



## **Illumination: Equity strategy and market outlook**

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May 2013

## Global perspectives: Beginning of the QEnd?

- **A simple narrative anchors bullish expectations.** Markets seem to be expressing the view that if central banks are printing money and interest rates are low then equities must go up – and for as long as this goes on. Empirical validation of this ‘liquidity’ theory over the last six months may have increased its appeal to those with short-term time horizons.
- **Profits surprise and valuation was an equally valid narrative.** Since the 2008 financial crisis, what surprised many investors was the robustness of corporate profitability in an environment of weak economic activity. Large companies with global franchises and pricing power have been able to maintain margins. Strong profitability combined with an unwinding of overly discounted valuations from 2009/10 has led to the striking outperformance of equities over other asset classes.
- **Reaching a fork in the road.** Slowing earnings momentum, combined with a sharp re-rating of global equities, has created a fork in the road. Bullish proponents of liquidity theories of asset prices are now splitting company with value-based investors. In our view, while we recognise excess liquidity has been shown to drive short-term returns in equity markets, in the long run valuation and the level of sustainable profits is what matters.
- **What are the limits to further monetary stimulus?** With inflation expectations clearly under control at present, we believe the fundamental limits are the development of asset price bubbles, the growth of broad money and the falling levels of official unemployment in the US. On these measures, the beginning of the end of QE is in sight.
- **Time to look for safety in the numbers, not safety in numbers!** We believe that following the herd into the highly visible ebb and flow of central bank activity does not at this stage represent an investment strategy. As the sudden 10% decline in the Nikkei clearly demonstrated only recently, this may be another manifestation of greater fool theory.
- **Sticking with the cautious, diversified strategy.** For the long-only manager, the obvious hole in the portfolio is the ultra-low yield from fixed income. Tempting as it may be to replace coupon income with dividend income by increasing exposure to quality equities, we believe valuations indicate this tactic may be at least partly played out. In our view, the better strategy in the current environment is to forego the modest pick-up in yield from ‘equity-for-debt substitution’ and stick with cash or near-cash until either bond yields rise to match the equity view of world growth, or equities fall to match the view of the bond market.

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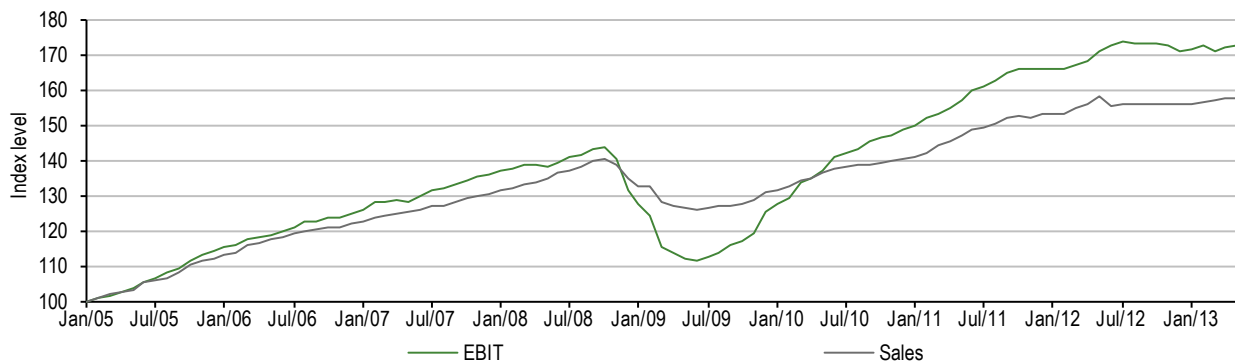
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## Choose your narrative with care

From 2010 through to the end of 2012, there were two entirely reasonable narratives to explain the exceptional performance of equities during a period of very sluggish economic growth. The first revolved around actual loose monetary policy and the expectation of more if the economy weakened further. According to this narrative, both the trajectory and volatility of economic activity would be controlled and therefore with ultra-low rates on low-risk investments equities could only rally.

An equally valid narrative taught that large government deficits would support demand. With restructured operations and non-existent pricing power of the labour force, profit margins would remain high even if economic growth remained sluggish. Combined with low valuations (and perhaps also the sense that excess volatility would be controlled), this gave an alternative bullish case for equities.

