Illumination: Equity strategy and market outlook

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Strategic perspective

- With the threat of a major recession now clearly on the agenda, European policymakers are moving towards actions that should address the eurozone bank funding crisis, albeit painfully slowly. While the recent German vote on the EFSF has helped to stabilise the eurozone banking sector for now, many investors will have suffered from substantial declines in commodity-linked sectors in the last week of September.
- We noted last month that the eurozone crisis may have diverted attention from the significant monetary policy tightening in China. A deliberately engineered slowdown – as measured by China PMI, money supply growth or sharp declines in spot steel prices – is underway.
- China's stock market is down over 20% from its year high in local currency. The slowdown will not therefore have come as a surprise to equity investors. However, global commodity investors appear to have only just noticed. Copper prices in September fell by 22%, the second-largest monthly decline for 20 years, which was accompanied by a sharp unwinding of speculative positions. The basic resources sector has also declined sharply but this is a legitimate reflection of heightened economic uncertainty. We are not yet persuaded there is sufficient value on the table to increase weightings given the high level of risk.
- We are also concerned in the medium term about China's investment-led growth model. Nearly 50% of China's 2010 GDP was accounted for by fixed capital formation. With Western nations increasingly focused on sovereign indebtedness and unemployment, China's export sector could be hit harder by an austerity-led slowdown than the developed markets it serves. In general suppliers are leveraged to their customers; investors should think carefully before attempting to avoid a slowdown in the US and Europe by shifting equity allocations to emerging markets.
- Though market action has been painful for those overweight commodities, declining prices will be helpful for consumers. Taking the oil price as one example, econometric models suggest the recent $20 decline should represent a stimulus of approximately +1% for world GDP, if sustained.
- Declining inflation expectations should also give policymakers more room to ease monetary policy. Even with an inflation rate of over 4%, September's minutes from the BOE reveal an active debate in regard to further quantitative easing, if only in response to deteriorating incoming data. Fed Chair Ben Bernanke has been clear that if inflation falls too low the Federal Reserve would have to respond.
- For our investment strategy we see no reason to change our focus on defensive sectors and quality names. We continue to believe European equities price-in relatively severe economic scenarios that, while possible, are not necessarily probable given likely policy responses. Though our sector allocation is certainly a lower-risk choice that would underperform a rapidly rising market, we continue to believe the absolute upside could be substantial given current discounted valuations.

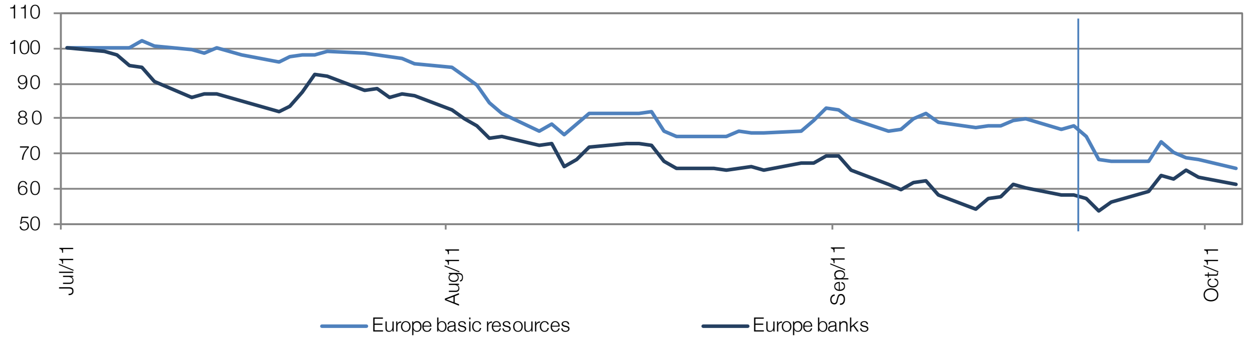
Fears shift from financials to commodities

Though the market has focused on the eurozone credit crisis the final week of September brought a dramatic shift in relative sector performance, Exhibit 1. Bank shares stabilised while commodity-linked sectors plunged. This will have been a shock to the consensus perception that commodities were a one-way bet, rising in the event of strong growth or alternatively rising in response to further quantitative easing.

