Illumination: Equity strategy and market outlook

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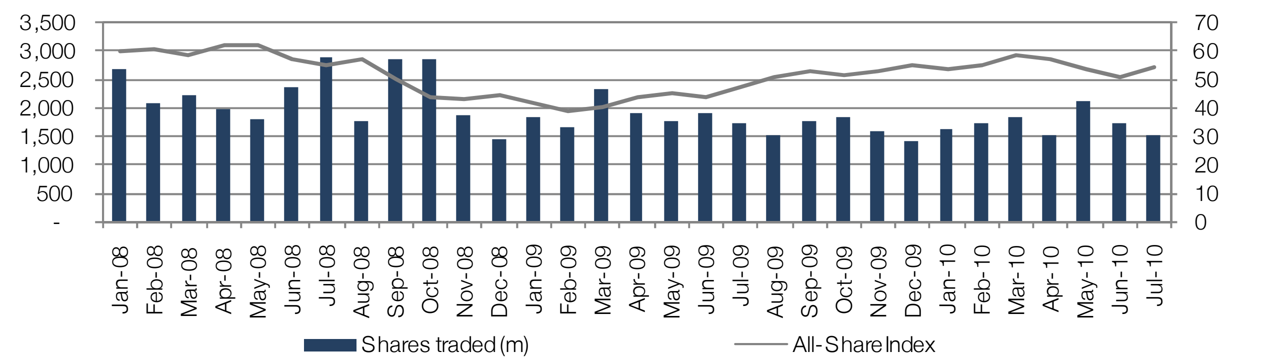
Equity market overview and strategy

Recent gains in global markets are unlikely to prove sustainable in our view. Our fundamental concerns over the sustainability of nascent growth have not dissipated. Sovereign debt issues, inflation, unemployment and confidence trends all point to a slowdown in growth over the next 12 months, a scenario that we do not feel is fully discounted in consensus earnings expectations. With estimates potentially under pressure, it is also hard to find support in valuation levels, with the UK equity market trading on around 15x 2011 P/E. Against this background, we see few attractive options for equity investors (we continue to favour gold as an asset class). In the near term, we expect to see further positive momentum for financials and retain our cautious stance on consumer cyclicals; longer-term, our preference is for stocks that offer high global diversification and undervalued growth potential.

The summer of uncertainty

Let us get one thing clear straightaway: a 9.5% gain in the All-Share and a 7.9% rise in the MSCI World Index over the last month is not something about which to get excited. Not only does it remain the case that both indices are barely in positive territory on a year-to-date basis (up 0.9% and down 1.4% respectively), but more fundamentally, trading volumes are down substantially – even by typical summer standards – and so, axiomatically, price and index movements have been noticeably more pronounced. To highlight the extent of the issue, just 30.3m shares were traded on the All-Share in July, down 13% relative to the same month last year, with the month being the third quietest in volume terms witnessed in the last two years (only December 2008 and December 2009 saw lower volumes).

Exhibit 1: Volumes are low – even by summer standards; price movements are more exaggerated



Source: Bloomberg, Edison Investment Research

As the *Financial Times'* Lex column (12 July) aptly describes it, a "spooky calm" seems currently to be prevailing. We concur, and also believe that any signs of nascent optimism that have recently emerged, driving markets higher, are misplaced. It should not be forgotten that July's bounce follows a six-month period through to 30 June that was the worst in performance terms for equities since the first half of 2008. We do not deny that the conclusion of stress test procedures for European banks and a favourable resolution over Basel III provisions for the banking sector may provide some near-term relief, but the fundamental concerns we have had for some time over the growth outlook (a natural consequence of ongoing painful deleveraging) are far from dissipating.

Both macro and micro data from the last month have proved highly inconsistent in our view, with as much grist for the mill being provided for both the most bullish and bearish market commentators. We definitively sit on the more cautious side of the fence and continue to believe that there remains insufficient evidence to suggest that recovery is sustainable. We have discussed the risk of 'double dip' scenarios previously (see the June edition of the *Insight*) and, as we show below, economic forecasts actually point to a *deceleration* in growth in 2011 relative to 2010. Corporate sentiment and consensus earnings estimates seem in denial of this issue, a phenomenon we find concerning.

To demonstrate the extent of the conundrum facing investors, let us consider the lack of consistent trends. We were unsurprised that the UK stock market remained virtually unmoved (up just 0.1%) following the release of the ONS figure for Q2 GDP on 23 July. 1.1% growth was considerably better than consensus had been assuming, but any positive surprise needs to be offset by remembering the low base from which this growth has come. Of greater concern for us is the fact that UK service sector confidence hit a 10-month low in July (according to the British Chamber of Commerce), while consumer confidence has now fallen for two second consecutive months with Nationwide's expectations index falling to its lowest level in a year.

