

Illumination: Equity strategy and market outlook

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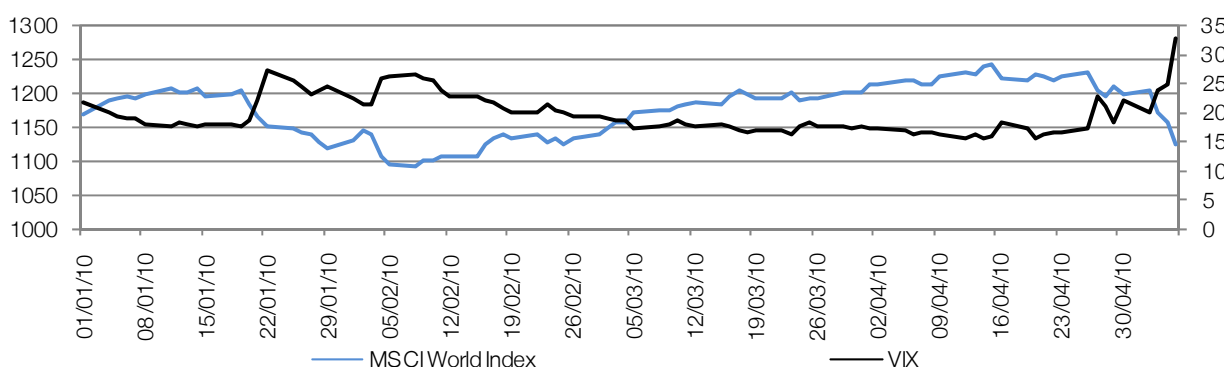
Equity market overview and strategy

After reaching a 22-month high on 21 April, just four trading days later global equity markets experienced their biggest one-day falls since June 2009. Equities have remained highly volatile and under pressure since, and the All-Share now finds itself down 1.6% relative to 1 January. Such volatility is indicative of the challenges facing investors: macro data and earnings momentum are improving, but risks have far from dissipated and we remain concerned that much of the 'better outlook' scenario is already reflected in valuations. Against this background, we maintain our sector strategy and favour a bottom-up approach, preferring stocks with high global diversification that offer undervalued growth potential. From a UK perspective, we are overweight industrial cyclicals and underweight consumer cyclicals.

As good as it gets?

Investors may be inclined to concur with the sentiment of the English Modernist poet T. S. Eliot, when writing in *The Wasteland* that "April is the cruellest month". Until 21 April, the global outlook seemed buoyant, with equity indices returning to pre-Lehman levels and the Dow briefly crossing 12,000 after seven consecutive weeks of rising markets. The IMF upgraded its global growth outlook on 21 April to 4.25%, one percentage point higher than six months ago, pointing to the fact that the recovery has been "stronger than expected this far". Some commentators even suggested that growth could be in the region of 4.5-5.0% for the world economy in 2010. The IMF's optimism may also likely have been supported by a swathe of positive earnings releases from global industry bellwethers including IBM, Intel, JP Morgan, McDonalds, Nestlé and Tesco. Additionally, Merrill Lynch's respected April fund manager survey showed that a majority of investors were currently overweight equities, with 71% expecting corporate earnings to rise by more than 10% over the next 12 months.

Exhibit 1: Equities and volatility closely correlated: both have moved the wrong way recently



Source: Datastream, Edison Investment Research

With the benefit of hindsight, the turning point for markets may well have been the optimism voiced by the financial press: positive equity moves were accompanied by what *The Economist* described as "a whiff of exuberance" (Leader Comment, 23 April) and *The Financial Times* characterised more boldly as "irrational exuberance" (Lex, 14 April). Equities are now trading almost 10% below their 2010 peak and the FTSE is at a lower level than at the start of the year. Exuberance seems far removed from many investors' minds following two days of 2%+ falls in markets (27 April and 4 May) as well as the biggest single day move in the VIX (30%, on 27 April) since the collapse of Lehman in September 2008. That gold (a key proxy for defensive-mindedness, in our view) continues to make new 52-week highs is perhaps most indicative of current investor sentiment.

