Illumination: Equity strategy and market outlook

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Global perspectives: Long-term questions

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- **Are we allowed to talk about global equity market valuations?** The recent recovery in developed markets places equity valuations back at fully extended territory, with a number of median valuation metrics at similar levels to those seen at previous market peaks.
- **Earnings estimates – reassuringly stable for now**. Recent trends in consensus earnings forecasts highlight analysts' confidence in corporate performance for 2016, even as GDP forecasts continue to decline. There also remains no observable impact on aggregate UK earnings forecasts from Brexit to date. In the UK, recent actual economic data has proved much more encouraging than survey responses.
- **Bank of England's reintroduction of QE well received by markets.** This was in our view less to do with the prompt re-introduction of QE and more closely linked to the clarification that negative interest policy (NIRP) has, for now at least, been ruled out as a policy tool. However, the current lack of supply in the gilt market highlights the need for a fiscal policy response later in 2016.
- **Over the last six months, markets have been driven higher by easier than expected monetary policy in the US and UK.** In the UK at least the anticipated economic slowdown has so far failed to materialise, leading to a short-term win-win for equity investors. Therefore, despite very high valuations, with global earnings estimates being revised upwards equity markets are likely to remain well supported. However, looking towards 2017 and as central banks question the benefits of negative interest rates and the focus turns to fiscal policy, we believe investors may wish to start taking take profits in government bonds. Having enjoyed the relief rally, we also believe equity investors should maintain discipline and look to take profits on positions in overvalued sectors, which may represent bond proxies.

Equity valuations – party like it's 1999... and 2007

Amidst something approaching a euphoric relief rally in global markets following the UK's vote to leave the EU, investors should not overlook valuation metrics, which have historically provided an excellent guide to returns over the long term. As Exhibit 1 shows, relatively low valuations preceded the bull markets in 1994-1999, 2002-2007 and 2009-2013 but valuations rarely form part of a market narrative.

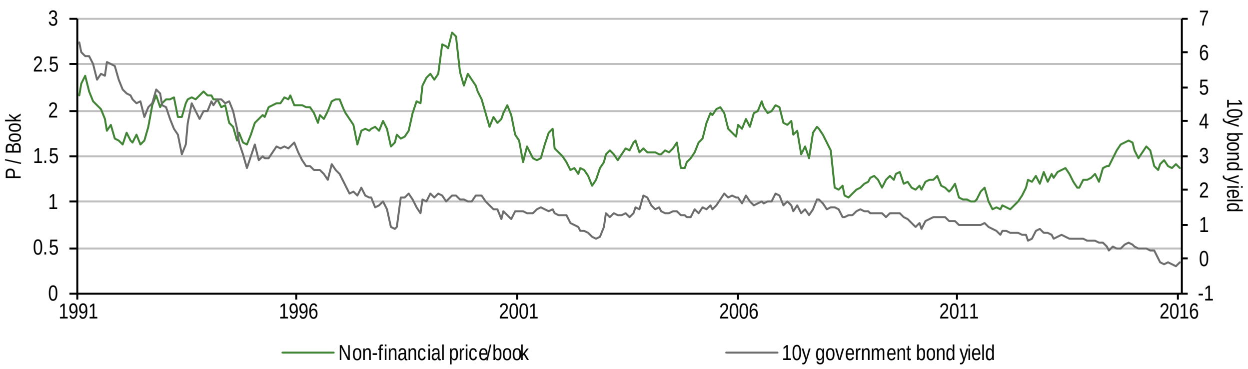
Exhibit 1: Price/book valuations have correlated with three equity cycles since 1990s

Source: Thomson Reuters Datastream, Edison calculations

Instead, the tendency amongst investors appears to be to "rationalise" the valuation data with whatever the current market narrative may be. In a rather clear example of behavioural finance the day-to-day information perhaps relevant for the short-term seems to take precedence over longer-term signals. In the 1990s, globalisation and technology narratives were offered a reason to ignore quite obvious signs of trouble ahead in equities. The reverse applied in 2002-2004 when the resulting stock market correction was mistaken for a long period of economic malaise.

