Illumination: Equity strategy and market outlook

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Global perspectives: 2017 – the year of the bear

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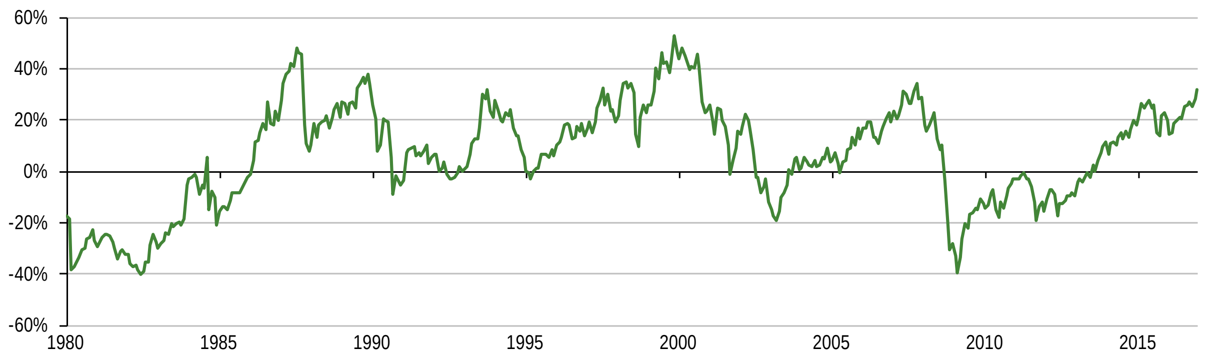
- **As headlines trumpet the arrival of Dow 20k, we are becoming increasingly concerned that the conditions for a sudden shift lower in equity markets are in place.** The combination of high valuations on a global basis and the prospect of tighter US monetary policy in 2017 is sufficient reason to be cautious and a stronger dollar is unhelpful for risk assets. However, it is political uncertainty which is giving us pause for thought.
- **Investors are being highly inconsistent with their beliefs. A high degree of confidence has been placed in Trump's growth- and US-friendly policies, even in the absence of earnings upgrades.** However, at the same time investors appear to be willing to ignore the more worrisome components of Trump's policy package, which lean strongly towards protectionism and a go-it-alone US foreign policy. To our surprise, Trump has also not to date shown any sign of pulling back from earlier and highly provocative views, which we previously regarded as electioneering. We also believe any challenge to US dominance of world affairs – in Asia, Europe or the Middle East – is likely to come sooner rather than later.
- **In terms of portfolio strategy, we therefore remain cautious on equities but now believe US 10-year yields are likely to hover around current levels rather than rise as the Fed increases US interest rates.** We are positive on the US dollar, which is likely to benefit from tighter US monetary policy, in addition to market expectations for a US fiscal easing and the prospect of dollar-friendly changes to corporate taxation. We continue to believe the cyclical trade (including mining and energy) was a 2016 story and would avoid high beta assets such as emerging markets at present. We would also maintain higher than average cash positions. In addition, investors able to do so may wish to consider hedging equity risk with out-of-the-money put options, which would benefit should market volatility increase.

2017: The year of the bear?

We believe 2017 may be the post-crisis year to avoid equity risk. We understand this may at first sight appear counterintuitive as markets extend their gains, in some cases to all-time highs. We are however stepping up from suggesting a cautious position on global equity markets to becoming outright bearish. In our view, investors may find that market exposure may be unrewarded over the next 12 months and at worst could lead to significant losses.

Our argument is based first on global equity valuations, which are now clearly stretched for all but challenged sectors and regions. Second, we believe the era of extreme unconventional monetary policy is drawing to a close as headline inflation rises and asset purchases by central banks will slow or reverse while interest rates are on an upward track. Third, with tighter US monetary policy, an anticipated fiscal stimulus and protectionist measures in the US, the US dollar is likely to remain strong which is likely to be unhelpful for risk assets. Finally, sweeping political change has given rise to geopolitical risks, which may be difficult to quantify but in certain circumstances could be highly detrimental to asset prices and world trade.

