Illumination: Equity strategy and market outlook

July 2010

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Published by Edison Investment Research

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Equity market overview and strategy

There are few causes for optimism as we enter the second half of 2010. The downward pressures being exerted on global equities as a function of ongoing uncertainties appear unlikely to dissipate in the very near term and we believe volatility will continue to dominate markets over the summer. We still see a disturbing confluence of substantial state debt burdens, rising inflation, persistently high unemployment and stalling earnings momentum combined with limited valuation support. This leaves few obvious attractive options for equity investors (we continue to favour gold as an asset class) and our strategy for sector and stock allocation relates to adopting a longer-term focus, preferring positions that offer high global diversification and undervalued growth potential. Near term, high yielding plays are likely to find most favour. On the negative side, we retain our high conviction underweight in consumer cyclicals.

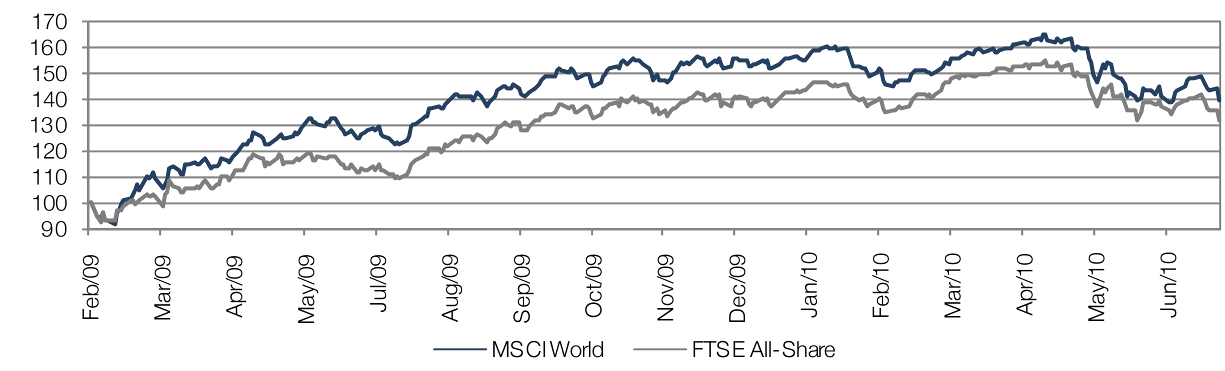
An "incredibly difficult period" – set to endure for some time further

Halfway through the year and with global stock markets in negative territory, US Treasury Secretary Timothy Geithner appears right when using the above expression (cited before a congressional hearing on 22 June) to characterise the ongoing painful transition being endured by the world economy. Despite a nine-day rally during the middle of the month, June is the third consecutive month when equities have fallen and Q2 also represents the first quarter since last year's rally commenced when equities will have declined in absolute terms. Overall, the first half of 2010 has been characterised by a volatile yet ultimately lacklustre performance in equities. The facts appear brutal: since 1 January, the Morgan Stanley World Index is down 10.3% and the UK's All-Share Index has declined by 7.9%.

Context is, however, important. While the UK market has fallen c 15% from its April high, this decline comes after a c 50% rise in equities from their March 2009 trough. Sentiment is also undeniably stronger than it was 12 months ago. Moreover, had it not been for a virtual halving in BP's share price in the last two months, then UK indices may have delivered an optically improved performance owing to BP's weighting (currently 4% within the All-Share, but almost 8% in April).

Exhibit 1: Recent declines have to be offset again strong moves from March 2009 trough levels

Note: Rebased to 100.



Source: Datastream, Edison Investment Research

Nonetheless, the strength of the recovery in equities from last year's lows has to be tempered by the extraordinary stimulus measures that have been required to get there. Economies around the globe arguably now have to endure the consequences of risk having been transferred from the private to the public sector. Sovereign debt issues have dominated sentiment, and will likely continue to do so. Those advocating the 'risk trade' have mainly lost out so far in 2010 and risk aversion levels (as well as equity fund redemptions – based on our anecdotal evidence) have generally risen. The VIX volatility index is up 34% year-to-date and stands 14% higher than it did this time last year.

