Illumination: Equity strategy and market outlook

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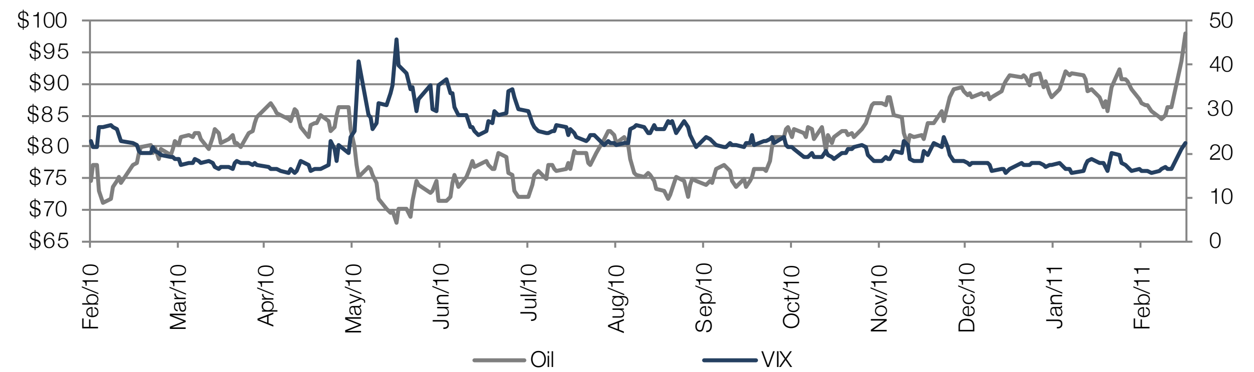
Equity market overview and strategy

- The 'risk trade' is under pressure. Firmly 'off' in the midst of the Libyan uprising, equity markets have since settled somewhat but uncertainty and hence risk aversion remain elevated. In the immediate aftermath, the two main trades seem to have been long volatility and short soft commodities.
- Libya and the Middle East uprising proved the immediate trigger for the recent market sell-off, but with hindsight the market was clearly over-bought in the short term. Complacency had crept into the stock market and levels of risk tolerance had in fact soared to multi-year highs, leaving little room to deal with such 'unexpected' events.
- Notwithstanding the ongoing geopolitical and inflationary risks, our core thesis is to stay long equities and use any correction to increase exposure to high quality names with pricing power. Monetary policy is inflationary but in our view will be supportive to equities. A bias towards high-quality global franchises with barriers to entry and pricing power is essential.
- Last month we raised the issue of the Plutonomy as a key driver of consumer markets (80% of the market potentially being driven by 20% of the population). This month we take a very brief look at China and highlight an interesting economic trend that could imply that China's economic output slowed markedly through 2010, contrary to the official statistics.
- The All-Share index is currently trading on 10.6x FY12 earnings – hardly excessive. We think there are still value opportunities in the UK and any further sell-off might offer considerable opportunities. Notably, there have been clear signs of sector rotation since the start of 2011, out of consumer and into healthcare.

Pragmatism (and a strong stomach) required

Our call in January that "central bank policies are likely to remain supportive to equity and commodity prices" was essentially a call for pragmatism by investors. One month on, that pragmatism is still vital, but now so too is a strong stomach. Our anticipation of increased volatility in markets did not take long to materialise. In the last week, the VIX index has spiked to its highest level in almost three months on the back of the well-publicised tension in the Middle East, a corresponding spike in oil price volatility and perhaps most importantly the exposure of what was, with hindsight, a complacent risk-inclined market. The consequence of all this is that the 'risk trade' does now seem to be well and truly 'off' for the time being.

Exhibit 1: Risk 'off'



Source: Bloomberg

While a market correction may or may not be in place, it seems to us that the key themes we outlined in February (governments printing money, inflationary pressures, and capital flight from bond markets) all hold true and will prove supportive to equity valuations in the medium term. We would not reduce equity exposure and, in fact, any sharp correction should be used to seek out high quality businesses.

