

Illumination: Equity strategy and market outlook

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Equity market overview and strategy

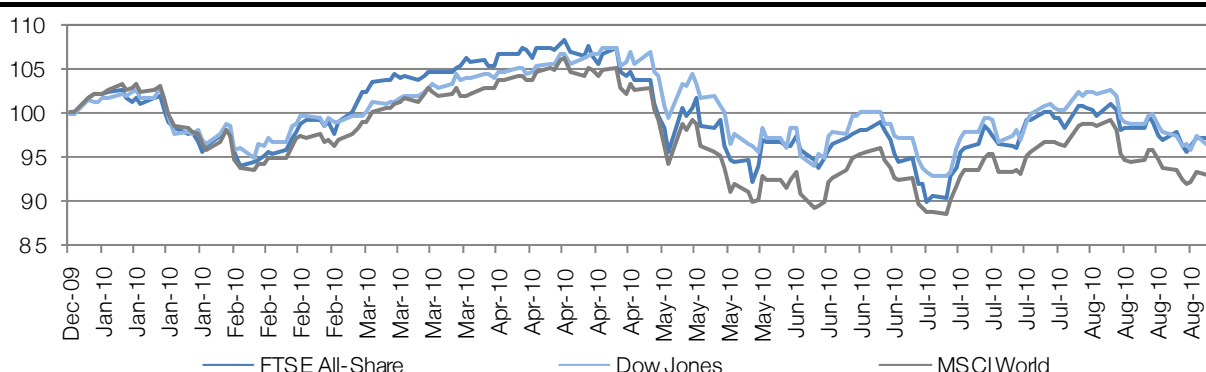
We expect global equity markets to remain under pressure through until the end of the year. Impending macro and micro data are likely to point to a further deterioration in momentum. Global GDP growth estimates are successively being downgraded and, for as long as both rising unemployment and inflation persist, we see risks to consensus earnings expectations particularly since we do not believe that a weaker outlook scenario is fully discounted in valuation levels. Against this background, we see few attractive options for equity investors (we continue to favour gold as an asset class). In the near term, with risk aversion levels rising, defensives look set to remain in vogue, and we can also construct a positive case for the financial sector. By contrast, we retain our cautious stance on consumer cyclicals. Longer-term, our preference is for stocks that offer high global diversification and undervalued growth potential.

The joyless recovery

One could almost be forgiven for believing that the UK (and global) economy remains mired in recession as equity markets continue to drift in a convictionless fashion and risk aversion levels rise painfully higher once again. Over the last month, the All-Share has lost 0.7%, the Dow 4.4% (dipping below the psychological 10,000 level on 26 August for the first time since 6 July) and the MSCI World Index 3.9%. Meanwhile, the VIX volatility indicator has spiked higher by 10.8%. On a year-to-date basis, every major global index we track is in negative territory, with the MSCI's global benchmark down 7.5%. If we are in recovery mode, then it certainly does not feel like it.

Exhibit 1: Major equity indices all in negative territory year-to-date

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

To our mind, the obvious question that requires asking is why investors have conspicuously failed to push up share prices, especially given the seeming strength of the corporate recovery, evidenced by Q2's reporting season in the UK, Europe and the US. Three simple answers spring to mind: first, the 'recovery' appears distinctly two-speed; second, economic data remain highly inconsistent; and, third, better profitability has not translated into more jobs, undermining economic upturn potential and placing increased pressure on an already-strained and highly indebted state.

By two-speed, we highlight that while companies within some sectors (especially financials, at present) appear to have beaten easily consensus expectations at their last reported results, there have been notable disappointments and soundings of management caution in others (consumer and technology – notwithstanding M&A activity in the latter). More fundamentally, companies across *all* sectors demonstrated a markedly better performance in terms of profitability than with regard to sales. An absence of top-line growth is clearly unsustainable and if inflation continues to ratchet higher – which we expect (and as we discuss in more

detail below) – then this represents an additional future concern for both companies and investors. Higher prices would logically eat into profitability over time.