Against this background, the cautious stance we have taken towards equities year-to-date has been vindicated. However, going forward, we consider it more constructive to discuss what factors may lead us to adopt a change in view and a more upbeat stance. In the last edition of *Insight* we highlighted three dynamics that could potentially drive a more positive opinion, and hence a better performance in equities, namely: a concerted and coherent approach to debt reduction; sustainable top- and bottom-line growth; and compelling valuation levels.

It would be fair to contend that policy-makers around the world have taken a generally proactive stance towards managing sovereign debt issues, although the ramifications of such policies will likely continue to be felt for some time further. Most European nations, including the UK, have introduced a series of austerity measures, but the key question remains whether fiscal tightening (equivalent to £40bn in 2010 for the UK) may impact the economy and choke off nascent growth. Indeed, the Office for Budgetary Responsibility (OBR) has recently reduced its UK GDP estimates to 1.2% for 2010 (from 1.3%) and 2.3% (versus 2.6%) for 2011. This second figure seems a far cry from the 3.0-3.5% GDP growth scenario posited by former Chancellor Alistair Darling for 2011 as recently as March.

Furthermore, there will be more fiscal tightening to come in the UK (and elsewhere) since according to the OBR, it will take until 2105 for borrowing to fall below 2% of GDP, down from its current level of over 11%. More importantly, the recent policies being adopted by Chancellor Osborne and his European counterparts appear to imply a clear move away from Keynesian state-led economics. Policymakers appear to be under the impression that the private sector is sufficiently robust to drive future growth, helped by supply-side stimuli and not impeded by 'crowding out' (of potential investment) from the public sector.

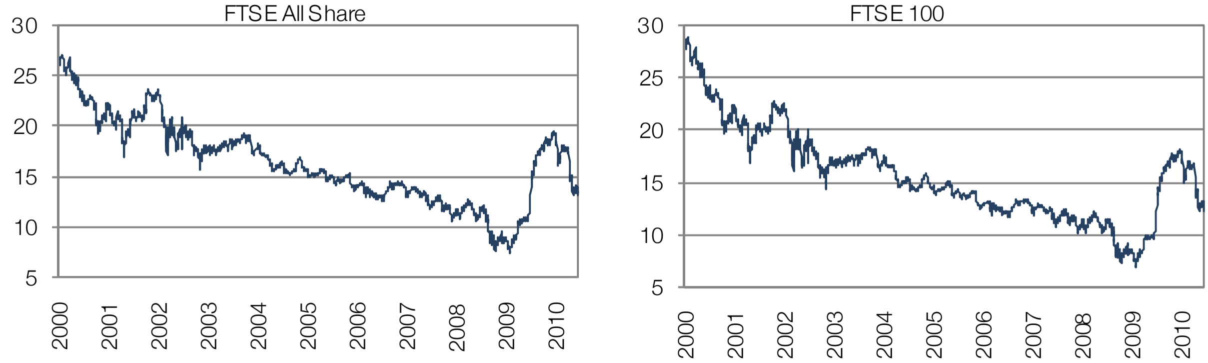
Such a contention appears highly debatable, particularly with regard to the UK economy. The strengthening of sterling by more than 10% relative to the euro in the last three months (the pound currently stands at a 19-month high) means the country's exports are now inherently less competitive. Meanwhile, the UK also clearly lacks the scope to reap the benefit from lowering interest rates (to improve competitiveness and/or stoke growth), and indeed the next move in rates will likely be up. Moreover, investors should not forget that with global inflation and unemployment on the rise, there is a clear danger posed by too many countries attempting fiscal and monetary tightening at the same time.

To return to Treasury Secretary Geithner's earlier comment, it is also concerning that his caution comes despite the American economy being seemingly further along the path to recovery than either the UK or Europe. Most developed nations would welcome forecast US GDP growth of at least 3.0% for the next two years (source: *The Economist*). However, recent data points appear to cast some doubt on the credibility of these estimates, or at least serve to underline the slow pace of recovery. Only 20,000 new jobs were created in the US on an underlying basis in May – significantly below consensus expectations, unemployment still stands at over 9.5% and US new home sales (a useful barometer for sentiment and spending power) are currently running at their lowest rate since 1963. US GDP growth was recently revised down for Q1 (from 3.0% to 2.7%) and there is a risk that Q2 figures may also disappoint.

