



Illumination: Equity strategy and market outlook

July 2016

Global perspectives: Look beyond Brexit

- **The worst fears over Brexit have failed to materialise.** We are not currently looking at a self-reinforcing cycle of declining UK markets, expectations and investment nor systemic implications for the rest of the world. Markets have been remarkably resilient, a testament to the faith currently held in central banks' ability to manage asset prices.
- **Very negative UK survey data cannot be entirely dismissed.** Close attention should be paid to the evolution of these data series over the summer. The level of uncertainty remains high in terms of the outlook for the UK even if the global impact of Brexit appears limited so far.
- **The Bank of England is likely to match market expectations for a rate cut in August, but at this stage is unlikely to exceed them in our view.** The US Fed is however once again becoming more focused on improving US jobs data and activity. Tighter US monetary policy and its resulting impact on market sentiment, commodities and emerging markets is something that could be much higher on the agenda by September.
- **Following the rebound in market prices, median UK equity valuations remain expensive in aggregate and growth prospects for sales and profits remain weak.** We believe investors' portfolios should therefore remain cautiously positioned.

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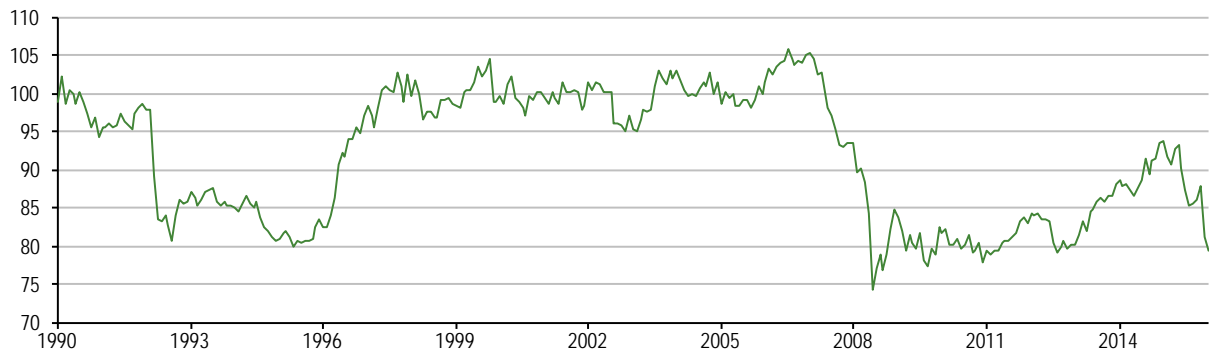
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Look beyond Brexit

The risk that Brexit could trigger a major global economic or market dislocation seems to have passed. The question is therefore no longer about some huge potential global shock, but instead quantifying the negative economic impact on the UK economy between light and moderate - and assessing just how much offsetting monetary or fiscal stimulus can be applied in the circumstances.

Exhibit 1: No rebound in trade-weighted sterling post-referendum



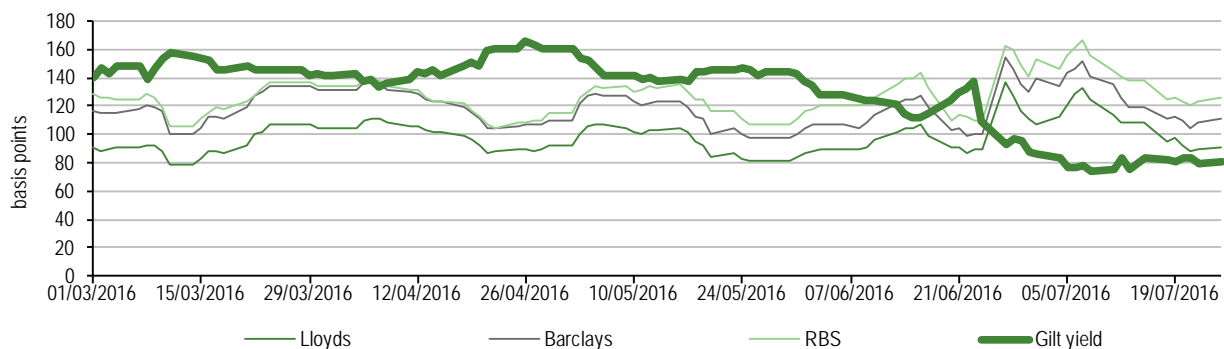
Source: Thomson Reuters Datastream

Clearly, sterling has fallen sharply and in effect borne the brunt of the adjustment following the UK's vote to leave the EU, Exhibit 1. Brexit may have been the trigger but the sterling exchange rate was in any case looking increasingly vulnerable, due to a current account deficit which had widened to as much as 7% of GDP recently.