Exhibit 1: Global equities – price/book premium to long-run average



Source: Thomson Reuters Datastream, Edison calculations

Equity valuations: Price/book valuations hit peak levels

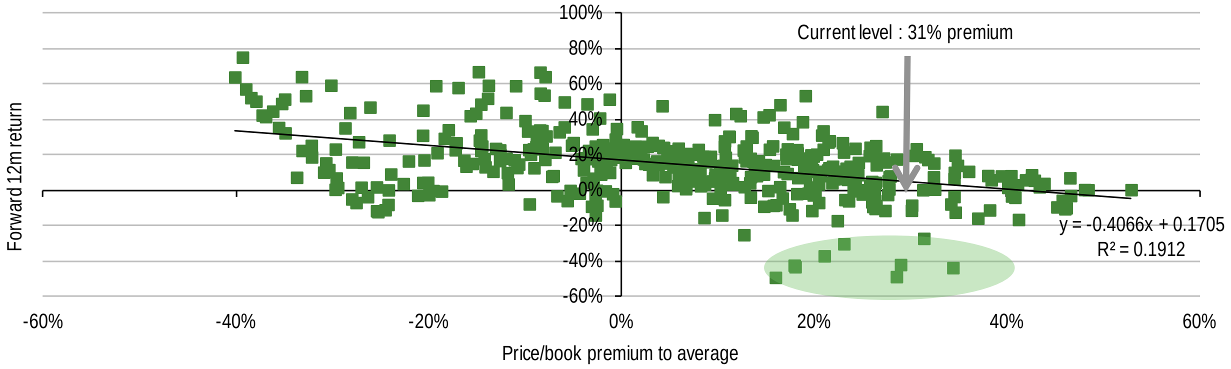
Judging only by current equity market price/book valuations, Exhibit 1, global equity investors are significantly more likely than usual to achieve only below average returns over the next 12 months, if prior correlations remain a guide to the future. In our view this factor alone is sufficient reason to proceed cautiously in terms of equity risk.

Average price/book multiples for world equities are once again at peak levels, similar to those prevailing in 2007 and 2000, and this is reinforced by a similar picture for P/E ratios. We believe investors should factor in the possibility that broad equity market exposure may result in weak or negative returns and stock pickers cannot rely on a tailwind of benign markets over the next 12 months.

From our perspective, 2016 was the year that investor positioning confounded many portfolio managers. Crowded bearish trades in energy and commodity sectors in Q116 were reversed by Q416 as the anticipated collapse in Chinese activity did not occur. The Brexit event, in some quarters believed to be a potential catalyst for significant volatility in world markets, failed to deliver anything other than a modest and short-term dip.

However, the current global average price/book premium of over 30% to the long-term average leads to an uncomfortable conclusion. As Exhibit 2 shows, it suggests not only that returns over the next 12 months are likely to be lower than average, but also that there is a greater than average risk of a meaningful decline, at least based on the historical experience of the last 35 years.

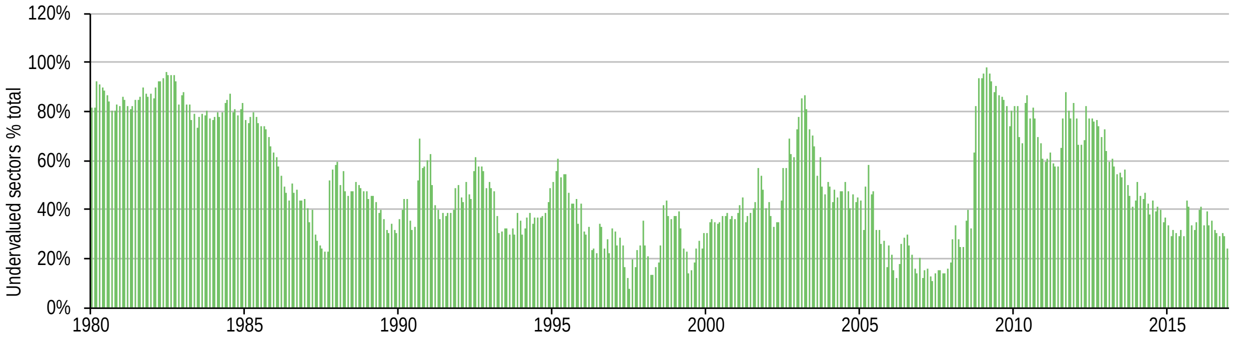
Exhibit 2: Global price/book valuation versus next 12-month returns since 1980