**Exhibit 1: 12-month forward US non-financial sales and profits forecasts**

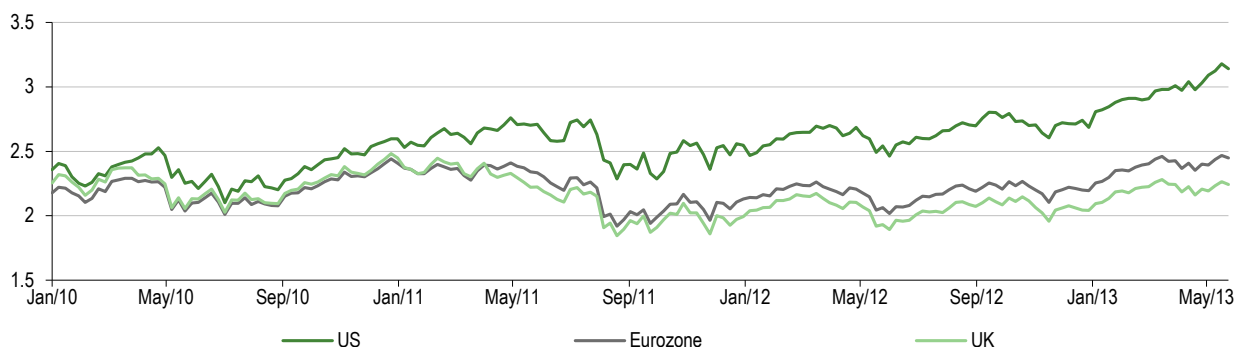


Source: I/B/E/S, Edison Investment Research calculations

Right now, these previously reinforcing narratives diverge. In the US, corporate profits growth has slowed significantly (see Exhibit 1), while the picture is no better in the UK and Europe. Exhibit 1 also shows the stronger growth of EBIT over sales from margin expansion since 2010. US price/book valuations have richened considerably since 2010 and are now as high as any time outside the dotcom bubble.

Although market averages in Europe are less extended, they are close to three-year peaks. In the UK, the median non-financial dividend yield is also close to a 30-year low. The fundamental arguments for an overweight equity position are falling away, leaving central bank policy as the sole driver. It is not at all clear what 'edge' can be achieved by a portfolio manager studying what are probably the most closely scrutinised central bankers in the history of financial markets.

**Exhibit 2: Price/book valuations – US, Europe, UK non-financials**



Source: Thomson Reuters Datastream

## Beginning of the QEnd?

The recent rise in US equity markets has been accompanied by a further significant expansion of the US Federal Reserve's balance sheet (see Exhibit 3). If we believed that quantitative easing could go on into perpetuity, we would clearly be unlikely to be so cautious on risk assets; in reality, QE policy faces limits. Although the fear of an inflation outbreak is the primary constraint (and this remains a tail risk at present), employment and to a lesser extent the potential costs of asset price bubbles also feature in decision making.

**Exhibit 3: S&P500 and size of Federal Reserve balance sheet**

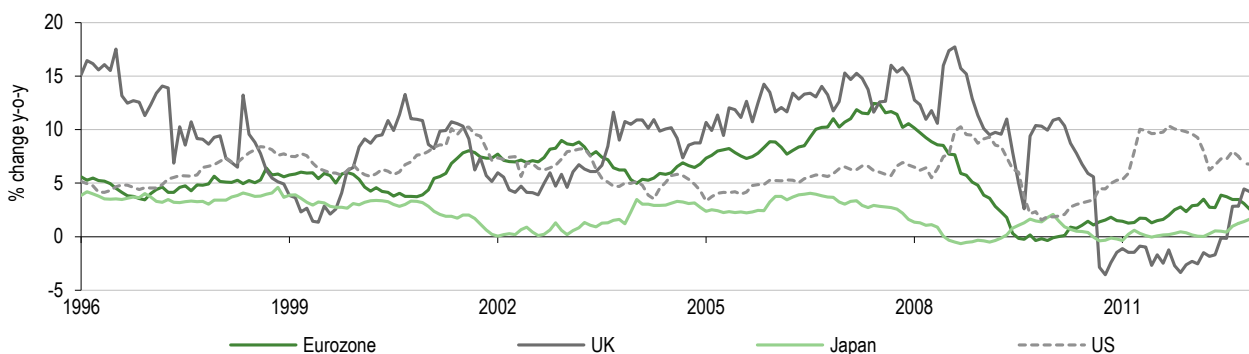


Source: Thomson Reuters Datastream. Note: Forecasts based on the continuation of current QE policy.

Measures of the broad money supply have improved significantly since last year (see Exhibit 4). This is especially notable in the UK, but also in the eurozone, even if the aggregate numbers conceal wide divergences between member states. Increases in broad money supply growth indicate an easing of credit conditions in the economy and reduce the justification for monetary stimulus. Indeed, broad money growth significantly in excess of nominal GDP growth is often a precursor to either asset price or consumer price inflation.

