

# Illumination: Equity strategy and market outlook

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## Global perspectives: Clarity and opacity

- **Incessant political activity has yielded little in 2012.** Yet another EU summit has passed with the publication of bold statements of intent but little in the way of deliverability. Our strategy of avoiding banks and the periphery of Europe is working and we see no reason to change our position at the present time. The non-deliverability of European policy initiatives is becoming painfully obvious to all.
- **Markets balancing declining economic prospects with potential for US QE3.** The ECB and the Bank of England have eased monetary policy over the last month. We expect the US to do the same over the summer. US new order survey data is declining as sharply as in 2008 and US inflation expectations are back to QE-supportive levels.
- **Investors looking-through declining earnings expectations.** Our top-down earnings forecasts remain much lower than consensus, although still at levels that represent solid profitability from the non-financial sector. We believe earnings declines have been discounted to a large extent and, in the short term, markets are now driven by the views of the US Federal Reserve.
- **In contrast to the clouded short-term outlook, the long-term evidence is clear.** We believe a return to traditional long-term equity investing will become increasingly popular as short-term trends become more random. In a difficult economic environment we believe the share prices of the best-placed companies will outperform weaker competitors. This supports our quality focus and avoidance of banks, basic resources and the European periphery. With real yields turning negative, the tail-end of the AAA-sovereign bond bull market is becoming an irrelevance for long-term investors.

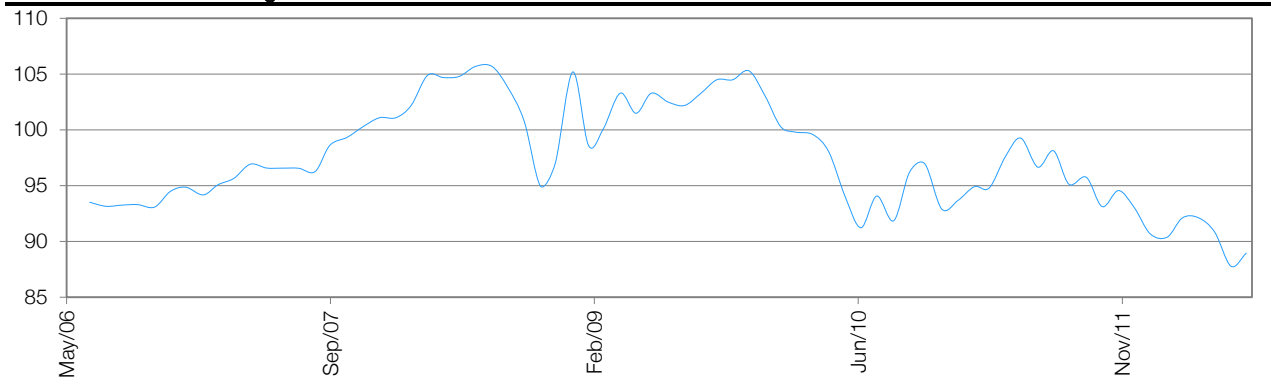
## Incessant political activity has yielded little

Yet another EU summit has passed by with the publication of a bold statement of intent but little in the way of deliverability. The summit statement of 29 June talked encouragingly of direct recapitalisation of Spanish lenders, thus breaking the sovereign-banking system feedback loop. But as soon as political leaders returned home it became obvious this was another statement that would be short on deliverability. Even the European Stability Mechanism has been delayed, courtesy of the German constitutional court that will meet in September to judge the merits of legal challenges to its implementation.

In the meantime, both Italian and Spanish 10-year bond yields have stayed near their highs. These funding costs are clearly unsustainable for any length of time. We see no reason to change our stance on avoiding the periphery – or banks, which would suffer in the case of a disorderly collapse.

However, the failure of politics is pushing market solutions to the foreground. We note the decline – finally – in the value of the euro on a trade-weighted basis. This will be incrementally helpful in terms of profitability (approximately 50% of Stoxx-600 sales are outside the eurozone) and labour competitiveness for the whole of Europe.