Source: Thomson Reuters Datastream, Edison calculations. Note: The higher the starting valuation level the lower the average forward 12m return and the greater the risk of a major move lower (green oval).

Exhibit 2 also highlights a long-standing and legitimate criticism of valuation analysis – which is that only a modest part of the variation in short-term returns can be explained by mean reversion in valuations. However, while we cannot rule out the possibility of markets becoming even more overvalued, we would highlight that over the last 35 years the most severe drawdowns of more than 20% – which are arguably the only ones that really matter – have only occurred when price/book valuations are as high as they are now.

Exhibit 3: Global sector price/book – ratio of undervalued to overvalued sectors



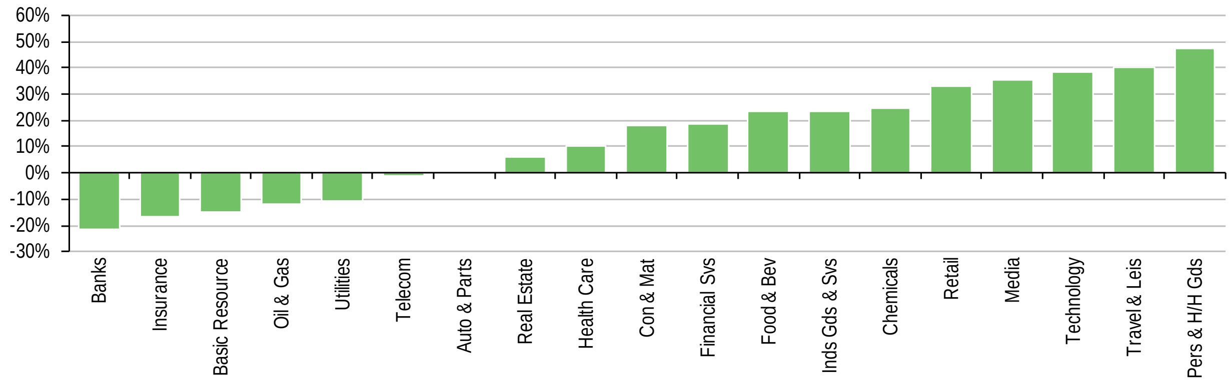
Source: Thomson Reuters Datastream, Edison calculations

Looking across world sectors, there is also an unusually large proportion of sectors which appear overvalued on price/book basis, versus those which appear undervalued. This is also a signal suggesting caution in terms of the outlook for equity markets, Exhibit 3. We would highlight the regime change between the 2009-13 period where confidence in the economic outlook was weak but valuations low and the 2014-17 period where equity returns were largely driven by a steady reduction in the risk premium.

The global sectors trading below their long-term average price/book ratios are financials, basic resources, energy and utilities although the discounts on offer are only modest. While we favoured the basic industries and energy sectors in early 2016 as they felt oversold in the circumstances, we believe the Trump rally represents a good opportunity to take profits.

Behavioural finance would suggest that it can be very easy to become caught on a compelling narrative while under-emphasising comparatively dull statistics that may have little emotional resonance. Furthermore, the prevailing market narrative often seems formed from the rather clearer image in the rear view mirror, while investors need to look forward. At present, the potential impact of a large US fiscal stimulus is at the forefront of investors' minds, even if the details remain uncertain. However, over the last 35 years casting narrative aside and focusing on the raw valuation data would have minimised exposure to the equity declines of 1987, 2000 and 2008.