If investors cannot gain any certainty about whether debt reduction and state austerity policies can help improve the outlook for equities, might there be other causes for optimism? Regarding the second of our three drivers, the jury also remains out, in our view, on whether corporate earnings are improving. June has been a quiet month in terms of UK corporate newsflow and more positive results/trading statements from companies including Aggreko, ASOS, Kingfisher, Premier Farnell and Sainsbury's need to be offset by the caution expressed by business such as Ashtead, Connaught, Home Retail Group and WS Atkins among others. Axiomatically, earnings momentum may be negatively affected by deteriorating macro trends and an additional cause for concern springs from the 10-percentage point decline in UK consumer confidence experienced in May, erasing almost all of the gains enjoyed in the past year.

Finally, we do not believe that valuation will become a sufficiently influential factor in investors' (top-down) decision making just yet. With the All-Share currently trading on c 13x P/E for 2010, we do not see equities as being obviously good value. As Exhibit 2 shows below, the UK market's P/E valuation has retreated only to levels last witnessed in 2006. Between 2006 and 2008, equities became more than 50% cheaper.

Exhibit 2: UK equities can still become considerably cheaper: P/E multiples since 2000



Source: Datastream, Edison Investment Research

Against this background, we see little immediate reason to change our caution with regard to the near-term outlook for equities. Sector and stock selection is therefore clearly challenging. We have higher conviction in our underweight positions (especially regarding consumer services) than we do elsewhere. For investors willing and able to adopt slightly longer-term perspectives, there is a good case for focusing on fundamentals and identifying key themes.

Over time, we remain convinced about the trends of emerging market growth and industrialisation as well as increasing globalisation. Although volatility will likely remain the watchword for coming months, implying potential further downward market corrections, we are happy to use weakness to build positions in basic materials. In general terms, we continue to look for stocks that appear undervalued and with strong global growth prospects. High yielding defensives may offer less risk in the near-term (and may also attract fund flows from investors looking for dividend-paying alternatives to BP), but have less scope for medium-term outperformance.

Market review: More pain in June

After funds suffered their worst losses in 18 months in May, June's performance is unlikely to have given investors much cause for cheer. The All-Share has declined for two consecutive months (and in four of the year's first six), and has lost 4.9% since 1 June. As mentioned earlier, some of this negative performance has been compounded by the sharp falls in BP's price, and the oil sector has seen a 16.7% erosion in its value over the last month. Nonetheless, the sell-off has been indiscriminate to the extent that only two sectors – both defensive (utilities and telecoms) – gained in absolute terms during the month.

Trends over a three-month period, where again telecoms and utilities have been the biggest gainers, suggest that investors have increasingly moved to adopt more defensive positions within their portfolios. By contrast, the high beta sectors have endured most pain during recent trading periods, evidence that the inverse of more defensive positioning has been an abandonment of the 'risk trade'. The basic materials sector has lost 6.8% in absolute terms in the last months, and 19.4% in the last quarter, a performance surpassed only by declines in the oil and gas sector.

Exhibit 3 provides another indication of how investors have reacted to recent market developments and growing risk aversion levels. We have discussed in previous editions of *Insight* how the UK market's global nature has helped it to outperform during times of improved sentiment and better risk appetite. This is evidenced by the All-Share's decline of 'only' 7.9% since the start of the year, a 2.5-point outperformance relative to the Euro-Stoxx. The inverse also holds true and, despite concerns about sovereign debt default within the eurozone, the All-Share has notably underperformed *all* the major European indices we track in the last month, for example, losing 3.2 points against the main Euro-Stoxx.

Nonetheless, debt clearly remains a major cause for concern and it is also clear from Exhibit 3 that investors exposed to the Spanish and Italian markets (Portugal and Greece would be at least as bad, but we do not actively track this data) have had to endure significant pain in the last three months. The Madrid index has fallen by almost 24% since the beginning of April while Milan's bourse has witnessed a decline of approximately 18%.