High-profile citations of inflationary pressure are now almost a daily occurrence in trading updates, and companies – particularly those without hedging in place or indeed pricing power – are feeling the effects fast. The speed of change is surprising to many: as a case in point, just three weeks after its interim trading statement in January, UK soft-drinks manufacturer Britvik last week raised its input cost inflation target from 5-6% to 9-11% (its share price falling 10% on the news). Meanwhile cocoa prices are up 25% since January and oil prices have risen 15%. Companies and investors need to be nimble to keep with such fast moving events.

Markets update

In the last four weeks, markets have been dominated by Q4 results and trading updates (broadly deemed to be ok), inflation (clearly *not* ok) and Middle East civil unrest (*definitely* not ok, and ultimately the straw that broke the market's back in the end). The broader UK indices have given up earlier gains and have been roughly flat month-on-month as of publication. Meanwhile, the Brent oil price has gained almost 12% in the last week alone.

Simplistically, one might attribute the renewed volatility solely to the tensions in the Middle East, but this is only part of the story. The truth is that markets had become overly complacent, with risk appetites at multi-year highs. This is clearly supported by the high-profile Fund Manager sentiment survey released last week, which showed that "Institutions have record equity and commodity overweights, very low cash levels and the strongest risk appetite since Jan '06". Cash had fallen to 3.5% of assets—a dangerously low level. The report went on to state that, in the past, when cash has fallen that low, a stock market "correction" has usually followed in a matter of weeks. It proved prescient and we suspect that risk appetite level has adjusted rapidly since. With the risks to oil supply coming to the fore, it is possible that we will see a sentiment overshoot in the opposite direction and on this vein we note a comment in the *FT* by Jeremy Legget, a leader of the UK industry taskforce on peak oil & energy security. The civil unrest in the Middle East, he claims "shows the extreme fragility of the global system. People don't realise how close we are to a potential precipice if this unrest reaches critical mass in enough OPEC countries. Governments need to draw up emergency plans and get cracking on proactive measures while we still have time." There are no signs of panicking in the oils market yet (and indeed the Edison Oils team is factoring in a decline in the oil price in H211), but clearly this has added a new risk dimension to global economic recovery paths.

Results season shows a majority of companies exceeding expectations

The last four weeks has seen the bulk of the US and European earnings releases for Q4. Results have been broadly positive: in the US the ratio of companies exceeding sales and EPS forecasts to those missing for Q4 was just under 2:1. Exhibit 2 shows these trends by sectors.

Exhibit 2: UK and US sales and earnings versus consensus

	ASX						S&P					
	Sales			EPS			Sales			EPS		
Sector	'Beat'	'Miss'	Ratio	'Beat'	'Miss'	Ratio	'Beat'	'Miss'	Ratio	'Beat'	'Miss'	Ratio
All Securities	54	35	2:1	76	17	4:1	246	132	2:1	265	117	2:1
> Oil & Gas	3	2	2:1	3	2	2:1	24	11	2:1	24	12	2:1
> Basic materials	4	5	1:1	6	3	2:1	14	9	2:1	16	7	2:1
> Industrials	15	9	2:1	20	4	5:1	35	22	2:1	39	18	2:1
> Consumer goods	1	4	0:1	4	1	4:1	22	10	2:1	20	12	2:1
> Healthcare	3	1	3:1	3	1	3:1	29	10	3:1	31	8	4:1
> Consumer services	7	8	1:1	13	2	7:1	29	14	2:1	38	5	8:1
> Telecommunications	0	1		0	1	0:1	4	5	1:1	4	5	1:1
> Utilities	2	0		2	0		11	20	1:1	17	14	1:1
> Financials	14	3	5:1	18	3	6:1	54	22	2:1	52	27	2:1
> Technology	5	2	3:1	7	0		24	9	3:1	24	9	3:1

