Illumination: Equity strategy and market outlook

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Global perspectives: Beware of buy and hold

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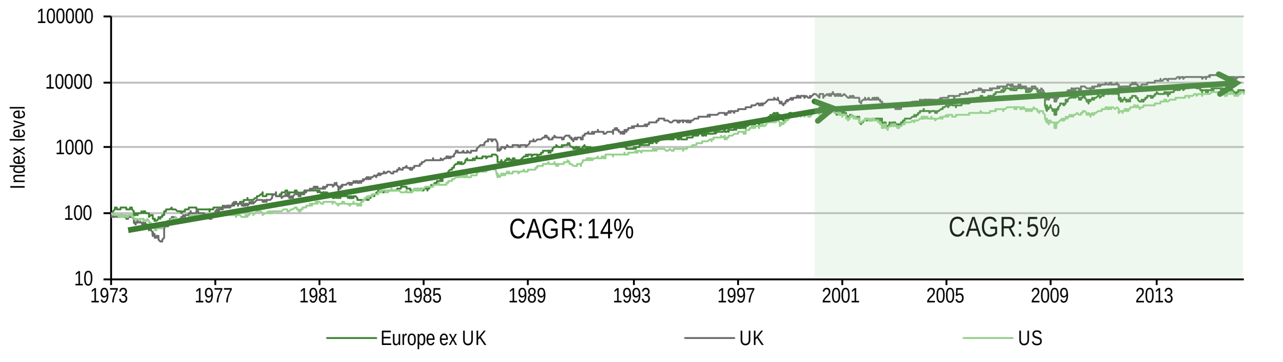
- **The combination of slow growth and high valuations points to a period of low returns for US, UK and European equities over the medium term**. The latter years of the 20th century appear to have been an exceptional period for equities where buy and hold or "time in the market" strategies fitted the then prevailing investment parameters. At present, the low expected return on equities offers no guarantee of outperformance over cash even over 10-year investment periods.
- **The release of the Fed's April meeting minutes has sharply increased the market-implied odds of a June US rate increase and reignited the dollar rally.** This rally has the potential to cause problems for risk assets, but in our view is likely to be self-limiting as Fed policymakers have demonstrated as recently as Q116 that they are attuned to the effects on the global economy of tighter US monetary policy.
- **Earnings momentum – absence of a negative is not a positive.** Earnings forecasts have stabilised but show little sign of upward momentum which we believe is a necessary condition for further sustained increases in market indices after the recent rally.
- **On balance, global equity markets have more reasons to disappoint than surprise to the upside.** High valuations and slow growth detract from the medium-term investment case, while in the short-run progress appears capped by the imminent prospect of one or more US rate increases. Within a cautious portfolio positioning, we note that niches of the property and corporate debt markets trade at levels which may offer returns similar to equities, but at a significantly lower level of risk.

Beware of buy and hold

The last few decades of the 20th century represented a golden era for equity investment with an average compound annual return, including dividends, of 14% pa in the period 1973-2000 for the US, UK and Europe. In this century to date, the annualised rate of return has fallen to 5%, Exhibit 1.

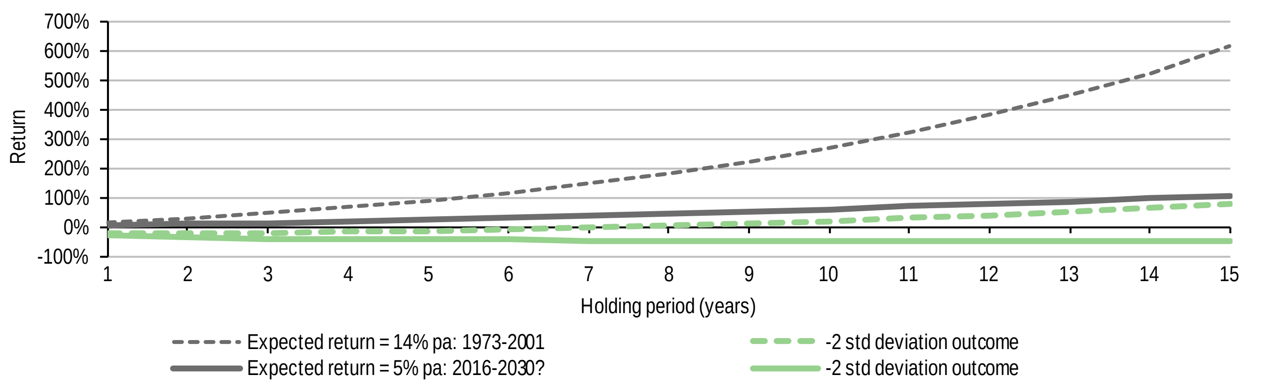
Exhibit 1: Total returns for major markets - buy and hold worked better up to year 2000