At present the current consensus narrative is that as interest rates and bond yields are very low, equity valuations "should" be high as investors are forced to go out on the risk curve to secure yield. This argument may appear logical on the surface but in our view is mistaken both empirically and theoretically. Empirically, we can see that in Japan until 2014 (when the Central Bank started actively targeting equities under its QE programme) lower government bond yields were associated with lower price/book valuations.

Exhibit 2: Japan – declining fixed income yields not always associated with rising valuations



Source: Thomson Reuters Datastream, Edison calculations

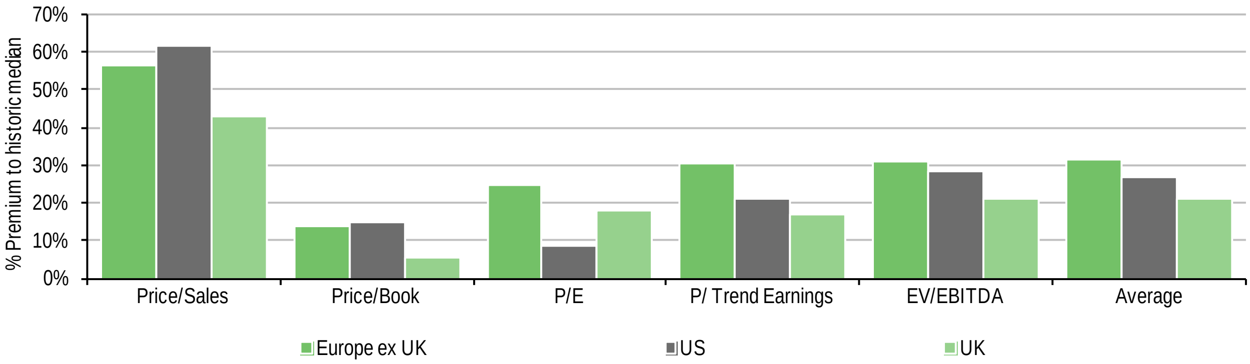
Theoretically, the link between the bond yields and equities also appears moot. The market dividend yield should in theory represent the difference between the sum of the equity risk premium and nominal risk-free bond yield, less nominal dividend growth. Declines in bond yields due to falling inflation expectations should be offset by declines in nominal dividend growth, leading to no change in the dividend yield on equities. Similarly, declines in bond yields, which represent a fall in expected real economic growth, would logically lead to the same fall in expected dividend growth and no change in equity valuations.

In a period of financial repression, real returns on bonds may be artificially suppressed for a time by central banks wishing to stimulate the economy by providing a subsidy on the cost of capital. We would agree this would raise equity valuations but only modestly, and on the assumption this policy was guaranteed of success. For example, a 2% reduction in the risk-free cost of capital for five years would be expected to generate only a 10% uplift in equity valuations.

The only remaining parameter is the equity risk premium and for a time during the 1990s there was an active debate on whether a reduction in inflation uncertainty post-Volcker could be linked to a sustained reduction in the equity risk premium. That argument may have had some validity at least.

However, in this cycle it is difficult to argue that the combination of very slow economic growth and experimental monetary policy during the current cycle is a reason for a sustained fall in the equity risk premium. To the contrary, it could easily be argued that the growing body of evidence that the effect of ultra-loose monetary policy on the real economy is transient and modest should imply a relatively high equity risk premium, as prevailed in the 2009-2012 period.

Exhibit 4: Current equity overvaluation compared to historic norms



Source: Edison calculations, median values

At present, valuation metrics in the US, UK and continental Europe are at the top of their historical ranges, indicating a substantial lowering of the long-term return on developed market equities. Exhibit 4 shows the extent of overvaluation on a number of measures. While the temptation is to focus on the headline numbers – and it is certainly more dramatic to use such data to forecast a crash – we have no reliable model to forecast how valuation metrics might mean-revert in future. There is for example no reason why any mean-reversion would not be gradual rather than sudden. However, in our view, the key point is that investors should remain focused on what this low level of expected return may mean for equity portfolios on a timescale of five years, similar to the likely timescale of global interest rate normalisation.

Specifically, taking the average current premium to historical valuation metrics of 20-30%, equities in each of the US, UK and Europe appear priced to tread water until the end of the decade as the capital uplift from slowly growing revenues and profits may be offset by the renormalisation of valuation parameters to long-term averages. Furthermore, if not by definition, there is no reason why global equities cannot trade below their long-term valuation averages at some point over the next five years.