The logical flaw in that argument is that quantitative easing can only be implemented when there is a clear danger of deflation, a scenario in which rising commodity prices would be incongruous. Now that commodity prices have fallen, the path to additional monetary stimulus is clearer, but so are the signals pointing to a recession or at least a marked global slowdown in 2012.

We believe the correct strategy remains focused on defensive sectors of the market. These sectors are currently trading at significant discounts to long-term multiples. Quality names that have high cashflow and dividend yields are the preferred investments in an environment where government bond yields are 2.5% or lower. Given current market volatility this is clearly a strategy for an investor rather than a trader; we believe it would be unhelpful to pretend to be able to call the short-term direction of the market.

Exhibit 1: European sector performance

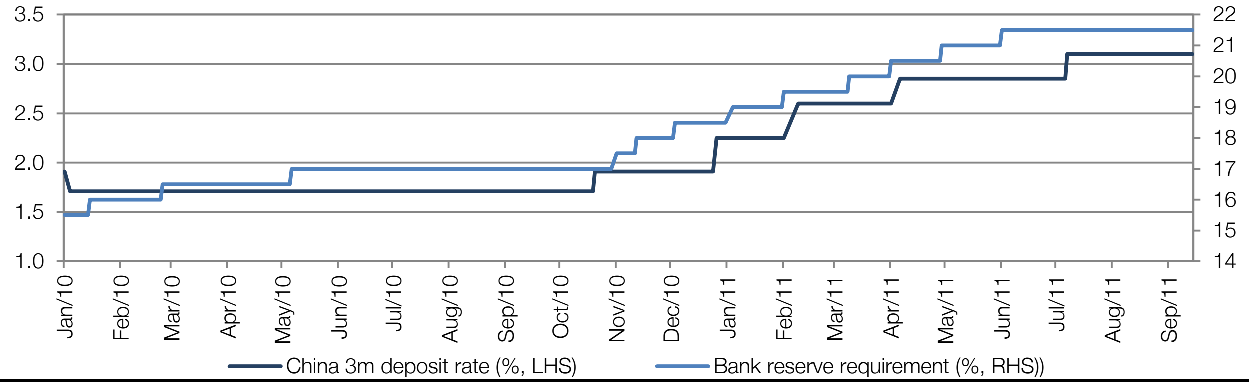


Source: Bloomberg

Tightening policy has slowed Chinese growth; staying neutral on basic resources

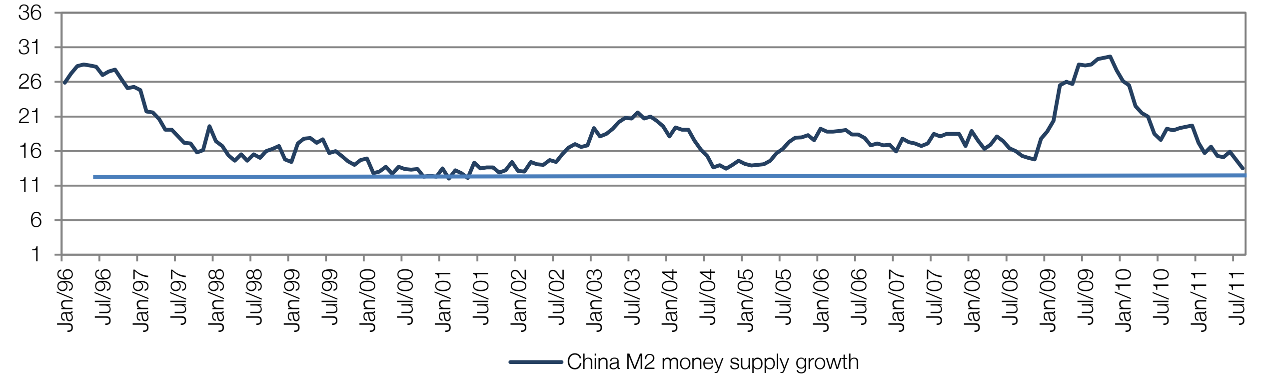
For 18 months up to the end of July of this year China has been attempting to restrain credit and money supply growth in order to moderate inflation in goods and asset prices, Exhibit 2. The Chinese stimulus package of 2008 was largely implemented through lending to state-owned enterprises and was directly responsible for the surge in the money supply and investment spending seen in 2010, shown in Exhibit 3.