Similar trends are playing out in other geographies too: we note that despite a consensus-beating ISM (industrial production) figure for July, the Fed recently cut its estimate for US economic growth for the first time since the recovery began with Ben Bernanke going as far as to state that the outlook was "unusually uncertain" in his 22 July testimony to the Senate. The decision appears to have been the right one given that the initial read for Q2 US GDP growth shows a drop to 2.4%, relative to Q1's 3.7% performance. We would also highlight that the University of Michigan US consumer confidence survey stands at its lowest level since August 2009, while homebuilder confidence is at its lowest since last April. In China too, despite record June export levels (up 44% year-on-year), manufacturing confidence is currently at a 14-month low.

At a micro level, we also see similarly mixed and inconsistent trends. Mid-way through the Q2 earnings season, there appears to be a broad balance between companies guiding to a better outlook and those painting a significantly more cautious picture. On the positive side, we note upbeat commentary from a range of global bellwethers including Alcoa, Apple, BASF, GE, Intel, JP Morgan, Pearson, Siemens and UBS. However, Arcelor, Boeing, Cable & Wireless, Google, IBM, Johnson & Johnson and Procter & Gamble among others seem of the view that risks remain weighted on the downside. If there is a salient theme that has emerged from the reporting season then it is that companies seem still to be delivering more effectively in terms of cost-cutting than with regard to top-line growth, a situation that is clearly unsustainable over the medium term.

Finally, we do not believe that investors should read too much into the recent spate of deal-making that has occurred, particularly in the UK market. Within the last month, Dimension Data, SSL International and Tomkins have all received bids, International Power has entered talks with GDF Suez, and Partygaming/bwin have announced plans to merge. Meanwhile, Barclays, BSkyB and Sainsbury's remain subject to break-up/take-over speculation. However, it is worth bearing in mind that $309bn of global equity issuance for deals in H1 represents the slowest start to the year since 2005. M&A activity should not be seen as a panacea for improved optimism among corporates: only companies with strong balance sheets are likely to be in a position to do deals, easy leverage no longer exists and it is harder than ever to assess future value. We also note the disappointing reaction to the Ocado IPO and the fact that Fairfield was forced to pull its flotation.

Against this background of uncertainty, it is unsurprising to us that UK and European pension fund managers are holding c 9% of their assets in cash, the highest since pre-Lehman levels (source: *Financial Times*, 15 July). Put simply, the bigger problems have not gone away, and it would be naive to assume otherwise. Prime among these is how policymakers can manage sovereign indebtedness (which currently stands at a sizeable €7,300bn in the Eurozone alone) and a nascent recovery and what this means for corporates and investors. Even if governments do prove successful in this balancing act – and we remain sceptical, especially given the recent switch from stimulus to austerity – then, at best, there will be uneven trends.

The consensus view among market commentators seems to be a strategy of seeking to buy on dips. While the logic seems obvious, we feel that this approach may be too optimistic since the risk of there being bigger dips ahead remains high to us. Our strategy therefore remains unchanged: stock selection is crucial and we continue to favour undervalued names with strong global growth prospects. Over time, we remain convinced about the trends of emerging market growth and industrialisation as well as increasing globalisation. Near-term, we have higher conviction in our underweight positions (especially regarding consumer services) than we do elsewhere, but, on a more optimistic note, we believe a strong case can be constructed for increasing weightings in financials.

Market review: Performance versus volume

With the All-Share up 9.5% in July and European bourses similarly robust, the past month has been the strongest in performance terms year-to-date, and the best recorded since April 2009. While market bulls may take obvious encouragement from such gains, as mentioned above, it should be borne in mind that volumes of shares traded in July (just 30.3m for the All-Share) constituted their lowest figure in 2010 so far and represented one of the quietest months witnessed in the last two years.

Impressive monthly gains were not only restricted to the UK, with the Euro Stoxx 600 broadly keeping pace with the All-Share and recording a 9.0% positive move over the last month. Unsurprisingly, with (albeit low volume) moves being accompanied by growing risk appetite during July, those indices and sectors which had suffered most in volatile performance terms in recent months, bounced most strongly. In other words, during July, the IBEX35 in Spain leapt 17.0% and Milan's main bourse showed an 11.6% gain.

