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Illumination: Equity strategy and market outlook

March 2016

Published by Edison Investment Research

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Global perspectives: Pause for breath

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- **Volatility has declined as central banks have taken two key risks off the table.** First, the risk of the US Fed tightening policy aggressively into a slowing global economy has diminished, at least in the near term. This has eased pressure on the dollar, commodities and emerging markets. Second, the ECB has broadened its QE programme to include corporate bonds. Combined with additional measures to support bank financing this has led to a welcome and significant decline in bank and non-bank credit costs in Europe.
- **Still too early to call an upturn in corporate profits forecasts.** Although the rate of decline may have slowed, so far there is insufficient evidence of an upturn in corporate profits forecasts. In our view, this is key for any sustained move higher in equity markets from current levels.
- **We expect global equity markets to be range-bound during April.** The next incremental shift in US monetary policy is likely to be (modestly) hawkish, possibly coming as soon as June. In addition, the recovery in commodities such as oil and iron ore has been rapid and progress is likely to be slower from here. Similarly, the strong performance of the high yield market since our recommendation last month also points to a slower rate of return ahead.

Was there a "Plaza" accord after all?

Perhaps the biggest news for March was the FOMC statement which was much more dovish than the markets and we were expecting. Going into the meeting there was a reasonable case for preparing the markets for a rate increase in early summer, given declining US unemployment and increasing US core CPI, Exhibit 1. As it turned out, external factors – perhaps a euphemism for undesirable moves in global markets and the US dollar – were in contrast almost overplayed. For us, market turmoil was last month's story, so why bring it up now?

Exhibit 1: US unemployment and core CPI close to target

Source: Thomson Reuters Datastream

We would shy from asserting that actual behind-the-scenes coordination between the Fed, ECB and BOJ took place at the G20 meeting in February. However, central banks may be independent of government but they are clearly not, in a policy sense, independent of each other. Focusing only on domestic conditions in setting monetary policy could easily mean a suboptimal outcome for all, due to the tightly woven global economy and in particular the world's reliance on US dollar funding.

For example, we believe that investors earlier in the year were fearing a go-it-alone policy from the Fed. This would have widened the policy divergence between the Fed and ECB – and if the Fed pursued a hawkish path, the ECB would have been under pressure to pursue even more aggressive monetary stimulus, possibly including ever more negative interest rates (NIR). Such a scenario may well have created increased market volatility and in these circumstances where would NIRP end? Bank investors could be forgiven for getting a little nervous.

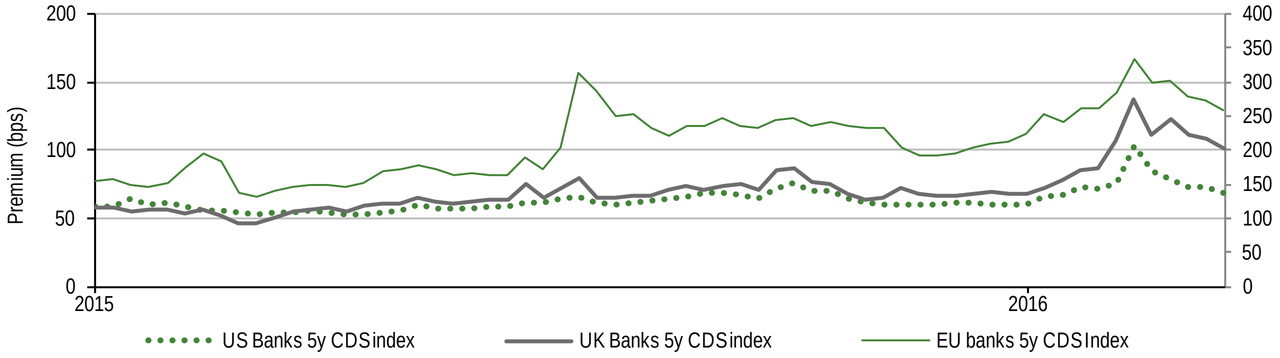
Now, central banks appear to be on the same page. The Fed is following market-implied rates lower, leading to reduced pressure on the dollar. To do so without losing credibility, the Fed has focused on external factors and risks.

In turn, ECB President Draghi has suggested that NIRP may have reached a near-term limit in terms of the ECB's current thinking. In Japan, the BOJ removed January's language that further rate cuts would be implemented as necessary from its March statement. The risk of a race-to-the-bottom has clearly diminished. For now at least, it would appear that small nations such as Denmark and Switzerland can play with significantly negative rates, but the big players have decided not to go any further down that road.

