Illumination: Equity strategy and market outlook

August 2019

Published by Edison Investment Research

EDISON

Global perspectives: Focused on the facts

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **Over-optimistic expectations for US Fed easing and renewed trade tensions have rattled markets.** The recent declines in global equities and rise in volatility since the beginning of August have highlighted yet again the headwinds of the US/China trade standoff, slowing global economic momentum and Brexit dynamics.
- **The moves in bond markets over the same period have arguably been more significant**. Reflecting fears that US Fed monetary policy is still lagging economic events, the US two-year/10-year yield curve slope is once again close to zero, indicating bond investors sense a recession coming.
- **Familiarity with the risks could breed contempt, for the unwary.** A challenge for investors is that none of the risks are 'new'. Yet the absence of novelty does not make a risk less dangerous. The US/China trade conflict continues to escalate while in the UK, Brexit will come to a head in only a few weeks.
- **When is it time to buy the UK?** In our view, the challenge is how to be able to take advantage of elevated day-to-day volatility in both UK equities and sterling in coming weeks and avoid being held hostage by events. With both sterling and UK equity market valuations now appearing inexpensive, at least on a relative basis, it is too late to be looking for opportunities to exit or short UK equities, in our view.
- **Tension is building between value and momentum factors but we stick with our cautious outlook for now.** Outside the US, equity valuations are slowly improving as many markets have delivered sub-par returns over the past five years even as corporate profitability has been strong. While possibly of interest to the long-term value investor, we remain cautious for the short term as incoming economic data remain weak and profits forecasts for 2019 are still under pressure.

Staying focused on the facts

Familiarity with the risks could breed contempt, for the unwary

The recent modest relapse and rise in volatility in global equity markets since the beginning of August has highlighted yet again the headwinds of the US/China trade standoff, slowing global economic momentum and Brexit dynamics. The moves in bond markets over the same period have arguably been more significant, reflecting fears that US Fed monetary policy is still lagging economic events. The US two-year/10-year yield curve slope is once again close to zero, indicating bond investors sense a recession may be coming.

Doing nothing is always a valid option in portfolio management, after having carefully considered all other possibilities. We have been suggesting a relatively cautious portfolio positioning since the mid-year as market sentiment had improved significantly even as economic fundamentals turned more negative, with the known risk factors of Brexit and US/China trade dispute proving increasingly intractable.

Exhibit 1: Five-year compound returns on equities have fallen well short of traditional hurdles outside the US

Source: Refinitiv. Note: Chart shows compound total return 28 August 2014–28 August 2019 compared with the traditional 8% equity hurdle rate.

US/China trade dispute: Rumbling on despite the impact on global trade

The recent increase in market volatility observed during August, Exhibit 2, in our view reflects a merry-go-round of risks. These risks are not new, but this year seem to have cycled from background to foreground, with predictable effects on short-term investor sentiment. For example, evidence of slowing growth and a likely protracted US/China trade dispute merely represent well-known risks which investors had chosen to ignore or downplay during Q218. For now, following a difficult and communiqué-free G7 meeting in Biarritz, which clearly demonstrates the absence of an international consensus on a variety of issues, the risks are once again in the foreground.

Exhibit 2: Merry-go-round of risks pushes implied volatility higher during August

Source: Refinitiv, CBOE

In our view, the US/China trade dispute remains unlikely to be resolved in the near future and it is becoming difficult to analyse a situation when the US administration appears to be playing from an unnecessarily irrational playbook. For example, Trump's most recent round of tariffs place the Chinese side in the unacceptable position of negotiating under threat, thus extending again the timeline of any resolution. Furthermore, the ordering of private companies to cease operations in China – which appears not to have any actual legal force – is somewhat nonsensical and further erodes the credibility of the office of the US President, in our view.