Source: Thomson Reuters Datastream

To a hesitant investor in the latter part of the 20th century, when dividend yields were 3-5% and corporate revenues were growing at 8-9% pa, the idea of "time in the market not timing the market" was backed by the statistics. A 14% expected return when combined with market volatility of 17% pa meant that the likelihood of losing money over any 10-year period became vanishingly small in theory. We show in Exhibit 2 below that under certain assumptions this would have been an event more than 2 standard deviations away from the mean expected return of 270% over a 10-year holding period. In practice, for the UK, there was only one period between 1965 and 2000 when this happened, which was during the bear market of the mid-1970s. Buy and hold, looking through the month-to-month variations in share prices, was otherwise sound advice for a generation of investors.

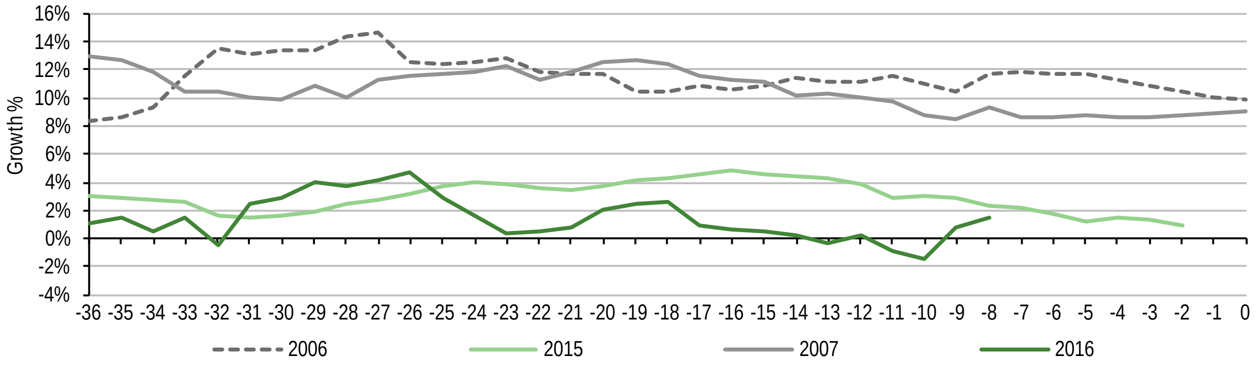
Exhibit 2: "Time in the market" sound advice for the 20th century – but maybe not the 21st



Source: Edison calculations. Note: Solid lines reflect 14% expected return, dashed lines 5% expected return.

Unfortunately, investing today is not nearly as simple. While investors may recoil from the sub-2% returns available on long-term government bonds and on the rebound may instinctively look to increase equity allocations, it is not, in our view, necessarily the right thing to do at this point in time. We continue to observe very high price/sales valuations in each of the US, UK and Europe and the evidence is building that we have entered a structurally lower growth environment for corporate revenues and profits, Exhibit 3.

Exhibit 3: Slowdown in forecast US sales growth in this cycle, compared to 2006/07



Source: Thomson Reuters Datastream. Data shows forecast sales growth *n* months prior to year end

The combination of high valuations and slow growth in corporate profits is pointing towards a much lower rate of return for equities over the medium term. In the past, the yield available on an equity portfolio of 3.5%, but more importantly the average dividend growth rate of 8%, mechanically led to the high expected and realised returns of the latter part of the 20th century. For comparison, if corporate revenues continue to grow at only 2-3% and are combined with dividend yields of 3%, expected returns could now be as low as 5-6% pa. In terms of yields, we would also highlight that in the UK at least, the market average yield is skewed to the large cap sectors which have recently been cutting dividends.

A return several times that of low-yielding bonds may still look superficially attractive, but only before proper account is taken of equity volatility. Equity markets over the long run have delivered annualised volatility in the region of 15% pa. When returns were in the double digits, this was of relatively little consequence to the long-term investor who was almost guaranteed a significantly positive return in almost all scenarios due to the effect of compounding.