This FX adjustment has clearly 'stuck', with little rebound in the weeks following the referendum. The Bank of England has shown no willingness to intervene at least to date; from the absence of action we believe policymakers believe the fall is appropriate, in the circumstances.

There is however a big difference between a fall in the exchange rate and outright capital flight. Capital flight is associated with a withdrawal of deposits from the banking system and declines in the price (or equivalently an increase in the yield) of assets such as government bonds. Neither of these possibilities have happened and in our view would be unlikely to occur now.

Exhibit 2: No sign of capital flight – bank sector credit risk stable and gilt yields declining



Source: Thomson Reuters Datastream

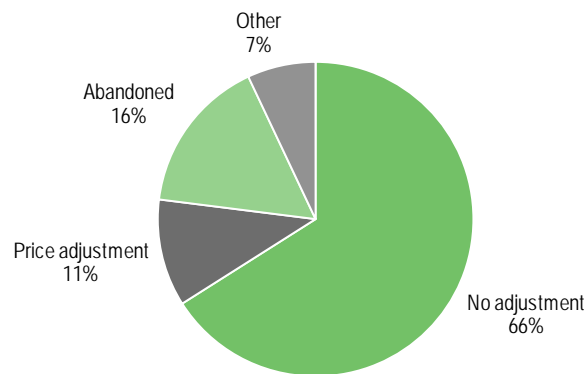
In fact, gilt yields were falling leading up to the vote and declined significantly afterwards. The earlier move lower was due to global factors – the perception that the US Fed was going to be on hold – and later the not unreasonable belief that the Bank of England will apply significant monetary stimulus over the summer.

UK commercial property market - weaker but orderly

However, even if there are few signs of capital flight, this is not to say all asset classes have escaped without any Brexit impact; it is clear with the gating of £25bn of property funds that at least some retail investors or their advisors have panicked out of this asset class.

To date, the market does not however appear to have completely seized up; at least one fund has been able to dispose of a central London property at short notice, at a discount of 15% to previous valuations. There have also been other property purchases post-referendum with no adjustment to the price terms agreed before the vote.

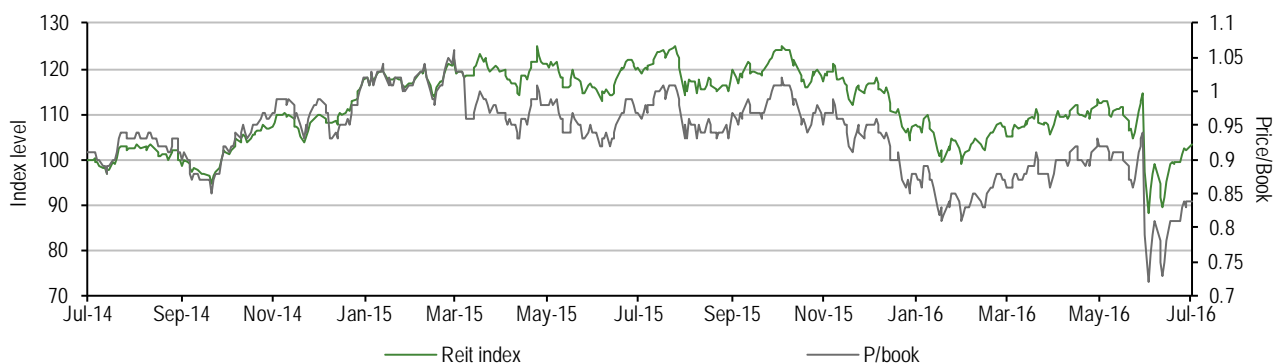
Exhibit 3: UK property transactions post-Brexit



