately had the effect of raising bank funding costs just as the prospect of negative interest rate policy threatens the core bank business model of taking in short-term deposits and term lending at higher rates.

In line with our forecasts at the start of 2016, global yield curves have flattened significantly, compressing net interest margins and impacting bank profitability. But in addition to concerns over credit risk, bank investors are now looking through to an increasingly likely scenario of widespread negative interest rate policy (NIRP), where rates move significantly below zero and are held there for more than a brief period. NIRP unfortunately creates a problem for the banks as many customers may fail to see the benefit of depositing money into a banking system which charges potentially meaningful penalties for doing so.

In Switzerland, for example, where rates have been -0.75% since January 2015, banks have been reluctant to pass on negative interest rates to customers and have taken the hit to margins. As a result, the consumer sector of the economy remains unaffected by the direct result of NIRP and the result of the policy would seem to be uncomfortably focused on the FX market, where large speculators suffer from an increasingly negative carry.

Small nations such as Switzerland or Denmark have been able to get away with the policy, but it remains to be seen what will happen if the ECB pursues policy rates which are significantly negative. It is not in our view a coincidence that in the UK, Europe and the US a number of policymakers and opinion pieces have started a debate on the abolition of high value bank notes; there may be an argument in favour of abolition due to the undoubted use of such notes for criminal activity, but it rings hollow given the timing. Such talk has an unfortunate side effect of revealing policymakers' internal expectations of just how low rates could go under NIRP. It stretches credibility to believe that criminal activity would be significantly hindered by the abolition of cash – there are many other potential alternatives.

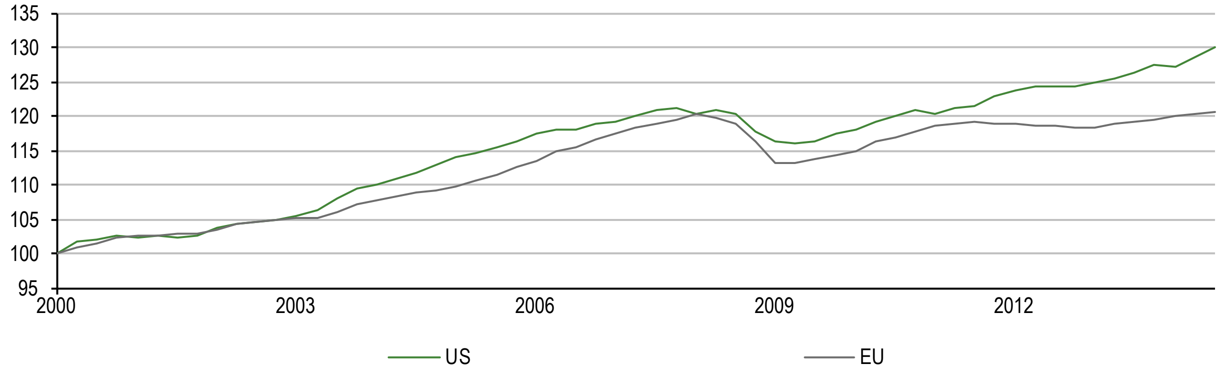
For individual consumers, in the medium term the incentives to store wealth in forms other than bank deposits can only increase if NIRP is pursued for anything other than a brief period of time. We believe the recent rise in the gold price is a direct result of the global shift lower in both short and medium-term interest rate expectations.

But from an economic perspective, central banks engaging in NIRP will need to explain how it will work to stimulate the economy given the negative implications for bank sector profitability and increased incentives for consumers to withdraw assets from the banking system. Yields curves may have flattened in anticipation of such policies, but equity investors at least have shown little appetite to price in any beneficial effect on growth.

Implications of Brexit

It seems obvious to us that the UK's membership of the European Union can only persist if it brings clear and durable benefits to both parties. However, to date it is not obvious the benefits have ever gone beyond those of a common market for goods and services. This has led perhaps to a large gap developing between outcomes and unrealistically high original expectations. The challenge for the EU in its present form is that while it may have succeeded in bringing an end to war between the continental European powers, it has failed to generate the promised economic benefits of closer integration. Aggregate GDP growth has lagged well behind the US for many years, Exhibit 6. If the EU had delivered a world-beating economic performance over the last decade we doubt electorates would question the loss of sovereignty and integration costs (notably immigration) associated with the project.