Source: Bloomberg

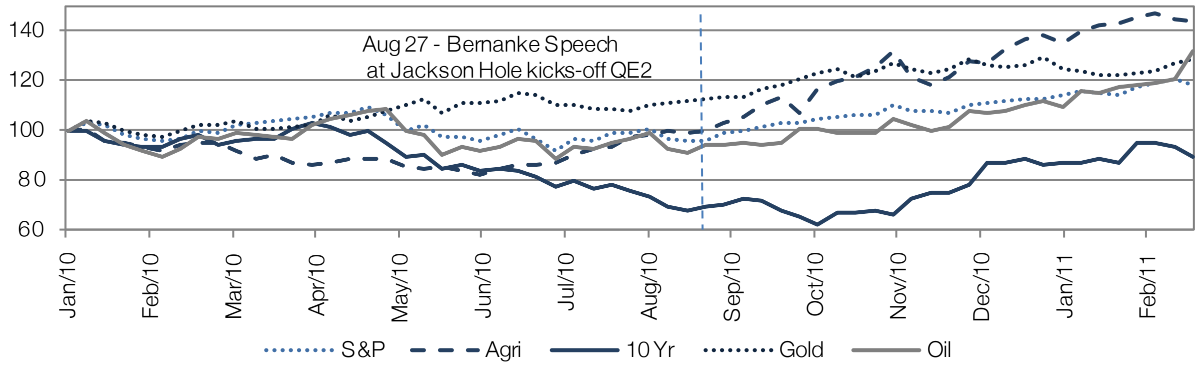
In the UK, with fiscal years skewed and the number of companies reporting figures much smaller at this stage of the year, the ratio of sales 'beats' is similar, while earnings 'beats' have been considerably higher. The proportion of sales 'negative surprises' is higher than earnings misses presumably due to companies' ability to adjust costs in reaction to a sales miss. While the UK sample size is small and therefore the usual caveat applies, financials, consumer services and industrials stand-out as three sectors which had a high proportion of earnings 'beats' in the UK. In the US, consumer services (especially retail and media) stands out as having the highest proportion of earnings 'beats'. All in all, these results should be broadly supportive to markets.

To fight or not to fight (the Fed)

Research has shown that in recent years there has been an 85% correlation between the S&P500 and the Fed's balance sheet growth. We are not necessarily suggesting that this is rational or that investors should base their asset allocation solely on the Federal Reserve's monetary policy. What we are saying is that, like it or not, quantitative easing is highly likely to continue for the foreseeable future and that this will be supportive of equity valuations as liquidity floods the equity markets. It could be argued that the QE rising tide lifts a lot of unseaworthy vessels and indeed 2010 saw quite an indiscriminate rally across most sectors. That may not continue – the key margin of safety for investors in our view will be to seek out quality business with strong franchises and crucially pricing power. Any further market correction which indiscriminately de-rates high quality asset valuations would be an opportune time to increase exposure.

There is a danger of course that if everyone becomes pragmatic (in not 'fighting the Fed'), the market is setting itself up for a major setback if there is any sign that the US Fed will not continue its quantitative easing programme when QE2 expires. Decision time for the Fed is mid 2011 and it is possible that the market will begin to fret about this in Q2. However, comments by the Kansas City Fed President Thomas Hoenig that another round of bond buying "may get discussed" if the numbers look "disappointing" indicates that the Fed is well aware of this.

Exhibit 3: Cause and effect



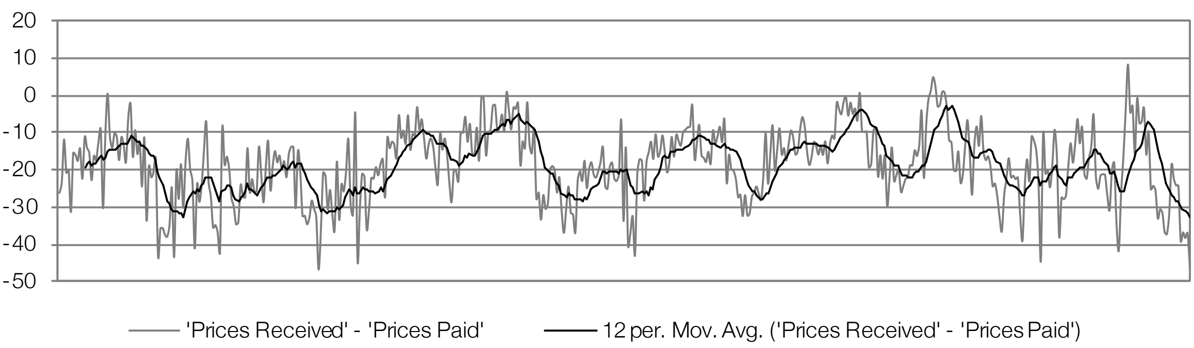
Source: Bloomberg

This might seem to be a very US-centric view of the world, but the same principals apply for UK monetary policy and indeed the UK indices are now heavily skewed to global commodity businesses, of which global interest rates are a key driver.

