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Will Valuation Segue to Growth?

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University of the West of England, 27th November 2013



Scenario analysis – 2013 Base Case (60% probability)

- Global growth environment to remain weak but pace revives towards 2014.
- Emerging market growth to exceed developed markets.
- Monetary policy to remain supportive across all geographies.
- ECB activates its OMT programme.
- Western developed ERPs to decline even despite limited policy progress on structural reform. Austerity continues.
- Triggers partial re-rating to 12x 12-month forward earnings (from 11x).
- European and UK margins bottom out in Q1 2013 results season.
- Earnings expectations revive with stronger 2014 in mind.

Scenario analysis – 2013 Bull Case (20% probability)

- The bullish case is predicated on aggressive (and decisive) policy response driving accelerated GDP growth
- US policy-makers arrive at a “Grand Bargain” over the fiscal cliff and debt ceiling
- Eurozone authorities lay out decisive steps towards banking and fiscal union
- ECB launches OMT programme
- Chinese growth surprises to the upside
- Corporate M&A revives as business confidence is restored
- Peripheral European bonds and equities outperform the core
- Stronger global growth drives strong EPS rebound
- Structural reforms drive strong equity market re-rating to 13x 12m forward earnings

Scenario analysis – Bear Case (20% probability)

- Continued policy paralysis and global growth disappoints
- US falls over the fiscal cliff and debt ceiling requires urgent remedial policy
- Asian growth disappoints expectations as the eurozone remains unfixed
- Eurozone recession becomes a depression as the periphery continues to underperform, infecting the core
- No progress on Western structural reform or economic direction change in China
- Rolling currency devaluation continues
- Credit rating agency downgrades begin to gain some traction and core bond yields start to rise
- Macroeconomic weakness prompts additional margin pressure, impacting negatively on earnings growth which disappoints throughout 2013
- 12m-forward PE slips from 11x to 10x, the bottom of its recent range

- Prefer equities to corporate and sovereign bonds
- Prefer UK and European equities to US. Emerging markets a beta play on Western economic revival
- Stronger Asian growth augurs in favour of maintaining portfolio orientation towards internationally exposed businesses
- Investing for income likely to remain a core determinant in 2013
- Looking to upgrade cyclicals over defensives but waiting for a Q1 2013 equity market trough to take the plunge
- Sectorally we look for areas of high valuation dispersion and low relative valuation...but value investing requires stronger growth environment
- Remain wary on the Banks, but Miners should recover in blended outlook

Welcome to the Hotel California

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Source: Reuters Ecowin Pro, US Federal Reserve, BNP Paribas

