Illumination: Equity strategy and market outlook

April 2012

© iStockphoto/321photography

Published by Edison Investment Research

Alastair George
+44 (0)20 3077 5700
institutional@edisoninvestmentresearch.co.uk

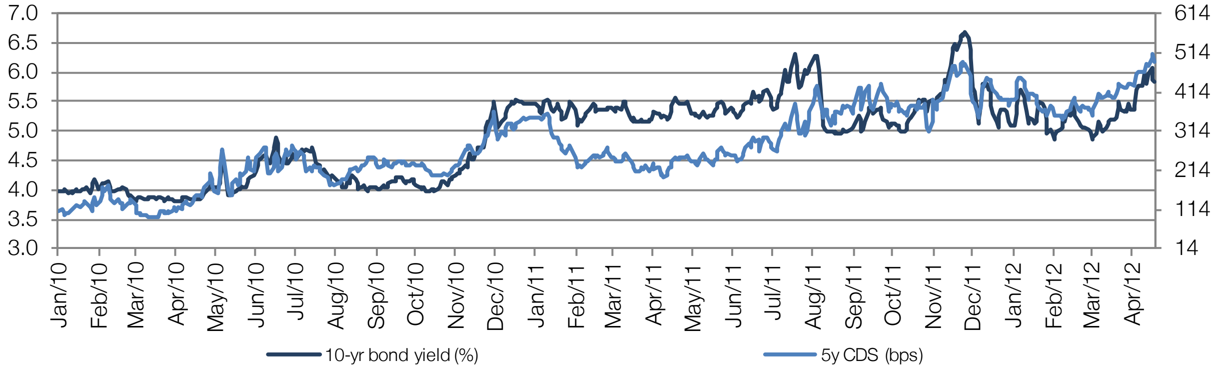
Global perspectives: Know when to fold

- **Spain – too big to ignore.** We recommended buying equities in Q411 and recommended adding beta in early February. Since then growth in Europe has disappointed and capital flight from Spain's banking, sovereign credit and equity markets is now driving European markets. Though the medium-term case for equities over bonds remains strong we suspect a resolution of the Spanish crisis will require another round of protracted political negotiations.
- **Time to cut our add beta call.** The uncertainty over the form and timing of a solution to the Spanish problem leaves us exposed now that market valuations are less extremely discounted. We believe a tactical retreat is pragmatic as better opportunities to invest cannot be ruled out over the next six months.
- **Divergence of Spanish and German equity markets**. In November we highlighted the lack of a valuation differential between the periphery of Europe and the core. Since then the DAX has outperformed the IBEX by 30% – a level of divergence unparalleled since the advent of the euro.
- **Too early to get involved in Spain.** Though tempting to bottom-fish, the level of corporate leverage in Spain remains a concern, as does the domestic share of revenues in the IBEX. Individual opportunities may present themselves, but for now the valuation case is insufficient to justify the risks at the aggregate level.
- **But not a call to abandon the equity market.** UK and core European markets remain inexpensive according to our analysis, while highly rated sovereign bonds remain at record-low real yields and interest rates are minimal. It may not be a novel observation, but coupons and dividends are the largest component of returns over the long term. We remain positive on the long-run prospects for high-quality non-financial equities.

Spain – an uncertainty too big to ignore

Over the past month European economic survey data has disappointed. The manufacturing PMI of 47 has clearly broken the strong uptrend that started in November. To compound the difficulties Spanish political leaders have backed away from previous deficit targets and the Spanish bond market has taken fright, Exhibit 1. With unemployment already at US Great Depression-era levels, the political room for manoeuvre in terms of austerity is limited.

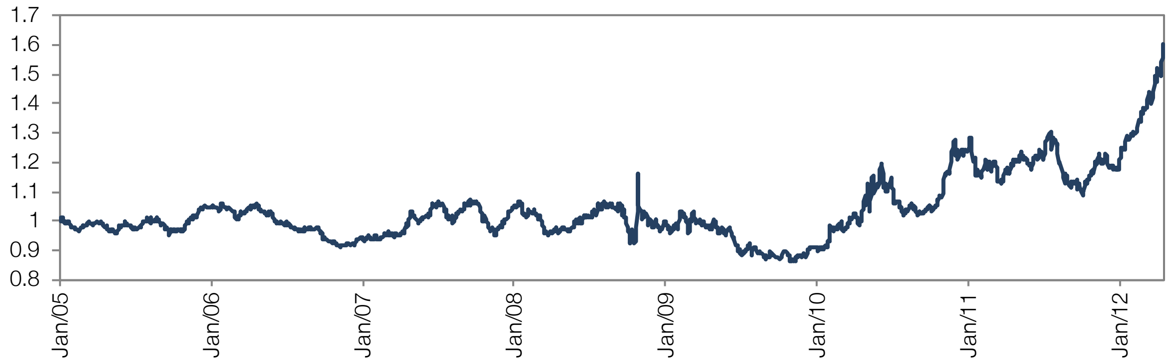
Exhibit 1: Spanish bond yields and CDS prices