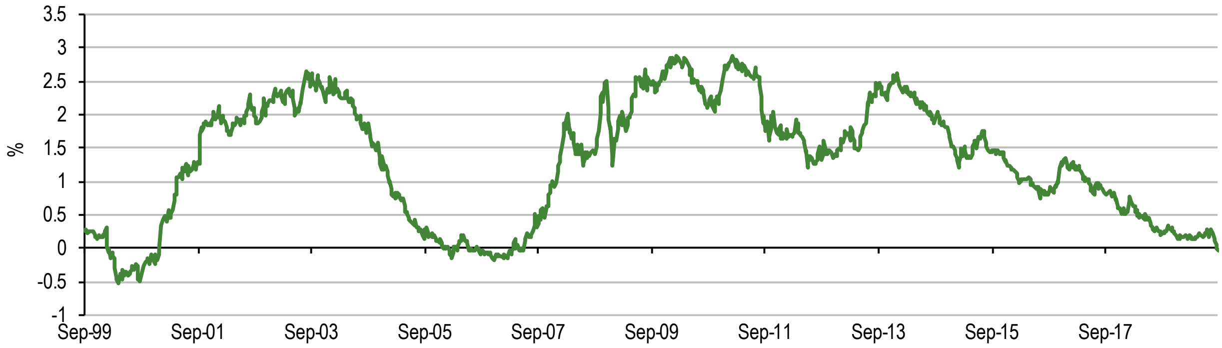
We believe the initial support within the US political system for resolving the real questions in respect of China, such as intellectual property protection and unfair competition, has instead given way to a distorted political campaign by the US President. Prioritising old economy and unprofitable industries risks handicapping the US technology and industry sectors' efforts to extend and sustain a US-centric dominance which is the envy of the rest of the world. It may not be an exaggeration perhaps to compare it the children's story of the boy who exchanged the family cash cow for a handful of worthless (soya) beans, in order to go on a wild adventure.

This sustained US lurch into protectionism is now contributing to a slowdown in the global economy with little prospect of an end in sight. In this regard, markets are now becoming extraordinarily sensitive to Trump's trade pronouncements, as evidenced by the decline in equity markets over the most recent weekend following the US/China tariff escalation. Furthermore, neither side shows any sign of backing down. The further decline in August of China's renminbi well past the symbolic RMB7 to the US dollar may offset US tariffs to a degree but has also only increased talk of a currency war.

If only everything in life was as reliable as the US Fed

While overly-ambitious market expectations for a 50bp US Fed rate cut in July were not realised, we believe it would be easy to overplay the apparent tension between the US Fed and a US President that appears both eager for rate cuts and is also becoming an increasingly vocal critic of the independence of the Federal Reserve system. To date, there is scant evidence that Fed policymakers are doing anything other than following their traditional technocratic and politically independent processes, with the focus in recent speeches shifting towards sustaining what is a US economic expansion of record duration.

Exhibit 3: US Federal Reserve needs to get ahead of an inverted two-year/10-year yield curve



Source: Refinitiv

At Jackson Hole, Fed Chair Powell stated that while the Fed's understanding of the dynamics of traditional cyclical economic parameters is well-established, uncertainty in respect of trade policy is a new challenge and there are no recent precedents to guide policy in this regard. As Powell has also at times regarded trade fears as a temporary phenomenon, we believe there is an unwillingness to allow the Fed to be drawn into a political US/China trade dispute, either as an 'enabler' by offsetting the negative short-term effects of sub-optimal trade policy (as has recently been suggested by former FOMC member, Bill Dudley), or as an institution that could be accused of trying to subvert the incumbent US administration's political agenda.

Instead, we believe the Fed will take account of the relatively low neutral rate of interest in evidence in this cycle and also the challenges of running effective monetary policy with rates close to zero. We believe US policymakers can be relied upon to proactively ease US interest rates, provided there is adequate evidence of slowing economic growth, either in the US or globally.

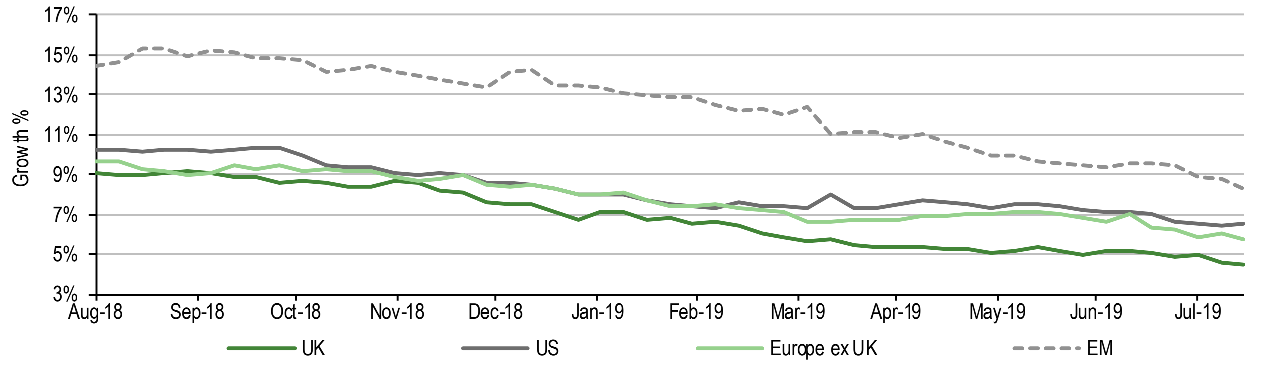
In particular, the progressive inversion of the US yield curve, Exhibit 3, is now a concern as it is driven by risk-aversion following the recent escalation of trade war rhetoric. The relationship between the US yield curve slope and prior recessions is sufficiently strong that if left unaddressed would risk a self-fulfilling set of expectations, which we believe the US Fed will be keen to avoid. With PMI survey data both in the US and the rest of the world remaining lacklustre, a further rate cut in September appears highly likely. This is also unlikely to represent the end of the current easing cycle; there remains the prospect of further emergency cuts in the lead-up to a potential no-deal Brexit.

