Illumination: Equity strategy and market outlook

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Global perspectives: Halfway house

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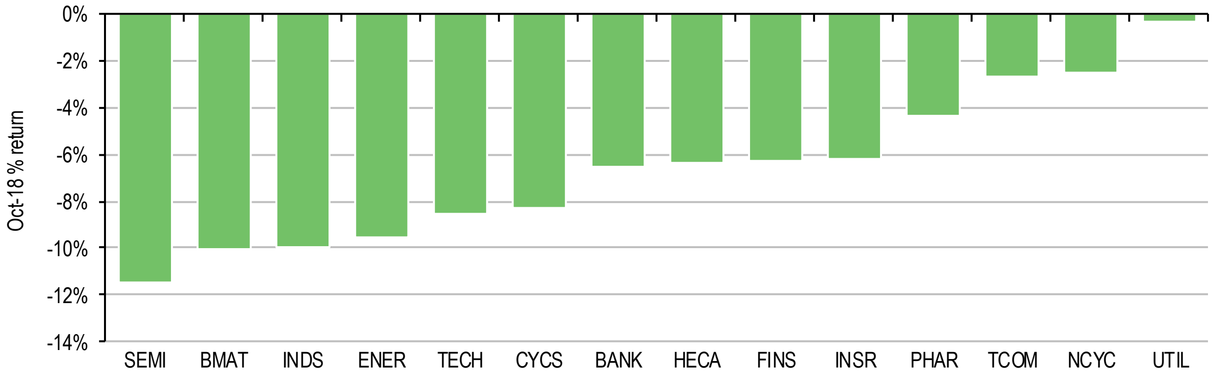
- **The global equity declines seen in recent weeks have had no clear trigger and therefore there is no clear path for a rapid recovery, in our view.** Having considered the modest moves in other asset classes and the absence of credit stress we view the global equity declines as a continuation of an ongoing de-rating process, as US monetary policy is normalised. We can understand that value investors might remain frustrated as there has been no sense of capitulation, nor obvious bargains at the market level.
- **Fundamental risks remain in place**. The US administration shows no sign of backing away from its trade confrontation with China. Furthermore, press reports suggest that the trade truce with the EU remains uneasy. The UK's Brexit negotiations remain unresolved while the EU has in recent days rejected Italy's proposed budget. Finally, US Fed policymakers remain on the hawkish side of prior market and our expectations. For these reasons we do not expect a rapid rebound in equities, even if earnings estimates for 2019 call for another year of 10% global profits growth and recent economic data has been in line with consensus forecasts.
- **We retain a cautious position on developed market equities.** While valuation risks have certainly diminished in continental Europe and the UK, US markets still appear very highly valued in a historical context. Investors looking to take advantage of recent market volatility may find opportunities in specific situations where poor liquidity has led to disproportionate price falls. However, for the broader market, we believe with the US Fed on a more hawkish path than we anticipated, the most likely scenario is that the de-rating process will continue, with profits growing while equities underperform traditional hurdles of 7-8% annual return.

Halfway house: An unsatisfactory position

Rolling global equity declines offer few directional signals

October's equity market performance to date may be amongst the weakest on record for this decade but is likely to be frustrating investors rather than enabling a new direction to be charted for portfolios. On reflection, we do not believe there was a proximate trigger for the recent declines. A hawkish interpretation of the most recent commentary emanating from Fed policymakers may have been unhelpful however, pushing two-year and 10-year US government yields higher in early October.

Exhibit 1: Global sector declines during October*



Source: Thomson Reuters. Note: *To 23 October 2018.

However, the prospect of higher US interest rates and bond yields could not have been more clearly flagged by policymakers and was well known by the market. Investor surveys suggested that concerns in respect of slowing growth were similarly widespread, thus overly bullish investor positioning is also unlikely to be the culprit. The widely reported issues in respect of Brexit or the Italian budget negotiations have been a long-running theme during the summer and could hardly have caught investors off guard.

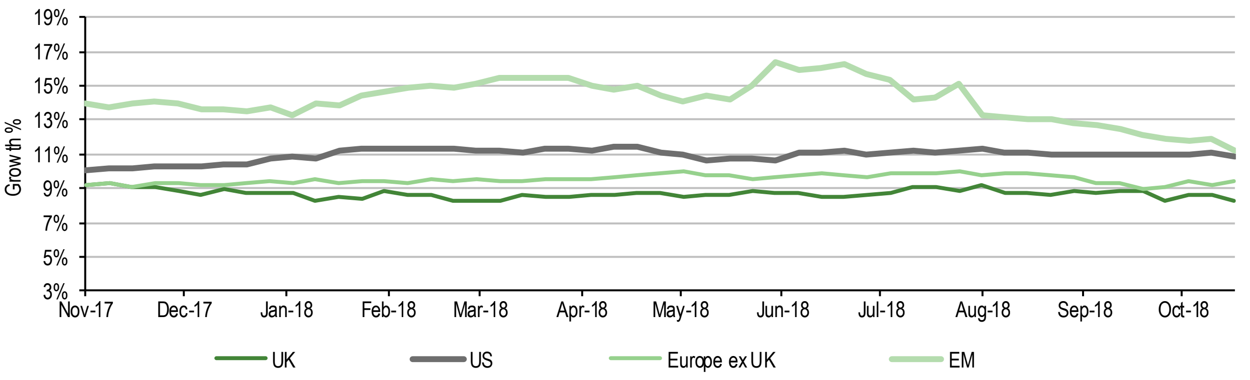
We have also not been able to discern, despite the recent warning from the Bank of England's financial policy committee, any meaningful widening of corporate credit spreads in recent weeks that might have spooked equity investors. Similarly, credit spreads in wholesale funding markets have barely moved during October. Gold has risen, but only modestly and the dollar and yen have strengthened only a little as global equity markets have fallen. We also note that during October emerging equity markets have fallen only in tandem with developed peers.