For us, **the key question is: what matters more for investors, fears over Greek debt default and European/global contagion, or growing evidence of a recovery in corporate earnings and the global economy?** Recent moves in equities would suggest the former. At the least, we feel some pull-back in stock markets is justified and, while investors should be encouraged by a broadly robust earnings season (in the UK, Europe and the US), it is also appropriate to question the sustainability of improving corporate trends.

Recent events in Greece and elsewhere in the eurozone serve as a potent reminder that governments cannot afford to spend at current levels forever. Meanwhile, it is also the case that businesses are not likely to be in a position to refill their warehouses indefinitely. Against this background, it seems clear that the private sector in general and consumers in particular need to play a more forceful role in driving demand if recovery is to be sustained and indeed, if current valuations are to be justified. However, this scenario is far from guaranteed in our view, given the lack of available credit, the risk of rising unemployment and the fact that spare industrial capacity (at least in the developed world) implies limited scope for new investment.

These factors all apply to the UK, given a context of still-rising unemployment (a greater number of people are now out of work than at any time since 1994) and declining consumer confidence (March's drop was the biggest since July 2008). The UK's situation is compounded by the fact that the country is set to endure a hung parliament scenario, which potentially lacks a clear mandate to govern. While sterling and Gilts will likely feel the impact of a hung parliament more than equity markets, it remains the case that the new UK administration will have to grapple with a debt burden of £163bn (equivalent to 11% of GDP – a figure approaching Greek levels) and the risk of possible policy stasis could make debt reduction more difficult.

Given the challenges facing the UK and other economies, we reiterate our thesis of preferring to build an equity strategy based around the benefits of global diversification, and particularly that of emerging markets exposure. Similarly, with events in Greece and elsewhere in Europe still not fully resolved, we would seek avoidance of too much eurozone exposure. We also note that in its World Economic Outlook, the IMF characterises the outlook as being "solid" in emerging markets but "tepid" for the developed world.

Against this background, we retain our core overweight in basic materials (which has remained one of our two favoured sectors since Q409), and also favour the industrials and oil & gas sectors. We note that the 19% correction in basic materials over the last month creates an attractive buying opportunity in this sector. Among the more defensive sectors, we find most merit in healthcare, given that it has less UK-specific exposure than either telecoms or utilities. On a similar logic, we are most cautious on prospects for consumer-facing stocks, particularly those with a high UK bias. Slowing earnings momentum may also become an increasingly important issue for these latter sectors.

Market review: Debt one, equities nil

If earnings momentum was the biggest driver of equity performance in March, then fears over Greek debt contagion and rising risk aversion levels have been the principal factor characterising market trends in April as well as May to date. What will matter most for the next month and beyond remains unclear: while we are encouraged by a number of macro trends (in particular, improving industrial output) that may further spur earnings, investors have not only Greece about which to worry, but also potentially the resurgence of other issues such as rising inflation and its impact on the economy.

Recent sectoral performance suggests an increasing adoption of risk-averse positions, although trends are far from uniform or consistent. Over the last month, the utilities, healthcare and telecoms sectors have outperformed the UK market (by 4.3%, 3.7% and 1.6% respectively). All three of these more defensively regarded sectors have, however, still underperformed the broader index on a year-to-date basis.

Of perhaps greater note, the basic materials sector has underperformed the market overwhelmingly on both a one-month and year-to-date basis, losing 5.9% relative to the All-Share since 1 January and 19.4% in the last month, making it the weakest performing sector in the UK. We remain confident over longer-term prospects and also highlight that over the last 12 months, basic materials have gained by 38.7% on an absolute perspective, 18.2 percentage points ahead of the All-Share.

If investors in UK equities have had cause for concern over recent equity moves, then it is worth bearing in mind that European equity markets have performed considerably worse in both the last month and since the start of the year. The Euro Stoxx has fallen 11.3% over the last month and 8.8% since 1 January, worse than the performance of the All-Share, which has moved down by 8.3% and 1.6% over these respective time periods.

There are two clear reasons for Europe's underperformance: first, sovereign debt and default concerns have had a considerably bigger impact on the stock markets of eurozone members than that of the UK. In particular, we note that the IBEX in Spain has fallen 16.2% in the last month, while Milan's MIBTEL has lost 16.6% over the same period. Both Spain and Italy have been disproportionately affected by the woes of Greece given their high debt levels and structural issues (note, Spanish unemployment currently stands at over 20%).

