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Illumination: Equity strategy and market outlook

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Global perspectives: Tightening tensions

- **2018 brings into view the prospect of a net decrease in central banks' balance sheets.** The winding down of policies that were statistically shown to depress risk premia in fixed income and credit markets should not be ignored in our view. Investors should be aware there are good reasons for risk premia across asset markets to start moving back towards historical averages as monetary policy is normalised.
- **The US Fed has offered ample guidance in terms of balance sheet reduction but the surprise may be on the other side of the Atlantic.** Economic activity has rebounded strongly yet interest rates remain negative. We understand the reluctance of the ECB to risk snuffing out the recovery by changing tack too soon but if the eurozone economy maintains its current momentum there will be increased pressure to scale back the ECB's unconventional monetary policy more abruptly.
- **Markets have pushed further into their low volatility/low return regime during 2017.** The collapse in day-to-day volatility is palpable and clearly visible in the data as it has declined faster and further than at any time since the 1970s. This is certainly an unwelcome development for active investors as it limits the number of trading opportunities. We view this as a temporary phenomenon likely to reverse as volatility returns to interest rate markets during 2018, as forward guidance becomes less relevant.
- **We maintain a cautious outlook for the medium term** on the basis of valuations that indicate very low expected returns in both equities and credit in developed markets. A major fracture in markets in the near term appears unlikely due to currently positive economic surprise but upside may be capped by tighter monetary policy in 2018. To deliver, investors may need to combine a relatively modest level of market exposure with carefully selected exposure to specific company- or event-driven situations.

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Quantitative tightening on the horizon

Investors seem reluctant to contemplate the implications

For a half-decade, steadily expanding central bank balance sheets in developed markets have contributed to a very strong performance of risk assets such as equities and credit. Now, the punchbowl is being diluted and removed - sufficiently gradually policymakers hope, for investors not to notice. However, in our view investors should pay careful attention and prepare accordingly.

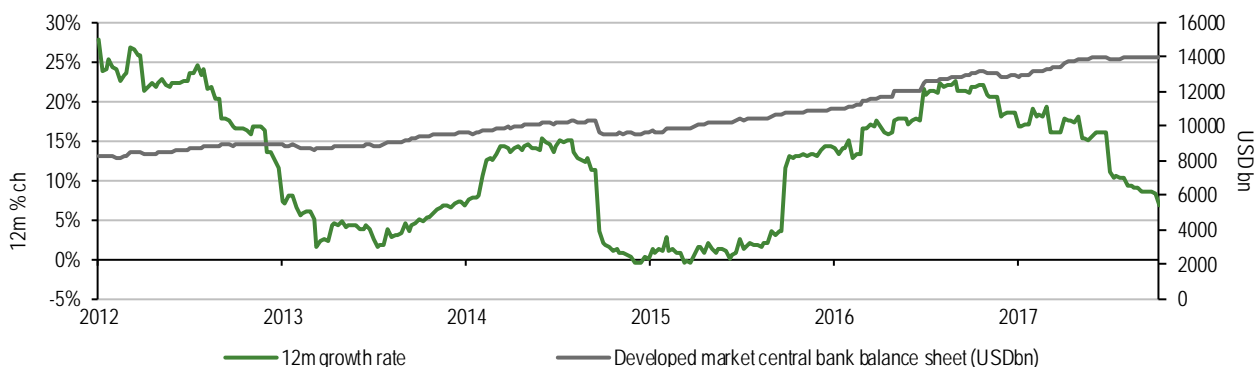
We are wary of arguments which suggest that this process of quantitative tightening will have no bearing on asset prices. Fed research has identified that long-term rates were lowered by quantitative easing and the policy objective of placing downward pressure on risk premia in credit markets was achieved through the purchases of mortgage-backed securities in the US and corporate credit in Europe. Even if it was only the Bank of Japan which engaged in direct equity purchases, the withdrawal of such large buyers of fixed-income assets is likely to have an impact on equity pricing.