If there was a single hidden factor that triggered the recent market declines, we believe it would have been identified by market participants at this stage. A more likely scenario in our view is that equity market declines, in the absence of credit stress or falling bond yields, point to a re-appraisal of either valuations or the likely direction of corporate profits during 2019. Our cautious view on equity markets – which has been in place for some time – has been based primarily on valuation concerns.

The long period of ultra-loose monetary policy following the financial crisis of 2009 in effect brought forward gains in markets by increasing market valuations. The actuality of normalising monetary policy in the US and the end of quantitative easing and the prospect of higher interest rates in Europe in H219 is now pressuring markets, even as corporate profits grow strongly.

In terms of earnings estimates for 2019, Exhibit 2, median growth profits forecasts for the US remain at 11%, with the UK and Europe at 9%. After downgrades during September, emerging markets forecasts also now call for 11% profits growth. In developed markets at least, there has not been the magnitude of reductions in earnings forecasts that would justify the recent market volatility, in our view. However, we acknowledge that the downgrades in emerging markets do justify some of the market declines seen in the year to date, despite our earlier positive views.

Exhibit 2: 2019 median earnings forecasts remain stable in developed markets



Source: Thomson Reuters, Edison Investment Research calculations

Recent market declines have equally frustrated value investors and those with high exposure to highly valued technology or growth stocks. The global hedge fund index has suffered sharp declines, as share prices of companies with activist shareholders on the register have underperformed, suggesting a degree of de-risking among this investor base.

The frustration felt by value investors is likely to be compounded by the sense that the data suggests this correction was long overdue, and does not of itself provide compelling investment opportunities for the future. Price/book valuations outside the US are now close to historical averages, but merely average valuations are hardly a strong buy signal or reason to make a large shift in portfolio asset allocations.

Furthermore, we see no sign of capitulation among investors. For US investors, the recent declines are barely visible on a long-term chart showing a doubling of the S&P500 over the past six years. In Europe and the UK, overall market performance may have been muted over the same period but there is still no sense of panic.

From a fundamental perspective the ongoing tensions within the EU in respect of the Italian budget and Brexit show few signs of resolution. Globally, the US continues to engage in confrontational and unpredictable policies in respect of trade. While the objective of levelling the playing field for US corporations competing with Chinese peers is understandable, the means by which the current US administration pursues it is less so.

Investors looking to take advantage of recent market volatility may find opportunities in specific situations where poor liquidity has led to disproportionate price falls. However, for the broader market, we believe with the US Fed on a more hawkish path than we and the market anticipated, the most likely scenario is that the de-rating process will continue, with profits growing while global equities underperform traditional hurdles of 7-8% annual return.

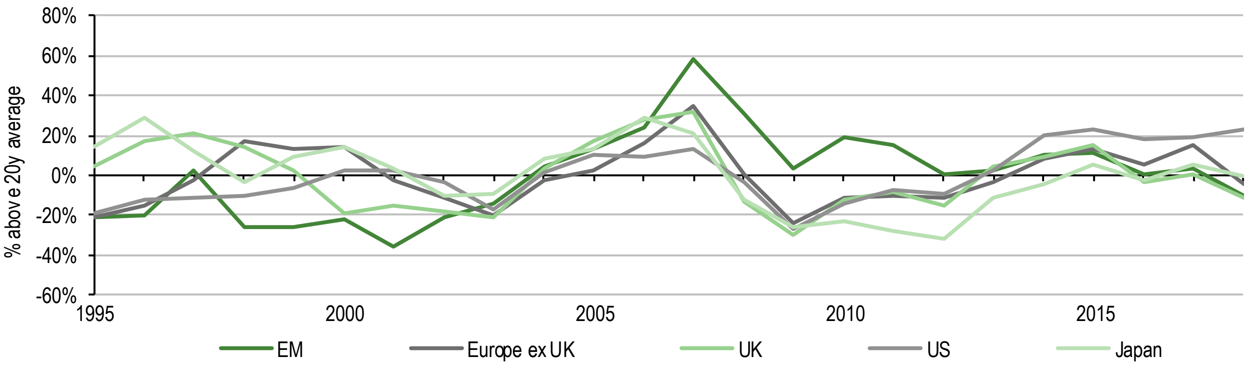
Market valuations improving in UK and Europe

Risks remain in place but at valuations that are now closer to long-term averages

Following the recent market declines, but following solid earnings growth and return on equity in 2018 to date, median non-financial price/book levels are now close to long-term averages in continental Europe, the UK and emerging markets. However, US equities remain the notable exception to this trend. While there may be concerns over the sustainability of current profit margins, rising bond yields or geopolitical events, valuations can now move down from the top of investors' lists of risks in our view.