Turning to the macro picture, we believe that investors have every right to be worried. While there are some bright spots (UK Q2 GDP, German consumer confidence), these are very much the exception rather than the rule. We find it most noteworthy that within the last month, the Bank of England, the ECB and the Federal Reserve have all downgraded their GDP forecasts for their respective geographies. Despite the fastest rate of growth witnessed in the UK since the third quarter of 1999 being reported last week, Governor Mervyn King continues to expect a “choppy recovery” where demand and output will remain “volatile”. 3.4% GDP growth for 2011 (the Bank’s assumption made in May) always looked too optimistic, but we sense that 2.7% growth next year (the revised forecast) may still be a struggle, especially in the context of the ECB assuming just 1.1% for the Eurozone as a whole.

The picture in the US looks even more concerning, especially since the American economy emerged from recession at an earlier stage than either the UK or the Eurozone. The downward revision to second quarter GDP (from 2.4% to 1.6%) was well-flagged and not as bad as some market bears had feared, but we note that a drop of 2.1 percentage points in growth over the first two quarters of 2010 represents a notable slowdown. Moreover, while there have been 13 consecutive readings of over 50 for ISM industrial production (implying ongoing expansion), two of the last three months have shown declines in the rate of growth. The rhetoric from Fed officials – both current and previous – has also become notably more cautious: Ben Bernanke said on 10 August that “the pace of outlook and employment has slowed in recent months” while Alan Greenspan, former Fed chairman, is pointing to a current “pause” in US recovery (2 August).

Even if the developed global economy escapes a double-dip (we have suggested since June’s edition of *Insight* that there would be an above-average risk of such a negative scenario), then we expect the ongoing recovery to be singularly joyless in its nature. This has clear implications for investors. Our core observation is that not since records began in the US – still the world’s largest economy – has so deep a recession been followed by so shallow a recovery in employment. With employers continuing to squeeze costs, the equation between growing profitability, more jobs and subsequent growth appears to have broken down strongly.

In the US, initial jobless claims continue to rise, with those seeking unemployment benefit for the first time now back at its highest level since February. July represented the second consecutive month in which jobs have been lost in the US (131,000 in total), while the private sector was able only to create 71,000 new jobs in the past month, substantially worse than consensus expectations. Four quarters after the US economy entered recovery, overall unemployment remains at 9.5%.

There is a similarly negative picture in the UK and elsewhere. Despite a 49,000 drop in unemployment in the three months to June (the last period for which data are available), the unemployment rate remains at 7.8% and is continuing to rise on a 12-month rolling basis. It is also worth highlighting that the number of people claiming unemployment benefit for more than a year rose over the quarter to total almost 800,000, the highest level for any three-month period since March 1997, while those claiming job seekers allowance for over six months also rose – for the first time since early 1999. A report from the British Chamber of Commerce (issued on 31 August) also suggests that UK unemployment will not peak until mid-2012. According to the BCC, those unemployed could reach 2.65m during 2012, up from 2.46m at present. For the Eurozone as a whole, unemployment has shown no sign of falling below 10% and is over 20% in both Spain and Latvia.

Against this background, it is unsurprising that it is becoming increasingly hard to identify where growth may come from either for corporates or for equity investors. It is interesting to note that even in China – often cited as the country that will drive most the global economy – has seen its rate of industrial production fall for four