The second reason why we feel UK investors have perhaps fared somewhat better relates to the fact that the UK stock market has increasingly become a play on global macro trends rather than purely domestic factors. Moreover, this 'global effect' is proportionately higher in the UK than elsewhere in Europe. As we highlighted in April's edition of *Insight*, the basic materials and oil & gas sectors constitute around 30% of the FTSE's weight, but, more importantly, are responsible for over 50% of the market's earnings momentum. By contrast, despite the healthcare sector constituting 7.6% of the FTSE's weight, it is responsible for just 1.4% of its 2010 earnings momentum and a similar argument also applies for telecoms (5.7% weight, 1.9% momentum). This perhaps also helps to explain the ongoing relative underperformance in these latter sectors.

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	(2.8)	(9.0)	4.0	2.3	19.7
FTSE All-Share	(1.6)	(8.3)	4.6	3.1	20.5
DJ EURO STOXX	(8.8)	(11.3)	0.5	(4.4)	10.1
DJ EURO STOXX 50	(11.9)	(12.6)	(0.8)	(6.5)	7.1
France CAC40	(9.7)	(12.3)	(0.2)	(4.4)	8.3
Germany DAX30	(0.8)	(5.5)	8.7	7.7	21.1
Spain IBEX35	(21.7)	(16.2)	(7.4)	(19.2)	1.3
Italy MIBTEL30	(16.2)	(16.6)	(6.4)	(13.6)	(3.1)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	9.1	3.6	4.8	8.8	12.6
FTSE All-Share vs EURO STOXX	7.2	3.0	4.1	7.5	10.4

Source: Datastream, Edison Investment Research

Outlook: Trends encouraging, but new risks emerging

Strategists' column inches continue to be dominated by how the 'Greek tragedy' of a debt burden greater than 13% of GDP and two-year bond yields of more than 30% (now back down to 'only' mid-teens) will play out. Our contention is that it is in the interests of all stakeholders to arrive at a swift and decisive solution to Greece's woes and that ongoing delays continue to have the inevitable effect of further destabilising sentiment and hence amplifying the problem. It remains the case that the formation of the Eurozone and the creation of a single currency for its members was driven more by political than economic imperatives, and so political – even if potentially botched – solutions will likely be required. Recourse to the IMF will also likely be necessary, but is not

without precedent and indeed the IMF's contribution to the Greek bail-out *may* end up being smaller than in other currency related debt crises (see Exhibit 3 below).

Exhibit 3: Recent debt crises, and their resolutions (in US\$bn)

Note: * Greek figures remain estimates for now.

Date	Country	Total Bail-out	IMF Contribution	IMF as %
2010	Greece*	60	20	33%
2008	Hungary	25	16	64%
2008	Latvia	10	2	20%
1997	South Korea	79	28	35%
1995	Mexico	71	26	37%
1992-2001	Argentina	27	27	100%

Source: Financial Times, Edison Investment Research

With memories of the Lehman collapse and subsequent financial dislocation still fresh in investors' minds, it would be imprudent to suggest that events in Greece may not end up having greater than anticipated negative consequences for equity investors. Moreover, contagion runs the risk of becoming a self-fulfilling prophecy, as evidenced by recent falls in Portuguese, Spanish and Italian stock markets (among others) and correspondingly rising bond yields.

However, it is *not* our intention in this piece to postulate a series of hypothetical future scenarios for Greece, the eurozone and its currency, since we do not claim to be either experts in bond markets or dedicated crystal-ball gazers (and, more fundamentally, some scenarios do not have 'obvious' solutions: namely, there is no provision in the Maastricht Treaty for countries to leave the eurozone and reinstate their legacy currencies). Instead, we feel it more constructive to state that **while equities and bonds will likely continue to be volatile in coming weeks, investors should to look beyond this and attempt to form a view on whether improving corporate earnings momentum can be sustained.** If such a case can be made, then we feel investors should attempt to capitalise on volatility and look to build positions on weakness.