Exhibit 6: Economic divergence of the EU and US post-2008



Source: Thomson Reuters Datastream

Furthermore, relatively predictable failures within key initiatives such as the common currency have created another layer of problems which now threaten to throttle the whole project. The UK's electorate is not the only one with serious misgivings over EU membership. But unfortunately for europhiles, the UK's ruling Conservative party's long-standing split on Europe has led to a referendum at a very inconvenient time. The referendum will be taking place as the EU grapples with the aftermath of the recent eurozone sovereign debt crisis, in addition to a seasonal surge in migration.

Investors should, however, be careful to distinguish between what is in essence a political question and one which will have a genuine and long-term bearing on the investment landscape. In the short term, with polls effectively split with only a small majority in favour of remaining in the EU, the uncertainty may create a deferral of inward investment spending until the situation is clearer. For this reason, sterling may remain under pressure while referendum campaigning is underway.

However, we doubt that many firms would permanently defer any but the most marginal investment projects, even in the event of Brexit. It may be too simplistic a view, but China is not in the EU and that has not prevented European firms outsourcing manufacturing there. It is also by no means clear that London's financial services industry would suffer a Brexit impact as severe as some have suggested.

It would take many years for another regional financial centre to overcome the in-built network effects of the co-location of so many financial professionals in the City. If one of the key advantages of leaving Europe is freedom from the EU's labour laws and stifling regulation, it is also counter-intuitive to think that an exodus is an inevitability. The EU still needs financial services performed efficiently and competently. While a protectionist policy is always a possibility, where both sides benefit from trade this outcome is also by no means inevitable. In this context, the proposed merger between the LSE and Deutsche Boerse is a striking counterpoint to those who believe that investment in London's financial services infrastructure will suffer in the event of Brexit. A re-energising restructuring of the relationship between the remaining members of the EU and the UK to retain the benefits of trade is in our view much more likely.

We certainly are intrigued by what a successful Brexit would say about the European Union in its current form, if one of the most dynamic, culturally diverse and fast-growing members elects to leave. Once again, investors may have to balance the fear of the unknown with the possibility that change is the trigger which creates the scope for a positive re-appraisal of the shape of the European Union.

Brexit would also bring about significant political change in the UK, starting with the shape of the incumbent Conservative party and possibly lead to a renewed attempt for Scotland to break away (re-joining the EU in the process). However, it would also add significantly to the pressure from separatist movements elsewhere in the EU, such as in France and Spain. Without a significant shift from the EU in response to these developments, on balance Brexit could be the beginning of a larger process rather than the end.

Despite these potentially seismic political changes, the impact on the investment outlook is much more modest and it is difficult to draw firm conclusions at this stage. The process of withdrawing from Europe would extend over a number of years and the ideas incumbent politicians have in terms of alternative relationships are perhaps deliberately vague. We would highlight that in this context investment returns remain likely to be driven to a much larger extent by equity valuations, monetary policy and economic outcomes rather than political change.

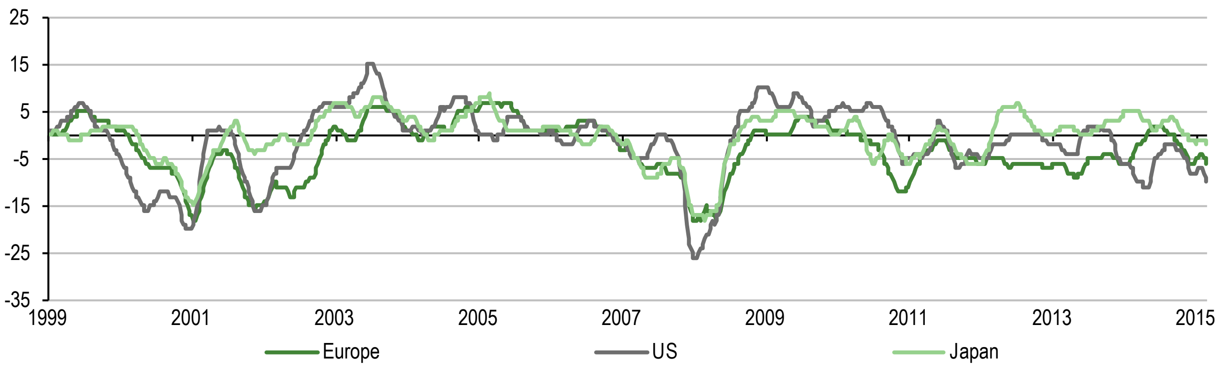
If, for example, the UK quit the EU we would certainly expect a period of greater uncertainty which would manifest itself in greater market volatility until markets gained a greater understanding of the likely terms of trade between the UK and the rest of Europe. On the other hand, it is also possible that investors would perceive the period of volatility as offering an incentive to politicians to better address the structural economic challenges in Europe and may therefore look through the volatility to a brighter future. A major market event either to the upside or downside is therefore by no means a certainty.