Global macroeconomic outlook: struggling back to trend

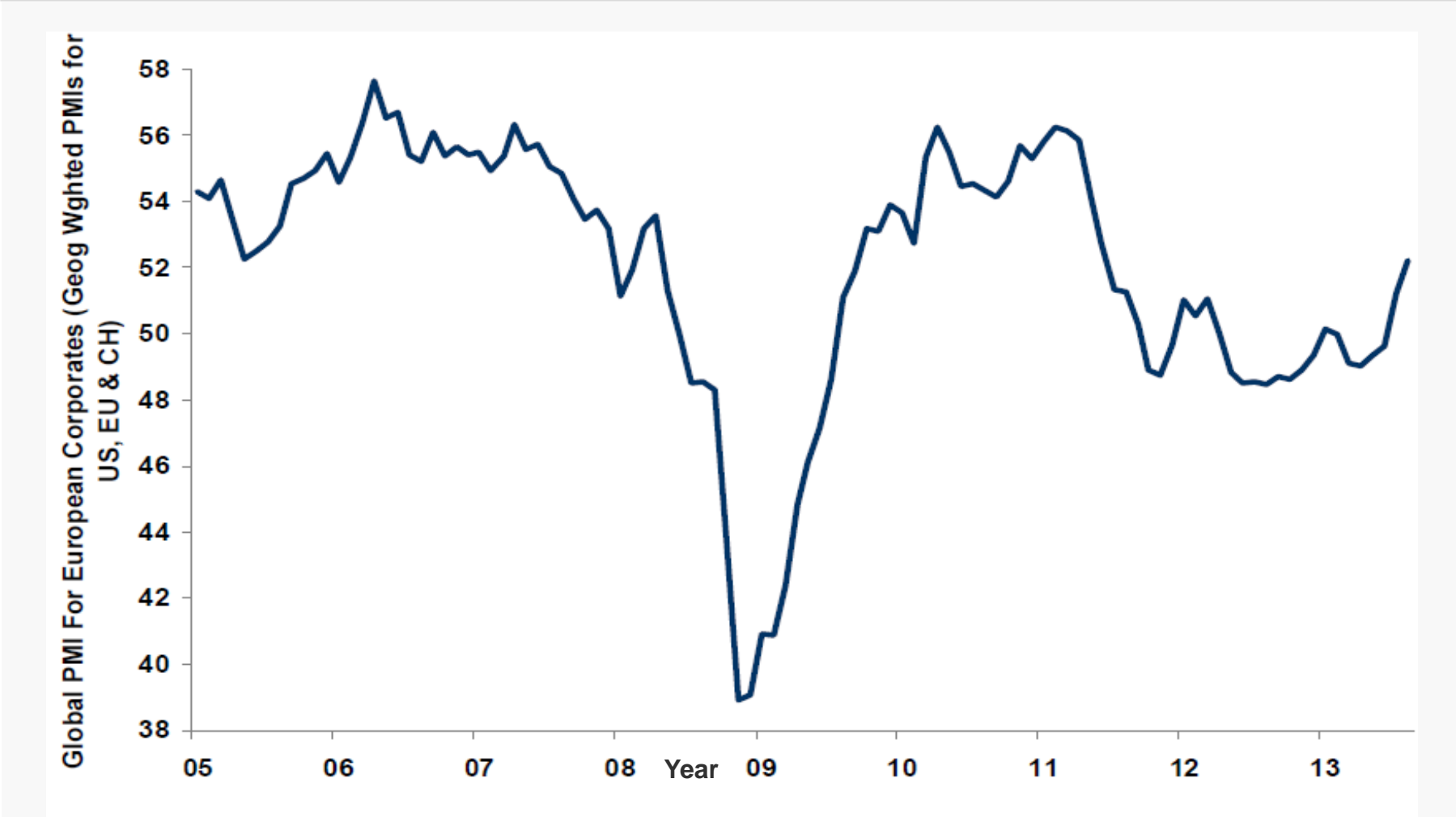
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New, old and consensus GDP growth forecasts (% y/y)

| | 2012 | New Forecasts | | | Old Forecasts | | Consensus | |
|-----------------|------|---------------|-------|-------|---------------|-------|-----------|-------|
| | | 2013e | 2014e | 2015e | 2013e | 2014e | 2013e | 2014e |
| World | 2.7 | 2.5 | 3.3 | 3.4 | 2.5 | 3.3 | 2.4 | 3.1 |
| Eurozone | -0.6 | -0.4 | 0.8 | 1.4 | -0.4 | 1.1 | -0.3 | 0.9 |
| USA | 2.8 | 1.7 | 2.5 | 2.7 | 1.7 | 2.7 | 1.6 | 2.6 |
| UK | 0.1 | 1.4 | 2.3 | 2.5 | 1.5 | 2.3 | 1.4 | 2.2 |

Source: CS and consensus estimates

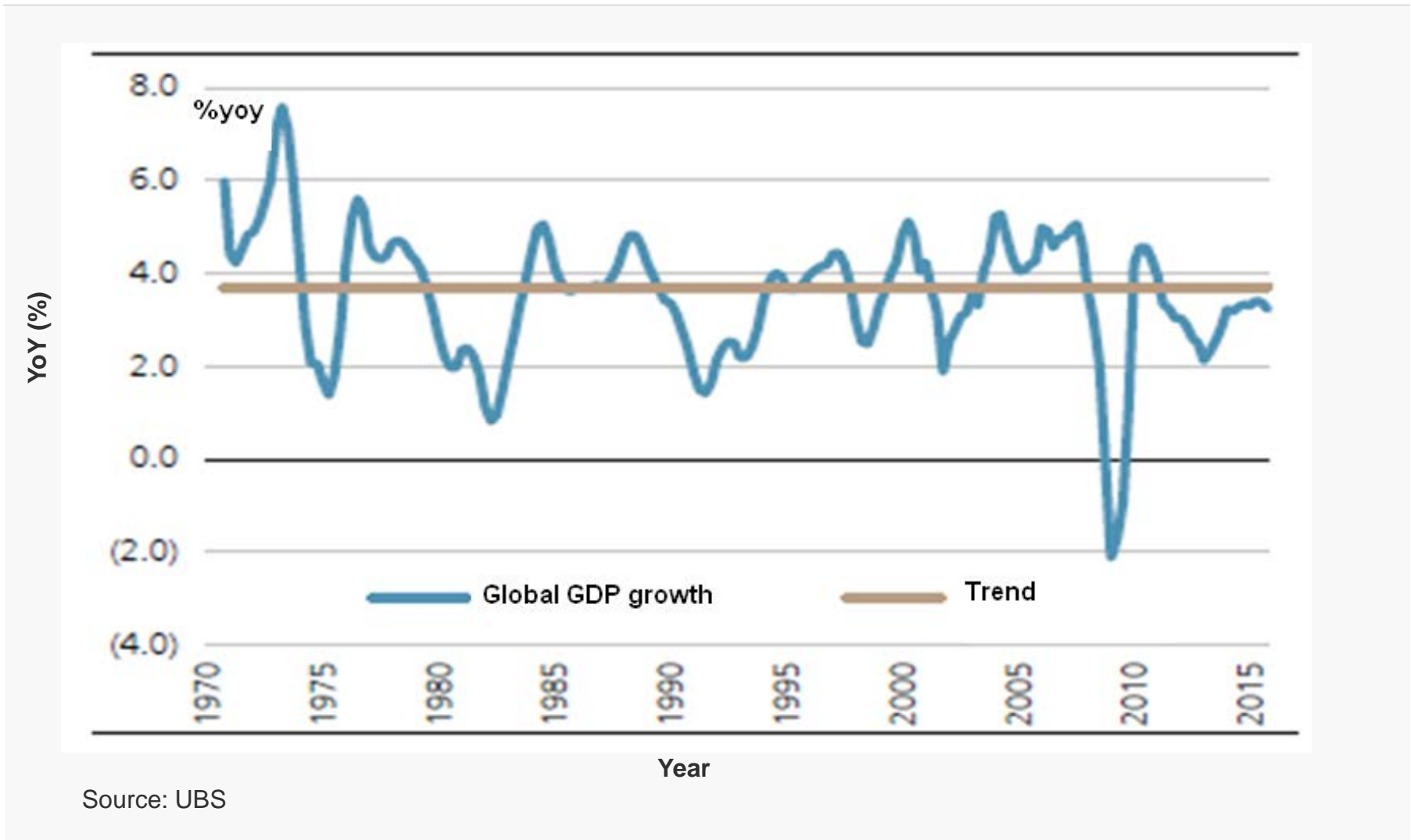
Hope-fuelled global PMIs signal economic acceleration



Source: Various National Sources, Markit, Bloomberg, Morgan Stanley Research

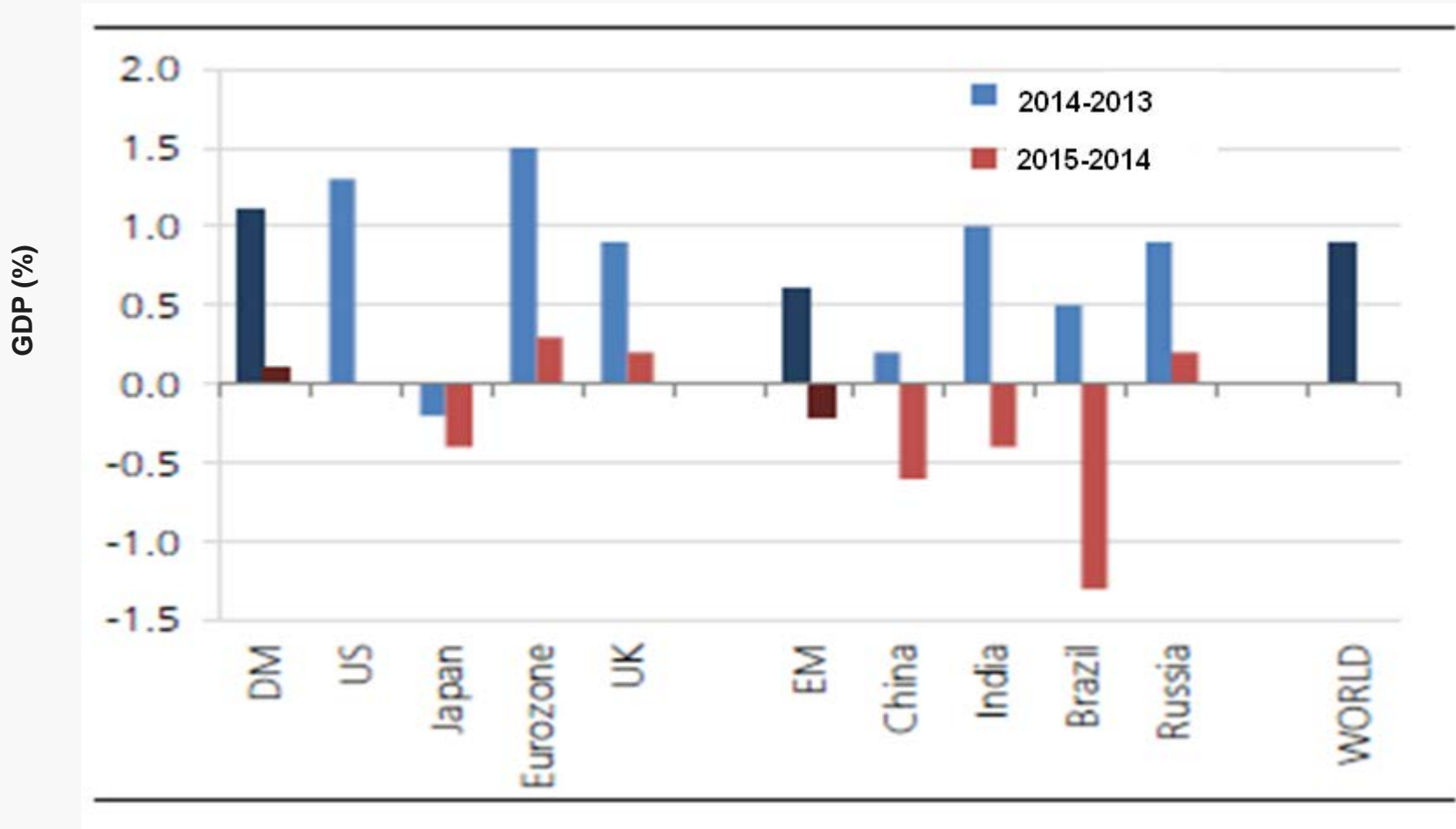
Global GDP growth forecasts vs. trend

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Source: UBS

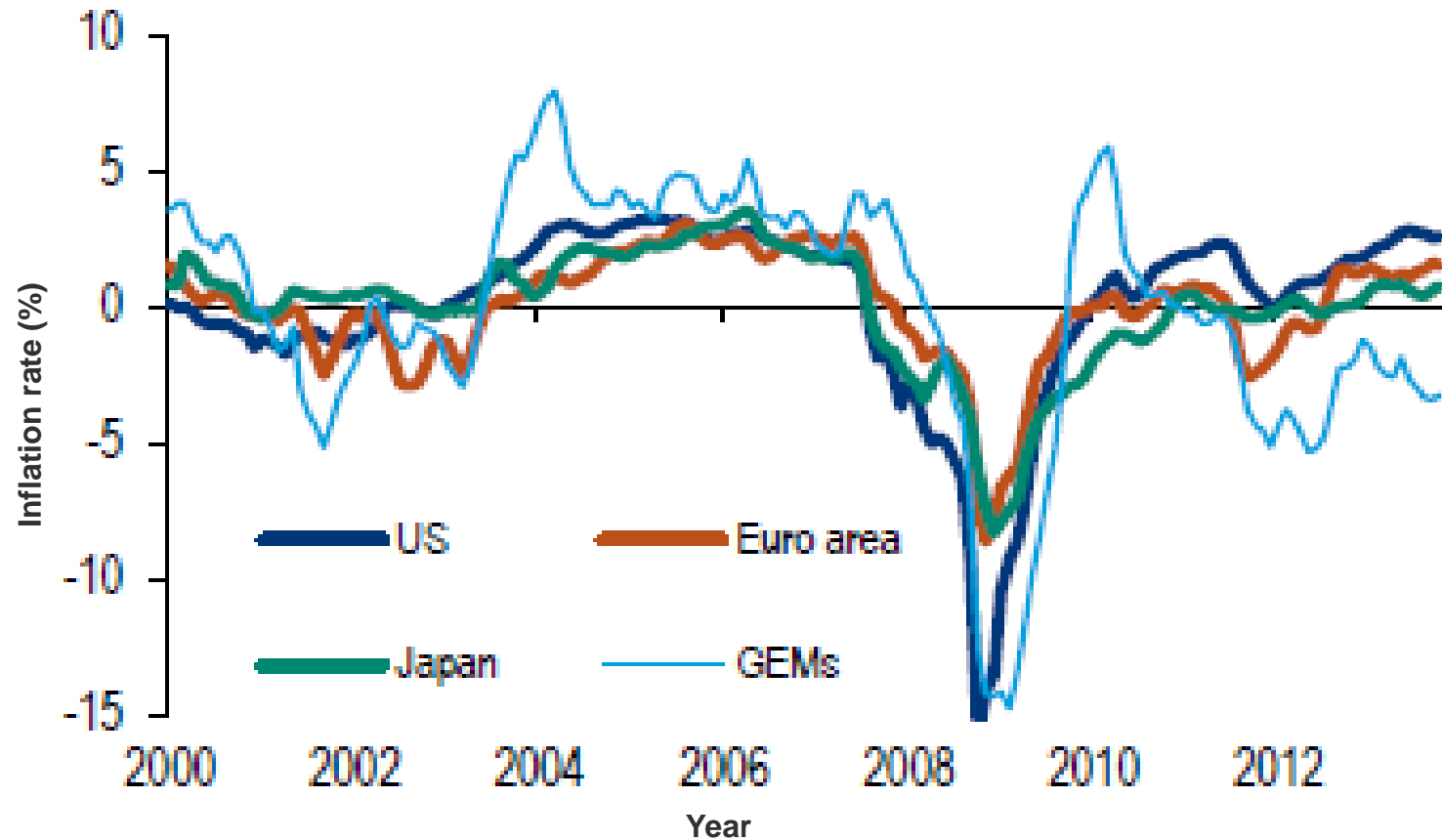
Developed economy acceleration. Emerging economy stagnation



Source: UBS

Official inflation very becalmed

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Source: BofA Merrill Lynch Global Research

The gap between official and real inflation

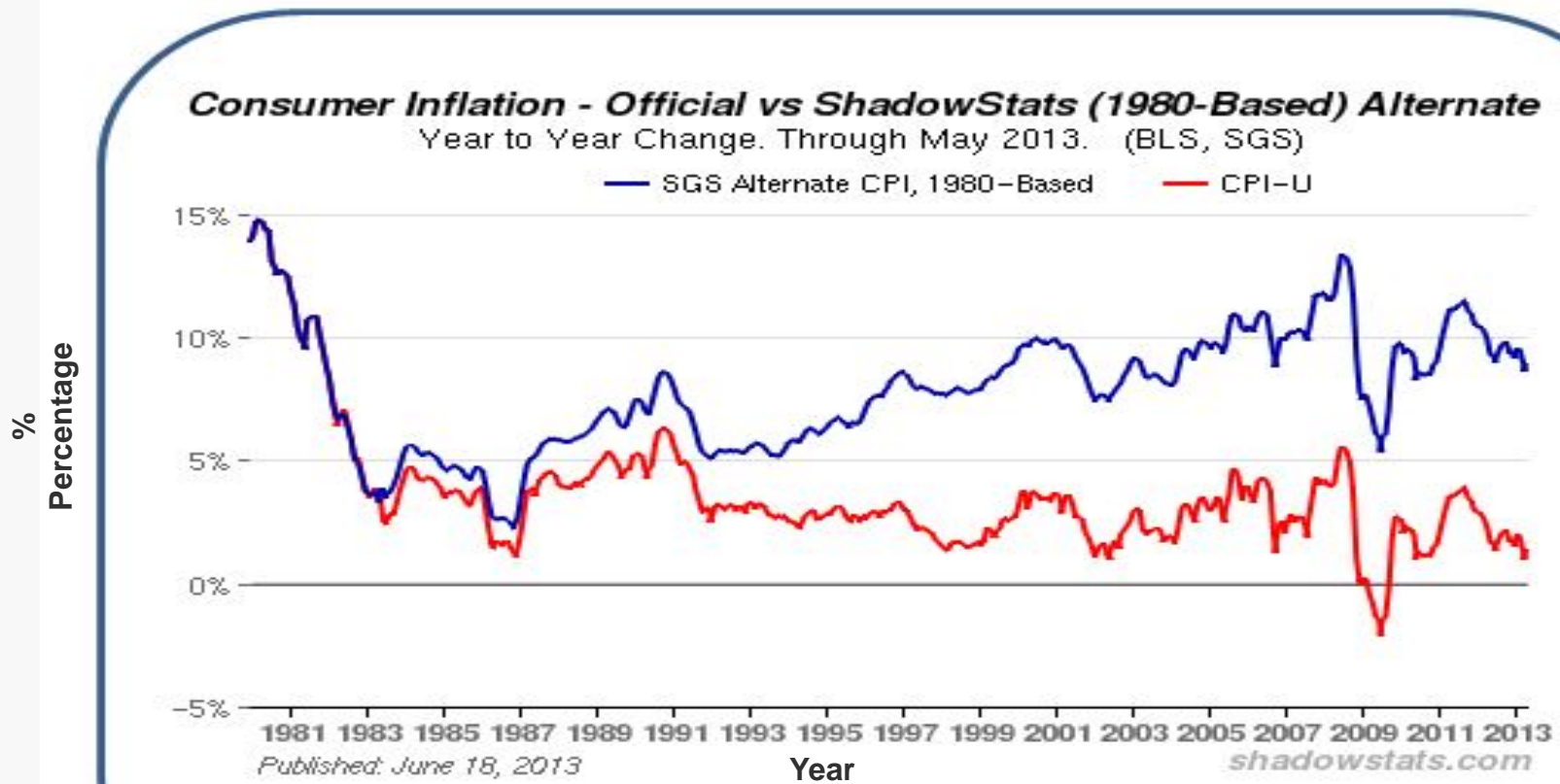
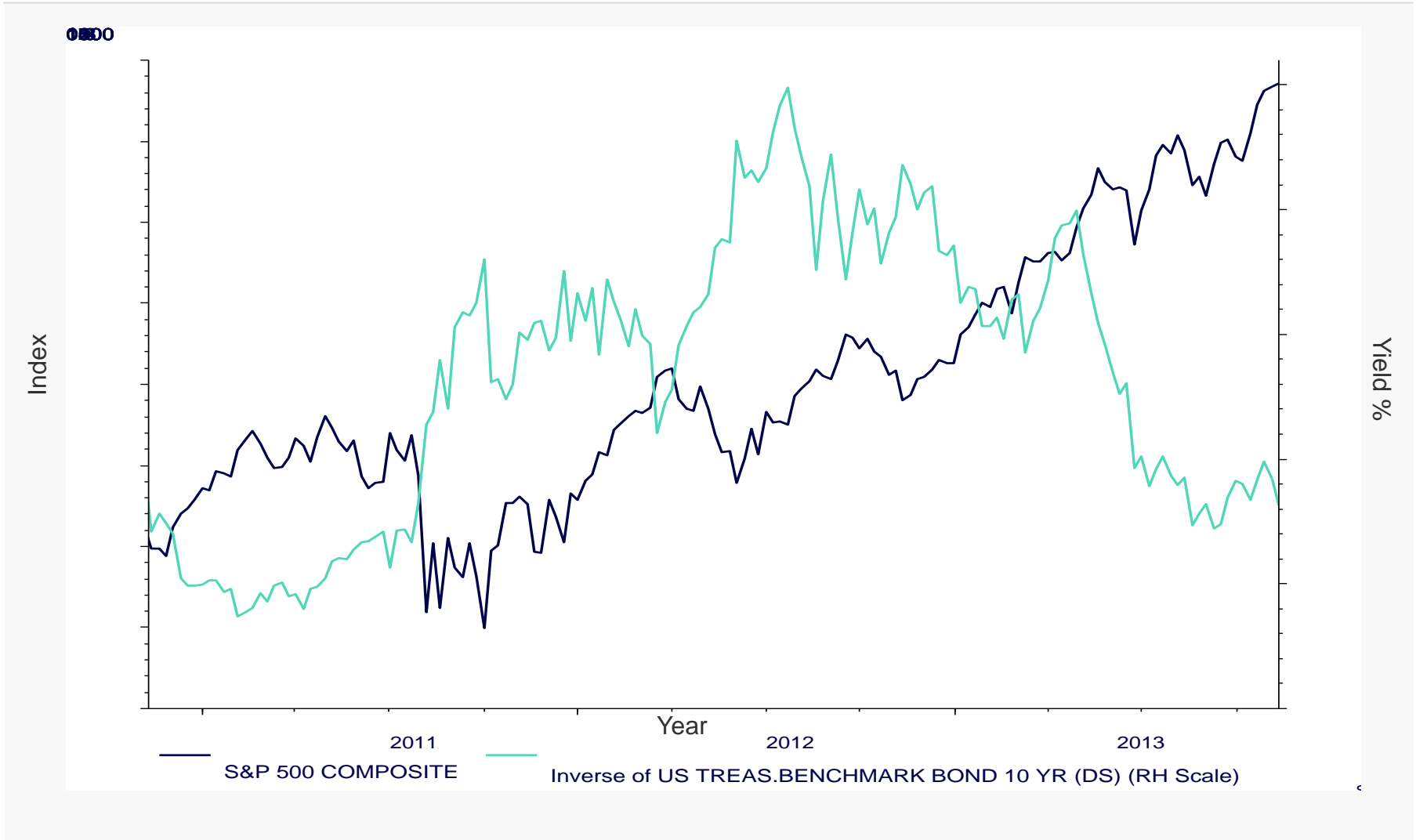


Chart: Courtesy of ShadowStats.com

In the US, as in Europe, equities decouple from higher market rates

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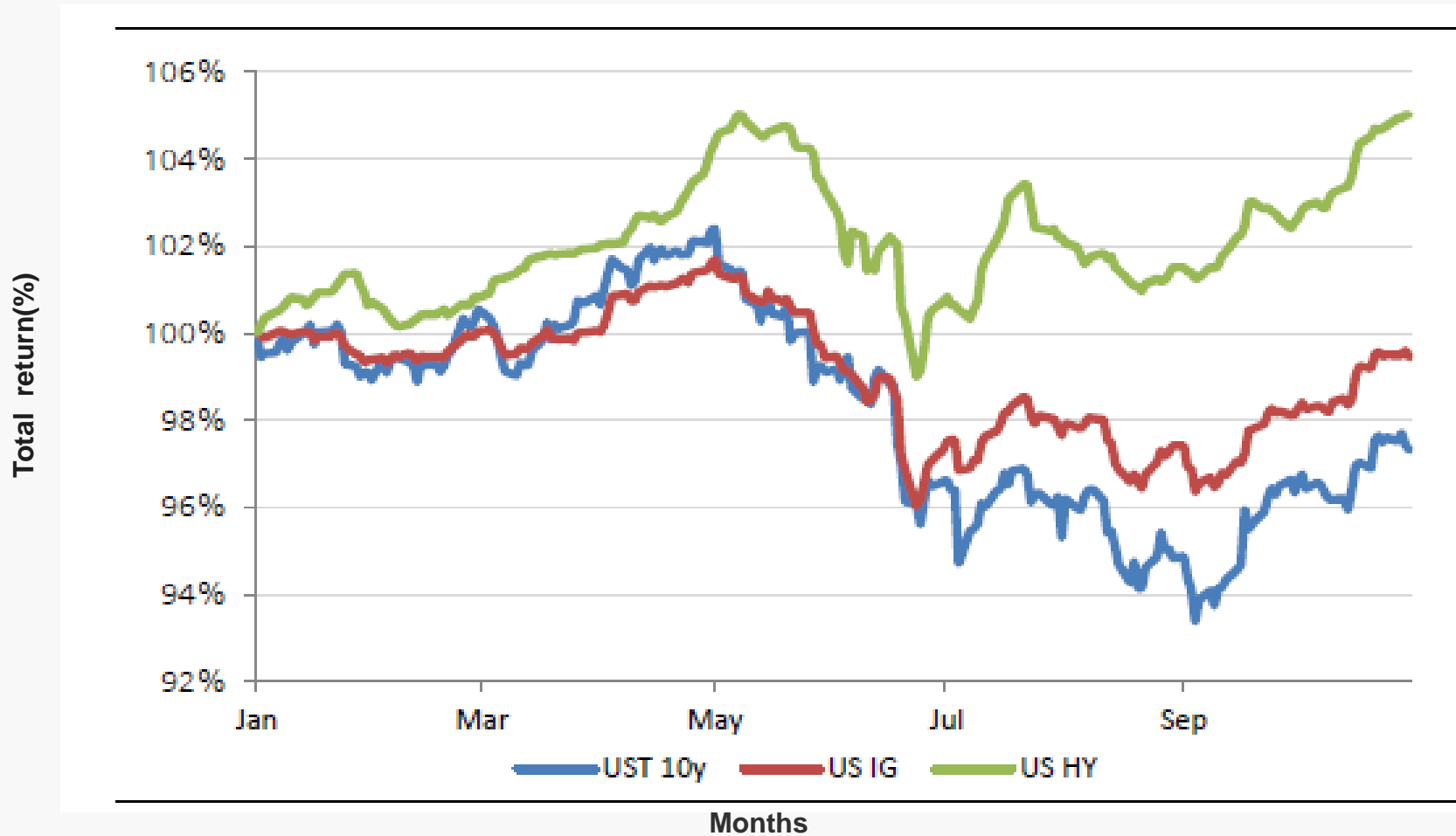
Global asset allocation: do you believe?