Exhibit 2: China tightening monetary policy



Source: Bloomberg

Exhibit 3: China money supply bubble now deflated



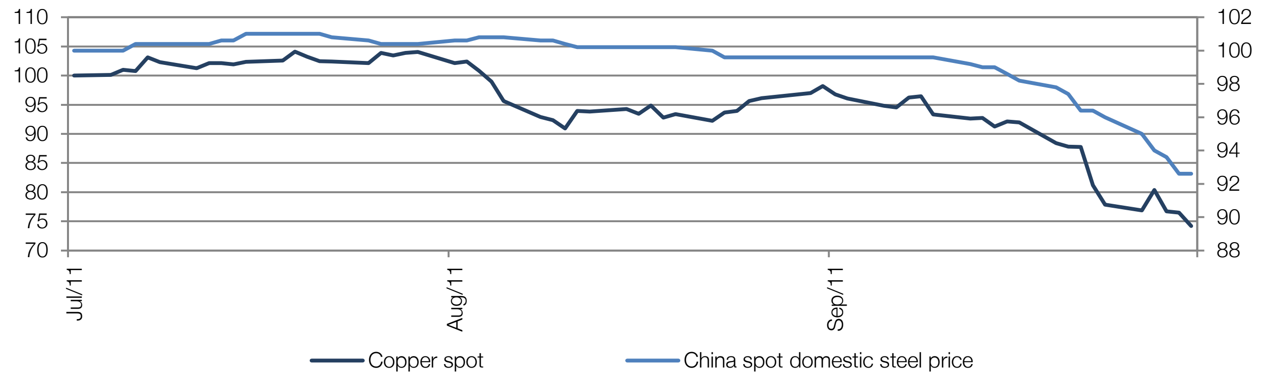
Source: Bloomberg

Asian steel prices have been falling rapidly since the start of September and speculative longs in the copper market have been steadily unwound since July. Market participants finally realised there was no real bid at the higher levels in copper; Exhibit 4 shows the metal suffered its second-worst one-month fall since 1990 in September. Commodity-related equities have followed the commodity markets lower.

Having brought about a significant slowdown in China the PBOC has plenty of scope to reverse course. Interest rates have risen from 2.25% to 3.5% and as importantly the bank reserve ratio has been increased from 15.5% to 21.5% in the last 18 months (it was 7.5% as recently as 2006). Despite the PBOC reiterating that it is still focused on inflation, interest rate expectations have declined by 55bps since the start of September.

From a purely domestic perspective it is difficult to determine whether China will manage to pull off a soft or hard landing. Credit markets point to significant funding difficulties among real estate developers with corporate bonds trading at significant discounts to par. On the other hand the policy flexibility would appear to be available given that inflation may have peaked and commodity prices have recently fallen very sharply.