If the UK votes to remain in the EU the tension between sovereign states and the growing feeling that the EU is failing in its mission to deliver the increases in living standards that the region is capable of are not going to go away, in our view. As the EU's powers and influence have expanded, this 'shadow government' would also need at the least to accept that a commensurate level of democratic regulation is a necessary, though not sufficient, condition for its continued existence.

Earnings forecasts stabilising?

In addition to the recognition by US Fed policymakers in recent weeks that economic activity has not been as strong as first thought and may warrant a slower tightening of interest rates, we believe equity investors are also sensing that earnings estimates may have been revised sufficiently far to take into account current conditions. The last eight months of earnings downgrades have been as sweeping as anything seen outside the period leading up to the financial crisis of 2008, Exhibit 7.

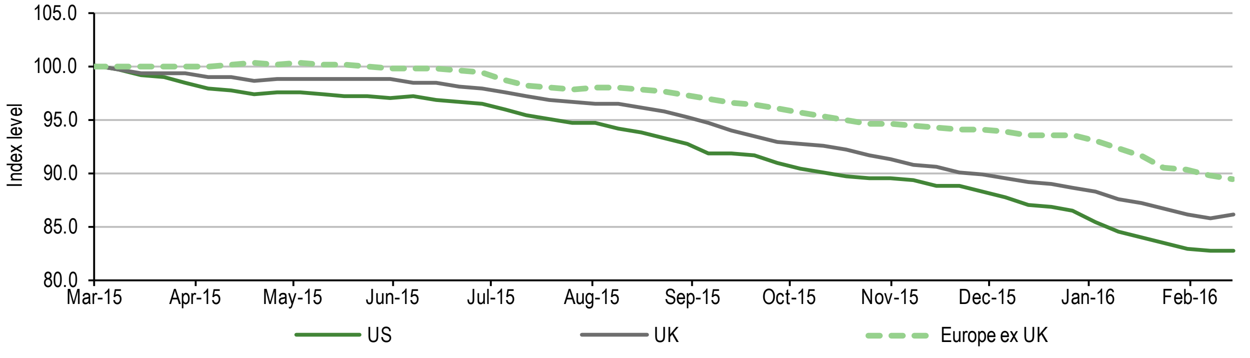
Exhibit 7: The 2015-16 downgrade cycle has been severe in a long-term context



Source: Thomson Reuters Datastream

However, we note that for the first time in a year, the month-on-month change in earnings estimates for the UK and US have not been negative, even if Europe ex-UK has been revised modestly lower, Exhibit 8. This welcome firming of earnings forecasts is at least an indication that forecasts have caught up with reality, though for us to have more confidence that this will be sustained, we would need to see evidence that the economic momentum has turned.

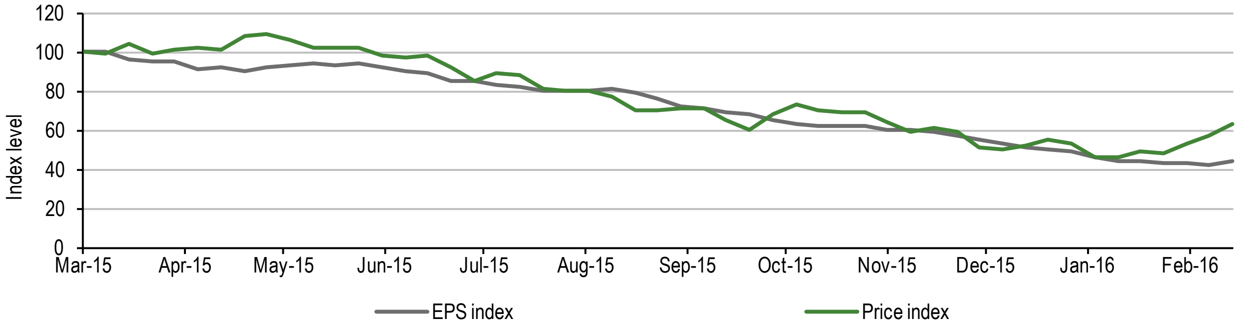
Exhibit 8: UK, Europe ex-UK and US 2016 EPS forecast revisions



Source: Thomson Reuters Datastream, Edison calculations

From a sector perspective, we would also highlight that UK mining sector estimates have ticked higher for the first time in a year, benefiting from a surprise recovery in iron ore prices, in addition to gold, Exhibit 9. With equity valuations for the sector at multi-decade lows, this modest uptick in commodity prices was all that was required to make the sector one of the best performers in 2016 year to date.