One final disturbing point to note is that, with the exception of the flat performance of the DAX index in Germany over the last month, every other index presented below has seen an absolute decline in its value on a one-, three- and six-month view. Twelve-month returns have also been significantly eroded, with the All-Share now up 16% and the Euro-Stoxx 9% higher relative to one year ago. In comparison, just two months ago the same analysis would have shown the All-Share 20% better and the Euro-Stoxx 10% up on comparable periods.

Exhibit 3: Relative performance of major European indices (in percentage points)

	YTD	Last month	Last three months	Last six months	Last 12 months
FTSE 100	(9.2)	(5.3)	(14.0)	(9.6)	14.4
FTSE All-Share	(7.9)	(4.9)	(13.1)	(8.3)	15.9
DJ EURO STOXX	(10.6)	(1.7)	(11.2)	(11.2)	9.0
DJ EURO STOXX 50	(13.8)	(2.2)	(14.6)	(14.6)	4.9
France CAC40	(12.8)	(2.3)	(14.2)	(13.3)	7.5
Germany DAX30	(0.1)	0.1	(3.3)	(1.0)	21.8
Spain IBEX35	(23.3)	(2.8)	(17.4)	(23.9)	(7.0)
Italy MIBTEL30	(17.3)	(1.2)	(16.7)	(17.7)	0.7
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	4.6	(3.1)	0.6	5.0	9.5
FTSE All-Share vs EURO STOXX	2.7	(3.2)	(1.9)	2.9	6.9

Source: Datastream, Edison Investment Research

Outlook: Challenges ahead

If events from the first six months of 2010 are anything to go by, then the 'new normal' for the global economy after the 2007/8 credit crisis is going to be constituted by continued and unpredictable bouts of volatility. From our perspective, it is perhaps easier to contend that the world has yet to return to a pattern of reasonable stability, and this has been evidenced by – at best – relatively directionless equity markets year-to-date.

We are of the view that the key risks facing most developed countries' economies have yet fully to dissipate. In other words, fiscal deficits, state interference and possible double-dip scenarios (particularly if over-zealous intervention stifles growth) remain key concerns. Put another way, even if sovereign debt issues do not reverse the emerging global economic recovery, then they will likely slow it.

This creates a conundrum and makes it much harder for micro data (ie better news and earnings momentum from corporates) to offset overarching macro concerns. Put simply, debt is the issue that refuses to go away. This is point that is also seemingly being raised with increasing urgency by a number of global institutions. The World Bank wrote in June that the European crisis causes "growth hurdles" for the global economy, while Glenn Stevens, Head of the Reserve Bank of Australia stated that "it cannot be denied that the potential for further financial turmoil exists" and the ECB went further in warning of the risk of "hazardous contagion". While these organisations are right to flag their concerns, not only do actions speak louder than words, but such commentary also further undermines investor confidence.

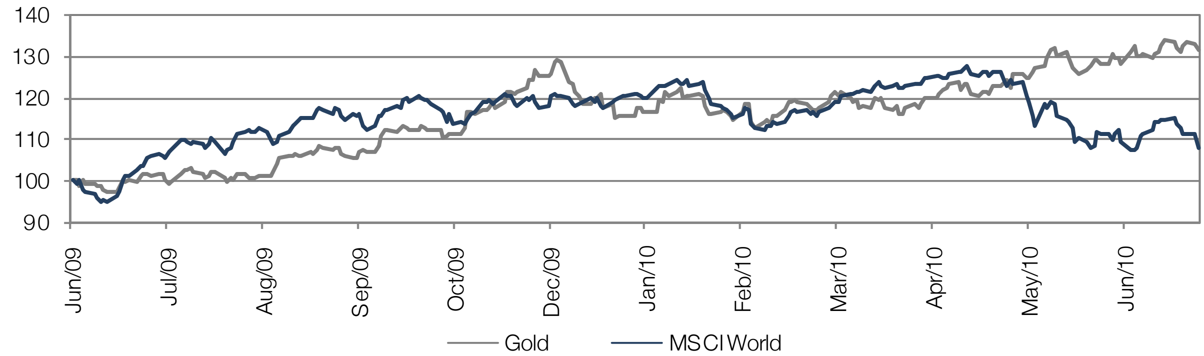
Key, then, is to consider how close debt issues are to being resolved, and unfortunately, the prognosis appears broadly negative. Despite concerted EU and global intervention, the cost of insuring against a default in Greek debt levels rose to an *all-time* high last week, while during the last month the Athens Stock Exchange hit a 12-year low. Some €4.5bn of Greek debt will also need to be refinanced during July. In addition to Greece, both Spain and Portugal have recently come more into the limelight, and all three countries have suffered debt downgrades from the ratings agencies. Portugal announced that it had also sought recourse to €36bn of EU bail-out money and, while Spain has yet to draw on European Union funds, the record spread in Spanish 10-year bonds of over 200 basis points relative to German Bunds suggests it is only a matter of time.