This is not to say that lower valuations provide an excuse to become significantly more positive towards equity markets at the present point in time. For continental Europe and the UK there are meaningful challenges ahead, which may explain why equities have de-rated faster than in the US.

Exhibit 3: Median price/book valuations outside US now in line with long-term averages

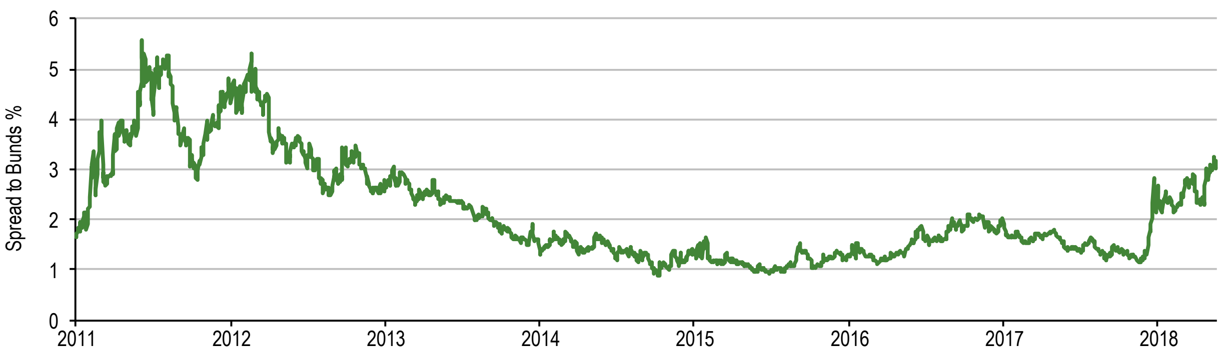


Source: Thomson Reuters, Edison Investment Research calculations

The challenges of reaching a Brexit accord that provides for no hard border in Ireland while at the same time allowing the UK as a whole to withdraw from the EU's customs union have thus far proved insurmountable. There appears to be a meaningful prospect that any withdrawal agreement that is acceptable to the EU will be unacceptable to the UK's parliament and vice-versa.

While this would be unlikely to lead to a no-deal Brexit directly by Q219 (as it would be logical to expect an extension to the Article 50 process in the circumstances), the probability of a change of UK government or a general election remains elevated. A future UK government might even find a way of derailing the entire Brexit project but, should it be left-leaning, investors would have to discount a number of potential tax and regulatory changes unfriendly to the corporate sector. Therefore, while valuations have moved lower, a risk premium for UK equities remains warranted, in our view. We have seen little in recent developments to suggest that substantive progress is being made in resolving the divisions within the current UK government in terms of Brexit policy.

Exhibit 4: Italy/Germany 10-year government bond spread continues to widen



Source: Thomson Reuters

In the eurozone, the elevated spread between Italian and German 10-year bond yields shows that the structural imperfections of the eurozone continue to simmer under the surface. Yet unlike the unpredictable dynamics of Brexit, there is a relatively predictable market mechanism for bringing populist politicians to heel within the eurozone, namely to threaten to withhold market support and allow sovereign financial pressures to build until fiscal policies are brought into line.

The recently proposed Italian budget deficit of 2.4% of GDP may be above the EU's target of under 1%, but the difference following negotiations is likely to be modest, and similar in magnitude to the additional interest expense faced by the Italian state due to higher bond yields. Despite the unprecedented rejection of Italy's budget proposals by the EU, it is not necessarily the case that a market crisis is unavoidable, at least in the near term. Over the longer term however, the challenges of refinancing Italy's debt burden as eurozone bond yields rise will require deft policymaking.

Conclusion

We do not see a proximate cause for the recent increase in equity market volatility which has been indiscriminate across developed and emerging markets but focused on more cyclical sectors. In the absence of a meaningful rise in credit stress, the declines still fit the theme of a de-rating as US monetary policy is normalised. Perhaps investors have in recent weeks belatedly woken up to the prospect of positive real yields on US bonds in 2019, at a time when US GDP growth is slowing from the fast pace of 2018. Yet a slowing rate of GDP growth is not necessarily a reason to fear a recession.

With investors still having to contend with a number of other fundamental risks such as US trade policy uncertainty, Brexit and Italian budget negotiations, we believe the de-rating is rational and that markets are likely to remain volatile.

Helpfully, the lack of progress in European and UK markets over the last two years has allowed market valuations to catch up with growing profits and these markets no longer appear overvalued on a price/book basis. US equities remain well above historical multiples however and therefore remain at risk from rising US bond yields.

We therefore retain a cautious position on developed market equities for now due, in our view, to the likelihood of a continuation of the benign derating regime as profits grow while global markets underperform traditional hurdle rates for equity investment of around 7-8% pa.

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