Source: Cushman & Wakefield

Recent data from the UK commercial property industry shows that 66% of property deals agreed before the vote have proceeded without adjustment to their terms and a further 11% proceeded following a price renegotiation. Of these deals, 16% have been abandoned as vendors refused to accept price reductions, which were in the region of 10%. Prices are clearly softening and buyers are choosing to walk away more often (the normal abandonment rate is 5-10%), but it is too early to describe the situation as catastrophic. Furthermore, in terms of listed REITs, the sector has recovered more than 50% of the post-Brexit losses as we show in Exhibit 4.

Exhibit 4: UK REIT sector posts strong recovery post-referendum



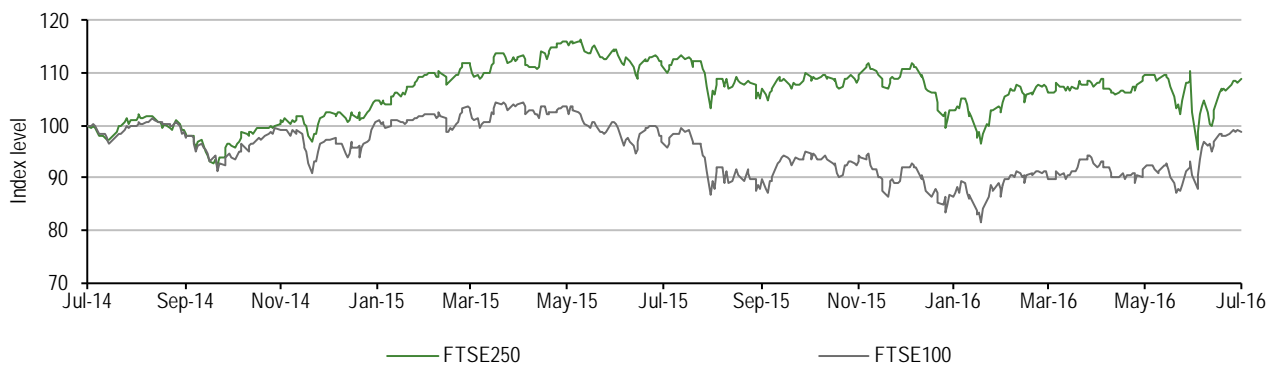
Source: Thomson Reuters Datastream

For commercial property, or for that matter upper segments of London's property market, the pattern is similar; prices had been on an upward trajectory and yields had declined to exceptionally low levels until the market stalled a year ago. Markets often adjust abruptly when over-extended on a valuation basis once they have lost upward momentum. We believe a modest correction in commercial property prices is however very unlikely to represent a systemic risk with large spill-overs to the banking system.

Separately, in terms of inward corporate investment, it is again still early days but we would also argue that Softbank's recent offer for ARM – or for that matter the recent bid for Premier Farnell – demonstrates that for the right UK corporate assets, international investors are continuing to see little problem investing in the UK, for businesses with global exposure at least.