The medium-term risks lie not only in currently high valuations but also in the expectation embedded in earnings forecasts that non-financial listed equities will continue to generate record EBITDA margins and a significantly above average return on equity (ROE), Exhibit 5.

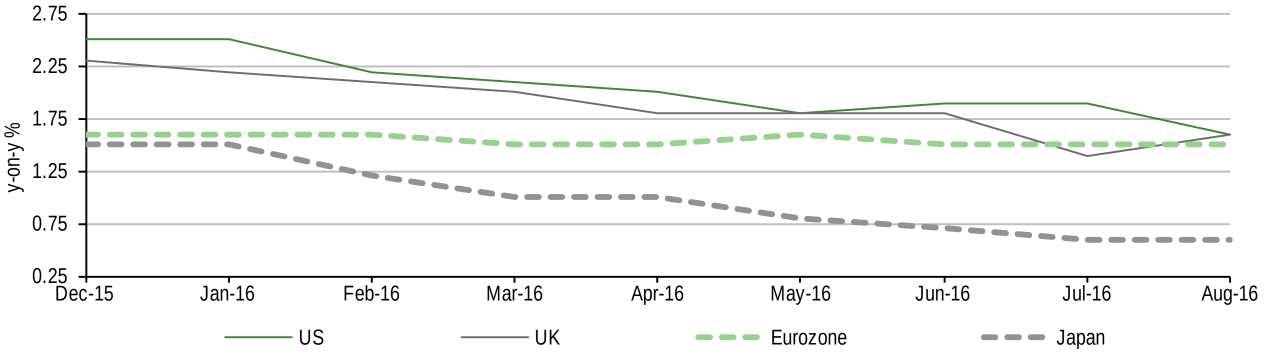
Exhibit 5: Median EBITDA margins and forecasts

Source: Thomson Reuters Datastream, Edison calculations

Earnings estimates – reassuringly stable?

Recent trends in consensus earnings forecasts highlight analysts' confidence in corporate performance for 2016, even as GDP forecasts continue to decline (Exhibit 6). For now, it appears that the global phenomenon of steadily declining earnings forecasts, a factor behind the relatively weak 2015 equity market performance, has receded. Exhibit 7 also shows there has been no observable impact on aggregate UK earnings forecasts from the UK's referendum on EU membership, although as we have previously noted FX benefits for UK exporters have offset modest downgrades to sectors focused on the domestic economy.

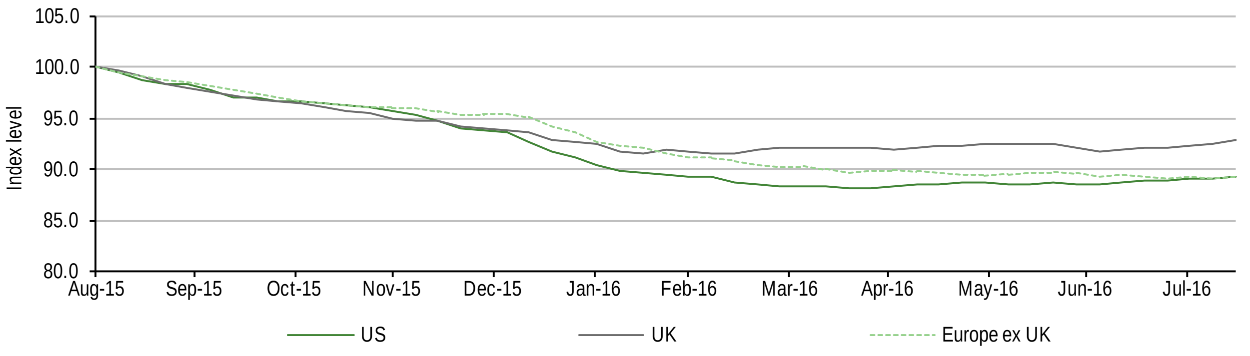
Exhibit 6: Consensus global GDP forecasts



Source: Thomson Reuters Datastream

Developed market equity valuations may appear extended at current levels, but the data suggest that at present at least, the specific risk of profit-warning led volatility appears modest, Exhibit 7. The stability in 2016 earnings forecasts has been directly supported by a significant recovery in major commodities markets including oil, iron ore and precious metals and indirectly by global monetary policy, notably in the US and UK, which has proved significantly easier compared to expectations at the start of the year.

