

Illumination: Equity strategy and market outlook

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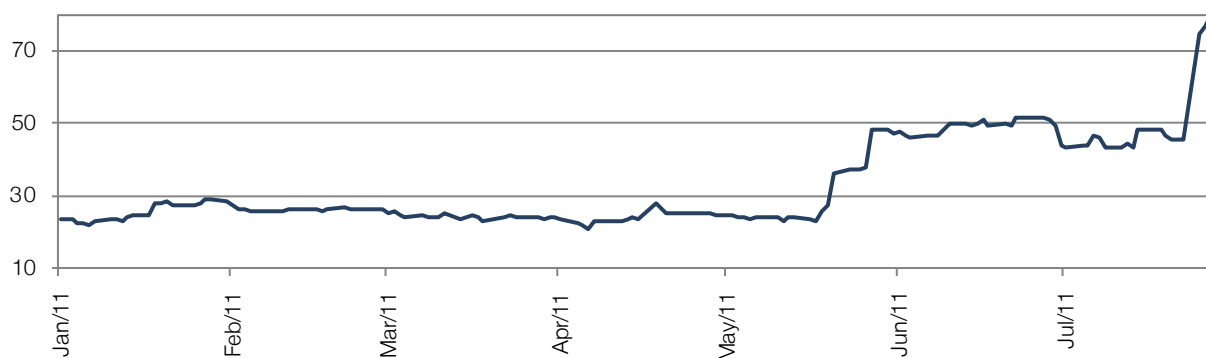
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Equity market overview and strategy

- Sovereign debt remains centre-stage. The reluctance of policymakers to accept the scale and nature of the problem and consider correspondingly radical but optimal policy choices only increases the uncertainty and ultimate cost to growth.
- A disorderly collapse of the peripheral eurozone debt markets has been averted for now by a sensible agreement between eurozone nations. Bond yields for Spain and Italy initially declined significantly following the announcement of the plan but have since returned to elevated levels due to doubts over implementation.
- Within 24 hours of the positive European announcement US politicians failed to agree on measures to address the US budget deficit. Although bipartisan support has now been secured for a compromise deficit-cutting plan, it is clear political divisions in the US have been wholly underestimated by market participants.
- Though a formal default was always unlikely the US sovereign credit rating remains at risk. The bipartisan plan is much less ambitious in terms of deficit cuts than the failed Boehner/Obama negotiations.
- With the notable exception of Japan, inflationary episodes are often part of a sovereign debt work-out. It is therefore no surprise that gold is trading at all-time highs in US dollars. Developed market bond and cash yields are low in historical terms and appear to offer little or no premium for the risks of inflation, devaluation or default.
- UK and European equities are not expensive with current multiples of price/book at or significantly below 20-year averages. From current price levels equities should offer real returns in line with long-term averages. As investors face significant price level uncertainty, fairly valued equities can provide a useful (though not perfect) hedge against inflation.
- The clearest fundamental risk to equities lies in the very high level of profit margins being reported in the US and Europe. Corporate profits have been supported by government budget deficits and margins are at cyclical highs.
- Rising input costs and weak European demand has led to an increase in the frequency of profit warnings. To mitigate this risk investors should focus on shares with a compelling value case centred on asset value and business franchise arguments rather than earnings multiples.
- Volatility is likely to remain elevated and portfolios should be positioned to take advantage of risk on/risk off swings in sentiment. This means running with relatively high cash levels to facilitate an opportunity-driven approach to investment and staying disciplined on entry and exit points.

Exhibit 1: US 1 year credit default swap level (basis points)



Source: Bloomberg

Sovereign debt centre-stage

US debt compromise reached

While markets have been preoccupied with the peripheral eurozone debt crisis for over a year, only in the last few weeks has attention turned to the world's reference risk-free asset – the US Treasury bond. Since the failure of the Boehner/Obama negotiations credit insurance premiums on short-dated US debt have risen by nearly 50% to record highs, Exhibit 1.

Ultimately it was always highly probable that an agreement on the debt ceiling would be found and an imminent default avoided. The bipartisan agreement was therefore delivered as expected. However, the strength of the political divisions has cast serious doubt on the risk-free nature of US government debt. It is not at all clear why a triple-A credit rating (with its implication of a negligible risk of default) is appropriate at this juncture.