Remarkable resilience of UK equities during July

Exhibit 5: FTSE100 and FTSE250 post-referendum performance



Source: Thomson Reuters Datastream

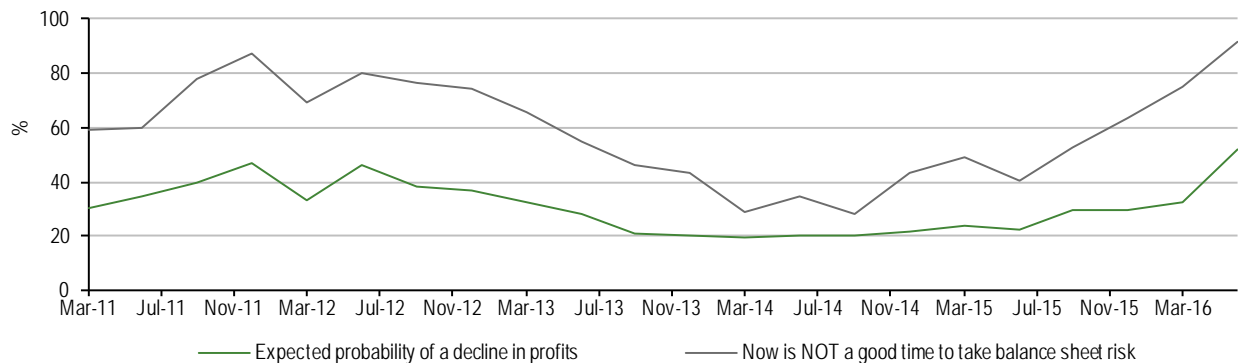
Turning to the performance of the UK equity market post-referendum, the FTSE100 is now trading at its highest level for the year, even if the performance is weaker in dollar terms. Although some of this strong performance may have in part been due to bearish investor positioning ahead of the vote, this is a reminder that the UK's FTSE100 is dominated by some of the world's largest businesses.

The post-referendum rebound in the mid-cap FTSE250 has also confounded those who thought that the UK's domestic economy would be hit hard by the aftershocks of Brexit and lead to severe downgrades in profits. In our view, on this point we believe the jury is still out.

Early UK survey data is very weak

While UK markets have performed strongly following the vote, we must also highlight that survey data is much more gloomy than the rebound in equity market prices would seem to imply. For example, the UK's Flash PMI for July was released last week, based on survey responses between the 12 and 21 of July. This was after the referendum, the rebound in markets and the appointment of a new UK prime minister. The data show a substantial acceleration in the rate of decline to 47.7, indicating a contraction in Q3 GDP in the region of 0.5%.

This was one of the sharpest contractions since 2009, with services impacted more than manufacturing. The decline in the UK's services expectations index was in fact the sharpest on record. So, while markets may be relaxed, confidence amongst executives is weak. In terms of business investment we would also highlight the Deloitte CFO survey conducted post-referendum, which indicates that only 8% of the survey panel believe that now is a good time to add balance sheet risk – the lowest since 2008, Exhibit 6. Capital expenditures are also now expected to fall and 63% of CFOs believe revenues will shrink over the next 12 months compared to 11% in Q1.

Exhibit 6: Deloitte UK CFO survey – now is not a good time to take risk


Source: Deloitte, Edison calculations

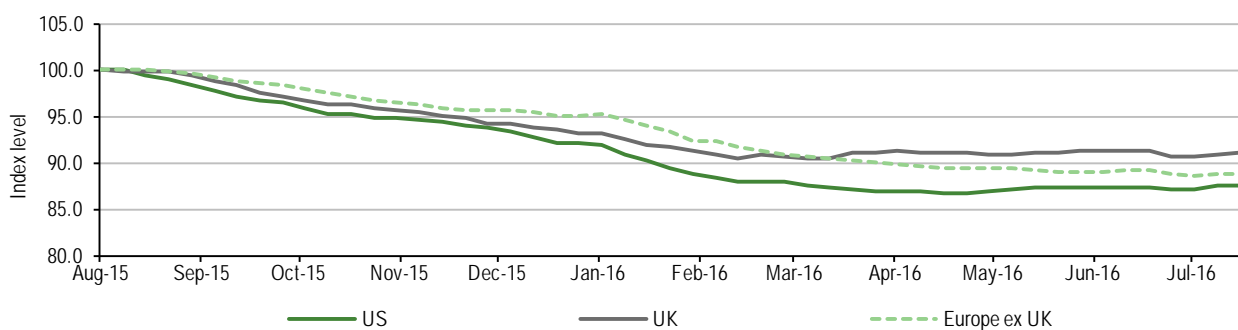
Furthermore, a post-referendum survey of residential house price expectations has also declined sharply, which is consistent with declines in the RICS survey of new buyer enquiries.

We are aware that in the case of a politically charged economic question such as Brexit, there is a higher than usual risk of placing undue emphasis on personal beliefs over the actual data and as a result in the circumstances recent survey data may be misleading. On the other hand, the UK survey data are pointing in one direction; we would suggest that as uncertainty is high incoming data should be watched more carefully than usual for a possible rebound in coming weeks, especially as the question of the UK's prime minister and cabinet have only recently been resolved.