Back in the UK, the last month's best performing sectors were basic materials (up 14.3%), oil & gas (14.1% higher, helped by a seemingly positive conclusion to BP's woes) and financials (a 13.4% increase). By contrast, those sectors typically regarded as most defensive – healthcare, telecoms and utilities – all noticeably underperformed the All-Share during July.

Exhibit 2: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	(0.3)	9.8	(2.8)	2.2	15.3
FTSE All-Share	0.9	9.5	(2.8)	2.7	16.4
DJ EURO STOXX	(2.2)	9.0	(0.4)	0.7	8.6
DJ EURO STOXX 50	(4.8)	9.7	0.2	(0.3)	5.5
France CAC40	(4.7)	9.0	(2.0)	(1.6)	7.9
Germany DAX30	5.6	5.5	2.0	10.2	15.9
Spain IBEX35	(9.3)	17.0	4.0	(2.7)	(0.6)
Italy MIBTEL30	(7.3)	11.6	(0.4)	(3.9)	3.0
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	4.5	0.1	(3.0)	2.5	9.8
FTSE All-Share vs EURO STOXX	3.1	0.5	(2.4)	2.0	7.8

Source: Datastream, Edison Investment Research

While a better July is encouraging for near-term sentiment, Exhibit 2 provides a useful reality check: in other words, it is clear that while markets have bounced recently, on a three-month basis only three of the indices we track (the Euro Stoxx 50, the DAX and the IBEX) are in positive territory. Meanwhile, on a year-to-date basis, only the DAX has recorded a gain of more than 5%. By contrast, the All-Share, the UK's main market, is up just 0.9% while the Euro Stoxx (comprising Europe's 600 largest companies) is down 2.2%. Moreover, as impressive as July's gains may have been in the Italian and Spanish markets, both indices will have to strengthen considerably further in order just to end the year flat, given that they remain down 9.3% and 7.3% respectively for 2010-to-date.

One sobering consideration is that despite a general improvement in equity sentiment over the last 12 months, investors in the IBEX index would have lost money during this period, with the main Spanish market down 0.6% in absolute terms. While Spain does have its own well-documented issues (unemployment close to 20%, failing state-sponsored caja banks etc) it is interesting to note that investors' gains in other indices also continue to erode. The All-Share has gained 16.4% in the last year and the Euro Stoxx has put on an 8.6% increase, but, despite July's share price strength, just three months ago the same analysis would have shown the All-Share 20% better and the Euro-Stoxx 10% up on comparable periods.

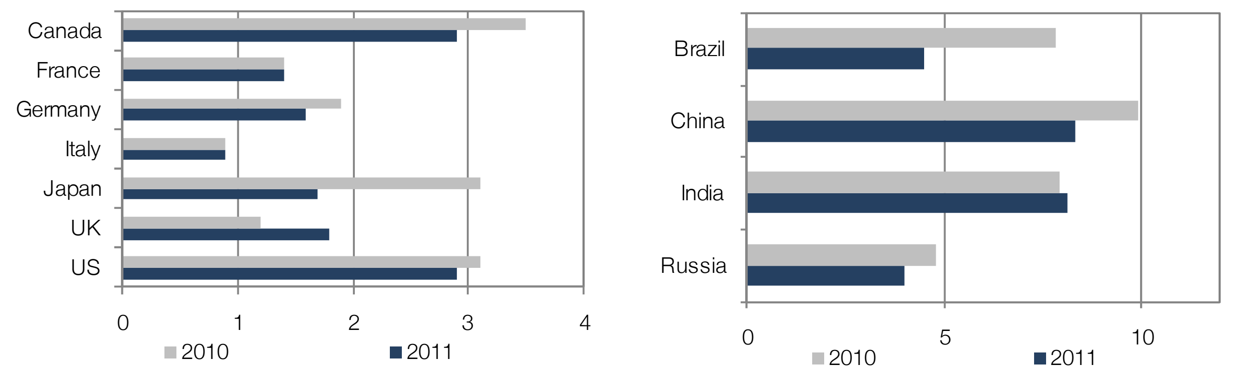
The fact that the All-Share has performed almost twice as well (16.4% vs 8.6%) as the Euro Stoxx in the last year can be put down to several factors, although three stand out to us. First, as we have discussed in previous editions of *Insight*, the All-Share is a considerably more 'international' index than its European peers: with a bigger percentage of UK-listed companies' revenues and profitability derived from non-domestic sources, the All-Share is inherently less dependent on the health of the local economy. The UK stock market has also benefited from being less afflicted by sovereign debt issues than its European peers (although this is not to ignore a state deficit equivalent to more than 10% of GDP in Britain) and has had the corresponding benefit of a non-Eurozone aligned currency.