Evidence of pending margin squeeze mounts

Last month, we raised the spectre of input cost inflation impacting company margins on the back of the January Philly Fed 'Prices Paid' increase. The February update shows a continuation of this trend and a chart of the survey's 'Prices Received' minus 'Prices Paid' (ie a proxy for margins) shows that – all else being equal – company profits are under the severest pressure in decades. There are now early signs that rising commodity prices have indeed begun to erode profits with a litany of companies across the globe experiencing margin pressure. What has been particularly surprising to us is the extent to which the market seems to have been caught off-guard by this (as evidenced by the share price reactions upon disclosure). A raft of companies across diverse sectors has experienced this. Electrolux the white goods manufacturer saw its shares fall 11% after warning on rising raw-materials (especially resins and base metals) costs. The company also faced the double whammy of pricing pressures. Volex (an electrical connectors manufacturer) also saw margin contraction due to unprecedented cost pressures. Charter International (the engineering business) also saw margin pressure.

Exhibit 4: US prices received – prices paid 1970-2011



Source: Philadelphia Federal Reserve

Is China a risk to global growth?

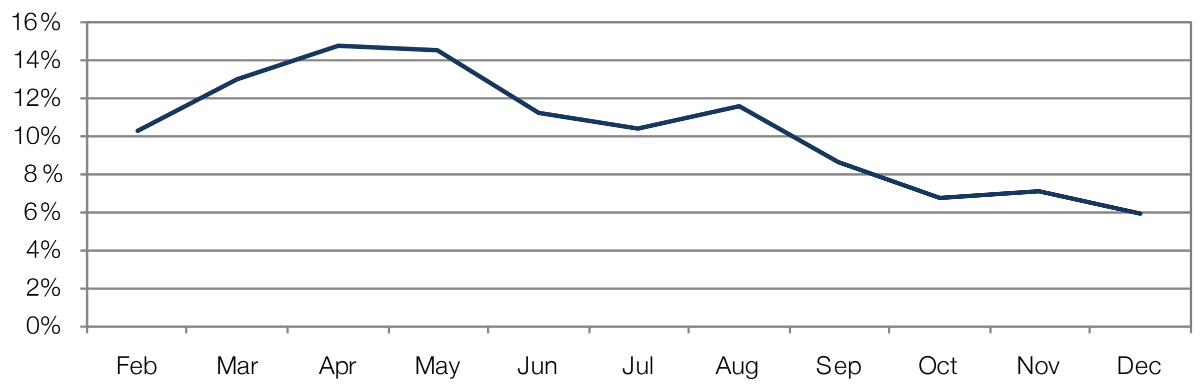
Each month we try to pick a topic that is not making the headlines but nevertheless may become an important issue for investors. Last month we looked at the 'Plutonomy' – an economy that is heavily influenced by the wealthy – as a driver of current consumer demand. This month we take a cursory look at China, a key driver of global growth.

Much has been written about the US trade deficit with China, China's investment boom, its supposedly under-valued currency and the country's increasing weight in world affairs. We do not proclaim to be experts in any of these areas except to know that China is absolutely crucial to future global growth. However, we do highlight two issues that are very interesting, are not widely discussed, but could have a huge bearing on global equity markets in the coming quarters, namely that China's growth might be slowing faster than is realised. We are well aware that many have tried unsuccessfully to call an end to China's growth phase. The major counterbalance has been government stimulus (the Chinese 'put'?) and its just-announced revised five-year growth targets (of 7%, down slightly from the previous target of 7.5%) suggests that this will continue. Nevertheless, we present some evidence of the risks and challenges facing the Chinese government.