Within the PMI data there is however only limited evidence so far of spill-over effects in Europe and the US. The most recent US manufacturing PMI data show evidence of a significant rebound in confidence with a sharp uptick in output growth, new business volumes and manufacturing payrolls. Similarly, in Europe, while the most recent PMI data have softened fractionally, there have been no sharp changes in the most recent data points.

UK earnings forecasts stable with domestic-led downgrades

Early indications are that 2016 UK consensus earnings forecasts have remained stable, a continuation of the trend seen since February and this is also the case in the US and continental Europe.

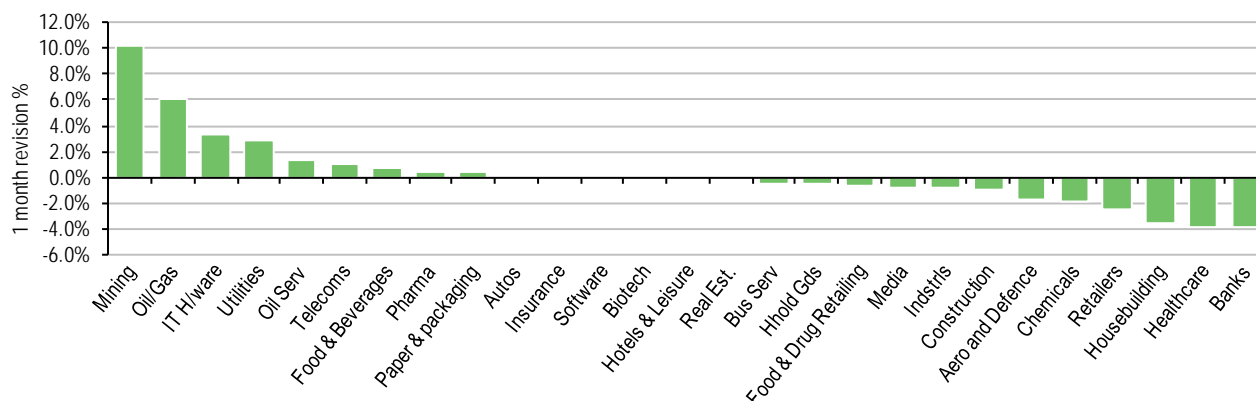
Exhibit 7: US, Europe ex-UK and UK 2016 earnings forecasts revisions


Source: Thomson Reuters Datastream, Edison calculations

The sector breakdown confirms the direction of earnings forecasts is as widely anticipated – larger international companies have seen a positive benefit from sterling depreciation, offsetting downgrades in smaller or domestically focused sectors.

The most important message from the changes in consensus profits forecasts is that any downgrades are relatively modest, at least to date; UK banks have suffered the sharpest sector downgrade but this was only 4%.

Exhibit 8: UK 2016 earnings revisions by sector



Source: Thomson Reuters Datastream, Edison calculations

On the positive side, mining and energy have shown the strongest upward momentum. We would therefore suggest that this is a very 'normal' set of earnings revisions, in contrast to the sharp swings in PMI indices.

Furthermore, recent trading statements, with a few high profile exceptions such as Foxtons and Easyjet, have tended to caution that it is too early to quantify the impact of Brexit. In our view, if a sudden stop had been observed in current trading, we think the incentive would be to disclose something easily attributed to external factors and we take some comfort from the absence of a large number of negative reports.