The scenario which central banks are aiming for is one in which steady progress in the world's economies enables the gradual removal of asset price support and ultimately a return of interest rates to a level consistent with long-term real growth and inflation close to 2%. That would be consistent over the medium term with long-term bond yields closer to 4%, compared to the much lower levels observable today.

With central banks having brought forward asset price returns in the past half-decade to support the economy, a period of sub-par returns is in our view increasingly likely, even if the economy continues to improve, due to rising yields across all assets in this scenario. We should note however that "a period of sub-par returns" is not a euphemism or code for a calamitous decline. A scenario of slowly rising yields which does not lead to capital losses in equity markets for example is quite feasible.

Exhibit 1 shows the scale of the issue. Developed market central bank assets have grown from \$8trn to \$14trn in the 2012-17 period. However, due to the shrinkage of the Fed's balance sheet and the likely pace of ECB tapering next year, the growth rate for central bank assets will move negative early next year and remain so until the end of the decade on current indications.

Exhibit 1: Major central bank balance sheets and annual growth rate



Source: Thomson Reuters Datastream

It is difficult to quantify the impact of this move on long-term yields with precision; however the Fed's 2015 review of the impact of QE on 10-year yields suggests that the programme contributed to a reduction in long-term yields of over 1%. The programme is due to be reversed only slowly and is at least partly priced into the market. Therefore, provided the expansion of US GDP continues into 2018, we would expect to see US bond yields perhaps closer to 3% from 2.4% currently as a

result of the unwinding of the Fed's balance sheet. Furthermore, 10-year yields in the eurozone below 1% appear increasingly at odds with the improving economic outlook.

In addition to this increase in long-term yields, investors will in just over 12 months' time have to contend with markedly higher US interest rates, if the current Fed median projection for 2.3% US rates is reached.

Notably, three rate increases for 2018 are still not priced in to the market, even if futures are grudgingly moving closer to the Fed's projections. It would also be logical to expect the Fed at that time to be stepping back from its policy of forward guidance, thus re-establishing market pricing and volatility in interest rate markets.

In our view, US interest rates above 2% would represent a real alternative for investors who reached for yield in equities and riskier elements of credit markets during the long period of ultra-low rates.

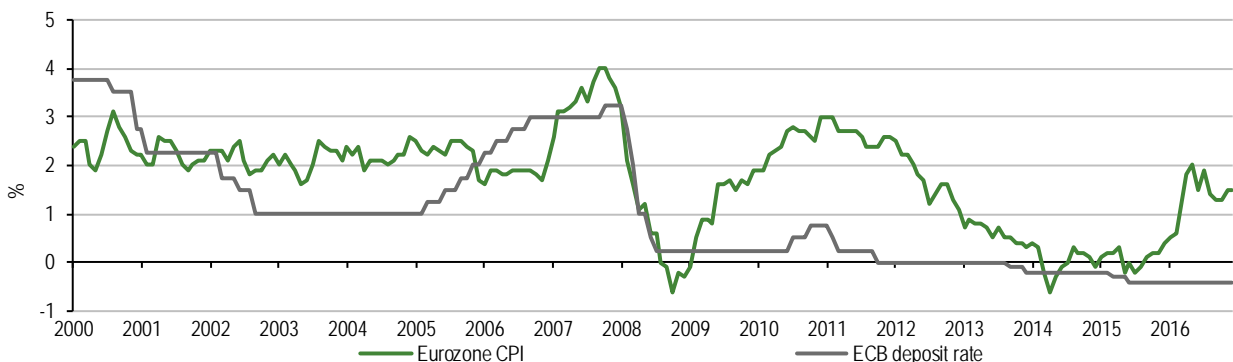
A caveat to this analysis is that we would have a stronger degree of confidence in the conclusions if we knew the future composition of the Federal Reserve Board. Trump's choice of Fed Chair for 2018 is still a matter of political speculation and subject to significant uncertainty with daily variations in the market's perceptions of the likely winning candidate.