The compromise agreement approved by the US Congress calls for headline deficit reductions of US\$2.5trn over 10 years, of which US\$1.5trn is subject to a bipartisan congressional committee recommendation due in November 2011. This is substantially less ambitious than the US\$3.7trn of savings that, according to media reports, were under discussion in the Obama/Boehner negotiations. Despite this bipartisan agreement the implied level of ongoing political uncertainty makes a US sovereign downgrade likely. It is no surprise that gold is making new highs in the circumstances.

Steps in the right direction

Events in the US have diverted market attention from a significant step in the right direction in Europe. On 21 July eurozone leaders formally recognised the Greek problem was one of solvency rather than liquidity. Agreement on this basic point has facilitated a much better policy response.

Included in the announced package of measures was a substantial reduction in the net present value of Greek public debt via subsidised interest rates and write-downs on face value. Though the stated write-downs are almost certainly insufficient and are likely to rise over time, the principle has been established.

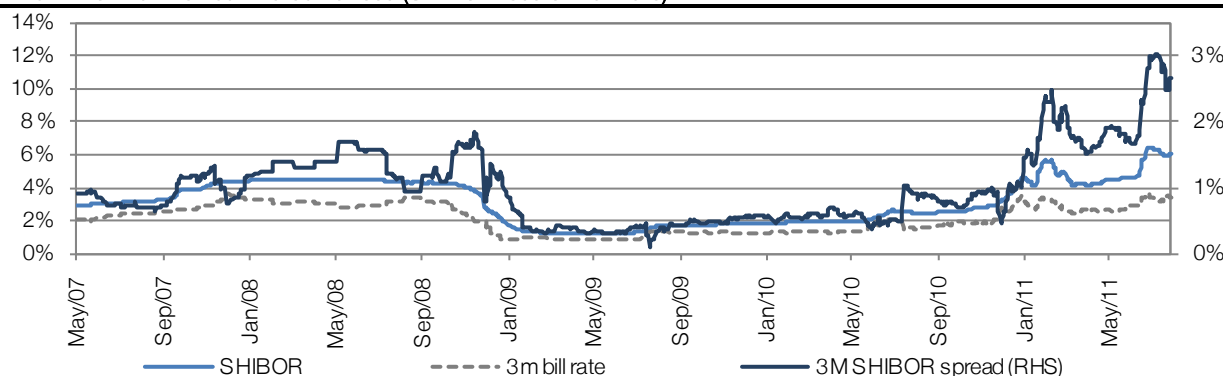
Furthermore, by providing heavily subsidised bail-out funding for Portugal and Ireland, eurozone leaders have also moved one step closer towards the optimal strategy of deploying the debt capacity of the entire eurozone to fix the debt problems of the periphery. With the core nations standing behind the periphery, the probability of a collapse of the eurozone has been reduced.

However, the precedent for Greece will give little comfort to other GIIPS bondholders. The private bond market has no incentive to hold bonds that have no security against being written down if bail-out funding is sought at a later date. The relaxation of the terms of bail-out loans makes further bail-outs a more attractive option for

distressed nations and therefore more likely. While the eurozone looks more secure investors may continue to move away from what could become legacy funding instruments – ie bonds issued by individual eurozone member states. Banks with large holdings of these bonds will clearly be at risk.

The phrase that was omitted from the communiqué of 21 July was “fiscal transfer”. Financial subsidies for bailed-out nations are a cost to the core. The political ramifications are clear – to survive the eurozone has to keep moving towards financial and fiscal integration.

Exhibit 2: China inter-bank credit stress (SHIBOR less 3m bill rate)



Source: PBOC, Bloomberg

China inter-bank funding stress

While there is no sovereign debt problem at present in China the consensus growth story is being undermined by evidence of credit stress. Inter-bank funding costs have risen substantially since the start of the year as the PBOC has tightened reserve requirements and raised interest rates. Though monetary policy works with a lag, stress in the inter-bank market can create an immediate negative shock. Investors should remain attentive.

Asset allocation in an uncertain world

Beware the risk-free asset

History has shown that sovereign indebtedness creates significant uncertainty in the outlook for inflation and exchange rates. The last resort to a debt problem is to print money to finance spending, which will tend to inflate away the problem (at the cost of leaving those on fixed incomes substantially worse off).