The release of the UK's first estimate for Q1 GDP does not present conclusive evidence supportive to the momentum thesis. Growth of just 0.2% in Q1 fell short of consensus expectations (for 0.4% growth) and was also below the level recorded for Q4 (also 0.4%). However, the OECD forecast in April that among the world's industrialised nations, only Canada would report better GDP growth trends than the UK during the first half of 2010, with the OECD predicting 2.6% UK GDP growth on an annualised basis. Agreement is far from uniform on this topic, with the influential Ernst & Young ITEM Club describing the UK's economic prospects as "dismal" forecasting 2010 growth of less than 1%, significantly below the forecasts of the Treasury and the Bank of England. It also remains far from clear what future policy plans the 'new-look' UK government will decide to adopt and whether likely pronounced tax rises and spending cuts may reduce GDP growth momentum.

On the positive side, we note the following data points as being supportive to the recovery thesis, lending credibility to those in the camp advocating emerging growth trends:

- Industrial output is expanding rapidly: the UK's Purchasing Managers Index rose at its fastest in 15 years in March, ahead of most analysts' forecasts and at recorded its best performance since October 1994. April's reading showed a slight slowdown relative to the previous month, but growth is still up strongly year-on-year. Nonetheless, a similar survey from CIPS (the Chartered Institute of Purchasing and Supply) has shown two consecutive months of UK new-order growth, which is running at close to a 14-year high.
- UK exports grew by 9.5% year-on-year in February (more recent data is not available), its biggest monthly increase since January 2004. Weaker sterling is clearly helping UK exporters for now.

- Against this background, UK business confidence stands at its highest in four years according to the Business Trends Survey from BDO (although note this survey appeared on 12 April, so before more recent Greek-related concerns).
- Staff hiring is also occurring at its fastest rate in 12 years – and across all sectors – according to KPMG's most recent survey (7 April).
- There is evidence of house-price buoyancy, with prices up 10.5% year-on-year in April according to the Nationwide, the first double-digit increase since June 2007. Note though, that the Nationwide says it expects the rate of growth to tail off, while Halifax's data points to a smaller rise.
- Tesco – a bellwether for the UK economy – reported strong results on 20 April and Chief Executive Terry Leahy stated that, in his view, the “recovery is gaining hold”.

While we are encouraged by the above indicators (and similar showings of industrial strength in other economies in particular), we do not feel they constitute a sufficiently strong body of evidence to support the more optimistic thesis posited by Tesco (and others) that the UK's recovery is gaining in strength. It is worth noting that Tesco's share price dropped by 1.6% on the day of its results (and by 2.6% relative to the market) as investors – perhaps rightly – took concern over the outlook.

Rising inflation and persistently high unemployment in particular may limit recovery prospects and correspondingly halt nascent signs of emerging earnings momentum. As we noted above, governments clearly cannot afford to spend at current levels forever and businesses are not likely to be in a position to refill their warehouses indefinitely. Against this background, it seems clear that the private sector in general and the consumer in particular need to play a more forceful role in driving demand if recovery is to be sustained and indeed, if current valuations are to be justified. However, this scenario is far from guaranteed in our view given the lack of available credit, the risk of rising unemployment and the fact that spare industrial capacity (at least in the developed world) implies limited scope for new investment.