Exhibit 4: Copper and steel markets



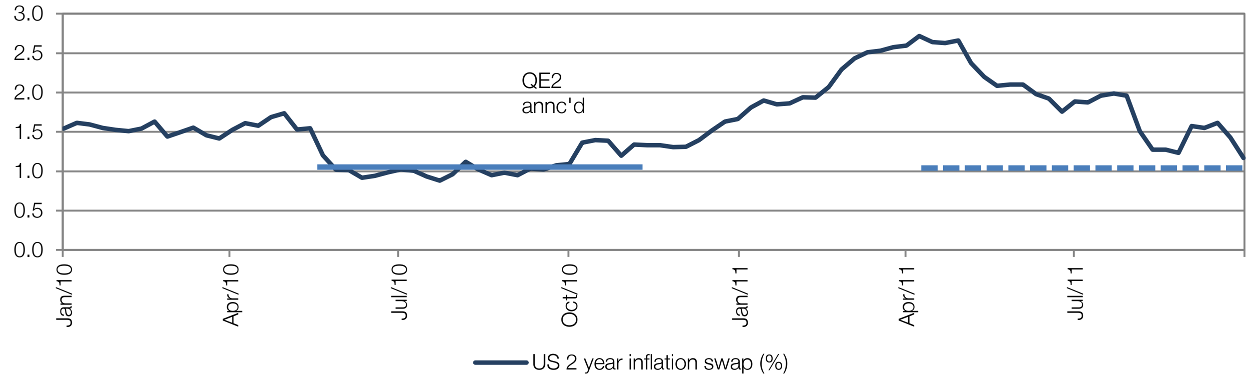
Source: Bloomberg

In our European sector allocation we have been relatively cautious on basic resources to date. This is partly due to our concerns over monetary tightening in China but also due to the relatively unfavourable risk/reward among the large-cap names. Though apparently cheap on forward earnings estimates and cashflows, resource sector estimates can be subject to significant revisions. The relatively high multiples of book value compared to the sector history should not therefore be ignored. The sector also has an exceptionally high beta, which means that returns have to be commensurately higher to justify an overweight position. As of the end of September, despite the sector being down by 19% over the month, on valuation grounds (aside from economic uncertainty) we still think it is too early to become more positive on the sector.

US Inflation expectations: Closer to the trigger point for QE

Avoiding expectations of deflation remains a key objective of the Federal Reserve. While the market response to Operation Twist was unenthusiastic, Bernanke has been clear that if inflation falls the Federal Reserve would “have” to act. In 2010 QE2 was announced when inflation expectations threatened to break through 1%. With the recent sell-off in commodities, US inflation expectations are now again within sight of the 1% level.

Exhibit 5: US inflation expectations close to trigger point



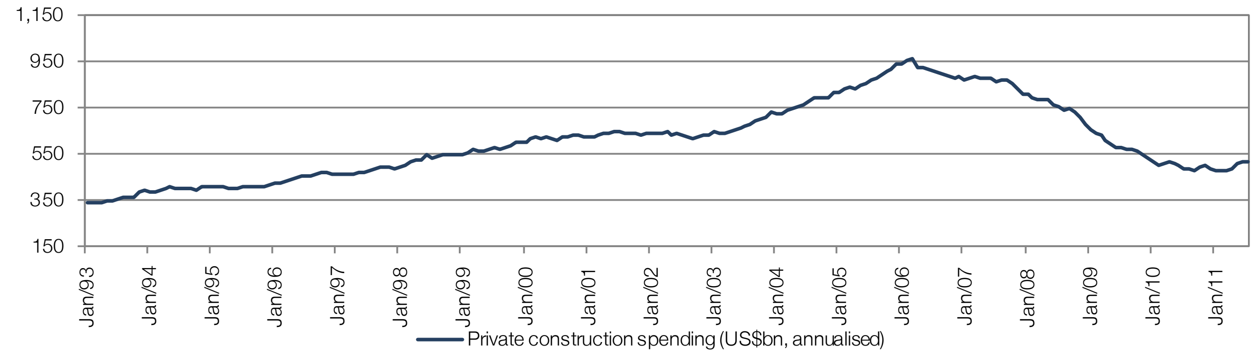
Source: Bloomberg

Looking for a bust? First, find your bubble – or uncomfortable truths for a key European supplier

Though the fear and funding stresses are currently acute in the eurozone, comparisons with the onset of the US financial crisis of 2008 are only partially appropriate. In 2008 the US problems were centred on excessive construction activity and speculation in the housing market, a situation that was mirrored in the financial sector. Fixing the problem required shutting off the excess construction and dealing with the financial fall-out.

In 2011, four years after the peak, US construction is running at an annualised rate of US$550bn, US$400bn lower than the all-time peak of US$950bn recorded in 2006. While the over-investment has been ‘fixed’ the cost appears to have been a further 5m unemployed US residents. (The shortfall in construction activity was coincidentally comparable to the annual impact of the US$800bn stimulus package announced in 2009.)