Eurozone economy no longer needs emergency monetary medicine

In Europe, the ECB policy appears rather behind the curve, albeit largely by design. Taken at face value, negative interest rates, forward guidance and quantitative easing appear at odds with a now extended period of recovery in the European economy.

Purchasing managers' indices are close to 15-year highs, inflation is only modestly lower than target and unemployment is falling. In Germany, inflation is already at 1.8%, unemployment is at a record low and IFO business confidence is at cyclical highs. It is only in the periphery that the effects of the eurozone debt crisis remain firmly embedded in the data. The ECB is at risk of having to move more abruptly in future if it does not move meaningfully now. In particular, we note the very rapid return of inflation to the eurozone over the last 18 months, Exhibit 2.

Exhibit 2: Sharp eurozone inflation rebound and ECB policy rate still negative



Source: Thomson Reuters Datastream

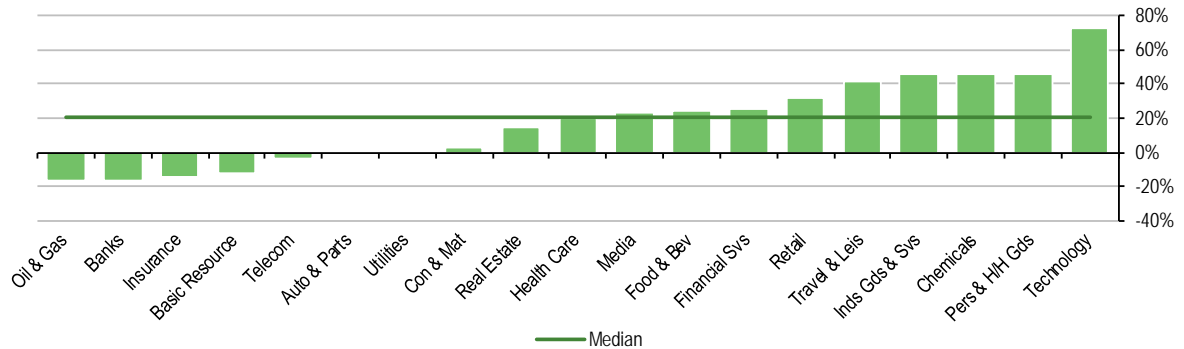
Given the recent improvement in the economic data, we believe there could not be a better time to announce the scaling back of the ECB's asset purchase programme. We expect the ECB to clarify its intentions in respect of its asset purchase programme in coming days by cutting the amount of monthly purchases significantly from the current rate of €60bn per month. To soften the blow, Draghi is likely to emulate the Fed and be very clear that the ECB remains dovish on interest rates until beyond the end of the period of asset purchases.

Equity valuations remain extended

2018 may be Main Street's year

In the context of the expected renormalisation of monetary policy, we still question the sustainability of the relatively high valuations of developed equity markets. Only a few sectors currently trade below long-term price/book levels, Exhibit 3. Such high valuations, despite a slowdown in organic revenue growth in recent years, indicate this is a lowering of expected returns on equity markets rather than an anticipation of a supercharged period of profits growth.

Exhibit 3: Developed market price/book premium to long-run average



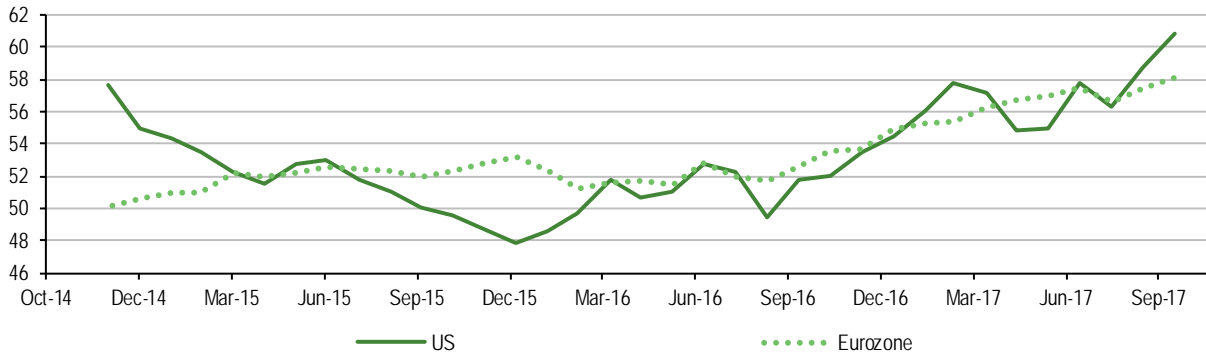
Source: Thomson Reuters Datastream, Edison calculations. Chart shows current sector price/book compared to 20-year average