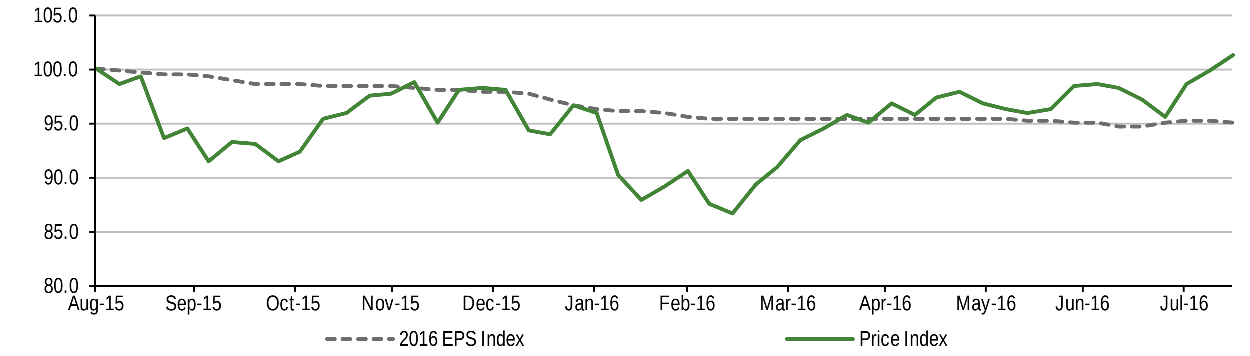
Exhibit 7: US, UK and Europe ex UK 2016 profits forecasts trends



Source: Thomson Reuters Datastream, Edison calculations

During the last 18 months, equity markets have been closely tracking revisions in earnings forecasts. Now, the link is not so obvious, as shown in Exhibit 8. Markets have rallied over the last quarter while estimates have remained unchanged. The data in fact point to investors' willingness to accept lower returns (equivalently higher valuations) in an environment where monetary policy is expected to remain looser for longer, as exemplified by the market recovery following the UK's referendum vote to leave the EU.

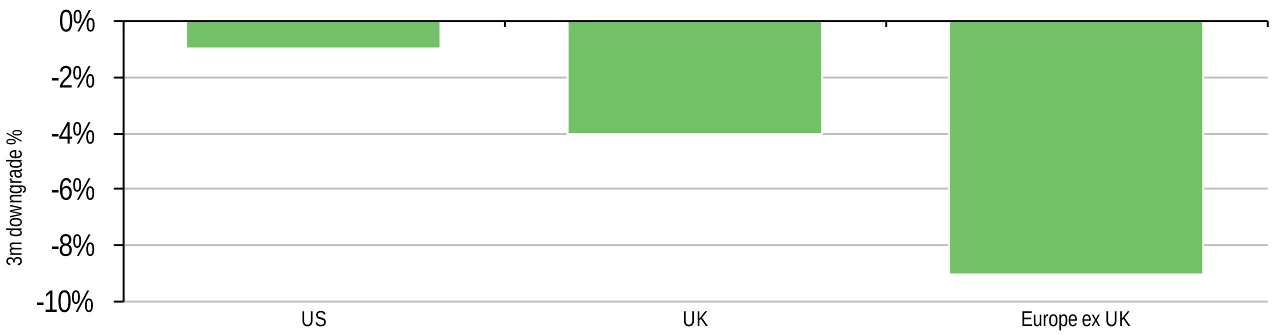
Exhibit 8: S&P 500 – decoupling from earnings trends?



Source: Thomson Reuters Datastream, Edison calculations

From a sector perspective, we note that over the last three months, 2016 bank sector earnings forecasts have only fallen modestly in the US (-1%) while declines in the UK (-4%) and Europe ex UK (-9%) have been more severe. We believe expectations are being crimped in the UK by the flattening of the yield curve and even more so in Europe where negative interest rates are being pursued and 10-year risk free rates continue to hover around 0%.

Exhibit 9: Three-month bank EPS revisions – Europe and UK suffering from low or negative rate expectations



Source: Thomson Reuters Datastream, Edison calculations

Following the15% gain in world equities since February it is in our view key to avoid the temptation to only look at evidence which rationalises the rally. The focus should remain on the risks. In particular, declining bond yields point to falling longer-term growth expectations and many of the uncertainties in terms of the trajectory of the EU project or the sustainability of China's economic model, to take two examples, remain in place.