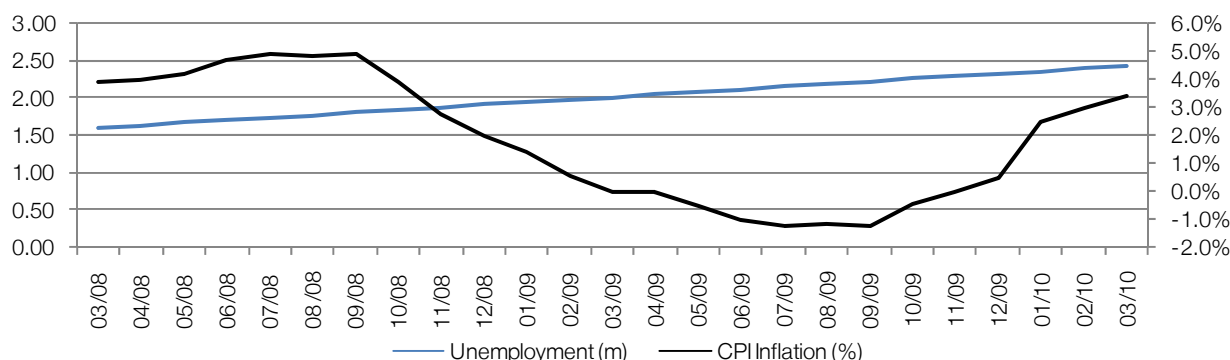
UK unemployment rose 43,000 to 2.5 million in the three months to February (the last period for which data is available), with the jobless total now at its highest since 1994. Meanwhile, the unemployment rate of 8.0% stands at its highest since 1996. We also note that, UK consumer confidence fell by 9pp in March, its largest fall since July 2008. According to the Nationwide, consumers are concerned about the impact that the recent Budget and election could have on employment, and subsequently spending, prospects. Likely public spending cuts in the UK could also see unemployment rising further.

These trends are not just restricted to the UK: in the US unemployment is still 9.7%, while the University of Michigan consumer sentiment index rose just 0.1% in March, considerably lower than anticipated and at its slowest rate since November 2009. According to the survey, the main concern cited by consumers is the risk of potential unemployment. In Europe, unemployment reached 10% in March and now stands at its highest level since August 1998. In Spain, one in five of the workforce are now out of work, the worst seen since 1996.

Inflation is not a ‘new’ concern per se, but signs of it rising create an additional challenge for policymakers since any inflation responses could exacerbate negative unemployment and confidence trends, potentially also creating a vicious circle effect, which would inevitably stifle top line growth potential. In the UK, CPI inflation rose 3.4% in March from 3.0% the month before (ahead of consensus expectations). Moreover, producer output prices rose by 0.9% in March, with the annualised rate hitting 5%, its highest since November 2008. Meanwhile, input prices rose by 3.6% in the same month, implying annualised growth of over 10%, also the strongest level since late 2008.

The implication from the above is that interest rates may need to start rising again soon, despite Bank of England Governor Mervyn King's expectation for inflation to fall back to 2% during 2010. Higher interest rates could limit consumer credit and hence spending potential. We note that although the Monetary Policy Committee (MPC) voted unanimously to keep rates on hold at its last meeting, the MPC highlighted that inflation expectations had been "drifting up". A further conundrum is posed by the fact that inflation rises are a global concern, with rates currently increasing by 2.6% in China, 4.8% in Brazil and 9.9% in India. This reinforces our conviction in the importance of taking a global approach to investing even just among UK equities, especially since the FTSE's (major) constituents are increasingly diversified in their nature. Global industrialisation will continue in momentum in our view, but is not without its risks, as rising inflation indicates.

Exhibit 4: A worst case scenario? UK inflation and unemployment both rising



Source: Office for National Statistics, Edison Investment Research

Towards a sector ranking: Key considerations

We believe that a case can be made for equities, but remain aware that there are limitations to this view. On the positive side, improving earnings momentum increases our confidence, but we would need to see at least another quarter of results to believe that the recovery in earnings is sustainable, particularly at the top line. Several factors could derail this, particularly were either industrial or consumer confidence to deteriorate, particularly against a backdrop of potentially higher interest rates. Moreover, recent events such as the Greek/eurozone debt crises serve as a reminder that exogenous events can severely destabilise (still fragile) global sentiment – and also take time significant to resolve. Against this background, we are no more than cautiously optimistic on the outlook for equities and consider it inappropriate to move away from continuing some holdings in more defensive sectors. Key factors that inform our sector and stock stance are:

- We favour high global diversity by end-market and particularly emerging market exposure; this factor is primarily driving earnings momentum in our view.
- Correspondingly, we continue to advocate industrial cyclicals over consumer cyclical.
- We feel that bottom-up analysis and stock-picking will continue to matter more than sector allocation.
- With regard to the UK, we are inclined to adopt a cautious perspective on stocks exposed specifically to the domestic economy given political uncertainties and the impact future policy may have on growth prospects.