To be viewed as a successful challenge to the growing consensus in terms of the elevated risk of a US recession, any US rate cuts will need to be of a sufficient magnitude to push longer-term rates higher, thus ensuring a positive yield curve slope. In our view, there is therefore also a possibility later in the year of renewed use of forward guidance to ensure market expectations for short-term US rates remain anchored at low levels, to ensure that a modestly positive yield curve slope remains in place.

Slowing economic momentum and profits growth keeps us cautious

We note that the recent ZEW survey in Germany indicates a further below-consensus decline in optimism. China's industrial production figures for July were also well below expectations at 4.8% year-on-year, the weakest for 17 years.

Exhibit 4: 2019 profits forecasts remain on a downward trend



Source: Refinitiv

For the immediate future we are still concerned that downgrades to 2019 estimates are continuing at a pace which, if sustained, would imply zero profits growth for 2019 compared with 2018. In the circumstances, equities are likely to struggle to deliver meaningfully positive short-term returns, absent a surprise resolution of the US/China trade dispute or a Brexit deal that provides for an orderly departure of the UK from the EU. Furthermore, central banks in Europe and the US are now widely expected by markets to continue to ease monetary policy over coming quarters, suggesting that monetary stimulus is, to a large extent, already discounted within market prices.

Equity valuations easing outside the US

At this point, valuation concerns are becoming less of a consideration in our still-cautious outlook for global equities. Equity valuations outside the US are becoming less demanding following a multi-year period of sub-par total returns in many markets. Exhibit 1 shows the majority of markets underperforming the traditional 8% hurdle rate for equities. As a result, and especially in the context of very low or negative long-term bond yields, free cash flow and dividend yields for UK and continental European equities are at levels that may attract long-term value investors.

The US stock market remains at the upper end of its valuation range following a very strong relative performance since 2015 compared to other equity markets. This has been driven in part by a very small number of US global technology champions which in many cases still have no serious international competition.

Yet for non-US markets this period of underperformance means forward market valuations outside the US may be at a meaningfully better entry-point compared to any other time in the second half of this decade.

Exhibit 5: UK forward price/book valuations now significantly below 15-year average

Source: Refinitiv, Edison calculations

There is therefore in our view a developing tension between valuation measures and momentum at the present time. Valuation metrics are improving as investors adjust to a lower likely trajectory of corporate profits. While we retain a cautious outlook this month, we are seeing better value developing in non-US equities. Should short-term political dynamics push, for example, the UK market significantly lower, we believe investors may wish to carefully examine the yields on offer before rejecting the entire market solely on Brexit concerns.

When is it time to buy the UK?

Corporate buyers rush in where public shareholders fear to tread

The UK's painfully obvious political splits on EU membership at every level – government, Parliament and among the general public, as illustrated by the referendum result – were fertile territory for a long, tedious and unpredictable path towards Brexit from the original public vote in 2016. Even now, there is no clear path ahead as both members of Parliament and members of the government explore ways of stymieing the efforts of the other.

UK profits growth has suffered from Brexit uncertainty but this is hardly a surprise to investors; for example, business investment growth has been lacklustre since the referendum. However, we may be reaching the point where it just takes the removal of the uncertainty to see a pick-up in corporate investment spend, which at least in part will be catch-up spending deferred from prior periods.

Added to this, the UK government will be determined to add fiscal stimulus over the Brexit period while the Bank of England will be on hand to offer monetary support. With sterling still trading on a trade weighted basis close to 40-year lows and UK equity markets inexpensive, 2020 could be a better year for UK markets than the consensus expects.