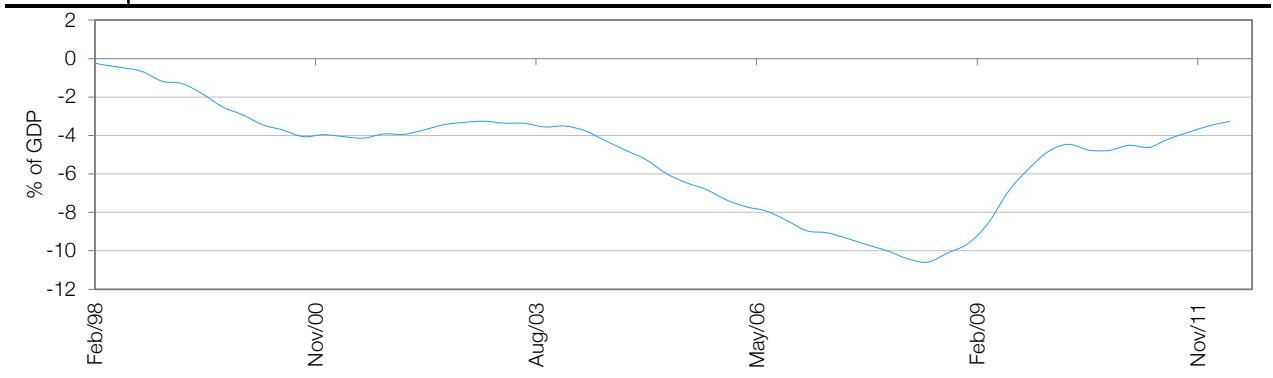
**Exhibit 1: Euro trade-weighted index**



Source: Bank of England

Furthermore, the collapse of the 'wrong kind' of growth (ie real-estate construction) in Spain has dramatically improved the current account balance. From a small surplus in 1998 the current account deficit peaked at over 10% of GDP (EUR12bn per month) in mid-2008 but is now only 3% of GDP. The bleeding on this particular wound has slowed to a trickle.

**Exhibit 2: Spain current account balance**

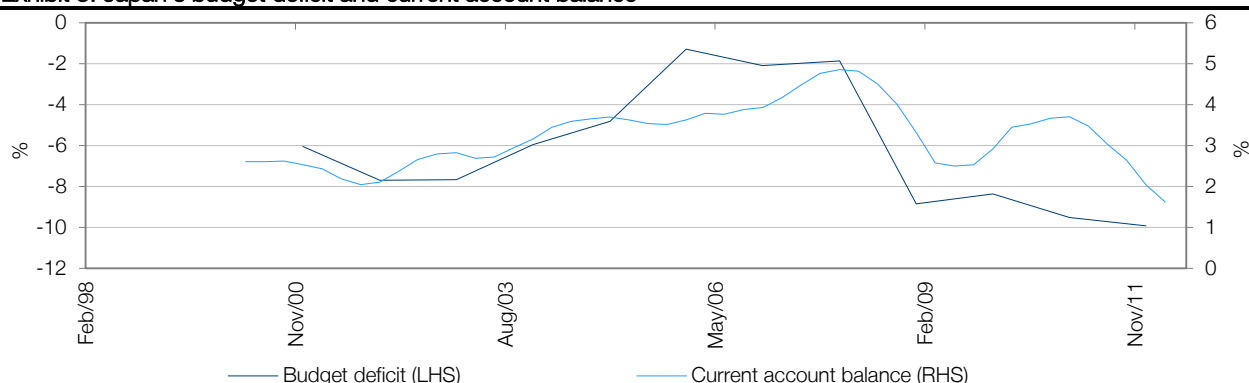


Source: Bloomberg

We cannot help but think that Japan is fortunate not to be geographically proximate to Europe. Japan's government debt load is 208% of GDP and 10-year Japanese government debt yields only 0.75%. A steadily

declining current account balance and sharply expanding budget deficit which is now 10% of GDP, Exhibit 3, make us wonder for how long this situation can be sustained.