Our base case at present is that markets will de-rate slowly, leaving headline indices moving sideways or only slightly higher as corporate profits grow. It is too easy to jump to the conclusion that as markets are overvalued a sudden and dramatic move lower will necessarily follow, but this is not borne out in the historical data. Crashes are eye-catching but the risk should not be overemphasised. In particular, we would need to have some evidence of credit stress at least somewhere in the world to suggest that an abrupt slowing in credit availability had occurred. This is clearly not the case at present.

A steady de-rating implies a period of sub-par returns even as profits continue to grow and is the basis of our cautious view on equities. What would change our view would be an unanticipated period of above-target inflation which would force the hand of monetary policymakers – but also appears absent for now, with the exception of the UK.

In fact, while valuation concerns for equity markets remain in place, recent economic data in the US and eurozone also point to something of a mini-surge in economic momentum over the last three months. PMI data have been coming in ahead of expectations and economic surprise indices have turned higher in all regions. During 2017, investors have had to balance their longer-term valuation concerns with generally robust profits growth and improving economic sentiment. While “soft” survey data such as PMI indices should not significantly shift portfolio asset allocations, if the improved economic data feeds through to profits forecasts a near-term slip in equities appears less likely.

Exhibit 4: US and eurozone PMI indices improving over Q317



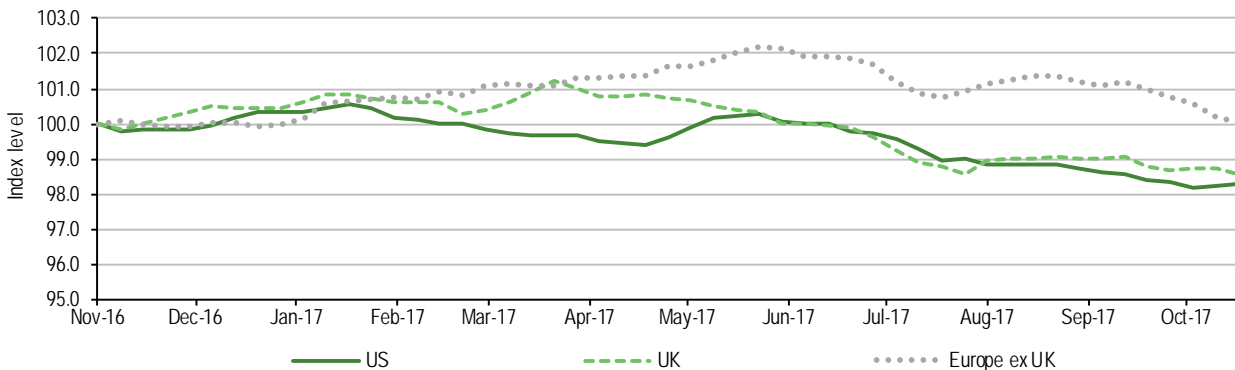
Source: Thomson Reuters Datastream, Edison calculations

Profits forecasts stable – but no positive surprises

While Q3 has brought something of a renaissance in economic surprise and purchasing managers' indices we can at present see no sign of this improved sentiment in profits forecasts for 2017 which remain a little under 10% for Europe and the US. Our weighted average consensus earnings forecast index remains steady for each of the UK, US and Europe ex-UK and the equal-weighted measures have declined modestly, Exhibit 5, since mid-year.