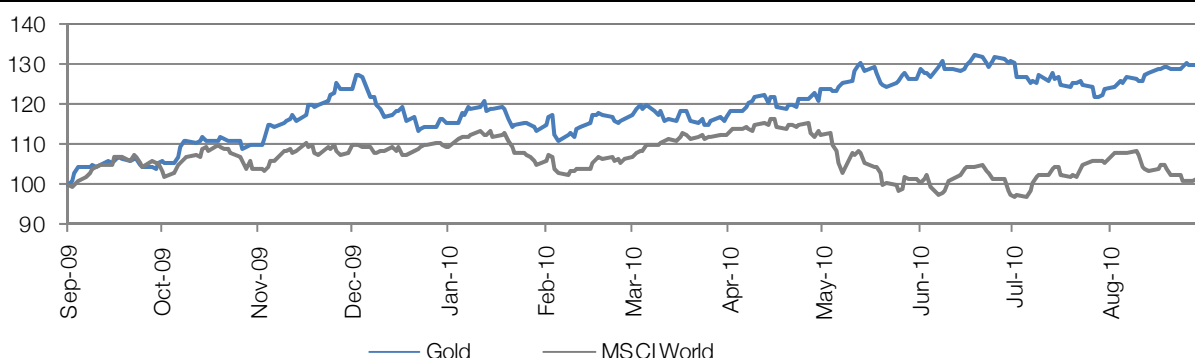
consecutive months, although the PMI report out on 1 September appears to show a slight bounce back. Elsewhere, chief executives from global corporate bellwethers as diverse as Unilever and Intel have recently voiced explicit caution about the outlook. More grist for the mill is provided by Merrill Lynch's well-respected monthly fund manager survey, which shows US investors at their most bearish since January 2009. A final sobering data point is that just 31 IPOs of more than €100m in value have occurred in Europe year-to-date, according to Dealogic. More than 50% of these are currently trading below their issue price.

All of the above supports our well-documented caution on equities. We find few reasons to be positive about the near term, particularly given valuation levels. The UK market, for example, trades on over 14x 2011 earnings. The end of the summer hiatus (holidays over, trading volumes picking up, debt markets re-opening) may also amplify downward pressures.

Given the challenges ahead, our strategy remains centred on portfolio diversification, particularly into other asset classes, and especially gold (which has risen 5.6% in the last month, 9.3 percentage points more than the MSCI global equity index). In the broadest terms, we continue to favour undervalued names with strong global growth prospects. At present, we also have higher conviction in our underweight positions (especially regarding consumer cyclicals) than we do elsewhere, but, over time, we expect the themes of emerging market growth and industrialisation as well as increasing globalisation to continue to play out positively.

Exhibit 2: Gold has been a significantly better investment than equities in the last 12 months

Note: Rebased to 100.



Source: Bloomberg, Edison Investment Research

Market review: Risk aversion back in fashion

Although the UK market lost only 0.7% in August – a considerably better performance than its European peers – the month marked the fifth this year in which the All-Share has ended the period lower than it began. On a year-to-date basis investors in the UK's benchmark index have lost 2.3%, with the All-Share now trading 10% below its 15 April high. The old adage of selling in May appears to have worked in 2010, with the market down 3.5% since the first trading day in May. Whether the St. Leger horse race (scheduled for 11 September) proves to be a turning point for equities remains to be seen.

Within the UK, defensives have very much moved back into vogue again with the utility, telco and healthcare sectors strongly outperforming not just in the last month but also over a three- and six-month perspective. All three sectors have gained at least 2.5 percentage points relative to the benchmark index in the last month and over five points on a three-month basis. While the utility sector has been helped by recent M&A activity relating to International Power's deal with GDF-Suez and all three 'defensives' may have benefited from yield-led rotation away from BP, the most obvious driver of recently improved performance seems to be a return to risk aversion. As discussed before, and for clear reasons given the potentially deteriorating environment, investors

appear to have shunned the 'risk trade', preferring safer havens. Furthermore, we find it unsurprising that there is a strong correlation between outperformance from defensives and the recently spiking VIX.

It is also of interest to note that not only in the last month, but over all time periods we track (as Exhibit 3 shows below), the UK's main indices have outperformed their counterpart pan-European benchmarks. In the last month, the All-Share has outperformed the Euro Stoxx by over six percentage points and the FTSE-100 has gained eight points against the Stoxx 50. On a country-specific basis, despite lagging over the last month, only the German bourse has performed better than the UK's main index.