However, in today's market with our expected return on equities close to 5-6% pa, the same maths shows that even over holding periods of 10 years there is a material probability of an absolute loss, (Exhibit 2) and a significant probability of underperforming the returns on risk-free government bonds. This is because this rate of return struggles to keep up with the increase in expected volatility over the holding period, even as volatility only increases with the square root of time.

There is unfortunately no easy answer to the pension trustee's or institutional manager's problem of delivering returns which satisfy benchmarks set in prior periods. The rate of return on risk-free bonds is very low and the risk/reward on equities appears unattractive. We would instead highlight niches of the market, which perhaps by definition are less liquid but offer returns only slightly lower than equities and at a significantly lower level of risk. At present for example, a combination of property investments, high yield bonds, senior loan and infrastructure debt will currently deliver a return similar to that on equities (ie 5-6%) with significantly lower volatility.

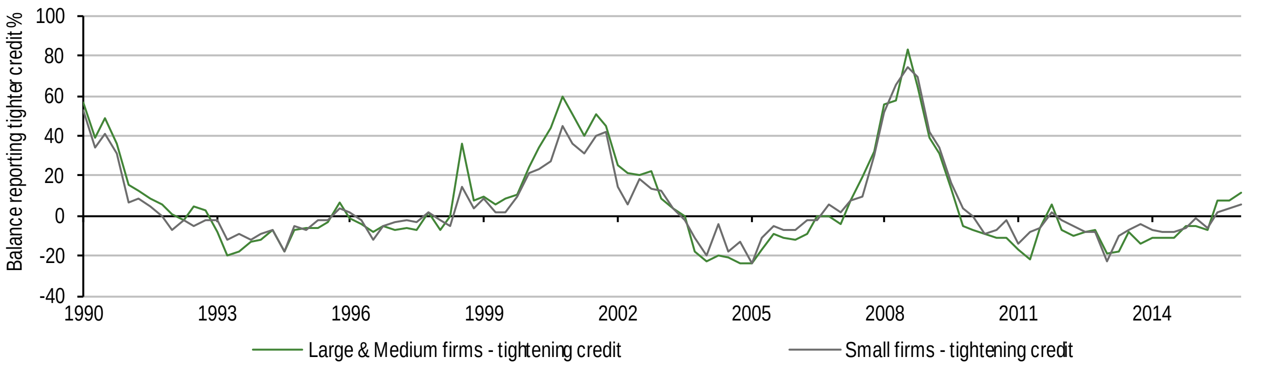
As a strategy, any rotation away from equities and into credit instruments would be a relative rather than absolute call; if there is a major recession ahead then both asset classes would obviously be expected to decline in value. However, credit would be expected to meaningfully outperform equity in that scenario. We believe the most likely scenario of sub-par but tolerable growth would be consistent with credit returns significantly above cash, while equities could easily underperform. It is only in the scenario where there is an unanticipated surge in corporate profits that equities are likely to outperform credit by a wide margin, which in our view remains a low-probability outcome given that non-financial profit margins are still well above average.

What is remarkable is that despite the slowdown in revenue growth and with valuations so extended, global markets seem completely focused on the US Federal Reserve's policy actions.

We can see numerous potential risks to the market and a dollar rally inspired by a newly hawkish Fed is just one.

For example, we see medium-term uncertainty in China's growth trajectory, of which the recent rapid credit expansion is a symptom. The risk of Brexit may be diminishing, but the democratic and legitimate rise of populist political movements is a natural response to the EU's failure to generate adequate GDP growth and may yet cause significant volatility. Recent survey and durable goods data indicate that a slowdown is underway in the US and we continue to watch bank surveys which indicate that US credit conditions continue to tighten, Exhibit 4. Perhaps in these circumstances it is not a surprise that M&A activity has slowed down significantly during 2016 and the statistics would have been much worse had Chinese corporates not been so active.

Exhibit 4: US credit tightening – US banks' senior loan officer survey (commercial loans)



Source: Thomson Reuters Datastream

In short, we see many risks and only a few positive triggers, by far the most important of which is that in any slowdown scenario there is a much higher probability compared to history that central banks will step into the equity market directly. We believe this continued perception of a central bank 'put' is responsible for holding markets up at levels which offer such low returns and to a degree explains the sensitivity of markets to the direction of monetary policy.