Exhibit 4: Global sector price/book valuations v 35-year average



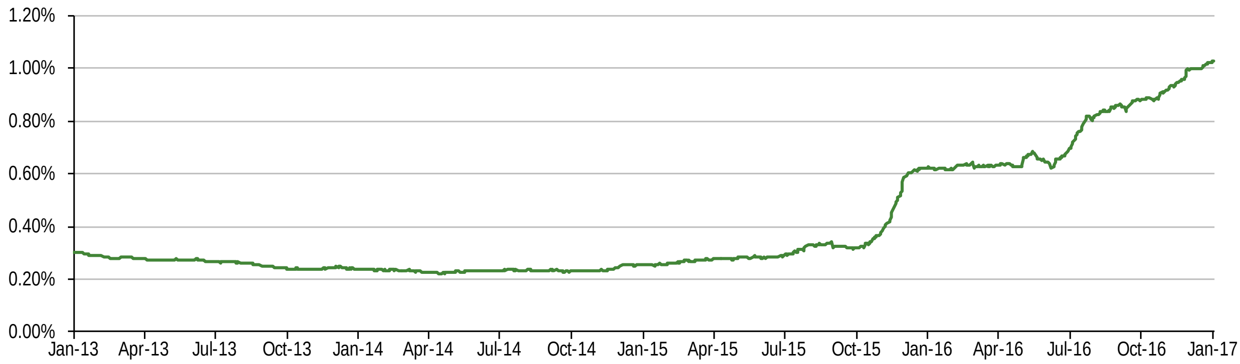
Source: Thomson Reuters Datastream, Edison calculations

Central banks have gone quiet – before the storm?

While it may be difficult to tell whether central banks have actually gone quiet or merely been drowned out by the increasing volume of political events, it is true that US dollar funding costs have been rising for over a year, Exhibit 5.

During 2017 comments from Fed policymakers have taken a hawkish tone and we believe this is a key risk for markets. It is also not the case that actual policy rates have to rise dramatically to trigger a stock market correction; while tighter monetary policy was thought to be a factor in the 1987 stock market crash US short term interest rates had only risen 1.5% from their 1986 cycle lows and 10-year yields by 2.5% by October 1987.

Exhibit 5: US$ three-month Libor now above 1%



Source: Thomson Reuters Datastream, Edison calculations

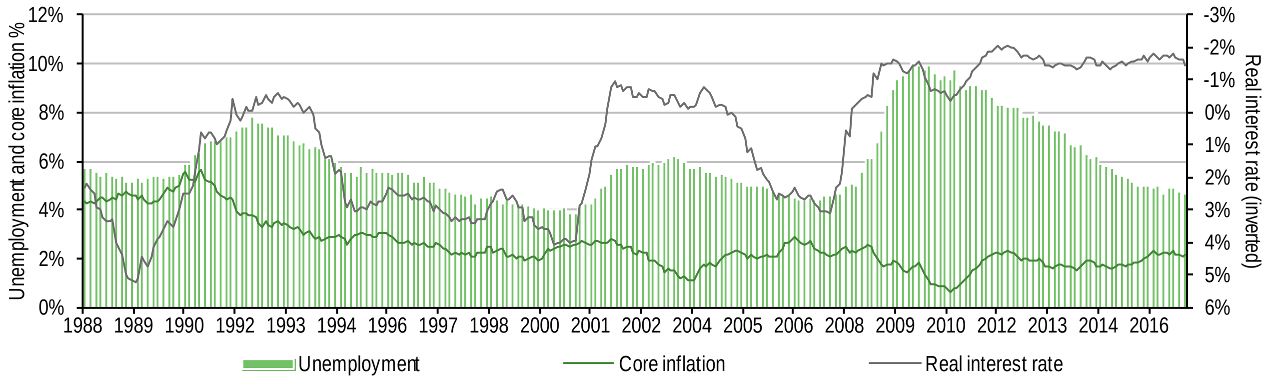
Fed policymakers have been clear that the US is essentially at full employment and inflation is close to target, Exhibit 6. This exhibit also makes clear that US monetary policy, as defined by the level of real interest rates, has remained exceptionally loose compared to earlier cycles, where the Fed tightened policy shortly after the peak in unemployment.