Given the outlook we detail below, we continue to favour a strategy of investing in globally diversified UK-listed stocks. We believe that over the remainder of 2010 (and likely too for 2011), UK bourses should outperform their broad European peers. The strength of the DAX – Europe's best performing major market to-date – also supports this theory, with German outperformance being driven by large export-led and international businesses such as BASF, Siemens and Volkswagen.

Outlook: Not too early to consider what 2011 may look like

As the Q2 reporting season draws to its close, the natural tendency is for estimates to roll forward a year. What happens for the remainder of 2010 is clearly important, but more crucial is what 2011 could look like. Our concern is that there remains too much optimism regarding the next 12 months, and, more fundamentally, there exists a major disconnect between bottom-up and top-down assumptions. As Exhibit 3 shows, according to *The Economist*, GDP is not set to accelerate in any G7 country next year with the exception of the UK, while growth will also slow in three of the four BRIC countries (Brazil, Russia and China). Another potentially good proxy for what the future may hold is the health of the Baltic Dry Index, which has fallen 13% in the last month and 41% in the last quarter, signalling that global (and particularly Chinese) trade flows are declining.

Exhibit 3: Growth set to slow in 2011 in both the G7 and the BRIC economies



Source: Datastream, Edison Investment Research

We also note that despite recent upward moves in equities, fund managers appear to have turned noticeably more cautious. The latest well-regarded Merrill Lynch survey showed that a net 12% of fund managers are currently expecting a worse outlook in the next 12 months, versus 42% expecting a stronger outlook just two months ago.

Our concern relates to the fact that if growth is set to slow and fund managers are noticeably more downbeat than previously, not only is there downside risk to consensus earnings expectations, but also equities may struggle to make headway in the coming months. Our analysis suggests that clear risks remain as we discuss in more detail below. We continue to believe that investors face an unappealing combination of substantial state debt burdens, rising inflation, persistently high unemployment and stalling earnings momentum combined with limited valuation support.

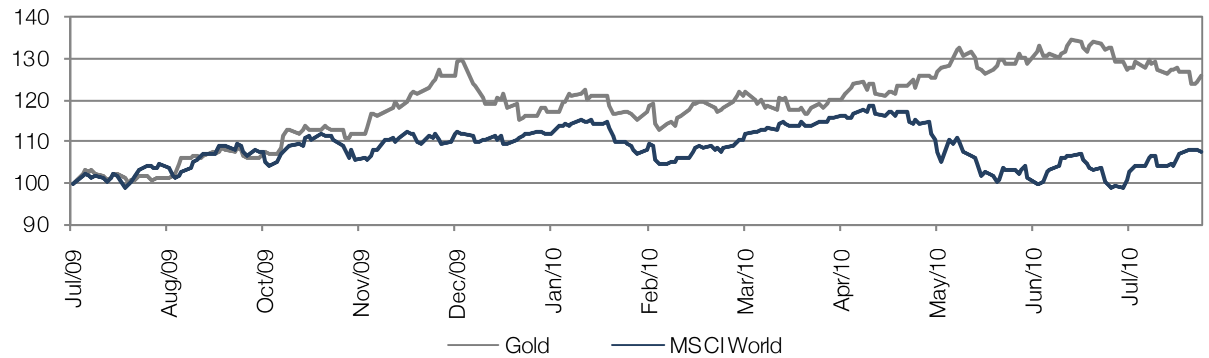
The return of QE?

Even if global economies are showing signs of economic growth, two factors in particular may impact future prospects negatively. First, unemployment remains stubbornly high: in the Eurozone, unemployment hit 10% in June (up 0.5 points relative to the 12 months prior), while in the US – which entered recovery sooner than any other developed nation – unemployment is set to remain above 7% even by 2012, according to research by the PEW institute (cited in *The Economist*, 24 July 2010). Second, the austerity programmes currently being pursued by governments across Europe and elsewhere may not only stifle growth but also exacerbate unemployment levels.

Investors have a very obvious reason to be concerned about the switch from stimulus to austerity: is it because the former is not working, or because new problems are arising? More fundamentally, the stimulus-austerity debate implies that a choice exists for policymakers, but perhaps the bigger problem is simply that current debt levels are unsustainable and neither strategy may ultimately work.