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	(3.5)	(0.6)	0.7	(2.4)	6.4
FTSE All-Share	(2.3)	(0.7)	0.9	(1.5)	7.0
DJ EURO STOXX	(8.6)	(4.0)	0.5	(2.2)	(2.6)
DJ EURO STOXX 50	(11.5)	(4.3)	0.5	(3.9)	(5.5)
France CAC40	(11.3)	(4.2)	(0.5)	(5.9)	(4.5)
Germany DAX30	(0.5)	(3.6)	(0.7)	5.8	8.4
Spain IBEX35	(14.7)	(3.0)	8.8	(1.4)	(10.4)
Italy MIBTEL30	(15.1)	(6.1)	1.0	(6.3)	(12.0)
UK relative to Europe					
FTSE 100 vs EURO SROXX 50	8.0	3.7	0.2	1.5	11.9
FTSE All-Share vs EURO STOXX	6.3	3.3	0.4	0.7	9.6

Source: Datastream, Edison Investment Research

We see such trends as providing further evidence for the growing risk aversion thesis. It would seem logical for investors to favour UK equities over continental European stocks for three main reasons, all of which we have discussed in previous editions of *Insight*. First, given our preference for a strategy of diversification, holding UK equities relative to European ones (which have a higher percentage of international revenue and profit streams) seems to make sense. Second, notwithstanding a robust performance from the German economy – which has been led primarily by exports – much of the rest of continental Europe continues to show sclerotic growth, noticeably slower than that witnessed in the UK, even if the latter's does not prove sustainable. Finally, as Ireland's recent debt downgrade serves to highlight, the Eurozone's sovereign indebtedness remains a cause for concern, and one that may surface more prominently in investors' minds as the summer lull moves to its close.

Given the outlook we detail, 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: The spectre of inflation

In the low growth scenario we discussed above with which the developed world now has to deal, inflation is undoubtedly the biggest disruptive risk factor. We have remained firmly in the inflation (as opposed to the deflation) camp and believe that many investors are failing to discount the clear risks attached to a world of rising inflation. Such risks may further undermine equity performance, but also reinforce the case for owning gold as alternative asset class.

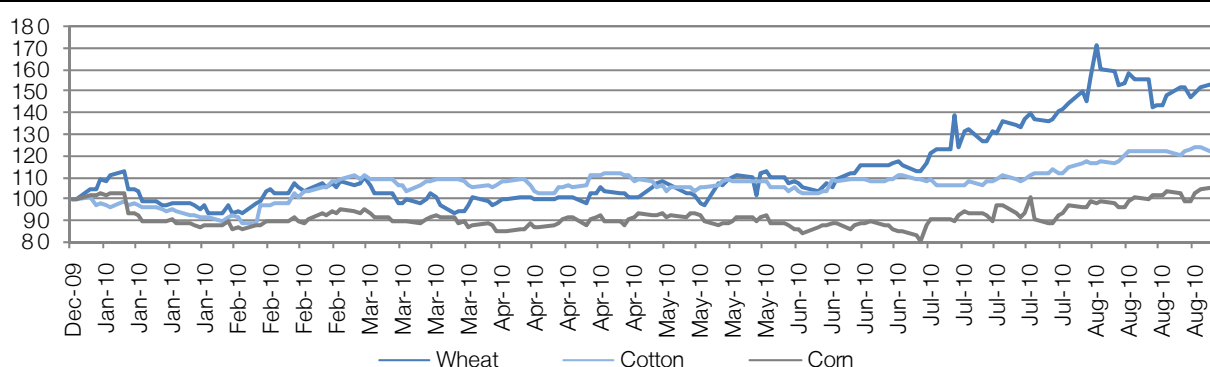
Academic research (see the latest report by André Meier for the IMF, cited in the *Financial Times*, 27 August) suggests that inflation can be present during periods of persistent low output growth, and empirical evidence

supports this contention. UK inflation has stood above 3.0% for every month of 2010, while inflation is currently running at over 1.5% in both the Eurozone and the US despite recent downward revisions to GDP growth assumptions in both geographies.