Source: Bloomberg

Capital flight is now taking hold in exactly the same manner as observed in Portugal and Greece in the final months of 2011. The Spanish equity market has underperformed the DAX substantially in the first quarter of 2012, Exhibit 2, a risk we had earlier highlighted. A fully deserved sovereign discount has now been priced into the equity market. In the credit markets, Spanish banks have been taking increasing quantities of ECB funding as private credit flows have dried up. Once capital flight has taken hold it can be difficult to find a way back without steadfast external support.

Exhibit 2: Outperformance of DAX (ex-dividend) versus IBEX



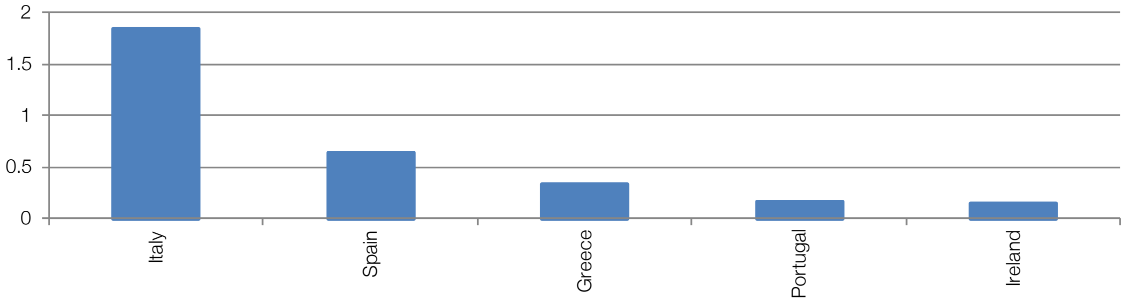
Source: Bloomberg

European policymakers are now dealing with self-inflicted policy failure as well as economic collapse in the periphery. Perhaps if core nations had mustered the political will to resolutely stand behind the periphery at the outset the financial costs would have been significantly reduced. The experience of the Swiss National Bank is instructive; the threat of unlimited intervention can achieve an objective with very limited actual intervention, if any at all.

Spain's sovereign bond market is over €600bn and as large as Greece, Portugal and Ireland combined. Past experience suggests that should a bail-out be required this figure would increase as external auditors examine the financial position, including local governments. Aside from the public debt, Spanish corporate debt is also high and in the household sector the issues over bad real-estate loans are well known.

It is tempting to think that the Spanish funding crisis is one of perceptions, which can be easily reversed, but this does not accord with the experience of the other bailed-out nations. To date, strong external support has always been required to stabilise the situation once private market creditors have withdrawn. We do expect a support package (perhaps framed as a pan-European growth initiative) to be forthcoming, ultimately, as too much political capital has to date been invested in the European project. However, recent experience has also shown the precise form and timing of any resolution will be uncertain and politicians will use market distress as a negotiating tool with impunity.

Exhibit 3: Size of government bond markets

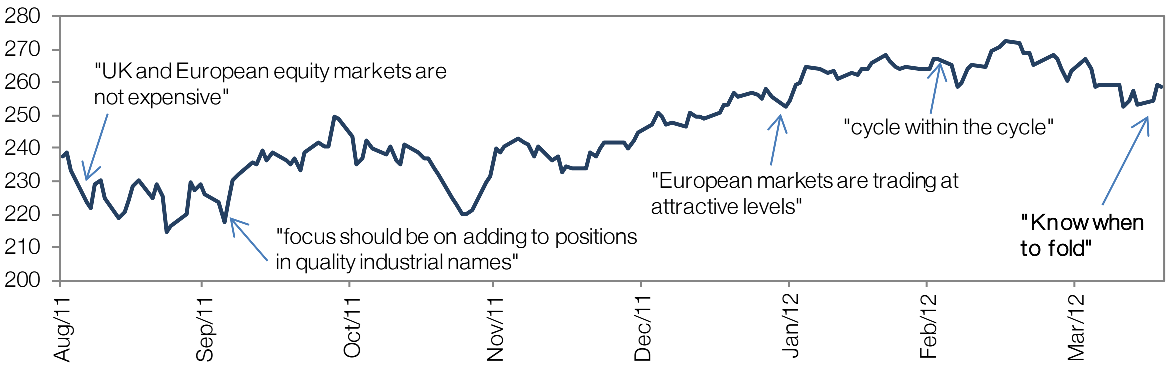


Source: Eurostat

Time to reconsider the 'add beta' call

Over the past six months we have been consistently bullish equities on the premise of valuation, Exhibit 4. There was no difficulty in making this call in Q411 as the valuation case was compelling. In early February, after markets had risen by 20%, the valuation case was supportive but not so compelling on its own. However, in light of Japan's experience, the empirical data indicated that further gains were likely, provided incoming survey data remained supportive.