As we have discussed before, this has clearly negative implications for equities as an asset class (hence our ongoing preference for gold), but, in the near term, what does seem possible is that governments may likely revert back to quantitative easing, potentially as an additional stimulant for declining economies. With regard to the UK, we feel this is a particularly likely scenario, especially since UK bank lending levels (according to the Bank of England) have already turned negative.

Exhibit 4: Gold has been a significantly better investment than equities in the last 12 months



Source: Bloomberg, Edison Investment Research

Rates: no way out

While there was clear evidence of synchronised interest rate cutting as the credit crisis emerged, consensus appears to be unravelling with regard to when rates ought to increase. Several countries in both the developed (Australia, Canada) and developing world (India) have now entered a rate-rising cycle. By contrast, both the Bank of England and the Federal Reserve seem to be of the view that rates need to stay low for the foreseeable future. Of particular interest was Governor Mervyn King's comments made before the Treasury Committee on 28 July: he argued that the Bank was more worried about slow growth than inflation, hence the need for rates to stay low. The respected Ernst & Young Item Club goes further, stating that UK rates should not rise before 2014 in order to counter-balance government spending cuts.

The fact that Australia began raising rates back in October reflects the relative strength of its domestic economy, which seemed to escape recession, but the case of India is perhaps of more relevance for consideration. India has now raised rates for two consecutive months to counter inflation, currently running at 11%. While rates in the developed world are clearly not close to this level, there remains a clear danger of complacency with regard to inflation. UK CPI inflation fell to 3.2% in June (down from its recent peak of 3.7% in April), but it remains clearly ahead of the Bank's 2% target. The Minutes from the last Monetary Policy Committee meeting (published on 21 July) also state that "near-term inflation prospects [have] worsened." Further stimulus measures and/or rising commodity prices would only risk stoking inflation (in the UK and elsewhere).

Policymakers (and hence investors subsequently) may be faced with a choice of the lesser of two evils, undergoing either a scenario of prolonged inflation or sooner-than-anticipated rate rises. Both outcomes are, again, ultimately more positive for gold than other asset classes. In the former scenario, inflation could mutate into stagflation since unemployment remains high, as we discussed earlier. By contrast, rate rises may not only hinder growth and risk stoking further unemployment, but would make equities relatively less attractive for investors. Yields on other asset classes would become more attractive and the rate at which forward earnings become discounted would rise, decreasing net present values.

Earnings outlook: another conundrum for investors

Where Q2 earnings have flattered, the reason has typically been clear: companies have continued to reap the benefits from significantly leaner cost bases relative to 12 months ago, exploiting spare capacity and/or operating leverage. Low interest rates have also helped depress the cost of debt servicing. However, there has been much less evidence of robust top line trends, and this is a clear cause for concern in our view, as much as anything because the scope to cut costs further is limited and, without revenue growth, business models cease to be sustainable.

It does not seem unreasonable to us to assume that the rate of economic growth will slow going into 2011 and could even turn negative. Even on a more optimistic, better-growth scenario, rising inflation would likely erode the benefits from improving revenue trends. While profit warnings during Q2 (ie in respect of the Q1 earnings season) reached a seven-year low in the UK, of just 45, according to Ernst & Young, the consultancy's most recent report (published on 12 July) expresses considerably more concern about the outlook for 2011. We concur and believe that consensus earnings expectations are potentially too high. The factors we see suggest the next 12 months could be *worse* for the global economy rather than better, a scenario which we do not believe is fully discounted at present.

Towards a sector ranking: Key considerations

Pronounced swings, a general lack of direction and bouts of volatility have all characterised trends in equity markets year-to-date. Against this background, bottom-up analysis has inevitably had to take precedence over a more sector-based approach. This has been our general contention, favouring undervalued stocks with diversified and global growth potential. Nonetheless, we feel it remains constructive to provide a conceptual framework for considering those sectors where we have the strongest positive and negative views.

Our sector rankings are reviewed monthly and for August we have made only one change relative to July, moving the financials sector further up our list. We adopted a more positive stance in May (having been negative since October 2009) and our decision to do so has been vindicated by a 4.5% gain in the sector relative to the market in the last three months. In July, financials was the UK's third best performing sector, helped by favourable stress test and Basel conclusions as well as a generally robust European reporting quarter.

We see no reason to change our positive fundamental view on basic materials (which we have held since 2009). While the sector is up only slightly since 1 January, it has still markedly outperformed the All-Share on a 12-month view, by 12.6%. Sector strength in July (a 14.3% gain for basic materials – better than any other sector) is also encouraging. Our increasingly positive stance on industrials (established in April) has also proven to be the right call, with industrials being the second best performing sector year-to-date.