A large fiscal stimulus, as envisaged by the Trump campaign, was bluntly described as “not obviously needed” to support growth by Fed Chair Yellen in December. Yellen also expressed the view that policy should instead target productivity growth first through education and training, followed by infrastructure and innovation.

These long-term productivity initiatives are uncomfortably close to the ECB’s concepts of necessary structural reforms, which always sound sensible but are so long-term the political incentive is remote, actual change rare and market impact negligible. In our view, the structural changes in productivity growth that should be expected from changing workforce demographics also continue to be underemphasised.

In any case, the Trump administration currently appears much more focused on "shovel-ready" infrastructure projects aimed at boosting US economic activity in the short run. The uncertainties over the timing, size and implementation of this "not obviously needed" stimulus in our view adds upside risk to US interest rates.

Exhibit 6: US unemployment, inflation and real interest rates



Source: Thomson Reuters Datastream. Note: Real interest rate defined as Fed funds rate less core inflation.

For example, in her most recent comments Yellen expects that US rates will be close to 3% by 2019, while other Fed policymakers are openly discussing the wind-down of the Fed's balance sheet. In our view, such an increase in US interest rates would be likely to push returns on all other major asset classes significantly higher, in a manner similar to the original "taper tantrum". The divergence between US rates and those prevailing in the eurozone and Japan would also only add to upward pressure on the dollar in our view.

2017 earnings forecasts: Where are the upgrades?

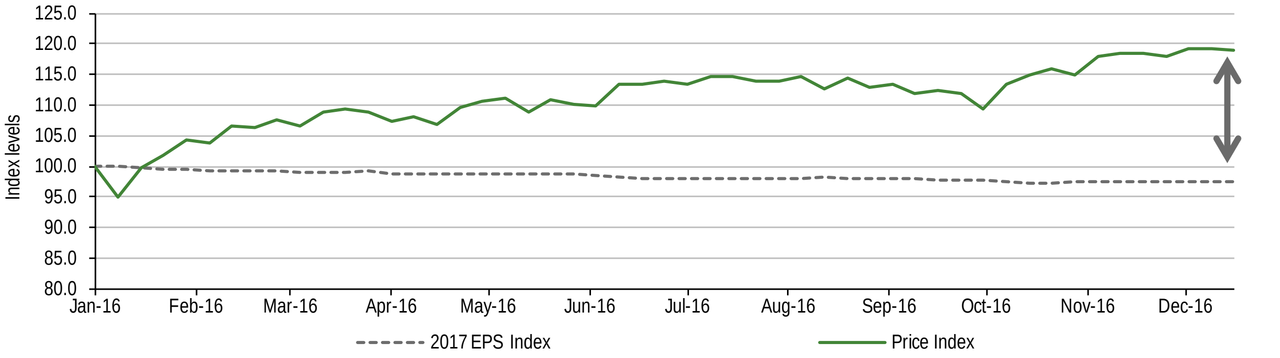
Although global equities continue to benefit from significantly increased investor optimism, US and continental European earnings forecasts for 2017 have remained stubbornly static over the last three months. However, we also find that in the UK 2017 earnings estimates have continued to move higher over the last three months, tracking the decline in sterling and providing a degree of fundamental support for the FTSE100. Should sterling stabilise as we expect however, this tailwind for estimates is likely to moderate in 2017.