We see evidence of the inflation threat from many quarters. A variety of soft commodity prices have risen sharply in the last few months, with adverse weather affecting supplies of wheat (in Russia), corn (in America) as well as cotton, barley and cocoa among others. Companies have also begun to reflect such dynamics in their guidance with Next and Marks & Spencer warning that cotton prices could adversely affect their profitability and Greggs citing rising wheat prices as a negative driver at its recent results. Rising input prices in emerging economies (inflation is, for example, currently above 11% in India despite four rounds of interest rate rises) also represent a clear threat for the consumers of imported goods in the developed world.

Exhibit 4: Recent commodity price rises suggest that inflation risks are building

Note: Rebased to 100.



Source: Datastream, Edison Investment Research

Against this background, we do not see it as surprising that Governor King believes that there is a “significant probability” that the Bank will need to write further letters to the Chancellor to explain why above-target inflation remains. Guidance from the Bank (see its 17 August *Inflation Report*) is for inflation to remain above 3% until mid-2011 and above-target (ie 2%) at least until 2012. Beyond currently rising commodity prices, next January’s increase in VAT to 20% could also further stoke inflation.

The persistence of inflation raises two specific concerns for investors in our view. First, in the low output scenario in which the developed world continues to find itself, rising prices will undermine top-line growth prospects while costs cannot continue to be cut indefinitely. This creates the risk of potential earnings disappointments, a particular risk ahead of the Q3 reporting season, especially given the relative confidence shown by many corporates in the previous earnings quarter. Second, how policymakers attempt to reconcile low growth and rising prices – or manage stagflation – could act as a major source of investor uncertainty and hence share price underperformance.

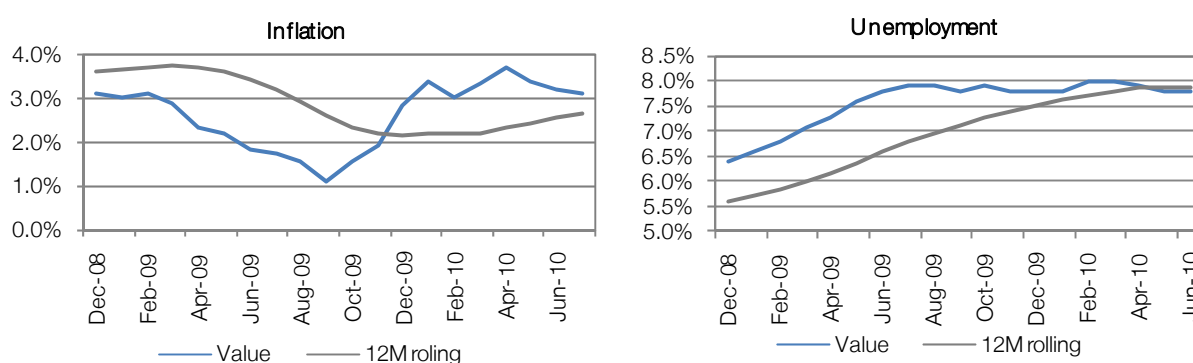
It is noteworthy that the Federal Reserve currently sees slowing growth rather than rising inflation as being the bigger concern. Its language of 10 August was unambiguous: rates are set to stay low for an “extended period.” Instead, the Fed has decided to embark on a second round of quantitative easing (dubbed ‘QE lite’), reinvesting more than \$150bn in annual proceeds from mortgage backed securities into Treasury debt in an attempt to stimulate the economy.