The negative view we have developed towards the consumer sector – on which we have adopted an increasing level of conviction – has yet to deliver the anticipated results in performance terms, although a series of core indicators, combined with valuation levels give us no reason to change our stance.

Exhibit 5 shows our preferred sector strategy, which we caution is strictly illustrative since it only relates to hypothetical positioning across UK equities whereas, in reality, investors will likely take into consideration a much broader range of factors. We provide additional explanation and justification below.

Exhibit 5: Edison sector rankings, key valuation and performance data

Note: * All Share benchmark weight.

Position	Sector	Weight*	P/E	Yield	YTD	Last month	Last three months	Last six months	Last 12 months
Best	Basic materials	12.0%	12.6	1.5%	0.9%	14.3%	(1.6%)	4.8%	29.0%
	Industrials	7.4%	17.4	2.7%	10.9%	6.3%	(1.7%)	10.0%	31.3%
	Financials	24.3%	22.1	2.8%	5.4%	13.4%	1.7%	7.3%	13.8%
	Telecoms	6.0%	8.0	5.3%	4.6%	7.5%	3.8%	9.2%	18.9%
	Healthcare	7.5%	11.8	4.6%	(3.6%)	0.2%	(0.1%)	(0.4%)	8.8%
	Utilities	3.8%	10.2	5.3%	2.2%	6.8%	3.5%	2.8%	20.3%
	Oil & gas	16.1%	17.5	3.8%	(12.3%)	14.4%	(14.4%)	(9.3%)	2.0%
	Technology	1.7%	19.9	1.2%	17.7%	7.8%	1.4%	9.7%	38.2%
	Consumer services	11.3%	15.0	2.9%	4.4%	7.3%	(5.2%)	3.7%	19.6%
Worst	Consumer goods	9.9%	15.6	3.4%	2.3%	3.3%	(0.9%)	2.7%	21.6%
Average		100.0%	14.9	3.2%	0.9%	9.5%	(2.8%)	2.7%	16.4%

Source: Datastream, Edison Investment Research

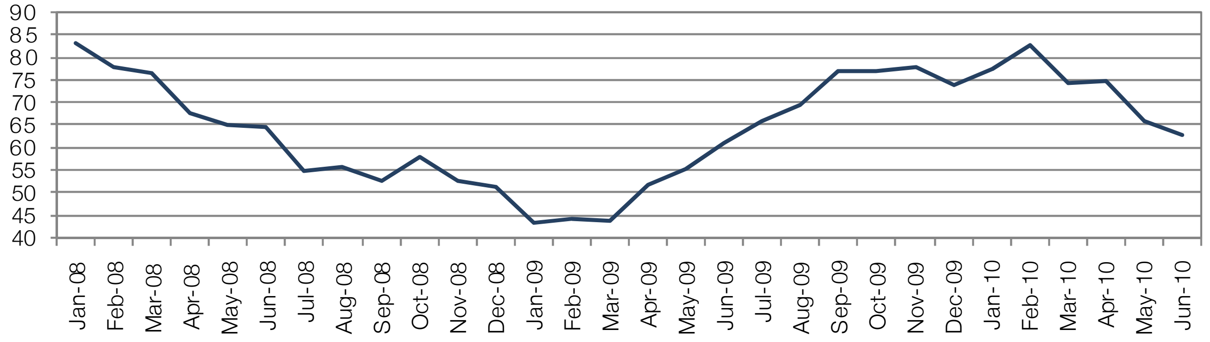
Underweight consumer goods and services

The consumer sectors have showed surprising robustness since the start of the year, with both goods and services outperforming the market (albeit only slightly). Not only has this result been surprising to us, but, as a consequence, the two sectors trade at a premium to the UK market and we believe this does not appropriately discount the potentially vicious circle scenario facing these companies. In particular, we are concerned that recent earnings momentum within the sector may not be sustained. We are encouraged that both the consumer goods and services sectors have begun recently to underperform, losing 6.2% and 2.2% respectively (on a market relative basis) since the start of July.

We are not misled by the recent strength in UK retail sales growth. According to the CBI, year-on-year growth of 1.2% in June (measured on a like-for-like basis) was the fastest pace witnessed since April 2007. Similar analysis from the ONS and the British Retail Consortium also demonstrates comparable current health on the high street. Growth has been partly flattered by the weather and summer sales as well as receiving a boost from the World Cup (a scenario we did anticipate). Looking ahead, consumers may also continue to spend in 2010 in order to pre-empt the increase in VAT to 20% from next January.