Exhibit 6: US private construction bubble



Source: Bloomberg

The point here is that while the timing was uncertain a significant ‘correction’ in economic activity was inevitable. The evidence is recorded in the statistics as one of the largest-ever declines in US GDP. In contrast there is absolutely no evidence of private sector over-investment in any sector in developed markets in 2011. Other than a spontaneous decline in consumer expenditure (a much larger proportion of which is likely to be non-discretionary compared to 2008, at least according to comments from the chief executive of WM

Morrison), it is not immediately clear where the decline in economic activity in developed markets will be coming from – except for austerity.

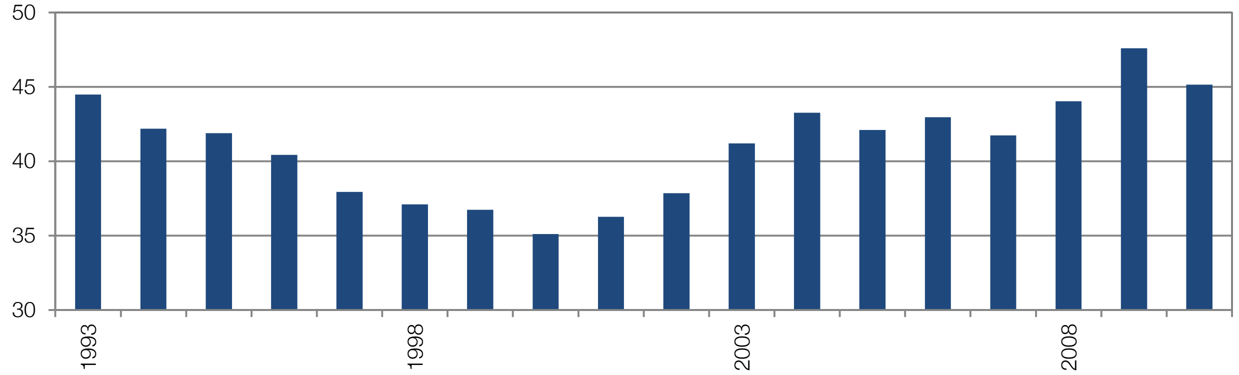
As we have noted in our earlier research, over-zealous government austerity remains the key risk to growth. For this reason it is helpful to see that EU finance ministers will be meeting this week to discuss how a modest degree of fiscal stimulus can be implemented, for those nations able to afford it.

Medium-term risks of an export and investment-led Chinese growth model

In the short term the evidence of a slowdown in the Chinese expansion is clear, but not of itself a reason for a structural concern – fluctuations in economic activity are normal. However, the nature of Chinese growth does have some disturbing medium-term aspects.

Like the bubble in US residential construction the excess has been apparent for some time, but the timing of the ultimate correction may be difficult to determine. For as long as China is prepared to hold ever increasing amounts of developed market debt it will in principle be able to continue growing exports substantially in excess of imports. The ultimate constraints are the level of unemployment tolerable in developed nations and the credit quality of developed market debt.

Exhibit 7: China investment share of GDP (%)



Source: Bloomberg

With both US and European unemployment at undesirably high levels and the trajectories of developed market debt being called into question, the vulnerability of China's export/investment-led model becomes clear. In 2009 a full 47% of China's GDP arose from investment, Exhibit 7. The investment share exceeds by some margin the 32% peak of Japan's investment-led boom of the 1980s.

During the 2009 global recession China unleashed a stimulus package of 7% of GDP via state-directed lending to state-owned enterprises to offset a 30% decline in exports. The extreme growth in credit, combined with recent tightening measures now looks likely to result in significant loan losses according to anecdotal evidence from the Chinese property market. In the event of a downturn, a second stimulus package therefore seems unlikely.

For now, we continue to view China's prospects as a leveraged play on developed markets. By implication increasing equity allocations to China or other export-led emerging markets will not reduce exposure to developed markets, in our view. As most nations run investment shares nearer 20% of GDP, the potential for a meaningful correction in the level of economic activity in China is clear.

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