Beyond country-specific issues, a broader worry is that when (on a balance of probability, 'when' seems more tenable than 'if'), the next banking crisis hits, governments will be unable to step in and support these organisations as they have done since 2008. This is simply because most governments' finances have been severely impaired and consequently, the state's capacity to borrow cannot be extended indefinitely. We are also not convinced that investors have fully discounted this scenario, since it implies a negative outlook for most assets classes including equities.

The one asset that would be a beneficiary from such an outcome is gold, where Edison has pursued a positive stance since early 2009. Gold is the one currency that does not come with counterparty or credit risk or concerns about over-supply. We also note that gold hit a record high of $1259/oz on 18 June (currently at $1244/oz) and, as Exhibit 4 shows below, its meteoric rise over the last year has contrasted notably with that of the equity market.

Exhibit 4: Gold continues to rise, while equities have remained under pressure

Note: Performance over last 12 months, rebased to 100.



Source: Datastream, Edison Investment Research

Moreover, gold should continue to be a clear beneficiary from the risks posed by prolonged yet necessary fiscal and monetary tightening, a policy being pursued on a simultaneous and also broadly unprecedented basis globally. Inflation remains a clear threat in both developed and emerging economies. While the inflation rate in the UK slightly moderated in the last month (from 3.7% to 3.4%), it remains significantly ahead of the Bank of England's 2% target. The Bank's latest inflation attitudes survey (from 11 June) also highlights that consensus opinion foresees a 3.3% inflation rate one year out.

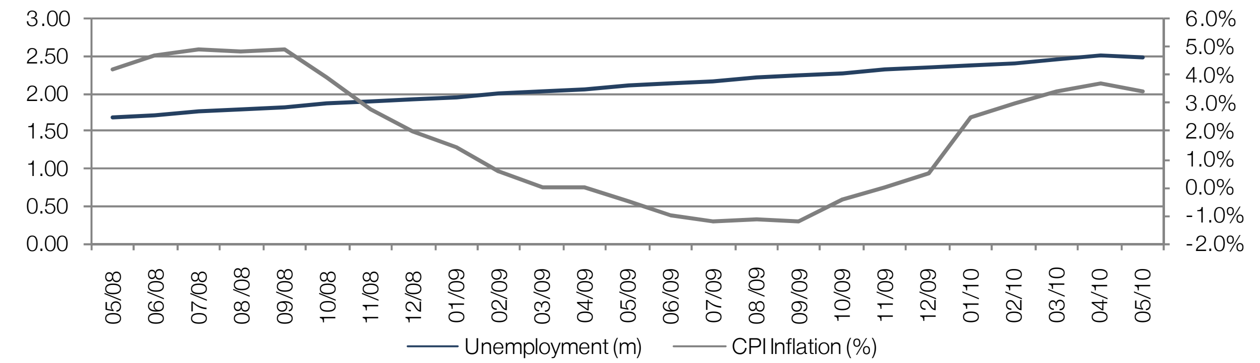
Interest rates may, therefore, soon need to start rising. While Bloomberg's poll of economists suggests that the prevailing view is for rate tightening to start in the UK during the first quarter of 2011, we see some risk that this process could begin somewhat earlier. We also note that according to the Bank's last set of Monetary Policy

Committee meeting minutes (issued on 23 June), one member voted in favour of raising rates immediately, the first time this has been the case since August 2008.