While the data are showing a recovery from the worst declines immediately after the 2008 financial crisis, it would be difficult to argue that money supply growth is excessive; in most regions it is below the long-run average. This does not look like a factor that will feature in monetary debates in the near future.

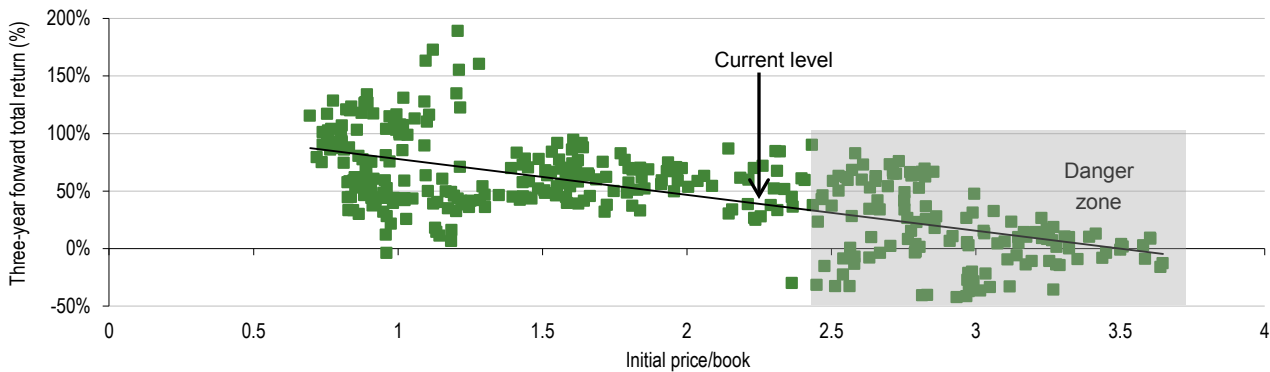
**Exhibit 4: Global broad money supply measures (% change y-o-y)**



Source: OECD, central bank data

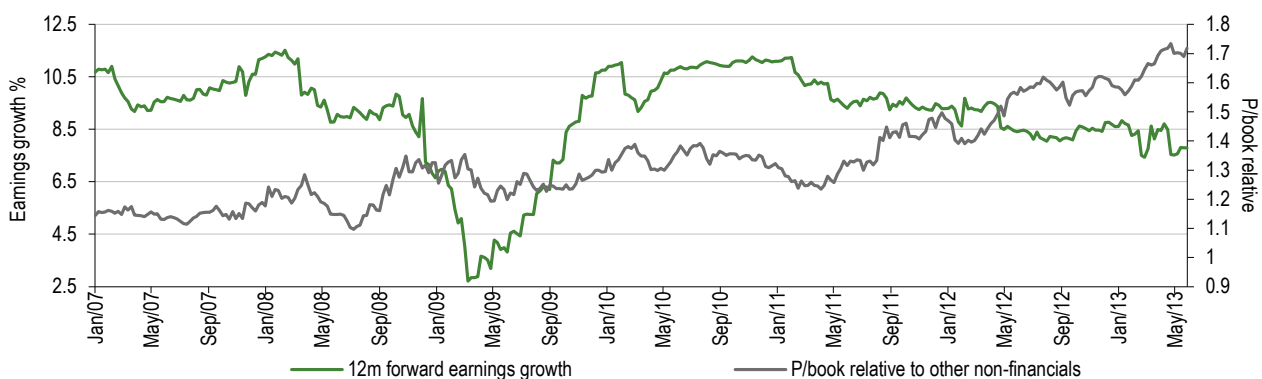
For consumer price inflation, the good news for bulls is that inflation expectations have been falling recently, in line with declining commodity prices. There would again appear to be little constraint on more QE from near-term inflation concerns at the present time.

In terms of asset price bubbles, we have been careful to describe our view on equities as cautious rather than bearish; a simple chart of price/book against the following three-year total return indicates we are not at valuation extremes (see Exhibit 5).

**Exhibit 5: No obvious bubble in UK equities**


Source: Thomson Reuters Datastream, Edison Investment Research calculations

Although we would prefer to see equities at somewhat lower multiples than historical averages to reflect likely slower medium-term growth prospects (and a further 10% rise from here would place UK equities in the danger zone for losses over the medium term), the data do not support talk of an equity bubble. There are also few indications of euphoria in the equity market and it is lower-beta sectors such as consumer staples that have outperformed (see Exhibit 6). One of the classic bubble signs is a sharp rise in trading volumes, something that has been totally absent.