However, our bigger concern is that consumer confidence remains moribund and could likely fall further, affecting future spending. According to Nationwide, consumer confidence has declined for two consecutive months and its current level (of 63) already stands a long way down from February's recent high of 83 and is just two points ahead of where confidence stood last June. We also note that Nationwide's expectations index (ie reflecting future spending intentions) is currently at a 12-month low.

Exhibit 6: UK consumer confidence continues to decline sharply



Source: Nationwide, Edison Investment Research

From a corporate perspective, better results from ASOS, Burberry and Primark are evidence of the strength of these companies' business models as well as their international presence (in the case of the first two). A much better reflection on the behaviour of the UK consumer are comments from bellwether Marks & Spencer, highlighting that it was "cautious about the outlook for consumer confidence and spending" (7 July) and from the CEO of Debenhams, who stated that "I think the whole market has seen a slowdown" (1 July). Kingfisher is another large retailer in the cautious camp.

We therefore continue to see potential scope for disappointment relating to future results releases from the UK consumer stocks, and struggle to see a strong case for sustainable sector outperformance until management teams can sound a noticeable voice of confidence on visibility and the outlook. Moreover, valuation – with the consumer goods sector on 15.6x 2011 P/E and the services sector on a multiple of 15.0x – is also not supportive in our view.

Overweight global industrial cyclicals: Keeping the faith and favouring fundamentals

Recent share price movements serve as a reminder that stocks in these sectors offer not just potentially above-average returns, but also increased volatility. The basic materials sector (which has been our core overweight since October 2009) has been the underperformer in the last three months, but has still strongly outperformed on both a six- and 12-month view. As importantly, we continue to be encouraged by the resilience of the industrials sector, being the second best-performing year-to-date.

While potentially deteriorating earnings momentum in certain industrial segments remains a trend to monitor closely (particularly given the restocking may be broadly complete at a number of businesses), our positive stance is driven by two key factors, and also reinforced by valuation considerations. First, companies continue to benefit from the effects of recent cost-cutting exercises, and the subsequent upside from operating leverage. Second, much of our future confidence is also driven by the fact that end-market demand appears robust, particularly from emerging markets. Even if measures are currently being undertaken to halt near-term growth (and inflation) in markets such as Brazil, China and India, we expect demand trends to remain healthy and endure over the medium term.

In particular, we favour businesses with global diversity, and especially those exposed to the Chinese and Indian markets. The growth prospects for these economies are well known and recent data points serve to reemphasise the strength of current demand. Chinese exports rose by over 40% year-on-year in June, while Indian industrial production increased by more than 15% over the same time period, an acceleration in its growth rate from earlier in 2010. Furthermore, we note that China alone is responsible for consuming a third of the world's base metals, supporting our positive stance on the basic materials sector.

Given growth prospects, we also regard current valuation levels as being relatively undemanding with the basic materials sector trading on a sub-market multiple (of 12.6x) and the industrial sector trading at a justified 20.0% premium.

Financials: Increasingly positive, as the outlook becomes clearer

Our decision to move towards a more positive position on UK financials in May has begun to deliver returns, with the sector outperforming the All-Share by 3.9 points in the last month and by 4.5 points during the last three months. On a year-to-date basis, financials have gained 4.5 points relative to the All-Share. We expect this better performance to prove sustainable over the near term, particularly following three items of positive news.

First, the stress tests to which European banks had to submit themselves demonstrated that the sector remains in generally robust health. Just seven of the 91 banks tested failed (and only one of the failures – a German bank – was an 'obvious' surprise to market watchers). Second, the revised Basel requirements for banks offered them a greater number of concessions than had been anticipated, regarding tier one capital, leverage and liquidity in particular. Finally, the recent reporting season demonstrated that a number of large banks in Europe (Credit Suisse, Deutsche, UBS) and in the US (JP Morgan, Morgan Stanley) appear to be clearly on the path to recovery.

Although expectations for future revenue growth are still low and the debate over what constitutes 'new normal' earnings has not been fully resolved, we see scope for consensus expectations to become more positive. On the positive side, most organisations are placing an increasing focus on cost reduction and synergy delivery, while revenues from a more diversified range of streams (particularly investment banking) seem to be coming through. Risk premiums have also begun to reduce as credit has normalised.