In contrast to profits expectations for companies, consensus GDP forecasts for 2016 have continued to decline. The divergence between corporate expectations and the outlook for the whole economy may yet be closed by a new found enthusiasm for expansionary fiscal policy, but at this time this remains highly speculative, at least except perhaps for the UK.

BOE QE: It takes two to tango

The failure by the Bank of England (BOE) to fully cover its first bond purchase order following the re-introduction of QE is indicative of a lack of volume sellers in the UK's government bond market. This highlights a possible constraint on the BOE's QE policy, at least until a more expansive fiscal policy delivers a significant increase in the future supply of gilts or substitute securities.

The BOE's re-introduction of QE on 4 August has been remarkably well received by markets. This was in our view less to do with the prompt re-introduction of QE but is more closely linked to the clarification that negative interest policy (NIRP) has, for now at least, been ruled out as a policy tool.

Ruling out negative interest policy has several benefits. First and most significant, the economic benefits of NIRP remain uncertain. Second, ruling out NIRP will ease fears of declines in bank sector profitability and the resulting pressure on bank equity values. Third, the only remaining policy lever is now QE. Provided inflation expectations remain relatively well contained, market participants will form expectations that incremental shortfalls in UK GDP growth relative to forecasts will be met with more QE, thus stabilising asset prices.

As comforting as this may sound, there are some technical caveats. There have to be sufficient assets available for the BOE to buy, to maintain a credible position of being able to continue or expand the QE programme for as long as is necessary to support economic growth. However, we believe that given the current uncertainty following the UK's referendum vote to quit the EU, the private sector would seem unlikely to significantly increase the supply of QE-eligible assets such as corporate bonds or bank loans eligible for securitization, even as yields fall. The apparent shortage of gilts is therefore something of a concern.

We fear the new-found confidence in domestically-focused UK equities is at risk of proving unsustainable unless there is a meaningful expansion of fiscal policy later in the year. Such an expansionary fiscal policy would both support profits growth by providing profitable opportunities to provide services to the government sector and also enable the BOE to credibly assert that its QE programme can be expanded and remain in place for as long as necessary to maintain confidence in current asset prices.

The equity market seems therefore to be taking UK Chancellor Philip Hammond at his word that there will be a "reset" of fiscal policy in November's autumn statement, even as current yields in the bond market indicate some doubt. Such a fiscal reset, involving for example a fiscal stimulus of 2% of UK GDP, would largely offset the increase in gilt demand from the BOE's QE programme, taking account of the widening of the budget deficit that should be expected as the economy slows.

Provided there is a credible fiscal plan, the UK's resulting net debt position would by no means become exceptional in the context of other developed nations. Furthermore, as long as the BOE was willing to purchase and hold government debt, Japan's experience suggests that a surge in government borrowing costs would be unlikely in such circumstances.

At current market valuations, a fiscal stimulus of this magnitude appears to be investors' base case. A significant "reset" in UK fiscal policy would now appears necessary to meet investor expectations, to give the BOE room to continue with unimpeded QE and also to support profits growth in the UK corporate sector. The UK Treasury will have to deliver against these high expectations it has largely set for itself.

Conclusions

For the longer-term, the concurrent rally in bonds, commodities, equities and precious metals is creating significant challenges for investors. As growth has fallen short in developed markets and unconventional monetary policy has remained in place for much longer than originally expected, the decline in long-term risk-free rates is a particular concern to pension fund managers, in addition to the lack of diversification due to such highly correlated moves in global asset classes.

We believe we may be close to a peak in bond valuations as the appetite for driving interest rates below zero appears limited in the US and UK and may be close to practical limits in Europe. A tentative shift in focus towards expansionary fiscal policy over the course of the next 12 months may also prove unhelpful for bonds although supportive of equities.

Nevertheless, valuations in developed market equities are now as extended as 1999 or 2007 and we are dubious of any theoretical basis of a linkage to low bond yields. Having enjoyed the relief rally, we believe equity investors should maintain discipline and look to take profits in overvalued sectors which may represent bond proxies.

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