Exhibit 5 shows our preferred sector strategy, which we caution is strictly illustrative since it relates just to hypothetical positioning across UK equities whereas, in reality, investors will likely take into consideration a much broader range of factors. Based on the commentary above, we have made some small revisions to our preferred sector allocation relative both to the previous month and to the start of the year. We provide additional explanation and justification below:

- We have become more cautious on the (UK) consumer sectors, which now constitute our core underweight. We do not believe share price moves (particularly in the consumer services sector) are justified given the likely outlook facing the sector, namely a context of rising inflation and unemployment, deteriorating confidence, and an uncertain policy outlook. Valuation is also unconvincing in our view.
- Our core overweight sector ideas remain unchanged, namely, favouring basic materials, industrials and oil & gas. We favour these sectors given their global diversity and based on their potential to surprise positively with regard to earnings. The sell-off in basic materials stocks over the last month (down 19.4%) creates a particular opportunity in our view, especially with the sector on just 12.2x 2010 P/E.
- Among the 'defensive' sectors (all of which have underperformed on a three-month and year-to-date perspective, despite the recent spike in the VIX), we continue to find merit based on yield and value. In particular, we favour healthcare (over telecoms and utility) given the typically more globally diversified nature of these business. We also note recent strong results from Astra and GSK.
- With regard to financials, we find it appropriate to reduce our longstanding (since October 2009) underweight on the sector. Sovereign debt fears notwithstanding, we see scope for consensus opinion to become more positive on the sector especially as companies begin to move towards 'new normal' earnings. We are also encouraged by recent confidence voiced by a number of listed banks across the globe.

Exhibit 5: Edison sector rankings, how and why they have changed

Position	May-10	Rationale	Apr-10	Jan-10
Best	Basic materials	Fundamentals, global exposure, valuation, recent underperformance	Basic materials	Basic materials
	Oil & gas	Global exposure although some macro risks	Industrials	Telecoms
	Industrials	Strong earnings momentum, improving sentiment	Oil & gas	Healthcare
	Healthcare	Defensive profile, valuation, recent underperformance, global	Telecoms	Utilities
	Telecoms	Valuation/ scope for positive rotation after 3-month underperformance	Healthcare	Industrials
	Utilities	Valuation/ scope for positive rotation after 3-month underperformance	Utilities	Technology
	Technology	Take profits after recent outperformance; demanding valuation	Consumer goods	Oil & gas
	Financials	Scope for sentiment to turn more positive	Consumer services	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: Edison Investment Research

Exhibit 6: 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	12.9%	12.2	1.5%	(5.9%)	(19.4%)	6.3%	7.5%	38.7%
	Oil & gas	18.0%	10.5	4.8%	(3.4%)	(9.1%)	3.5%	0.1%	13.6%
	Industrials	7.2%	15.3	2.7%	9.1%	(3.4%)	11.2%	13.7%	30.1%
	Healthcare	7.3%	10.5	4.6%	(5.8%)	(4.6%)	0.8%	2.1%	19.4%
	Telecoms	5.7%	8.9	5.3%	(3.8%)	(6.7%)	(0.9%)	1.0%	10.4%
	Utilities	3.3%	14.7	5.3%	(3.3%)	(4.0%)	0.1%	8.6%	11.5%
	Technology	1.6%	23.0	1.3%	11.2%	(5.4%)	6.5%	15.2%	43.5%
	Financials	22.8%	21.1	3.1%	(3.3%)	(8.5%)	4.4%	(4.4%)	14.4%
	Consumer services	9.9%	14.8	2.8%	4.5%	(4.3%)	8.1%	7.4%	19.1%
Worst	Consumer goods	11.3%	15.8	3.3%	0.5%	(5.9%)	4.4%	7.6%	31.8%
Average		100.0%	14.9	3.4%	(1.6%)	(8.4%)	4.6%	3.1%	20.5%

Source: Datastream, Edison Investment Research

Underweight consumer goods and services

While earnings momentum has been encouraging, we have been surprised by recent share price strength among the UK's listed consumer companies. In the last month, consumer stocks have outperformed the All-Share by an average of three percentage points. Both the consumer goods and services 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.