At one level, this seems to miss the point since not only does QE *not* have any proven basis of success, but also the printing of additional money may risk driving inflation rather than stimulating growth. From a more fundamental perspective, governments and central bankers globally seem faced with indecision over whether to favour demand or supply-led led stimuli, simply because the policy cupboard is bare: QE may not work (it has

not in Japan for at least 10 years), interest rates can fall no further (and should perhaps start rising, particularly in the UK) and austerity is back in vogue (implying no scope for Keynesian demand pumping or tax cuts, quite the opposite).

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. Such an outcome is not fully discounted in consensus expectations in our view.

Exhibit 5: Stagflation is coming – in the UK, both inflation and unemployment continue to rise on a 12-month rolling basis



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 reviewed monthly and for September we have made no changes relative to August, despite recent strong performance from the defensive sectors and corresponding underperformance from the basic materials and industrials sectors. Given likely further volatility and directionlessness in equities through until the year-end (investors have persistently oscillated between risk-trade 'on' and 'off' strategies since the start of 2010), our approach is to focus more on fundamentals, and attempt to adopt a slightly more medium-term perspective.

Against this background, we see no reason to change our positive fundamental view on basic materials, which we have now held for a year. Although the sector has lost 5.8% since the start of 2010 (2.5 points worse than the UK benchmark), on a 12-month perspective, the sector has gained 23.6%, considerably ahead of the UK market and a performance bettered only by the tech sector. Although industrials have also lagged in the past month, we continue to hold firm with our positive view on this sector (which we have adopted since April – and which has delivered outperformance over this period). However, for both sectors we would stress some caution and reiterate our preference for those stocks with high global end-market diversity.

Nearer-term, we have higher conviction on our core underweight sector stance, namely towards consumer cyclical where we have adopted an increasing level of conviction. While this has yet to deliver the anticipated

results in performance terms (both the consumer goods and service sub-sectors have slightly outperformed year-to-date), a series of core indicators, combined with valuation levels give us no reason to change our stance. On a more positive note, our increasingly upbeat stance on the financials sector (pursued for the last four months) has delivered relative outperformance, which we believe can be sustained.

Furthermore, we expect the defensive sectors to remain in vogue for at least as long as risk-averse attitudes continue to prevail. Such a stance is somewhat consensual, but we have favoured telcos in particular for some time and note that they are currently the second-best performing sector on a year-to-date basis, up 6.7%.

Exhibit 6 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 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	11.6%	9.0	1.5%	(5.8%)	(2.7%)	(2.2%)	(2.3%)	23.6%
	Industrials	7.2%	17.5	2.8%	5.0%	(3.4%)	(2.3%)	2.1%	15.0%
	Financials	24.0%	18.3	3.0%	0.5%	(1.6%)	4.3%	(0.1%)	(0.9%)
	Telecoms	6.3%	8.2	5.3%	6.7%	3.4%	10.7%	9.9%	14.3%
	Healthcare	8.0%	12.1	4.5%	(0.3%)	4.4%	6.3%	3.3%	7.6%
	Utilities	4.0%	10.6	5.2%	4.8%	4.7%	13.8%	5.6%	15.1%
	Oil & gas	15.8%	18.2	4.0%	(16.3%)	(1.5%)	(8.4%)	(13.4%)	(7.1%)
	Technology	1.7%	21.2	1.3%	16.2%	0.0%	6.0%	9.9%	29.4%
	Consumer services	11.5%	13.9	3.0%	1.0%	(0.9%)	(0.5%)	1.1%	10.1%
Worst	Consumer goods	9.9%	14.1	3.6%	0.3%	(1.0%)	1.3%	(1.7%)	14.7%
Average		100.0%	14.3	3.4%	(2.3%)	(0.7%)	0.9%	(1.5%)	7.0%