1) **Is growth slowing in China?** It is not controversial to say there is a possibility that China's GDP figures are massaged to smooth GDP growth trends. An interesting sense-check into China's actual economic growth might be gained by using electricity production as a proxy for growth. As shown in Exhibit 5, China's electricity production slowed considerably in the latter half of 2010 which may have been an indication of slowing economic activity.

2) **'Near-shoring' is gaining traction.** It is nothing new to highlight the rising wage inflation in China or how food prices are impacting China's populace severely. Our sense is that with rising wage inflation and falling capacity utilisation and crucially – with the first phase of mass urbanisation now behind it, the days of 'easy-growth' may be over for China. We have anecdotal evidence that would support this assertion. Our discussions with some European companies (including private SMEs) indicate a slow but definite shift away from outsourcing to China. In many cases, production is being shifted back to (often Eastern) Europe where costs are becoming comparable to China and crucially where companies can often make significant cashflow savings due to shorter lead times. This has been termed 'near-shoring'. We have heard directly from two disparate companies that are shifting production from China back to Eastern Europe which has led to a positive cashflow impact to their businesses.

Exhibit 5: China growth stagnating? 2010 Supply of electrical power in China, y-o-y

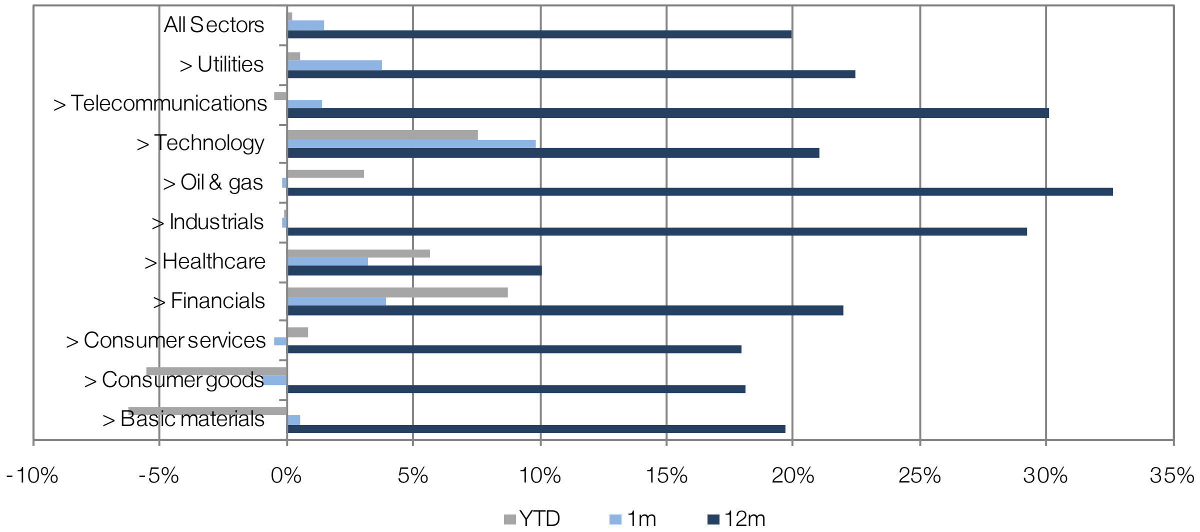


Source: National Bureau of Statistics of China

Valuation update

Based on the Q4 results update, earnings in aggregate have trended up slightly: earnings expectations for the All-Share index (ASX) currently rest at £294 for FY12 (a P/E of 10.6x) while for the AIM market earnings for the same period are expected to reach £42 or a 22x P/E multiple. Exhibit 6 below shows the 12 month, one month and year-to-date median performances of the major sectors in the FTSE 100. With the exception of the technology sector (mainly tech hardware +29% YTD) and perhaps financials, we can see clear evidence of sector rotation out of Consumer Goods & Services and Basic Materials into Healthcare.

Exhibit 6: UKX sector performance – median returns



Source: Bloomberg

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