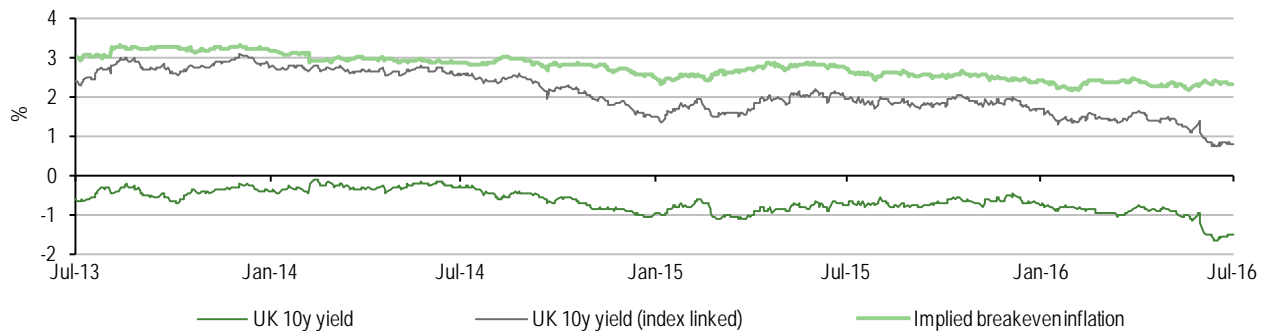
If this data is not followed by further downgrades during the summer, the 50bp reduction in long-term UK interest rates over the past six weeks would more than offset these modest reductions in earnings prospects, which may partially explain the much better than expected short-term performance of the FTSE250.

UK rate cut priced into equities and interest rate markets

It is therefore possible that UK equities are pricing in a modest reduction in growth prospects and looser monetary policy. The risk is that the Bank of England takes too much comfort from the lack of market distress and fails to follow through with the promised stimulus; a low probability scenario perhaps – but at current equity valuations we would caution investors are taking further stimulus as an article of faith.

At the next Bank of England monetary policy committee meeting in early August the combination of the recent survey data and downgrades to UK GDP forecasts – in addition to the recent comments from Mark Carney and other policymakers – make it highly likely that monetary policy will be eased.

A cut to interest rates of 25bp has already been priced into interest rate markets since the referendum; what will be of great interest will be the willingness – or lack of willingness – to reintroduce some form of asset purchases to support growth. And to this end we will be watching closely for any clues on where the MPC believes the lower bound on interest rates may lie.

Exhibit 9: UK market-implied inflation expectations unchanged – sterling decline offsets slowdown


Source: Thomson Reuters Datastream

In addition, we note that market-implied inflation expectations have actually risen a fraction since the referendum as slower growth is offset by the decline in sterling; there is perhaps less room for manoeuvre than might be thought at first sight. Therefore, we expect the Bank to match or at the very best slightly exceed market expectations but those looking for a positive surprise for equities may be disappointed.

Focus likely to return to US interest rate policy

Before Brexit, the investment community was much more focused on the direction of US Fed policy and we believe this will once again be the primary focus by September. The July FOMC announcement highlighted the renewed vigour in the economy seen in the survey data and the improvement in US jobs data, which is making the disappointing May non-farm payrolls report look like a one-off.

In contrast to the UK where bond yields have moved lower and stayed lower, US 10-year yields have been on an upward path during July as interest rate expectations have risen, as indicated by the yield on the two-year note.

The recent strength of markets is less surprising if the UK's referendum can be put to one side for a moment. Markets had been prepared by the Fed to expect interest rate increases which were then deferred until after the summer. This modest easing of financial conditions has been beneficial to both commodities and emerging markets. We can see with the rising probability of a US rate increase this particular market mini-cycle may be close to completion.

UK makes swift political process

Returning to the UK, last month we highlighted the significant uncertainty related to the UK's political leadership and the timing of any Article 50 notification. In respect of the former, there is now no doubt – the new Prime Minister Theresa May has been clear that she will lead the country out of the EU. The expected leadership contest due in September was cancelled due to the overwhelming support for May. PM May has moved quickly to stabilise the situation with respect to the EU and meetings with other EU leaders have progressed smoothly and the rhetoric has calmed. There is now recognition that it is for the UK to decide when to trigger Article 50 and that a period of time will be required in order to establish the UK's negotiating position. We continue to believe this process will be rational as both the EU and UK can ill-afford a sub-optimal relationship.