At present, ultra-low yields on developed market bonds and cash appear to offer little protection against inflation, devaluation or default. If there was any doubt about this, the recent comment from a senior insurance executive quoted in the FT (24 July) is illuminating – “We don’t want to buy bonds, we want to buy equities. But we can’t.”

Exhibit 3: European non-financials – price/book



Source: Edison Investment Research estimates

Exhibit 4: UK non-financials – price/book



Source: Edison Investment Research estimates

Equities are not expensive

In comparison to the unattractive outlook for fixed income, UK and European equities are not expensive in a historical context. Price/book multiples for European non-financials are near the low end of the range of the last 20 years, Exhibit 3.

Income-based multiples are very low (especially on a forward-looking basis) but this is because of very high corporate profit margins, which are cyclical and therefore should not be the basis of an investment case.

Stating that equities are “not expensive” does not mean we expect out-size returns. Developed nation GDP growth is likely to be lower than the recent past due to the related issues of ageing populations and excess sovereign debt. Therefore despite relatively modest market valuations we expect equities to generate returns only in-line with historical averages (c. 7% pa total return in nominal terms).

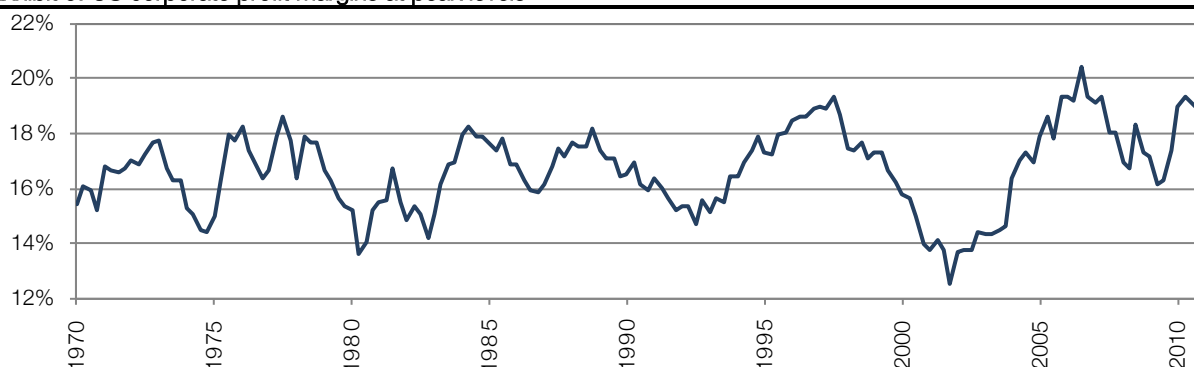
In addition to the market return, the skilful portfolio manager should be able to capture some alpha through stock selection. A well-managed equity portfolio could therefore reasonably have expectations of achieving a 10% return pa. This level of return compares very favourably to low fixed-income yields.

In terms of sectors, we should point out that the inherent uncertainty in the value of fixed-income securities and loan portfolios implies a cautious stance towards financials remains appropriate, except in niche areas or where valuations reflect the dynamics of a special situation.

Profit margins at cyclical highs – the key portfolio risk

Corporate profit margins are at record highs across the developed world. In the US, corporate output has returned to the pre-financial crisis peak, yet unemployment remains at over 9%. Cash from government stimulus packages has been captured by the corporate sector rather than re-invested into new jobs.

Exhibit 5: US corporate profit margins at peak levels



Source: US Commerce Department

The US Commerce Department data has a long history and is illustrative of other markets, Exhibit 5. If governments start to take austerity seriously, budget deficits will be squeezed and the margin expansion will reverse.

The growth of emerging economies and structural natural resource depletion has led to strong input cost inflation over the last 12 months. Companies that have communicated cyclically high margin expectations but sell predominantly into developed markets are most at risk of disappointing investors, in our view.

Conclusion

In times of uncertainty, risk premiums should be elevated and this is why UK and European equity markets have struggled to rise in spite of the above-average profitability of the non-financial sector. At present UK and European equities are priced at relatively attractive levels compared to their 20-year history and there is no reason to think they should not deliver returns at least in line with historical averages while offering at least some protection against loss of purchasing power. In short, much of the bad news is in the price.

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