Investors 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 stubbornly high. According to the ONS, with some 2.5m unemployed in the UK, there are now more people out of work than at any time since December 1994. Eurozone unemployment also stands at all-time highs (10.1% for May) and, as mentioned earlier, current US job creation remains disappointing.

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. All of the above makes for inevitably sobering reading, particularly from an equity investor's perspective, and suggests that challenges remain, at least for the second half of 2010 and potentially beyond.

Exhibit 5: Persistently high inflation and unemployment represents a negative scenario for investors



Source: Office for National Statistics, Edison Investment Research

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 revised monthly and as Exhibit 6 shows below, our highest conviction sector stances have changed somewhat since the start of 2010 and also over the last quarter. We have seen no reason to change our positive fundamental view on basic materials (which we have held since 2009). While the sector is down 10% since 1 January, it has still markedly outperformed the All-Share on a 12-month view. Our increasingly positive stance on industrials (adopted at the beginning of Q2) and financials (developed during Q2) have both proven to be the right calls, with industrials being the second best performing sector year-to-date and the third best quarter-to-date, while financials have also outperformed the All-Share in these two time periods.

Exhibit 6: Edison sector rankings, how and why they have changed

Note: Sector preference relates to our view at the *start* of each quarter.

Position	Q310	Rationale	Q210	Q110
Best	Basic materials	Fundamentals, global exposure, valuation	Basic materials	Basic materials
	Industrials	Strong earnings momentum, improving sentiment	Industrials	Telecoms
	Telecoms	Valuatiion, defensive; improving outlook for mega caps	Oil & gas	Healthcare
	Healthcare	Defensive profile, valuation, global exposure	Telecoms	Utilities
	Utilities	Valuation; scope for rotation after underperformance	Healthcare	Industrials
	Financials	Becoming more positive on outlook; risks priced in	Utilities	Technology
	Oil & gas	Sector major likely to remain out of favour for now, but value case	Consumer services	Oil & gas
	Technology	Valuation demanding; we see case for taking profits	Consumer goods	Consumer services
	Consumer services	Near-term outlook, with rising risks; unsupportive valuation	Technology	Consumer goods
Worst	Consumer goods	Near-term outlook, with rising risks; unsupportive valuation	Financials	Financials

Source: Datastream, Edison Investment Research

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 position on these sectors.

Over the last month, the oil and gas sector has witnessed the biggest negative move, losing 16.7%, making it the worst performer since 1 January and also during calendar Q2. This has been driven primarily by BP's well- (no pun intended) documented woes. Given that BP has fallen 50.4% since its Gulf of Mexico disaster, we believe now is not a constructive moment to assume a significantly more negative view on the oil sector at this stage. While a clear value case can be made for oils at present (the sector trades on 8.3x 2010 P/E, and BP on just 4.8x), our impression is that the sector will remain under pressure in the near-term. Moreover, the IEA also recently warned of over-supply in both the oil and gas industries, implying potential downward pressure on the oil price.

Against this background, we have made some changes to our most- and least-preferred sectors. Our core positions (overweight in basic materials and industrials; underweight in consumer-facing stocks) remain unchanged, but we have become more positive on financials, less so on oil. By default, the more 'defensive' sectors have also moved up our rankings. These represent a natural safe haven amid market volatility, and quest for yield (particularly with BP – currently responsible for c 12% of UK dividend income – under pressure) may also drive investors towards a number of the larger stocks within the telco, pharma and healthcare sectors.