Exhibit 9: UK mining sector 2016 EPS index – first weekly uptick in revisions and prices

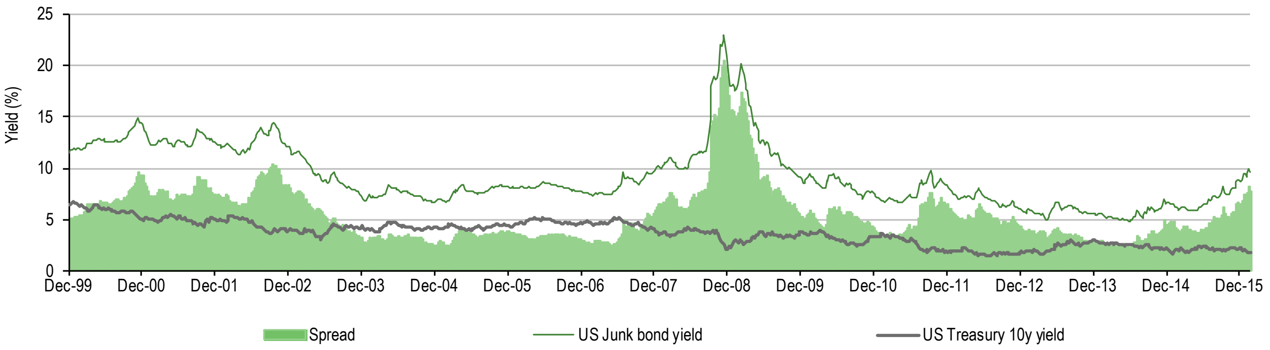


Source: Thomson Reuters Datastream, Edison calculations

High yield bonds discounting a recession

We have consistently argued in recent notes that despite the continued declines in equity markets, few opportunities have arisen as markets remain some way above long-run valuation averages. In our view this remains the case today; in the event of a recession, both earnings and valuation multiples would have some way to fall to reach levels seen in prior downturns.

Exhibit 10: US junk bond yields and spread to US government bonds



Source: Thomson Reuters Datastream

The situation is, however, different in credit markets. After years of trading at very tight spreads to similar duration government bonds, junk bonds are now trading at yields close to 10%, Exhibit 10. With a yield advantage over 8% above those available on government bonds, junk is now trading at a risk premium not seen since just before the 2008 financial crisis. It is remarkable how quickly sentiment has turned; yields have doubled from the record lows of 5% recorded in early 2014. Well-known problems in the energy sector may be partly responsible for the sell-off, but we would note this sector now only accounts for less than 10% of global high yield market indices.

As Exhibit 10 shows, should we in fact be on the cusp of a financial crisis yields, junk bonds could still rise much further as defaults and liquidity-driven selling increase. We would suggest that the probability of a slowdown or profits recession is relatively high over the next 12m, in which case prior experience suggests that defaults would rise but junk bonds would still offer returns well above risk-free rates. It is of course a very bold call to suggest that a calamitous deleveraging of the financial sector is around the corner; due to the infrequency of such events, confidence in such a prediction has to be exceptionally high. In our view, the evidence is not sufficiently strong at present.

In contrast to the high yield market, we would view equities at current valuations as relatively ill-prepared for even a modest slowdown from current levels. Certainly, for investors looking for equity-like returns of over 5% in the current environment, high yield is in our view the better hunting ground. But, even pure equity investors may wish to cast an eye over credit markets to at least understand why pricing has become so much more conservative in recent months.

Conclusion

Recent weeks have global markets bouncing off bad news as yield curves adjust to discount further delays in US monetary tightening and further monetary accommodation in Europe. As global policy interest rates threaten to move below zero, investors are correctly questioning the impact of NIRP on bank sector profitability; in our view it is by far the greater threat to the effectiveness of such a policy in comparison to the perceived problems with high value banknotes. In a negative interest rate environment, the relative attractions of gold have only increased.

Commentary which recognises the weakening of the US economic outlook by Fed policymakers has also eased upward pressure on the dollar. This has helped stabilise equities which have also benefited from what at the very least is a pause in the pace of EPS downgrades in the US and UK.

We also believe high yield credit spreads have widened to the point where investors should be looking for opportunities, in contrast to developed market equities where current valuations do not price in any further deterioration in the profits outlook.

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