We believe it is unlikely that US and continental European markets will continue to run higher in the absence of upward revisions to profits forecasts given already very high valuations. In this respect, the recent series of positive economic surprises on a global basis is notable, Exhibit 4. These data are clearly in contrast to flat lining earnings forecasts, which in our experience tend to marginally lead the economic and survey data.

Given the lack of upward momentum in earnings forecasts, we therefore tentatively conclude that macroeconomic forecasts may have been too pessimistic at the start of 2016 given the headline political risks during the year, and the resulting positive economic surprises may not in fact translate into earnings upgrades. However, this view can only be confirmed with more data, which means that an uncomfortable waiting period for equity investors may lie ahead.

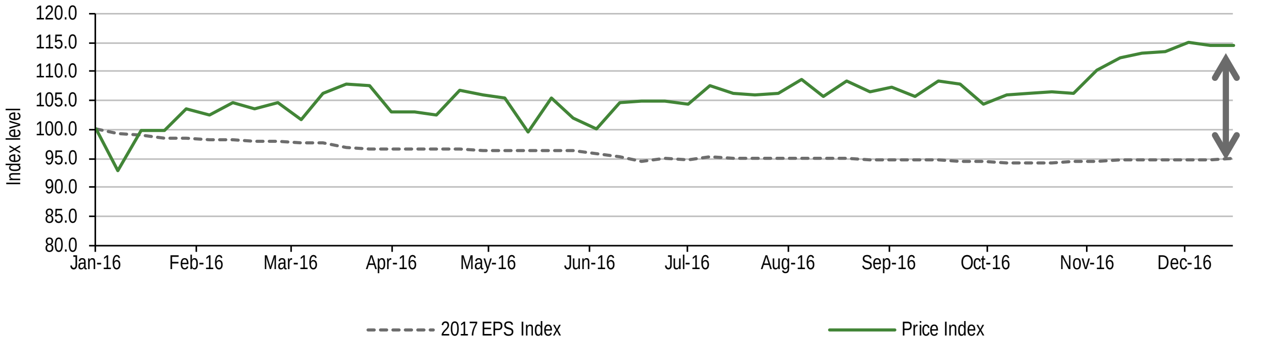
In addition, for US and continental European equity markets, the increasing divergence between 2017 profits forecasts and their respective price performance, when added to the lack of valuation support, puts a question mark over short-term prospects. While we acknowledge that there will be investors who will take heart from the significant improvement in the economic surprise indices, we still believe it is better to commit capital during periods when economic and investor sentiment is much weaker than at present. In any case, economic surprise indices are mean reverting by definition; in our view there was a good case for buying the (economic) rumour last year and also one for selling the news in Q117.

Exhibit 7: US – 2017 EPS forecast revision index and market performance



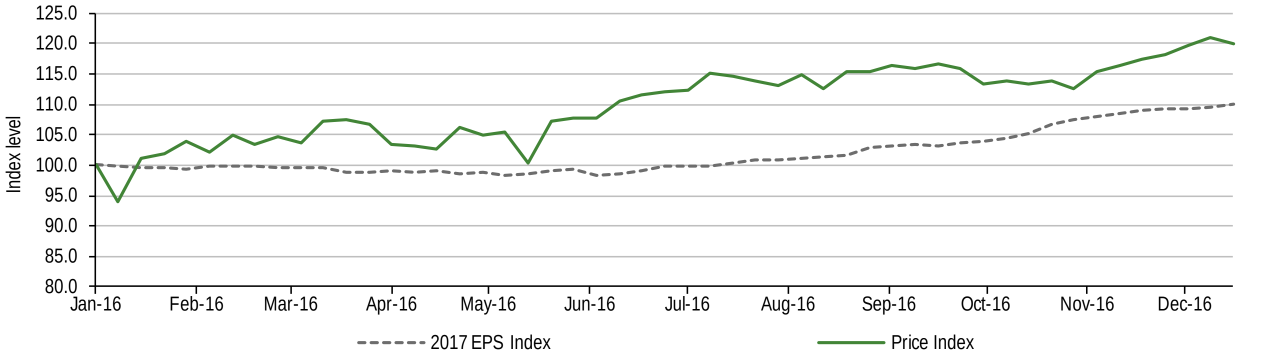
Source: Thomson Reuters Datastream, Edison calculations

Exhibit 8: Europe ex-UK – 2017 EPS forecast revision index and market performance



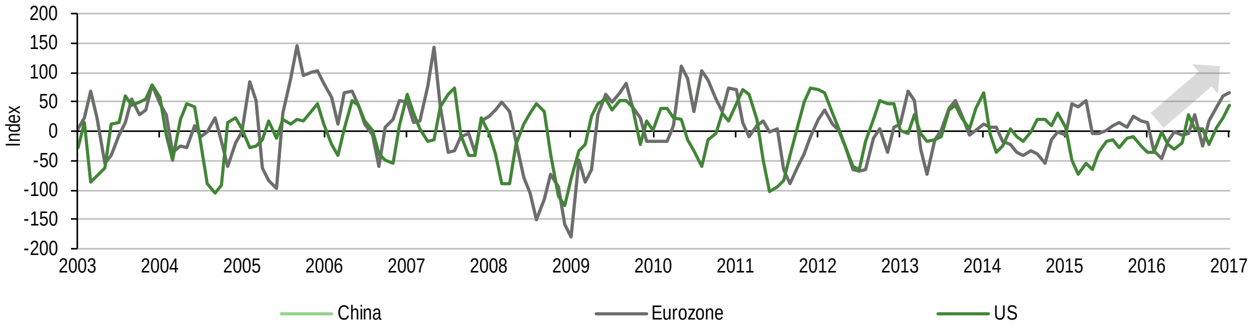
Source: Thomson Reuters Datastream, Edison calculations

Exhibit 9: UK – 2017 EPS forecast revision index and market performance



Source: Thomson Reuters Datastream, Edison calculations

Exhibit 10: Citigroup economic surprise indices surge in H216



Source: Thomson Reuters Datastream, Edison calculations

Political uncertainty

The failure to achieve political stability in the Middle East – most recently in Syria – has been a key driver of geopolitical tension, in addition to the sluggish economic recovery, which has created a groundswell of support for populist movements. Normally, such regional conflicts would be of only modest relevance to investors. However, viewed in the context of the straining of US/Russia relations and the significant additional pressure from refugees and economic migrants on the EU's doorstep, the relevance becomes clearer.

The incoming US administration's response to these challenges, which appears explicitly focused on an "America first" policy rather than working to build an international consensus, would represent a major change in US foreign policy and another source of uncertainty. In certain respects, investors are failing to recognise that the 21st century may be moving away from the 20th, in terms of the power structures that maintained peace in the post-war era.

Trump's open challenge to the structures of NATO or the EU and his recent support for Brexit fails to acknowledge that while these structures are imperfect, encouraging their break-up will create many moving parts and unpredictable side effects, significantly decreasing visibility for investors. Conceptually, the issue is that many of these factors have binary outcomes and are difficult to assess in a quantifiable way – adding uncertainty rather than risk (as measured by normal market volatility) to portfolios. Judging by recent market price gains, monetary policymakers have been unsuccessful in communicating their clearly voiced concerns over policy uncertainty to market participants.

For example, possible outcomes include increased support for populist political parties, which would support further *n*-exits from the EU. Any exits of eurozone members and a return to national currencies would undermine most, if not all, of the policy initiatives undertaken by the ECB in recent years and may lead to significant volatility in financial markets. Recently ECB President Draghi highlighted the potential EUR 360bn cost to Italy of settling outstanding Target 2 liabilities should it leave the eurozone. Therefore, in terms of investment portfolios which may have return objectives spanning decades these seismic political events are not on the far horizon and in our view should be incorporated into any portfolio strategy.