**Exhibit 6: European equities – consumer staples win premium rating**


Source: Thomson Reuters Datastream

The risk of a bubble seems much higher in certain segments of the credit markets. We cannot help but highlight the reduction in yields on US junk bonds to all-time lows of less than 5%. This yield compression has been combined with a surge in the issuance of 'cov-lite' leveraged loans (ie bank loans made to riskier companies without the traditional covenant protection). According to S&P Capital IQ, \$129bn of cov-lite loans have been issued during 2013, an increase of six times compared to the same period last year. There has been a similarly dramatic increase in loans used to pay dividends to private equity owners. In short, investors are currently bidding for reduced quality paper at the lowest yields on record.

High-quality government bonds are still yielding 2% or less and in our view this is a conundrum, relative both to equity market valuations and consensus economic forecasts for 2014 and beyond. Even if relatively weak real growth of 2% returns to developed markets, normalised yields in a 2% inflation world should be closer to 4%.

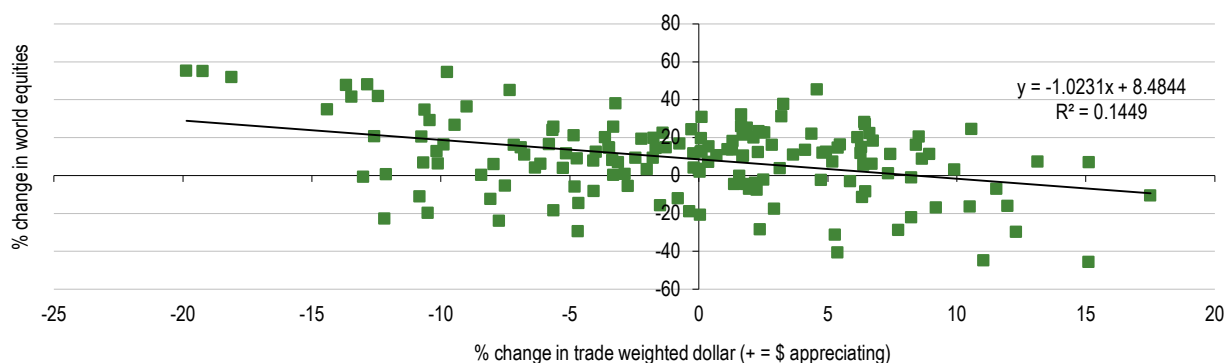
On a 10-year bond, a doubling of the yield would create significant capital losses and volatility (as Japanese banks and insurers have recently found to their cost). It would appear that for a variety of reasons – QE absorbing government bond issuance, bank capital regulatory pressure and the desirability of owning eligible collateral during a crisis – high-quality government bonds are still priced at a meaningful premium to their investment value.

This may not be a bubble; we expect many holders have very modest expectations for the returns on their fixed-income portfolios and know they are paying a 'safe haven' premium. If we see continued repair of the financial system, this 'safe haven' premium is likely to recede and yields move higher.

Therefore, in terms of constraints on QE, we see little evidence of irrational investor behaviour outside perhaps the riskier end of the credit markets. However, the combination of a modest degree of growth in both US broad money and the US economy, plus a narrowing of the spread between the official US unemployment rate of 7.5% and the Fed's target of 6.5%, would seem to put the end of QE on the horizon.

The recent rise in the trade-weighted value of the US dollar, together with a sharp uptick in US Treasury yields and mortgage-backed securities (MBS) indicates currency and bond markets are starting to price in QE exit prospects, even if the equity market appears unconvinced. Although indicative of a strengthening US economy, a strong dollar would not necessarily be good for world equities; the correlation between the trade-weighted value of the dollar and world equities is not perfect, but significant and negative (see Exhibit 7) due to the implicit tightening of world monetary conditions.

**Exhibit 7: One-year change in US\$ and world equities**



Source: Thomson Reuters Datastream, Edison Investment Research calculations

## Sticking with the cautious strategy

We believe that following the herd into the highly visible ebb and flow of central bank activity does not at this stage represent an investment strategy. As the sudden 10% decline in the Nikkei clearly demonstrated recently, this may be another manifestation of greater fool theory. A glance at valuations indicates that 'safe' or 'defensive' sectors are trading at historically extended levels relative to the broader market.

For the long-only manager, the obvious hole in the portfolio is the ultra-low yield from fixed income. Tempting as it may be to replace coupon income with dividend income by increasing exposure to quality equities, we believe valuations indicate this tactic may be at least partly played out. In our view, the better strategy in the current environment is to forego the modest pick-up in yield from 'equity-for-debt substitution' and stick with cash or near-cash until either bond yields rise to match the equity view of world growth, or equities fall to match the view of the bond market.

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