We believe the outperformers in a bullish scenario would be domestically focused UK equities, which may benefit twice over from a reduced Brexit risk premium and UK stimulus efforts. On the other hand, UK-listed exporters may face a stronger currency headwind. Nevertheless, the road to Brexit remains paved with uncertainty; the government could yet fall during the autumn leading to early elections.

It also remains quite possible that the EU will blink at the last minute in the run-up to 31 October, dropping the totemic and controversial right of veto of the UK's departure from the customs union which has been embedded within the current Irish backstop arrangements. We believe given the extreme level of bearish investor positioning at present, an orderly Brexit with a deal would be quite bullish for sterling and UK assets. This would eliminate overnight the near-term uncertainty over the UK's trading arrangements. Combined with a domestic stimulus package this could quickly reverse the negative sentiment that currently surrounds the UK economy. Taking a position against the UK at this point is not a one-way bet, even if it has become a trade crowded with high-profile hedge funds.

In terms of valuations, UK equities are no longer expensive, having underperformed other global markets since 2016. The median forward free cash flow yield for a FTSE 250 company is currently 5.5%, a 10% discount to the average over the prior 10 years. In addition, UK forward price/book multiples are also significantly below their 15-year average.

Given the political theatre evident in the UK's House of Commons this year, it can hardly be a surprise that sterling has come under pressure. Yet with open short sterling futures positions at record levels, the strong market consensus that sterling can only fall appears at odds with the currency's long-run valuation; real, trade-weighted sterling is trading close to a 40-year low and has already declined by 20% since immediately prior to the referendum. Merely a workable Brexit deal would, in our view, see traders rush to cover short sterling positions.

The investment paralysis surrounding Brexit, both in terms of portfolio flows and the real economy, is in our view related to few market participants having any clarity as to the shape of the Brexit outcome. UK business investment has provided little support to overall economic growth since the 2016 referendum. Perhaps every market participant can envisage a scenario that would play out poorly, thus contributing to the paucity of investment spend and weak UK stock market performance in recent years. This would also imply that mere resolution of the uncertainty could bring a significant boost to UK business investment and UK equity market inflows, even before any government stimulus.

Despite the apparently entrenched positions on public display for now, a no-deal Brexit would cause significant disruption for businesses in both the UK and the EU. Amidst the rhetoric, this would be an unnecessary and avoidable economic conflict that either side can ill-afford while global growth continues on a weakening trend.

As the UK's prime minister is discovering, it can be difficult in a parliamentary democracy to negotiate from a position of strength when up against EU officials who do not need to consider their support base. The unilateral disarmament of the UK's no-deal 'nuclear option' has become something of a passionate cause among many British politicians. However, the difficulty is that by taking away a credible threat of punishment, the probability of an acceptable deal is only reduced. The UK government's recent announcement of a five-week suspension of Parliament may be dramatic but with court challenges already underway, it remains unclear whether it will be a viable way forward to delivering Brexit.

For investors, the challenge in our view is to be able to take advantage of the near-inevitable elevated day-to-day volatility in both UK equities and the currency in the coming weeks, and avoid being held hostage by events. Nevertheless, with both currency and equity market valuations now appearing relatively inexpensive at least on a relative basis, it is too late to be looking for opportunities to exit or short UK equities in our view.

Conclusion

Despite sustained political attacks, the Fed is, in our view, likely to continue to cut rates in the face of evidence of further weakness in the global economy, which is likely to limit the downside for global equities later in 2019.

Nevertheless, evidence of slower economic growth and the consequential pressure on 2019 profits forecasts continues to build. It may be frustrating but in our view the reality is that the risks, as discussed above, have not gone away. As a result, global equities appear to have become stuck in a trading range.

We expect most, if not all, investors will now be familiar with the data showing a slowdown in the global economy and US foreign policy is never far from the headlines. However, just because a risk is familiar it is not less dangerous; the risk at present may be complacency. We therefore remain cautiously positioned in terms of the outlook for global equity markets, noting finally that governments still appear overly focused on domestic populist agendas and oblivious to the increasingly evident risks to global economic growth.

EDISON

General disclaimer and copyright

This report has been prepared and issued by Edison. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

The Investment Research is a publication distributed in the United States by Edison Investment Research, Inc. Edison Investment Research, Inc. is registered as an investment adviser with the Securities and Exchange Commission. Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas,
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia