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Illumination: Equity strategy and market outlook

July 2017

Published by Edison Investment Research

EDISON

Global perspectives: A narrow path for equities

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- **Good times to invest are when there are a multitude of ways to win and limited downside.** At present, however, the bull case for equities seems to be increasingly based on a single 'Goldilocks' scenario. In other words, if equity valuations remain as high as they are; *and* the global economy continues to slowly expand; *and* profit margins remain at record levels; *and* monetary policy remains accommodative; *and* volatility remains low *then* investors will have no alternative but to drive equity prices higher.
- **The problem with "A *and* B" is that probabilities are multiplied.** If the probability of each of the conditions listed above were even as high as 80%, then the probability of all the conditions being fulfilled would only be 32% (if for simplicity we assume independence). In contrast, in a volatile or uncertain market when valuations are low many securities can trade at levels which in effect just need the crisis to pass to move significantly higher. We think genuinely active investors should be willing to invest at such times of distress and take profits when markets are priced over-optimistically.
- **We continue to believe investors should maintain a cautious position.** Low volatility has contributed to a lack of trading opportunities, also evident in US brokers' recent results. Valuations for many developed market equities remain high. However, in-line with our previous views we do not expect central banks to tighten policy in a manner designed to engineer lower asset prices - but the absence of upside is reason enough to run portfolios at below benchmark risk levels.

A narrow path for equity markets

Acceptable returns on equity markets contingent on too many variables

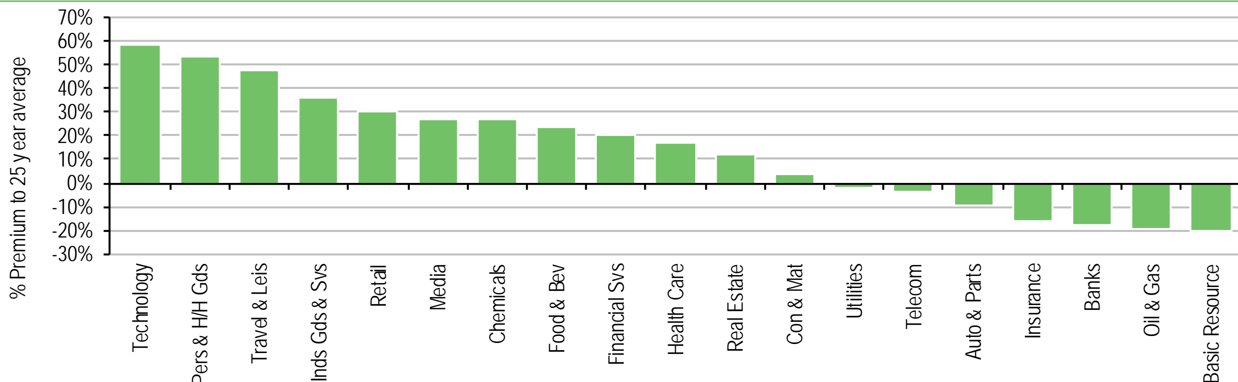
Good times to invest are when there are a multitude of ways to win and limited downside. At present however, the bull case for equities seems to be increasingly based on a single 'Goldilocks' scenario. In other words, if equity valuations remain as high as they are; *and* the global economy continues to slowly expand; *and* profit margins remain at record levels; *and* monetary policy remains accommodative; *and* volatility remains low then investors will have no alternative but to drive equity prices higher.

The problem with arguments based on "A *and* B" is that the probabilities of each event are multiplied together. For example, even if the probability of each of the conditions listed above were as high as 80%, the probability of all the conditions being fulfilled would only be 32%, if for illustration we assume independence of the conditions.

In contrast, in a volatile or uncertain market when valuations are low, markets can trade at levels where there may be a number of ways in which to win. Since 2012 in Europe, following Draghi's "whatever it takes" speech, the way to win was to assume that the ECB would commit to significant quantitative easing and just wait for the crisis in confidence to pass. In turn, there has been a collapse in sovereign bond spreads which contributed (ultimately) to the upswing in eurozone economic activity which we have seen over the last 12 months.

But more generally the situation back in 2012 could have been written rather differently to our first paragraph: In 2012, if equity valuations were to recover from depressed levels; *or* the economy merely limps on; *or* profit margins recover; *or* monetary policy becomes accommodative; *or* volatility declines, *then* equity prices should move significantly higher. Here, only one condition needed to be met to earn an attractive return.

Exhibit 1: Developed market sector price/book valuations



Source: Thomson Reuters Datastream

There is a further significant difference in the language between 2012 and today. It seems that in the current circumstances, for developed market equities to deliver even average returns a number of parameters will all need to remain at historically unusual levels. In 2012, all that was required to generate high returns was a return to an economic scenario closer to normality – hence a relatively much more probable outcome, which also offered greater upside. We remain cautious on the outlook for developed market equities.

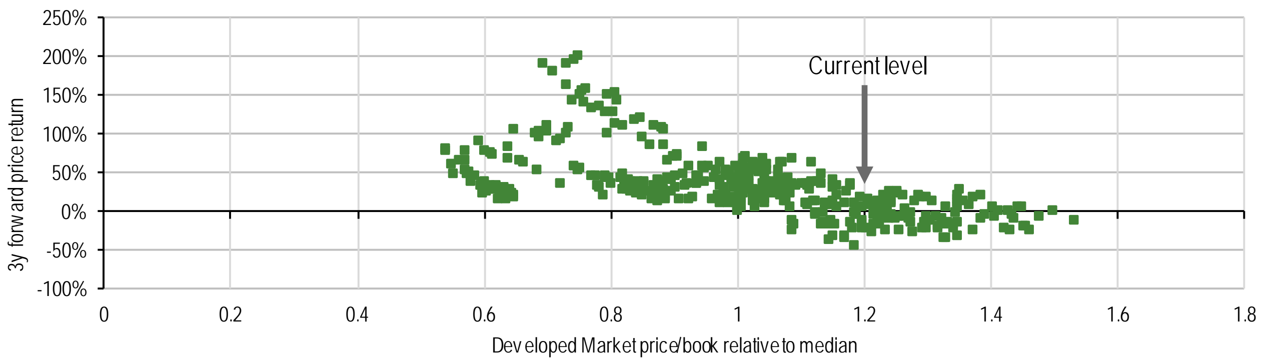
Developed markets remain expensive in our view

It is of course important to re-check where we are on the parameters. There is no doubt that 2017 corporate profits growth expectations have been robust in H1 and currently point to high single-digit

growth for the full year, even if forecasts have ebbed somewhat recently. The recovery in profits growth means that return on equity has been strong, thus in turn facilitating book value accretion.

However, this appears to be fully priced in terms of developed market price/book valuations (see Exhibit 1). We do acknowledge that the phenomenon of sector valuations trading well above historical average price/book multiples (with the exception of those with arguably structural challenges) is not new in this cycle.

Exhibit 2: Correlation between starting price/book ratio and subsequent 3-year price return



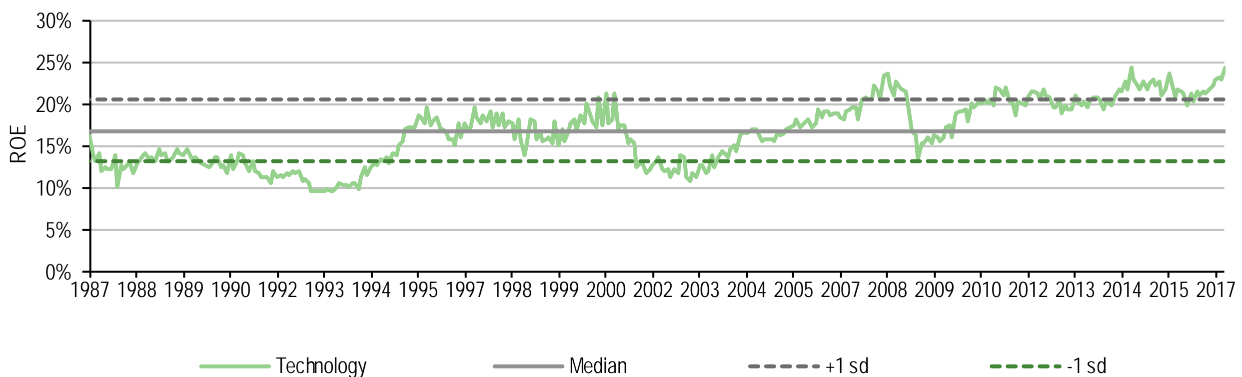
Source: Thomson Reuters Datastream, Edison calculations. Note: Time period 1980-2014.

Nevertheless, we believe it remains important not to become habituated to extremely high equity valuations. Investors should be aware that the numerous companies in the industrial goods and services sector currently trade at a 40% premium to their long run average price/book multiple for example. Since 1985 and over a number of economic cycles, there has been a strong correlation between the starting level of the developed market price/book ratio and the next three years' price returns, Exhibit 2.

For the technology sector, if judged by the currently very high price/book ratio (see Exhibit 1), the consensus view appears to be that record high returns on equity will be sustainable over the medium term. There is no doubt that US "Big Tech" has been extraordinarily successful in recent years, to the point antitrust regulators are starting to take an interest once again.

But while recent corporate performance has been strong, is the situation so different from the tail end of the 1990s when "everyone knew" that the future was mobile and belonged to Nokia, Ericsson and Motorola? A further parallel with the current enthusiasm for tech is the first Microsoft era (1990s) which ended with the faster growth of the internet over MSN – and a decade-long decline in the share price followed. Technology is not a new sector – and we note that return on equity has proved mean-reverting over the last 30 years, Exhibit 3.

Exhibit 3: Developed markets technology sector ROE – historically mean reverting



Source: Thomson Reuters Datastream, Edison calculations. Note: Dashed lines represent 1 standard deviation bands.

There are likely to be many ways to innovate with and process digital data which have not yet been invented. Probability suggests that these innovations are more likely to occur in companies other than the current incumbents – perhaps in start-ups which have not yet even been formed.

The paradox is that Silicon Valley entrepreneurs preach rapid and continuous industry disruption, while stock market investors currently price in long periods of stable, if not oligopolistic profits. At current valuations it may be time for investors to consider taking some profits in mainstream tech and – if exposure is to be retained – consider rotating to companies with technologies at an earlier stage of adoption or development.

We are also cautious on sectors which have seen yield compression, such as personal care and household goods, as investors have pushed further out on the risk curve following the decline in long-term bond yields. Now, central banks have started the long walk back from ultra-loose monetary policy. Fed Chair Yellen has been clear that the neutral real rate of interest is likely to rise in coming years, implying that the Fed currently believes that gradually rising rates may not even be viewed as tighter policy.

Despite recent commentary indicating something of a softening of a previously hawkish stance, we believe US policymakers only need to see stability in the US economy to continue to tighten monetary policy. Furthermore, US policymakers are only likely to be encouraged with the ease with which their hawkish talk was absorbed by US equity and credit markets. Even if market interest rate expectations for 2018 have recently started to fall short of the Fed's dot-plot forecasts, with reductions in the Fed's balance sheet now on the table for September there is more than one option available to tighten policy.

Within a cautious overall equity outlook, we continue to believe the insurance sector is worth considering. A relatively highly regulated industry with a stable return on equity and defensive characteristics, yet it is still trading in line with historical averages. We do not anticipate exceptional returns but with a dividend yield of 4% and mid-single digit earnings growth, expected returns over the medium term appear likely to be significantly above long-term bonds, which is more attractive in our view than many other sectors.