We are concerned that recent earnings momentum may not be sustained. While Marks & Spencer recently reported results that were ahead of consensus expectations and showed the best quarterly sales trends in three years, CEO Michael Rose was more downbeat on the outlook, saying that he expected sales to remain “pretty flat” and that there was “no reason for optimism” (8 April). Moreover, despite Tesco indicating at the time of its results that the UK recovery was “gaining hold” (20 April), its share price fell on concerns over the UK consumer outlook. Similarly, Next said on 5 May that it remained “very cautious in our outlook for the year ahead.” Recent results from Debenhams and JD Wetherspoon were also mixed and Thorntons became the first UK retailer for some time to lower guidance at the time of its results (20 April), describing the economic environment as being one where consumers “remain focused on value”.

The key problem is that consumer confidence is falling and could likely fall further, affecting future spending. In March, UK confidence fell by nine percentage points, the largest drop since July 2008. The revised UK government will likely be forced to implement a series of austere fiscal imperatives, certainly in the form of public sector cuts and also potentially via tax (VAT) rises too. As a result, the UK faces a scenario of possible rising (or at least, not falling) unemployment, and consumers likely spending less. According to the ONS, UK retail sales volumes during March (the last month for which data is available) rose by just 0.4% month-on-month, and fell short of consensus expectations (for 0.6%). Meanwhile, the British Retail Consortium’s figures also showed a deterioration in underlying spending patterns (stripping out the effect of Easter, which fell in April this year, but March in 2009) and stated in its 13 April releases that prospects remained “uncertain”.

We therefore see potential scope for disappointment relating to first quarter (and beyond) 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 15.8x 2010 P/E and the services sector on a multiple of 14.8x – is also not supportive in our view.

Overweight global industrial cyclicals

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 FTSE’s worst performing sector in the last month (down 19.4%), but remains a notable outperformer on both a six- and 12-month view. We are also encouraged by the resilience of the industrials sector, being the second best-performing year-to-date and also over the last month.

As we have explained elsewhere, the biggest driver of recent (or, at least, pre-Greek) stock market outperformance has been strong reported results from a range of companies across sectors. However, the area where expectations have been exceeded most consistently has been within the industrial segment, with Aggreko, Bodycote, Tomkins and Wolseley among others delivering better than anticipated figures (although we note a slightly higher degree of caution recently expressed by GKN and Rolls Royce). Performance has also been helped year-to-date by positive commodity price moves, while higher oil prices (currently at c \$80/ barrel) have helped to lift energy stocks. Both BP and Shell both recently reported results ahead of consensus expectations and energy policy makers also seem sanguine and keen to embrace less volatility (in the oil price) rather than lower prices per se.

Some of the outperformance has been driven through the implementation of ‘self-help’ measures such as cost-cutting and the subsequent benefits of operating leverage. However, much of our future confidence is also driven by the fact that end-market demand appears robust, particularly from emerging markets. In particular, we favour businesses with global diversity, and especially those exposed to the Chinese and Indian

markets. We note that 70% of the world's GDP growth is set to derive from emerging markets, with the latter two contributing 40% of the globe's growth in 2010 (according to *The Economist*, 17 April). Moreover, China alone is responsible for consuming a third of the world's base metals, supporting our positive stance on the basic materials sector. Interestingly, Rolls Royce (among the more cautious companies we have met recently) was also considerably more optimistic about emerging market prospects than those for the developed world. Looking forward, we expect demand trends to remain intact (although likely reductions in public spending will clearly have a negative impact on some stocks – hence our preference for global diversification). Moreover, our confidence in these sectors is reinforced by the fact that the basic materials and oil & gas sectors continue to trade on sub-market multiples, of 12.2x and 10.5x 2010 P/E respectively. We also note that the oil & gas sector offers a 4.8% dividend yield – ahead of the UK market – and hence our relative preference for this sector over industrials, given the latter's valuation premium and dividend discount.