In prior periods, our earnings forecast index tended to move slightly ahead of PMIs and economic surprise. The more recent data has not followed this pattern and while it is too early to tell for certain whether this will persist this divergence bears watching in the context of a number of below consensus earnings reports during recent weeks.

Exhibit 5: Median 2017 forecast revisions US show modest declines since mid-year



Source: Thomson Reuters Datastream, Edison calculations

If you think it is quiet...it is

Lowest levels of daily volatility since the 1970s for developed markets

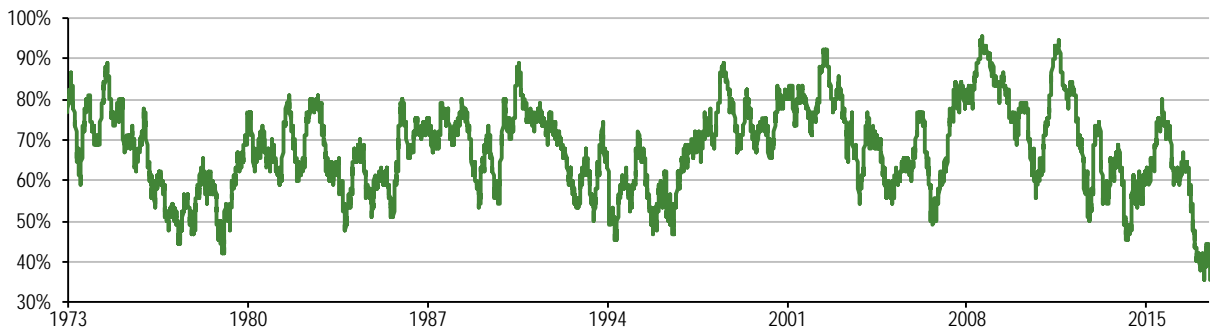
In June we highlighted the low level of volatility in global equity markets. This low volatility regime has continued through the summer and, as Exhibit 6 shows, represents a dramatic and sudden break with 2016.

For the Datastream developed markets index, if measured by the percentage of days with a greater than 25bp close-to-close daily move, the summer of 2017 represents the quietest period for developed markets since inception of the index in 1973. This remains a challenging environment for active managers. From a risk management perspective, investors should perhaps consider that

market volatility is on average 50% above current levels when building portfolios for the longer term.

The lack of market volatility is especially challenging as it is becoming harder to identify the pressure points for investors as events such as North Korea or the separation movement in Spain are having such little impact. In many respects, the picture is the mirror of 2012 when the smallest change in the outlook for Greece could swing the value of the world financial sector by several percentage points in a day. Neither situation was especially helpful, nor ultimately sustained. The normalisation of monetary policy is likely in our view to be associated with market volatility returning to previous levels.

Exhibit 6: Developed market volatility lowest since 1973



Source: Thomson Reuters Datastream, Edison calculations, percentage of days with > 25bp close-to-close move

Conclusion

Bull or bear pieces often make for a more entertaining read. We have been both bullish and bearish in the past but the data is at current equivocal. We take the cautious road as we expect major economies to continue to grow over the short term, but at the same time recognise there is a long period of monetary tightening ahead in that scenario. The surprise for investors in the 2012-17 period was just how strongly asset markets could perform despite weak growth. For the next few years investors may struggle to understand why asset prices fail to deliver even as the economy continues to progress.

To generate returns in this environment, investors will have to be highly selective in terms of equity holdings and able to take advantage of opportunities as they arise. This points to a lower than benchmark allocation to equities and higher than usual allocation to cash.

For fixed income investments, the upcoming period of quantitative tightening and rising interest rates points to a period of weaker returns for bonds and we would aim to carry lower than usual duration exposure. For corporate credit and junk bonds, yields currently clearly favour the issuer rather than the investor; we would also carry underweight and selective positions.

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