Exhibit 7 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 7: 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	11.7%	11.7	1.5%	(10.2%)	(6.8%)	(19.4%)	(10.6%)	37.5%
	Industrials	7.7%	14.4	2.8%	4.9%	(2.4%)	(5.8%)	4.6%	31.3%
	Telecoms	6.2%	7.7	5.6%	(0.9%)	2.7%	(4.8%)	(1.2%)	21.4%
	Healthcare	7.9%	10.2	4.7%	(7.2%)	(1.0%)	(7.3%)	(8.0%)	10.6%
	Utilities	3.9%	11.5	5.6%	(4.7%)	3.6%	(4.8%)	(4.5%)	8.9%
	Financials	23.5%	23.5	3.2%	(6.8%)	(3.3%)	(11.6%)	(6.9%)	16.1%
	Oil & gas	15.3%	8.3	3.7%	(23.9%)	(16.7%)	(26.4%)	(24.7%)	(8.1%)
	Technology	1.7%	22.0	1.3%	9.0%	(0.5%)	(5.6%)	9.1%	37.4%
	Consumer services	10.2%	13.3	3.0%	(2.2%)	(3.6%)	(9.2%)	(2.5%)	20.3%
Worst	Consumer goods	11.9%	15.1	3.5%	(1.7%)	(0.8%)	(7.6%)	(1.9%)	24.9%
Average		100.0%	13.1	3.4%	(7.9%)	(4.9%)	(13.1%)	(8.3%)	15.9%

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 dropping by less than 5%. 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,

The key problem is that consumer confidence remains moribund and could likely fall further, affecting future spending. In the words of the Nationwide, May's figure was particularly "unsettling", as its consumer confidence index fell by 10 percentage points, erasing almost all of the gains witnessed since last autumn. Consumers are – unsurprisingly – concerned about the risk of rising (or at least, not falling) unemployment, fiscal tightening and the government's recently announced rise in VAT to 20% from January 2011. While the rise in value-added tax at the start of next year may see some consumers bringing forward purchases that they may otherwise have deferred until 2011, any potential small pick-up is unlikely to be a panacea for the sector in our view.

Our concerns also appear to be echoed by corporates: in the last month, retail bellwethers, Kingfisher, Home Retail and Sainsbury's have all released generally downbeat statements. Kingfisher highlighted that "headwinds look set to continue"; Home described economic conditions as remaining "challenging and uncertain", driving a lack of "willingness to spend"; and Sainsbury's characterised the consumer environment as "challenging". We regard these comments as being more important than the fact that both Kingfisher and Sainsbury's did actually surpass consensus expectations in their releases. A broader perspective on the state of the UK retail environment is evidenced by ONS and British Retail Consortium sales figures: UK retail growth of 0.6% for May is not indicative to us of healthy growth prospects, and both organisations have suggested in their most recent releases that growth could turn negative during 2010.

We therefore see potential scope for disappointment relating to future results releases from the UK consumer stocks, and struggle to see a strong case for outperformance until management teams can sound a noticeable voice of confidence on visibility and the outlook. Moreover, valuation – with the consumer goods sector on 15.1x 2010 P/E and the services sector on a multiple of 13.1x – 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) dropped 6.8% in the last month, but has still outperformed on a 12-month view. Indeed, over the last year, basic materials have performed better than any other sector, gaining 21.6 percentage points relative to the UK market. As importantly, we continue to be encouraged by the resilience of the industrials sector, being the second best-performing year-to-date and down just 2.4% in the last month.

While potentially deteriorating earnings momentum in certain industrial segments remains a trend to monitor closely, 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 benefits 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.