For basic industries which are still trading below average multiples, we believe the year of recovery was 2016. Price momentum within the sector has eased significantly since then as commodity prices have stalled. For banks, the recent announcement of capital returns in the US are a reminder that low valuations persist, although latent risks still suggest the sector is to be approached on a region and stock specific basis.

Fed policy: Don't forget your flip-flops

US inflation and growth numbers undershoot expectations

It is just a few weeks since the US Fed raised interest rates and central bankers globally opined on a removal of monetary accommodation (albeit slowly) as the global recovery gathered momentum.

Unfortunately, some inconvenient facts are already casting their shadow. The Atlanta Fed US GDP nowcast for Q217 has fallen to 2.4% from 4% at the start of June, with disappointing US retail sales contributing to the downgrade. Furthermore, US core CPI has undershot expectations with the year-on-year figure now at 1.7% for June, compared to 2.3% at the start of the year. Fortunately for central banks, the holiday season has started and the focus may be elsewhere.

During 2017 the US Fed has steadily increased the volume in respect of its concerns over financial instability (ie the apparently low level of current risk premia in credit and equity markets) even as the dual mandate of the US Fed is to maintain maximum unemployment and stable real economy prices.

In theory at least, the primary policy lever in respect of financial instability risk is prudential regulation of the banking sector, rather than monetary policy. In this regard Fed policymakers believe significant progress has been made and a decline in asset prices would not necessarily have systemic implications – something which should on its own put investors on guard.

There is even currently something of a consensus amongst market commentators in respect of the possibility of the Fed tightening policy monotonically and as a result creating a crisis in equity markets in the second half of this year, in the event the US economy slows due to the lagged effect of interest rate increases to date.

As previously noted, we certainly share the view that equities are expensive on a global basis and particularly in defensive and technology sectors where investors have been starved of yield and growth stories respectively.

We also share the view that the US Fed would like to normalise policy while the US economy is growing and in part due to rising asset valuations. In other words there is currently a bias to tighten. Other central banks also appear to be moving in the same direction.

However, while we agree that this current bias to tighten represents something of a near-term ceiling on risk assets such as equities, fears of a dramatic fall in markets require central banks to commit a policy error. Based on the experience of the last 10 years an unforced error appears relatively unlikely; across developed markets policy has been systematically loosened at every downward turn in activity.

The risk in our view is therefore one of a constrained policy solution where rapidly rising inflation trumps growth concerns. Furthermore, even if econometrically valid, it is unlikely that the Fed would or could sustain such an unpopular policy stance on merely an inflation model or forecast.

There is at present very little sign (outside the special case of the UK) of inflation which would constrain monetary policy. Energy and other commodity prices have stumbled over the past year for example. In the US, core inflation has fallen to 1.7% year-on-year to June having been as high as 2.3% in January.

We expect in turn that the US Fed is likely to ease back on the hawkish rhetoric over the summer if US data continue to disappoint. Such a flip-flop would by no means be unprecedented nor should necessarily imply a criticism of policymakers; this is just what data dependent policy means.

In this respect the path of least resistance for the Fed may be to continue to prepare the market for balance sheet reduction, but to take the prospect of a near-term increase in interest rates off the table. This is certainly consistent with July's FOMC statement which pointed to a September start for balance sheet reduction but did not raise interest rates further. In this way, the slope of the yield curve (and bank profitability) would be maintained even as monetary policy remained looser. Such a policy would also avoid a renewed dash into equities by yield-seeking investors as long-term rates are maintained or rise modestly.

Conclusion

We still have difficulty becoming more constructive on developed equity markets as at current valuations the number of scenarios in which even an average return can be achieved seems relatively limited. Earnings momentum in the US and UK has also ebbed in recent weeks, adding a question mark over near-term index performance.

Our cautious view on equities is driven more by the absence of upside rather than fear of the downside. It remains unlikely in our view that central banks would deliberately seek to engineer declines in asset prices by tightening policy but the headwinds for equity markets in terms of valuations and monetary policy remain in place, offsetting the positive benefit of corporate profits growth during 2017.

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