Markets have in our view missed something by remaining focused on moves in exchange rates as the indicator of the success, or otherwise, of monetary policy initiatives. We were much more concerned a month ago about spiralling CDS premia and the related sell-off in bank sector bonds cascading into a more significant drag on credit provision in Europe.

The ECB has significantly boosted confidence in the bank sector by providing additional funding facilities out to 2021 and as importantly, by adding corporate bonds to its QE package, Exhibit 2. The effect on the corporate bond market has been immediate with a surge of issuance in the week after the ECB's announcement, met by enthusiastic investor demand.

Exhibit 2: Europe bank CDS index falls post-ECB



Source: Thomson Reuters Datastream

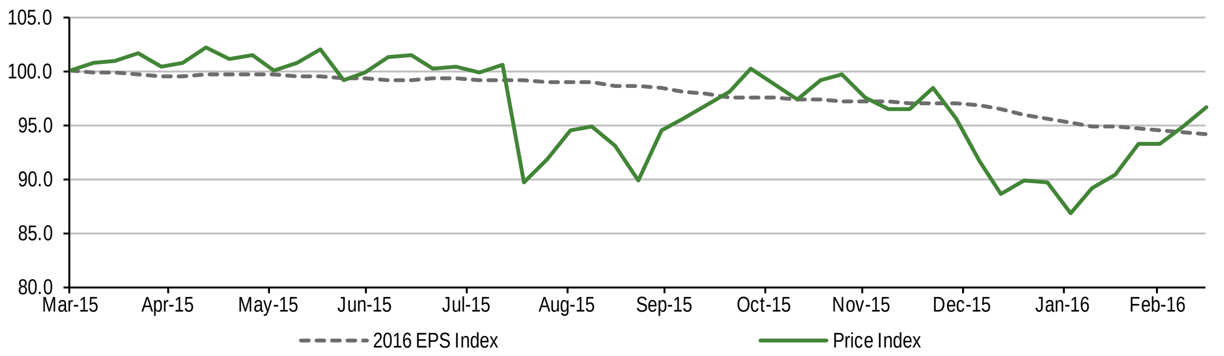
We believe the importance of the Fed's new dovish bias is that it has eased pressure on the dollar, to the benefit of emerging markets and commodities. In turn, the ECB's policy action has eased bank funding pressures and as a result, for the short-run at least we expect market volatility to remain lower.

Corporate profits – too early to call an upturn

While it can feel like every move in the markets is down to the nuances of monetary policy, for equities we believe the silent killer of performance over the last 12m has been the mundane – that is, very weak trends in corporate profits forecasts. For example, in western markets, forecast corporate revenue growth is now a fraction of what it was in previous cycles, having slowed to a crawl of 2-4% pa.

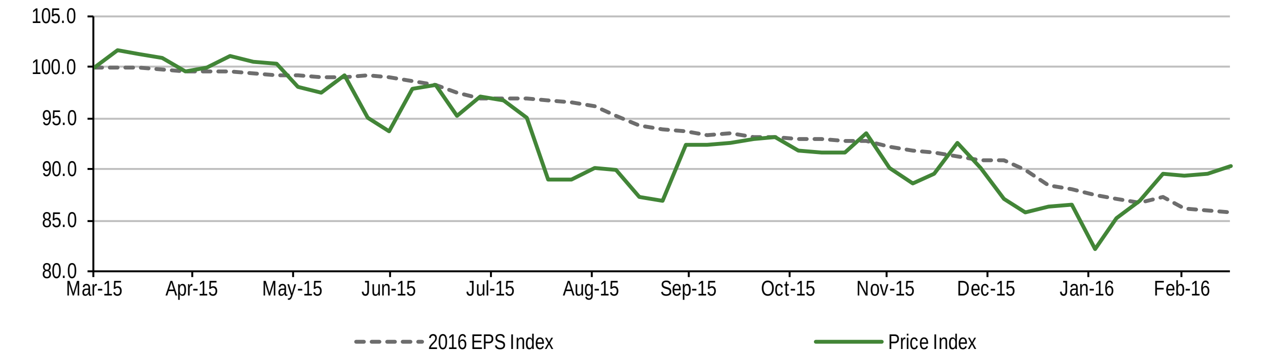
Given this lack of sales growth, trends in forecast EPS intuitively become proportionately more important in terms of the direction of markets on a three- to six-month time horizon and this is certainly backed up by the recent correlation data. While we could easily point to, for example, the end of US QE as the reason markets have failed to make any progress over the last 12 months, an even simpler narrative is that markets are following trends in forecast 2016 EPS, Exhibits 3-5.