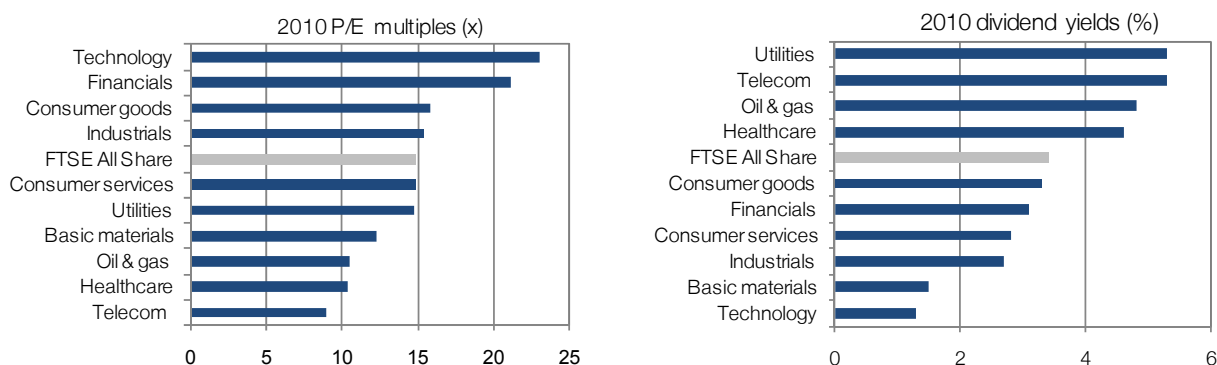
Neutral defensive sectors: Attractive on yield and other factors, healthcare preferred

The appeals of defensive sectors are broadly understood: namely, yield and value, combined with relatively low economic risk. However, despite market volatility year-to-date, healthcare, utilities and telecoms have all notably lagged the All-Share. We see such underperformance as creating an opportunity for investors, especially given encouraging industry trends. Our relative preference is for the healthcare sector given that its major listed plays have more global exposure than either the telecoms (ex Vodafone) and utilities sector, which are more dependent on the UK economy and future policy from the country's new-look government.

With regard to the healthcare sector, the mega-cap pharma stocks seem to be finding a renewed degree of confidence, as evidenced by recent 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. Recent US healthcare reform may also be a positive driver for the sector over the medium term.

The UK healthcare sector trades on 10.5x P/E for 2010 on a headline basis (although both Astra's and GSK's multiples are below this) and offers a 4.6% dividend yield. Yields are higher for the utility and telco sectors (currently 5.3% for both), although growth prospects in these latter sectors are significantly less compelling. M&A may, however, serve as a potential additional driver for utilities and telecoms. 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 earlier this year 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.

Exhibit 7: 2010 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

Financials: Becoming gradually more positive

Our underweight financials stance has been one of our longest standing (along with overweight basic materials – a relative trade that has yielded over 10 percentage points of outperformance in the last six months), and while we do have some clear remaining concerns, we feel that now is an appropriate time to consider moving towards a somewhat more positive stance. Indeed, despite recent concerns over sovereign debt default risks, on both a one- and three-month view, the UK financials sector (which includes insurance companies and quoted asset managers) has traded only very slightly below the All-Share.

Consensus remains broadly negative (or at least, not yet positive) on the sector, based on the most recent Merrill Lynch fund manager survey, which showed financials as investors' most underweight sector. Although expectations for future revenue growth are still low and the debate over what constitutes 'new normal' earnings has not been resolved, we feel there are a number of indicators that point to a more encouraging outlook. This has also been evidenced by results from financial services companies around the world including Barclays, Citigroup (who said at their Q1 results on 19 April that they had "turned a corner"), Credit Suisse, Deutsche, JP Morgan, Lloyds and UBS.

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 widespread sector reform; the latter is currently being debated in the US Senate), 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. In valuation terms, there remains significant disparity across the sector (whose headline 2010 P/E multiple remains above 20x), and our preference is to favour those business with superior – and diversified – business models.

Conclusions

Global equity markets continue to show significant levels of volatility as evidenced by the fact that after reaching 22-month highs on 21 April, most indices (including the UK) are now in negative territory for 2010, following several days of major correction. Such volatility is indicative of the challenges facing investors: macro data and earnings momentum are improving, but risks have far from dissipated and we remain concerned that much of the 'better outlook' scenario is already reflected in valuations. Against this background, we maintain our sector strategy and favour a bottom-up approach, preferring stocks with high global diversification that offer undervalued growth potential.

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