Source: Datastream, Edison Investment Research

Underweight consumer goods and services

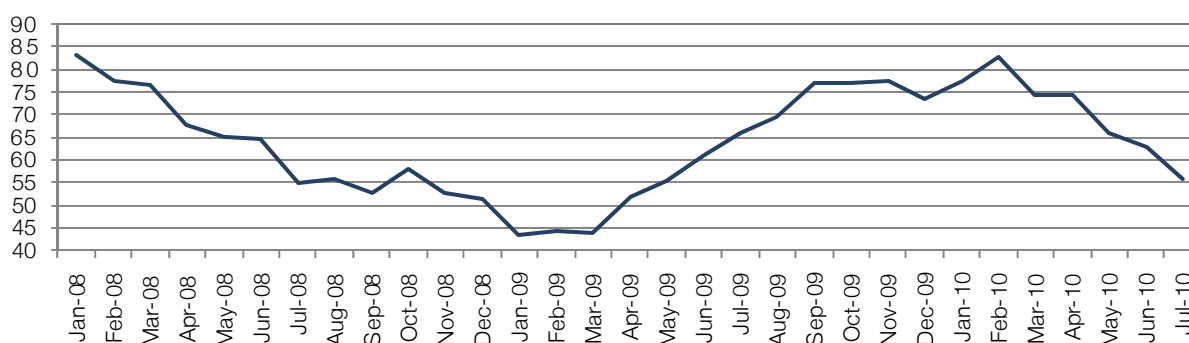
Our negative stance on the (UK) consumer is well-held and has been well-documented in previous editions of *Insight*. Despite slight outperformance from both the consumer goods and services sector since the start of the year, we see little reason to change our view, particularly given the macro outlook. We do not believe that the potentially vicious circle scenario facing these companies, where earnings momentum proves unsustainable, is fully discounted in current valuation levels.

As we foresaw, the strong retail sales growth trend of June (where year-on-year growth of 1.2% occurred on a like-for-like basis) was not sustained into July. Growth of just 0.5% was witnessed in this, the last reported, period, with the British Retail Consortium (BRC) citing a noticeable drop off in 'big ticket' items in particular. Wet weather for much of August may also have dampened high street footfall for the month ahead, even if some consumers 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 three consecutive months and its current level (of 56) already stands a long way down from February's recent high of 83 and is also five points *below* where confidence stood last July. We also note that Nationwide's expectations index (ie reflecting future spending intentions) has now dropped beyond its long-run average. Nationwide believes that consumers are "continuing to show caution" while the BRC talks of consumers being "unsettled" particularly by impending public spending cuts (and therefore likely related higher unemployment). Mori, the polling agency, even goes further in describing UK consumers as being the "most pessimistic in the world" (11 August) with regard to how they see their economy.

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. We also note caution from Marks & Spencer and Next in the past month as well as profit warnings from within the travel and leisure sub-sector (Thomas Cook and TUI). Moreover, valuation – with the consumer goods sector on 14.1x 2011 P/E and the services sector on a multiple of 13.9x – is also not wholly supportive in our view.

Exhibit 7: UK consumer confidence continues to decline sharply



Source: Nationwide, Edison Investment Research

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 3.4 points in the last three months and by 2.8 points on a year-to-date basis. We expect this better performance to prove sustainable over the near term, particularly after a recent robust reporting season as well as two more positive structural developments.

We note that all the main UK-listed banks (Barclays, HSBC, Lloyds and RBS) exceeded consensus expectations at their results released over the last few months, consistent with trends witnessed in continental Europe (BNP Paribas, Credit Suisse, Deutsche, UBS) and the US (JP Morgan, Morgan Stanley). Although expectations for future revenue growth are still low and the debate over what constitutes 'new normal' earnings has not been fully resolved, last reported results show that banks appear to be clearly on the path to recovery. 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.

From a structural perspective, the revised Basel requirements for banks have offered them a greater number of concessions than had been anticipated, regarding tier one capital, leverage and liquidity in particular. This has helped provide a fillip for the sector as did July's stress tests for European banks, where fewer than 8% of those organisations subjected to stressing failed.