It cannot be a surprise the red lines for each side remain access to the single market and free movement of labour; on the latter point we would at this stage highlight that the EU clearly has a politically charged immigration problem and over the next several years it is not inconceivable the

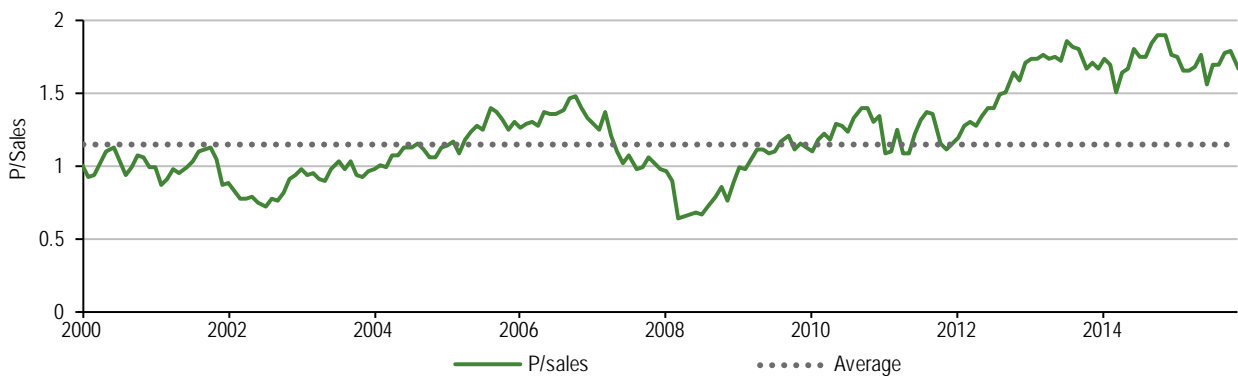
EU could even move closer towards the UK's position on population control across the region, which would significantly narrow the differences between the two sides.

Uncertainty no longer priced into equity markets

Having covered the evidence of a slowdown in the UK's domestic economy but the relatively modest knock-on effects in respect of the rest of the world, it is time to look at what is priced into equities. This is where numbers become a little discouraging, especially for UK pension fund managers no longer able to achieve even 1% returns on UK government bonds.

Following the recent run in equities over the past month, in our view UK markets look expensive and certainly do not price in some of the more pessimistic views expressed by the participants in post-Brexit surveys.

Exhibit 10: Median price/sales for UK equities back in peak territory



Source: Thomson Reuters Datastream, Edison calculations

Median price/sales ratios across the US, UK and continental Europe remain well above historical averages. We can understand that with bond yields low investors are searching for yield and the first reaction is to chase dividends as bond yields fall. There may be even be some justification for this if real yields are temporarily depressed by central banks to stimulate economic growth. However, we believe investors are still failing to acknowledge the much lower prospects for revenue and profits growth in this cycle, with forecasts still running at one-half of those seen in prior cycles.

Valuation multiples may be extended but this is not the primary reason for our concern – it is that investors are having 'sticky' expectations for too-high growth and are in effect prepared to compartmentalise, rather than reconcile, the very different growth expectations built into equity and bond market pricing.

In that context, we believe following the recovery over the last six weeks that markets have another period of trading water ahead. The combination of high valuations and low profits growth is only conducive to subdued equity market performance at best in our view; global equity indices are no higher than in 2013 in dollar terms.

We believe the Bank of England will provide sufficient monetary easing to match current market expectations while the ECB may have reason to continue with current policies and the US Fed may as soon as this week start to push expectations for a rate increase higher.

Conclusions

The worst fears over Brexit have failed to materialise and we clearly are not currently looking at a self-reinforcing cycle of declining UK markets, expectations and investment nor systemic implications for the rest of the world. Markets have been resilient – even remarkably resilient – which is a testament to the faith currently held in central banks' ability to manage asset prices.

However, we believe the very negative survey data cannot be entirely dismissed and close attention should be paid to the evolution of these data series over the summer. The level of uncertainty remains high in terms of the outlook for the UK even if the global impact of Brexit appears limited to date.

In terms of monetary policy, we believe the Bank of England will match market expectations but at this stage is unlikely to exceed them. The US Fed is however once again becoming more focused on the recent improvement in the US jobs market and activity. Tighter US monetary policy and its resulting impact on market sentiment, commodities and emerging markets is something that could be high on the agenda by September.

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