**Exhibit 3: Japan's budget deficit and current account balance**

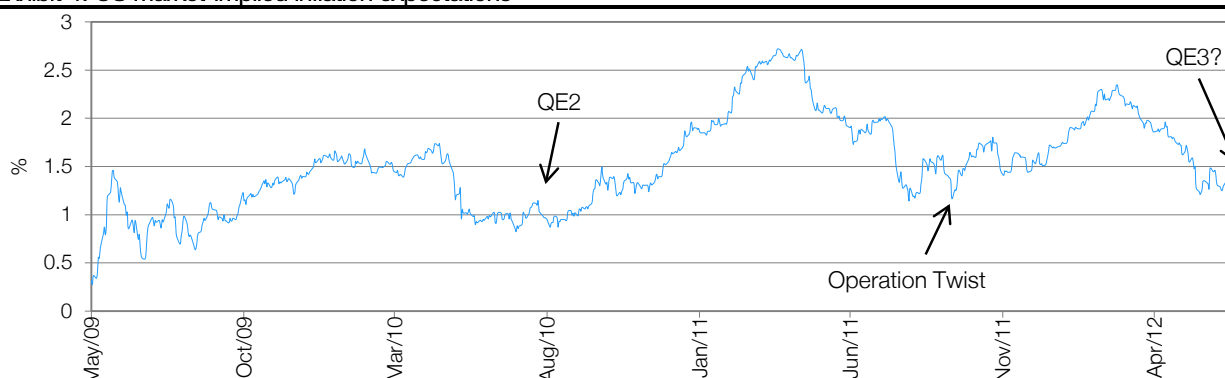


Source: OECD, Bloomberg

### Monetary policy easing coming through as expected – and supporting markets

Sharp declines in survey data and declining earnings expectations would normally be associated with declining equity markets. This time markets have been rising in anticipation of monetary easing. Over the last few weeks the ECB and the Bank of England have eased monetary policy.

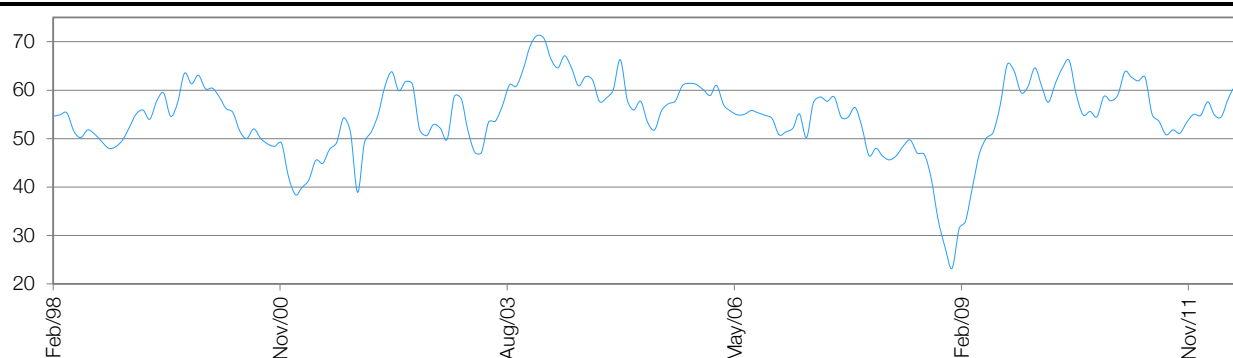
**Exhibit 4: US market-implied inflation expectations**



Source: Bloomberg

We expect the US Federal Reserve to follow suit, possibly as soon as next month. US inflation expectations are falling back to the levels that triggered QE2 in 2010, Exhibit 4. US survey data is declining as sharply as in 2008, as shown by the purchasing managers' new orders index, Exhibit 5. We do not expect QE3 to lead to a significant rally in global equity markets as it has been well anticipated by investors.