The expectation that investment strategy is about making all the right calls all of the time is at odds with the reality of the marketplace. There are times, such as now, when it is hard to discern which way the dice will roll. We cannot be sure for example that the next faltering of economic activity will lead to a further intervention by central banks into (equity) markets, or whether the Fed is about to finally call time on a strategy of ever easier policy. In our view, this is the time to follow a strategy of owning diversified and robust, rather than optimised, portfolios which can achieve an acceptable return in many scenarios and sufficient preservation of capital in all.

US Fed minutes 'surprise'

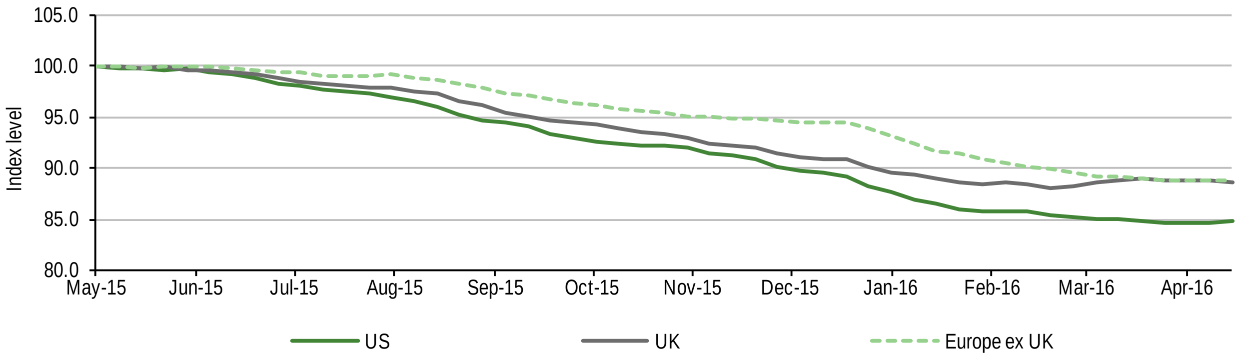
Although it spooked the markets for several days last week, it was no surprise to us that Fed policymakers were keen to push up abnormally low market expectations for a June rate increase. We believe the market had underestimated the Fed's focus on financial conditions (ie risk premia in global markets) as the reason to defer a rate increase earlier in the year. Consequently, market participants had failed to acknowledge that an easing of financial conditions would put a June rate increase immediately back on the agenda with both US unemployment and core inflation close to target.

However, in our view the Fed remains constrained by the likely impact of rate increases on the value of the US dollar and global financial conditions. Therefore, any tightening of policy will be conditional on stability in global markets. We have many reasons to run a cautious portfolio positioning, but the possibility of a Fed raising rates without regard to the global consequences is not actually so high on the list; the deferral of rate increases as recently as Q116 shows how attuned current policymakers are to this particular second-order effect.

Earnings momentum – absence of a negative is not a positive

Profits forecasts for the US, UK and eurozone have been stable for the past 2 months. In the context of last year's relatively dramatic declines in profits expectations (the worst year in a decade), we view this as a welcome development for equity investors, Exhibit 5.

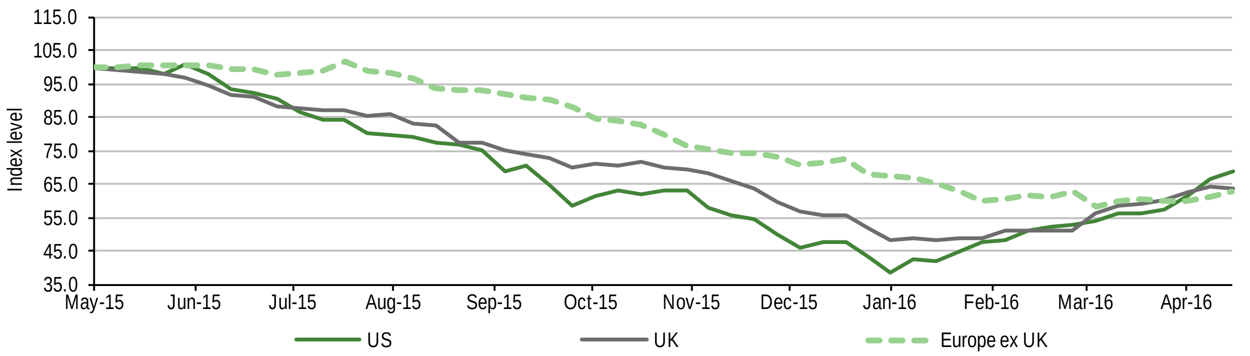
Exhibit 5: 2016 forecast EPS index for the US, UK and Europe ex UK