Looking ahead, there may also 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.

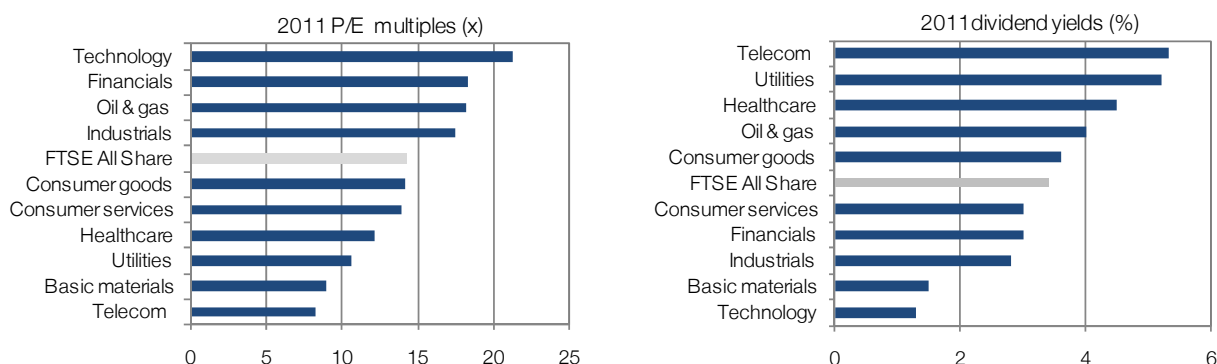
Telco, pharma and utilities: Attractive on yield and other factors

The appeals of defensive sectors are broadly understood, in particular, their combination of attractive dividend yield and value, combined with relatively low economic risk. As risk aversion has come back into vogue, the healthcare, telecoms and utilities sectors have all outperformed, gaining relative to the All-Share on a one-, three- and six-month view. Although growth prospects are clearly more limited over the medium term than elsewhere for these sectors, outperformance could be sustained through until the year-end should investors continue to seek relative safety within equities.

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, particularly Vodafone, which has added 13.5% in the last three months. We favour Vodafone's global exposure and are also attracted by the fact that its already compelling 5.3% 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.

Exhibit 8: 2011 P/E multiples and dividend yields for UK sectors – defensives screen well on value and yield



Source: Datastream, Edison Investment Research

Overweight global industrial cyclicals: Well-positioned on a longer-term view

Recent share price movements serve as a reminder that stocks in these sectors offer not just potentially above-average returns, but also increased volatility. Basic materials has been the second-worst performing sector year-to-date, but remains the second-best performer on a 12-month perspective. Investing in this sector requires adopting a somewhat longer-term perspective, but current valuation levels (9.0x 2011 P/E) constitute an attractive entry point in our view. On a separate, but related note, we continue to be encouraged by the resilience of the industrials sector, which gained 5.0% year-to-date and 15.0% over the last 12 months.

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 re-emphasise the strength of current demand. Chinese exports rose by over 40% year-on-year in July, while Indian industrial production increased by more than 12% 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.

Conclusions

We expect global equity markets to remain under pressure through until the end of the year. Impending macro and micro data is likely to point to a further deterioration in momentum. Global GDP growth estimates are successively being downgraded and for as long as both rising unemployment and inflation persist, we see risks to consensus earnings expectations particularly since we do not believe that a weaker outlook scenario is fully discounted in valuation levels.

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 evidence of the emergence of sustainable top- and bottom-line growth; and (more) compelling valuation levels. Investors would also likely value a concerted and coherent approach to policymaking, particularly since sovereign indebtedness remains an issue that has yet to go away and may pressure equities further.

Against this background, we see few attractive options for equity investors (we continue to favour gold as an asset class). In the near term, with risk aversion levels rising, defensives look set to remain in vogue, and we can also construct a positive case for the financial sector. By contrast, we 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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