Furthermore, there may be some upside potential for the sector from value crystallisation within the sector. There has been an increasing level of commentary from the investment community about group break-ups, particularly with regard to Barclays and Lloyds Banking Group. Valuation levels across the group remain very broadly spread, and we retain our preference for businesses with superior – and globally diversified – business models.

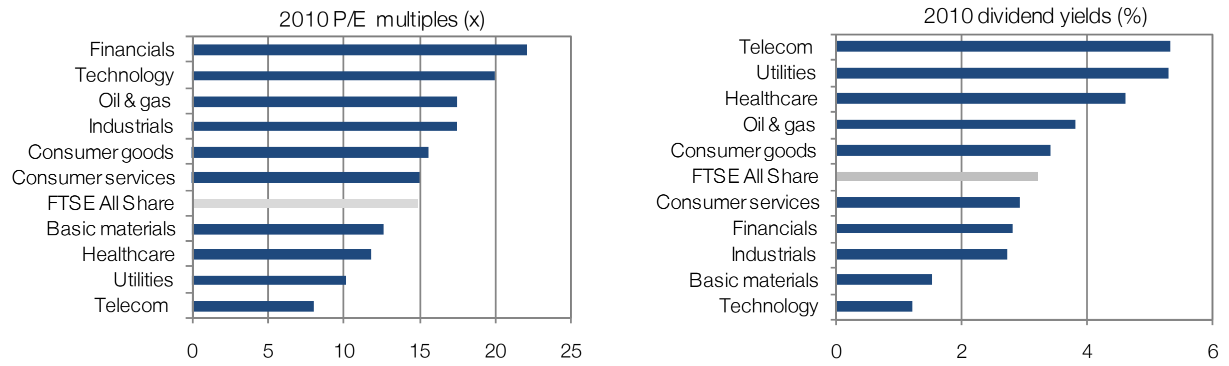
Telco, pharma and utilities: Attractive on yield and other factors

The appeals of defensive sectors are broadly understood, in particular, their combination of attractive dividend yield and value, combined with relatively low economic risk. Among these, our relative preference is for the telecoms sector, which is also currently the highest yielding. The two sector majors (Vodafone and BT) have both enjoyed strong recent performance. We favour Vodafone's global exposure and are also attracted by the fact that its already compelling 5.6% dividend yield could be boosted further should the company start receiving dividends from its US partner Verizon Wireless. Meanwhile, BT appears to have put many of its pension issues behind it and its last set of results also exceeded consensus expectations.

With regard to the healthcare sector, the mega-cap pharma stocks seem to be finding a renewed degree of confidence, as evidenced by last reported results from both Astra and GSK. Our healthcare team finds favour in both, with Astra providing investors with a pure-play pharma business offering attractive growth but concomitantly higher risk, and GSK representing more of a utility-like play on healthcare with stable future revenue streams.

While growth prospects for all three sectors are relatively unattractive (and so they have underperformed in the last month as investors' near-term risk appetite has improved), M&A may serve as a potential additional driver for all three of the aforementioned sectors. Within pharma, activity has begun again, with Shire's recent acquisition (of Movetis) and Genzyme entering into talks with Sanofi. Meanwhile, the UK water sector has long been seen as ripe for consolidation, a scenario recently advocated by the chief executive of Severn Trent, while press coverage has suggested that Northumbrian Water could be a potential bid target. Turning to the telco sector, both Cable & Wireless and Carphone Warehouse have helped crystallise value for their shareholders via recent demergers and may now be involved in further M&A activity, while Daisy Group continues to consolidate the smaller end of the market.

Exhibit 7: 2011 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

Conclusions

Recent gains in global markets are unlikely to prove sustainable in our view. Our fundamental concerns over the sustainability of nascent growth have not dissipated. Sovereign debt issues, inflation, unemployment and confidence trends all point to a slowdown in growth over the next 12 months, a scenario that we do not feel is fully discounted in consensus earnings expectations. With estimates potentially under pressure, it is also hard to find support in valuation levels, with the UK equity market trading on around 15x 2011 P/E.

As we have mentioned before, we do not feel there is yet significant supportive evidence of emerging trends that would allow us to adopt a change in view and hence a more upbeat stance. Key will be a concerted and coherent approach to debt reduction; sustainable top- and bottom-line growth; and (more) compelling valuation levels. We may be waiting some time for any (let alone all) of these scenarios to come to pass.

Against this background, we see few attractive options for equity investors (we continue to favour gold as an asset class). In the near term, we expect to see further positive momentum for financials and retain our cautious stance on consumer cyclicals; longer-term, our preference is for stocks that offer high global diversification and undervalued growth potential.

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