Source: Thomson Reuters Datastream, Edison calculations

However, following the 12% rally in these markets since February we believe the absence of a negative is no longer a positive; at this point we need to see positive earnings momentum for markets to make a sustained move higher. The lack of positive earnings momentum remains a key behind-the-scenes factor in the stuttering of global markets during April and May, in our view.

Exhibit 6: 2016 forecast EPS for mining sector



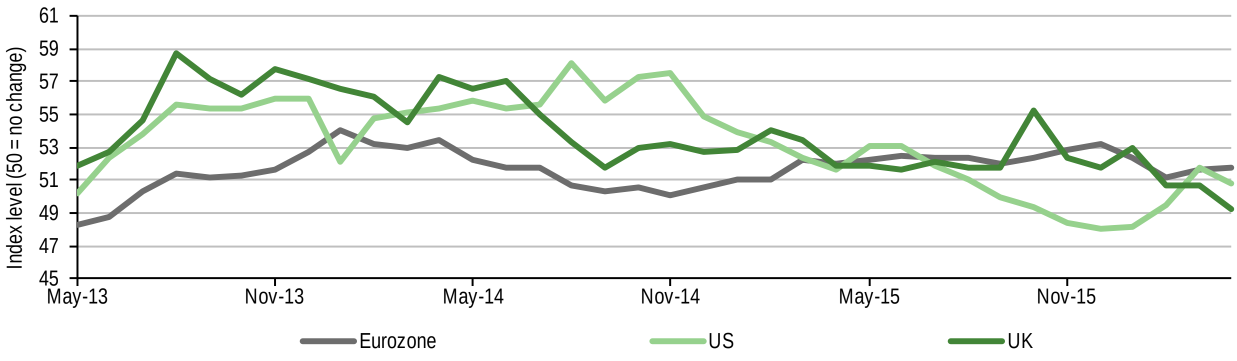
Source: Thomson Reuters Datastream, Edison calculations

From a sector perspective, Exhibit 6 shows that the mining sector continues to benefit from upgrades as a result of the surprise turn in commodity prices since February 2016. These increases are now largely in the rear view mirror, especially as China clamps down on commodity price speculation. Although the global mining sector continues to trade at very modest price/book multiples relative to its long-run average, the sharp relief rally looks to have run its course, as forecasts have now caught up with the change in commodity prices.

For oil-related industries, the oil price rally since February has brought the oil price much closer to the marginal cost of US shale. Therefore, as another upward move would seem inconsistent with Saudi Arabia's policy of maintaining market share, oil prices and earnings expectations seem unlikely to rise significantly above current levels and we would be cautious about chasing performance in this sector.

More generally, the majority of sectors in each of the US, UK and eurozone have seen relatively few earnings revisions over the past month. On balance, we believe the next revisions are more likely to be modest downgrades as manufacturing PMI indices in the US and the UK indicate that economic activity has been decelerating recently, even if the eurozone has been performing relatively better since the ECB's expansion of its QE programme, Exhibit 7.

Exhibit 7: Manufacturing PMI Indices



Source: Thomson Reuters Datastream

The lack of an investment theme based on earnings momentum leaves investors sitting on an uncomfortable combination of relatively high valuations and very modest sales and profits growth forecasts. Adding to the fear factor is the prospect of a US interest rate increase in June. While investors have on a number of occasions appeared rescued by a US Fed hyper-sensitive to financial market volatility, there is in our view nowhere near enough stress in global financial markets at present to justify another deferral for that reason alone.

Conclusion

The combination of high valuations and slow revenue and profits growth implies low expected returns on equities over the medium term. In our view, investors should consider taking the opportunity presented by the recovery in equity markets to diversify by reducing equity exposure and allocating capital to segments of the property and credit markets which currently offer similar levels of return but at significantly less risk.

The US Fed has triggered a re-appraisal of the potential for a US rate increase in June or July. However, this had been our base case and therefore does not change our view that markets are likely to struggle to make progress until there is a broad-based upward trend in earnings revisions, which has been absent to date.

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