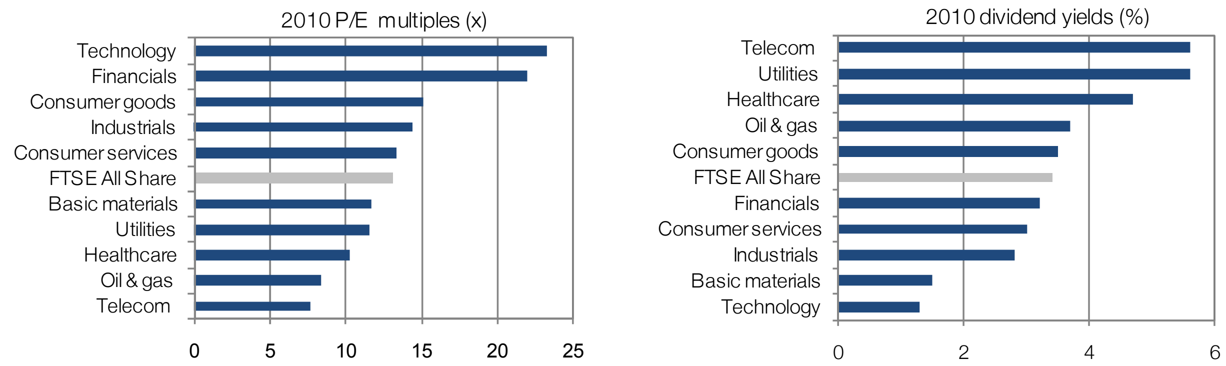
In particular, we favour businesses with global diversity, and especially those exposed to the Chinese and Indian markets. The growth prospects for these economies are well known and recent data points serve to reemphasise the strength of current demand. Chinese exports rose by almost 50% year-on-year in May, while Indian industrial production increased by 17.6% 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 11.7x) and the industrial sector trading at only a 10.0% premium. While the oil sector would also appear to be a logical beneficiary of global industrial demand trends and also clearly trades on a lower multiple (8.3x) than either the industrial or basic materials sectors, we believe the sector will likely remain out of favour in the near term, at least until BP can provide full clarity on its outlook.

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. The former has come to the fore in recent weeks, particularly given the pressure under which BP has suffered. With the oil major constituting around 12% of all UK dividend income, it seems logical that investors should consider looking for alternative high yielding equities. The three highest yielding sectors in the UK market are (in order) telecoms, healthcare and utilities.

Exhibit 8: 2010 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

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 5.9% 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. The telecoms sector has been also been the best-performing sector in the last month.

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, which represents more of a utility-like play on healthcare with stable future revenue streams. Meanwhile, for the sector generally, the M&A cycle seems to have run its course for the time being, while med-tech is now focusing on the opportunities provided by an ageing population demographic.

While growth prospects for all three sectors are relatively unattractive (so they may start to underperform once investors do decide to revisit the risk trade), M&A may serve as a potential additional driver for telecoms and utilities. 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. Within telecoms, 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.

Financials: Becoming more positive

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 1.7 points in the last month and by 1.5 points during the last three months. On a year-to-date basis, financials have gained 1.1 points relative to the All-Share.

Although expectations for future revenue growth are still low and the debate over what constitutes 'new normal' earnings has not been fully resolved, we feel there are a number of indicators that point to a more encouraging outlook. Despite recent concerns over sovereign debt default risks, we see scope for consensus expectations to become more positive. Recent results from financial services companies around the world have been encouraging. Meanwhile, there has been an increasing level of commentary from the investment community about the scope for potential value crystallisation within the sector from group break-ups (especially with regard to Lloyds Banking Group).

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. Moreover, risk premiums have begun to reduce as credit has normalised. While the road ahead will likely continue to be bumpy (given banks' exposure to sovereign risk, new Basel requirements and potential further regulatory reform), we contend that the industry now finds itself in a period of relative stabilisation, a scenario that should allow investors to begin to form a more constructive stance on the sector.

It is also noteworthy that the major UK listed banks responded positively to Chancellor Osborne's announcement for a sector levy. While this had admittedly been well flagged, banks should be able to more than offset through future lower corporation tax. Political developments in the UK, however, serve as a reminder that our preference is for businesses with superior – and globally diversified – business models.

Conclusions

We believe there are few causes for optimism as we enter the second half of 2010. The downward pressures being exerted on global equities as a function of ongoing uncertainties appear unlikely to dissipate in the very near term. As a consequence, we believe volatility will continue to dominate markets over the summer. Investors continue to face an unappealing cocktail of substantial state debt burdens, rising inflation, persistently high unemployment and stalling earnings momentum combined with limited valuation support.

Moreover, we do not believe 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.

This leaves few obvious attractive options for equity investors (we continue to favour gold as an asset class) and our strategy for sector and stock allocation relates to adopting a longer-term focus, preferring positions that offer high global diversification and undervalued growth potential. Near term, high yielding plays are likely to find most favour. On the negative side, we retain our high conviction underweight in consumer cyclicals.

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