Geopolitically, the second-round effects of a destabilisation of the EU and NATO appear to be to the benefit of Russia. Since the end of the Cold War until recently, Russia has unable to halt the flow of previous Russian satellite nations into the EU. However, Russia's recent foreign policy suggests that any EU instability would be used to re-energise Russia's sphere of influence. The risks of a further escalation of military tension in Eastern Europe under such circumstances seem clear.

In Asia, the incoming US administration will also have the challenge of dealing with a more militarily assertive China and, based on current rhetoric from the new Trump administration, we believe increased tension in this region is also a distinct possibility.

Another lurch towards protectionism

It is becoming clearer that a number of Trump's more controversial campaign commitments were not just electioneering. His protectionist views are also supported by similarly minded officials taking senior positions in his administration. The breaking of the consensus that lower tariffs on global trade are ultimately to the benefit of all is of concern to us and raises the question of whether a second phase of de-globalisation (the first being renewed domestic regulation of the banking sector following the financial crisis) is upon us. If true, this could have a major impact on globally integrated supply chains and multinational corporations.

In terms of protectionism, Trump has already highlighted the perceived unfairness of the trading relationship with China and this has been echoed by commerce secretary Wilbur Ross, a private equity veteran with experience of restructuring struggling US Rust Belt companies. Ross has also highlighted the scale of state-subsidised financing for China's corporate sector, which is a concern in its own right, but more for China's financial stability than competitiveness versus the US. Furthermore, Trump's tendency to threaten corporates with border taxes unless they re-shore and invest in the US manufacturing base creates its own uncertainties for multinationals.

Proposals such as a corporate tax regime which provides for destination-based corporate taxation, remains fraught with difficulties in terms of compatibility with WTO rules, but the intent to favour domestic production is clear. A much more confrontational approach to international relations and trade (and a new focus on short-term benefits to US producers, rather than consumers and long-term economic efficiency) is a new and volatile dynamic, which investors are yet to discount in our view.

While it is unlikely that US tax legislation incompatible with international rules and treaties would be passed into law, we believe the principle of an "America first" policy is a new reality that cannot now be denied. This policy is likely to be negative for global trade and the possibility of some form of trade war cannot be excluded. For example, should a form of House Speaker Ryan's current tax blueprint be put into effect, it is in our view inconceivable that such *de facto* barriers to trade could be erected without similar legislation being enacted in other regions such as Europe.

Outside the US, even though the recent shift in the UK's position towards a 'hard' Brexit may be of less significance for global markets, the UK appears to have given up on the possibility of remaining in the single market or customs union. Despite the warnings from senior diplomats that any UK/EU trade deal may take many years to establish, markets appear to be offering only a limited discount for disappointment.

Conclusion

We believe that at the start of 2017 world equities have many of the elements of a set-up-to-fail scenario. High valuations, tighter monetary policy and three separate US policy reasons (tariffs, easier fiscal policy and capital expenditure incentives) to expect a stronger dollar are at least headwinds for global equity markets. To this should be added renewed geopolitical uncertainty.

As energy investors found in 2015, being caught in the cross hairs of a geopolitical debate (which in that case was the Saudi push to take market share from the US) can lead to significant market volatility and price overshooting before the issues are resolved. The geopolitical battle this time is not over oil market share but the share of world GDP growth; we believe there is a scenario where global investors could be held hostage in the process.

Entering 2017, we are therefore increasingly cautious on the overall outlook for equity markets and would continue to focus equity portfolios on highly specific or event-driven situations. While it is difficult to call the top of a rally as powerful as that in mining and energy with precision, we would also continue to scale back overweight holdings as the prospect of abnormal gains appears to have passed.

While currently bearish on the market outlook, financial market history counsels strongly that bearish views should be held only for short periods of time. Should economic activity surprise to the upside, brewing trade conflicts blow over or, in particular, the US Fed flip/flops to a more dovish stance, the risk/reward balance will have shifted again. In such circumstance, we would have to reflect on our position. But for now in Q117, we can see good reason to avoid equity market risk.

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