**Exhibit 5: US PMI new orders index**



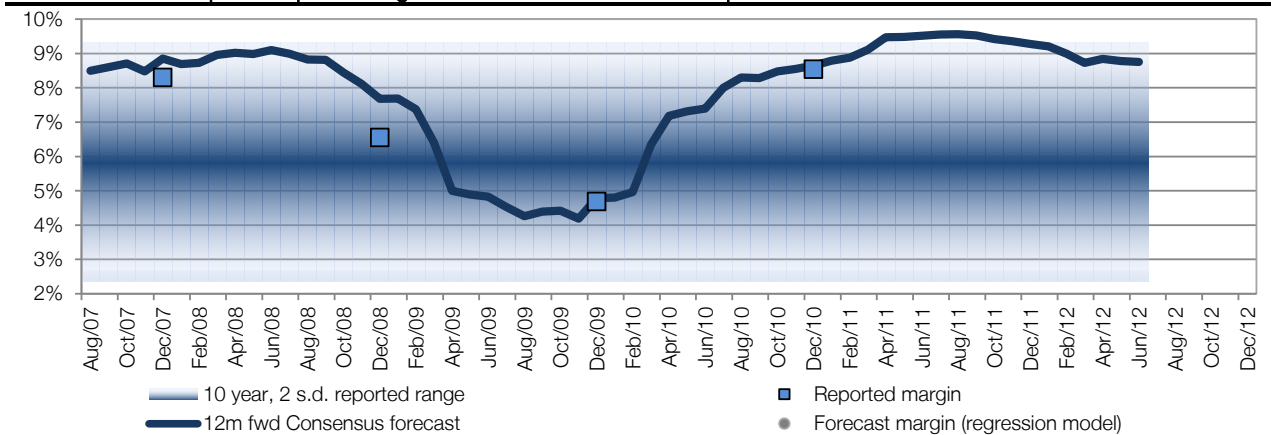
Source: Bloomberg

## Investors looking-through declining earnings expectations

Our top-down model continues to indicate profit margins for European industrials will ultimately prove to be significantly below the current analyst consensus, Exhibit 6. We think this has been largely discounted by the loss of market momentum over Q2; recent downgrades have not been an impediment to the rising market.

At present the economic outlook is still consistent with a robust profits performance from the corporate sector in 2012. The fundamental picture is that demand would have to fall much further to take industrial margins to below mid-cycle levels.

**Exhibit 6: Edison top-down profit margin forecast v consensus – European industrials**



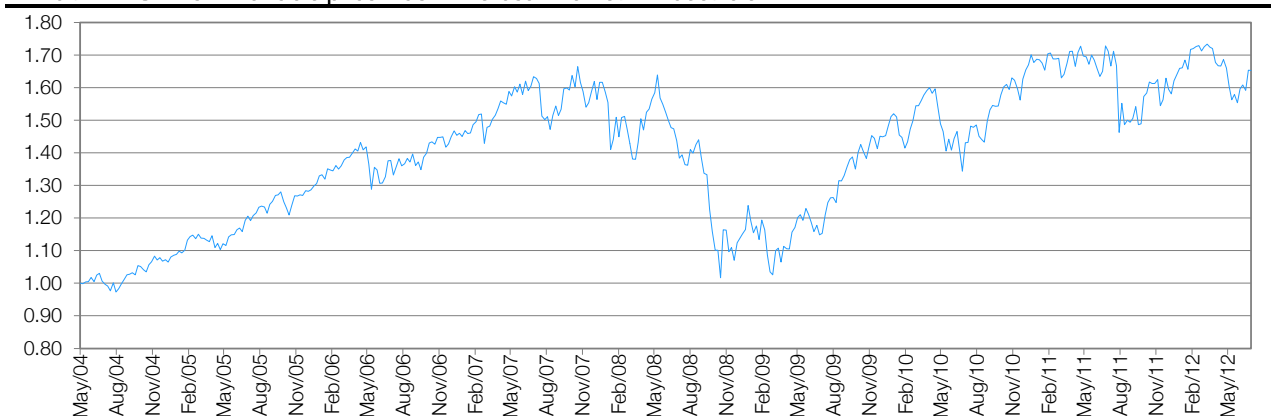
Source: IMF, Bloomberg

## A focus on the long term will pay dividends

We believe in recent months equity markets have efficiently discounted both the prospects of further monetary easing and declining earnings expectations. Sectors that have underperformed have typically done so for a reason – whether it is banks, peripheral European equities or the basic resources sector on concerns of a China slowdown. In our view there are not any compelling short-term opportunities.

Despite the significant short-term ebb and flow, the tide is coming in for investors in dividend-paying quality equities. There is no bear market here – the FTSE non-financials index is close to new highs. The arithmetic is simple – if dividends are at sustainable levels a yield of close to 4%, quality equities are likely to outperform bonds significantly over the long term.

**Exhibit 7: FTSE Non-financials price index – no bear market in industrials**



Source: IMF, Bloomberg

Based on current valuation levels we believe non-financial equities are priced at or above their long-term average rates of return, even we assume economic growth remains weak (dividend yield + growth rate = c. 7%). Clearly this is not exceptional – it is the risk premium over bonds yielding 1.5% which is the outlier.

## Conclusion

The short term is particularly difficult to discern at present as markets have efficiently discounted a revival in growth driven by global monetary policy easing over H212 and we take no position. Over the long term, the rate of return (dividend yield + growth) on Europe's industrial equities points to a historically large risk premium in favour of equities over bonds.

We have a sense that both bulls and bears are likely to be disappointed as events unfold. Bears will be frustrated by policy responses to declining growth while bulls will be stuck with the dividend return and only a grudging re-rating. In uncertain times a policy of sticking with quality equities will continue to pay dividends.

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