Exhibit 3: US equities and 2016 EPS forecast index



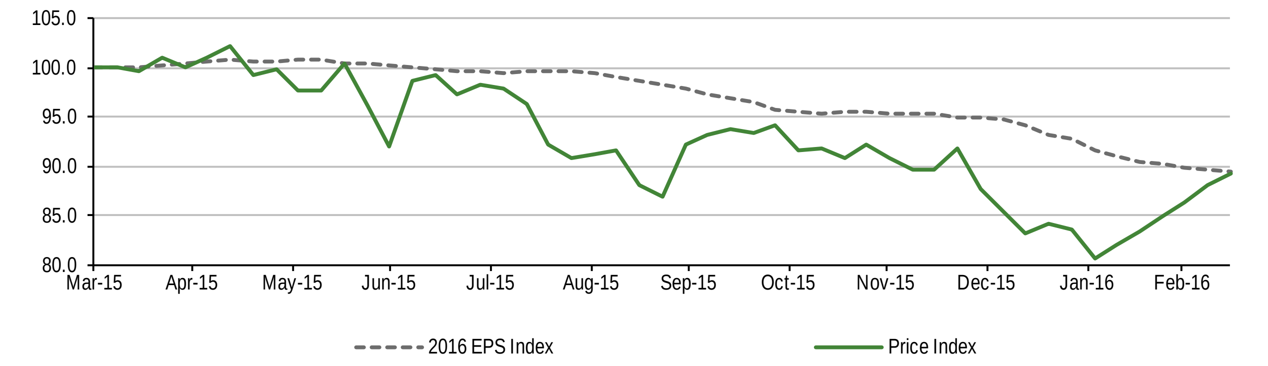
Source: Thomson Reuters Datastream

Exhibit 4: UK equities and 2016 EPS forecast index



Source: Thomson Reuters Datastream

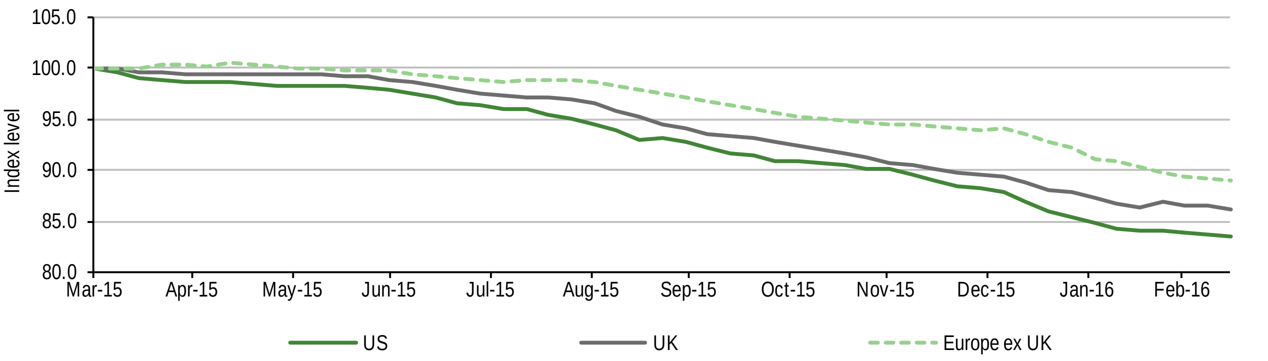
Exhibit 5: Europe ex-UK equities and 2016 EPS forecast index



Source: Thomson Reuters Datastream

The unweighted data shown in Exhibit 6 emphasises that although the rate of decline appears to have slowed, EPS forecasts still show few signs of entering an upturn, even in the US where there has been something of a surge in positive economic surprises recently. For investors taking heart from what in our view were important policy shifts from central banks, earnings trends remain the Achilles' heel of the equity investment case.

Exhibit 6: 2016 forecast EPS trends (unweighted)



Source: Thomson Reuters Datastream

Conclusion

A more dovish Fed has reduced upward pressure on the US dollar while the ECB’s broadened QE package has had an immediate positive effect on the worrying signs of stress in the European banks sector. These policy actions appeared aimed directly at two of the factors responsible for the recent market volatility.

However, while earnings forecasts for 2016 are not declining as fast as at the start of the year, we have still not seen the upturn or stability we think is necessary for investors to have confidence in forward multiples. Markets are likely to drift sideways during April in our view.

We discussed the oil and high yield market at some length last month and note the continued price gains during March. Corporate debt has benefited from the rebound in commodities and the ECB’s decision to purchase non-bank corporate bonds.

We view the flow of data during March as justifying current market levels rather than providing reasons for further gains; based on still-high valuations and the absence of evidence of a real upturn in earnings forecasts equity investors should stay cautiously positioned in our view. While April may be calmer, we believe volatility may pick up again in June if the Fed reverts to focus on US domestic conditions as markets stabilise.

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