Exhibit 4: Strategy calls



Source: Edison, Bloomberg

Therefore we suggested letting profits on equities purchased in Q4 run. At the margin we favoured increasing portfolio beta. The premise was that increasing growth expectations, primarily in the US but also in Europe, raised the possibility of a self-reinforcing "cycle within a cycle". Since then, markets are unchanged but the outlook has darkened with disappointing European survey data and the prospect of a summer of negotiations over Spain.

In response, we think it is time to raise cash in preparation to take advantage of opportunities that may be thrown up over coming quarters – and getting out flat on the tactical increase in beta made earlier in the year. While the equity markets are unchanged over the last six weeks, the facts have changed. The funding stress on the Spanish sovereign cannot be ignored any longer.

For now, the notable divergence of Spanish and German equities does not have us changing our preference for core equity markets over the periphery. For as long as funding stress continues, relative valuation is likely to be a poor guide to the path of future equity prices. However, given the sharp move in the relative valuation, our value investor instinct suggests that if visibility on the political process improves then our assessment may change.

NOT a call to abandon the equity market

In terms of the longer-term call, blue-chip non-financials are globally one of the few asset classes that remain at or below historical valuation norms. Therefore in terms of strategic (ie long-term) asset allocation, the valuation case for such equities over bonds remains clear. Those favouring bonds should take note that in the UK and US the prospect of further QE is in our view key to the availability and cost of deficit funding.

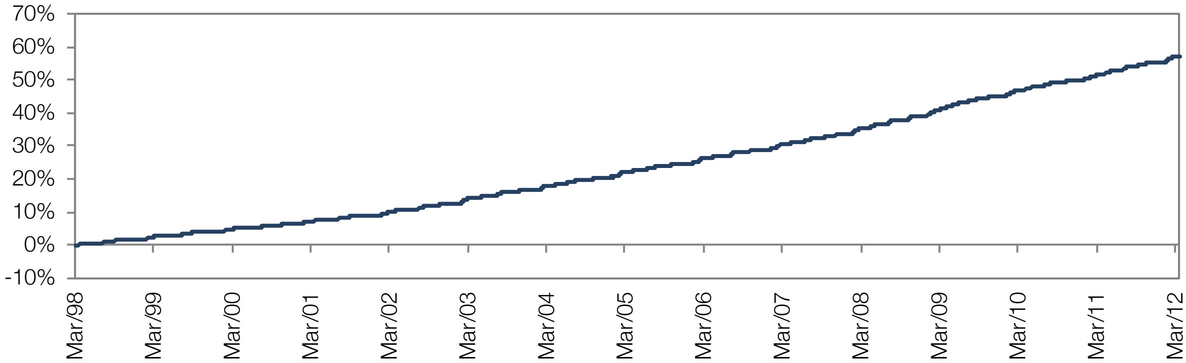
If you believe in QE, then you believe in deficits; if you believe in deficits you believe margins will remain strong. And if you believe margins will remain strong you should prefer equities over bonds at these valuations.

Exhibit 5: European non-financials Price/Book

Source: Edison, Bloomberg

Finally, the role of dividends in investors' returns should not be underestimated. While investors can often remember the level of major market indices these generally exclude the dividend return, with the notable exception of the DAX. Over time the divergence between the total return and the capital gain can be significant. While the FTSE is unchanged since 1998, an index tracking investor would have earned a return of 60% since then (3.4% pa) while the market de-rated from an exceptionally overvalued market to the undervalued levels of today.

Exhibit 6: Outperformance of FTSE total return index vs FTSE



Source: Edison, Bloomberg

Conclusion

Sometimes what we would like to do does not coincide with what we have to do. The leverage in the European financial system has led to a positive feedback loop between growth and asset prices. As European growth has faltered the spectre of capital flight in Spain has been raised. While maintaining a positive view on non-financial equities over the long term, we believe investors should position themselves to take advantage of further dislocations in peripheral Europe over the next six months.

Edison Investment Research

Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
Registered in England, number 4794244. Edison Investment Research is authorised and regulated by the Financial Services Authority.

Edison Investment Research Limited

Lincoln House, 296-302 High Holborn, London, WC1V 7JH
Tel: +44 (0)20 3077 5700 Fax: +44 (0)20 3077 5750

enquiries@edisoninvestmentresearch.co.uk
www.edisoninvestmentresearch.co.uk