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- Asset allocation depends on your belief in global recovery
- Consensus growth forecasts show only a reversion to long-term average
- No acceleration in 2015
- Normalising growth = normalised sovereign bond yield curves
- Developed world base rates to remain anchored near zero in 2014
- Equities the only game in town with regional disparity

Fixed income performance this year

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Source: Bloomberg, UBS

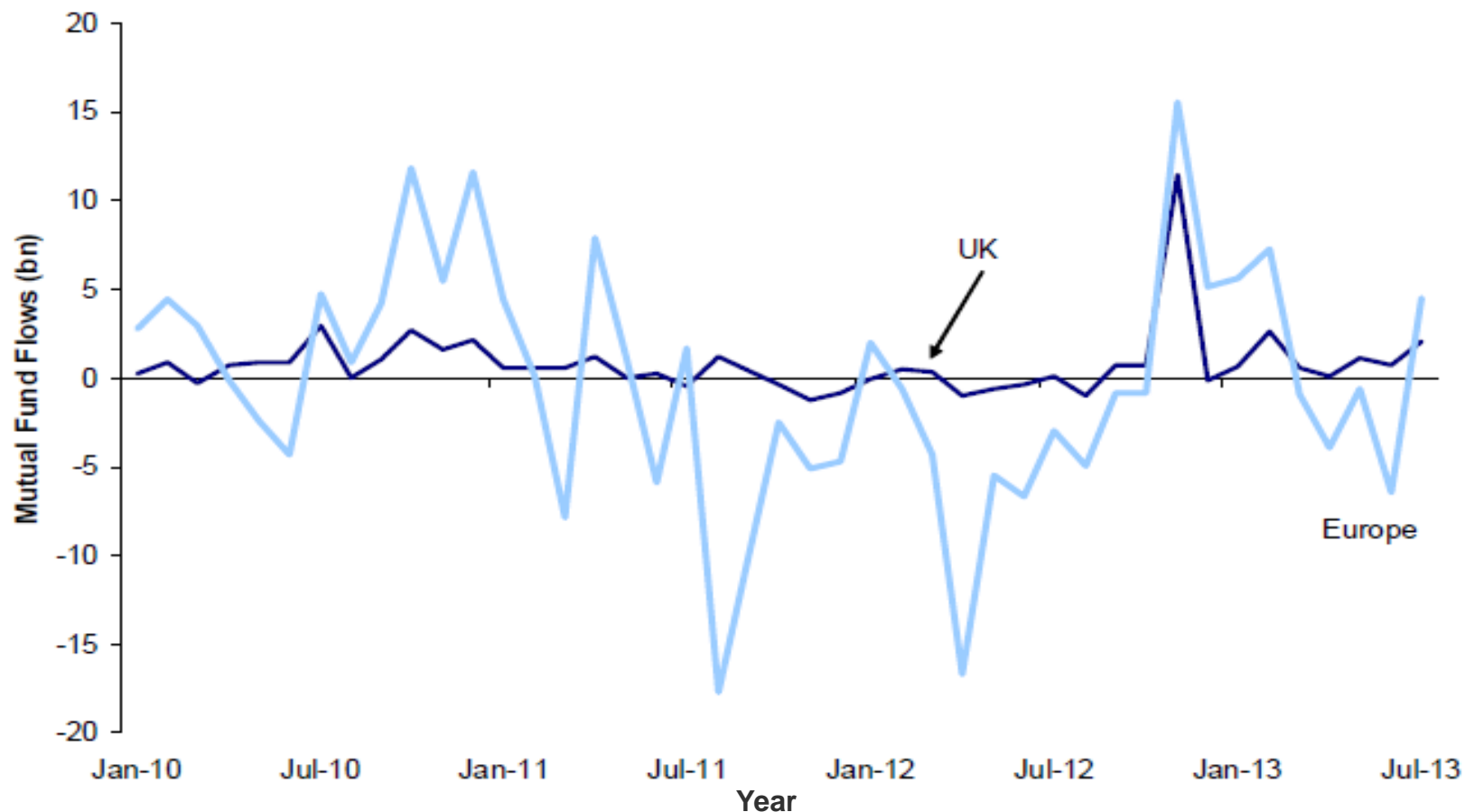
Acceleration, stabilisation, accommodation

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Equity inflows are picking up

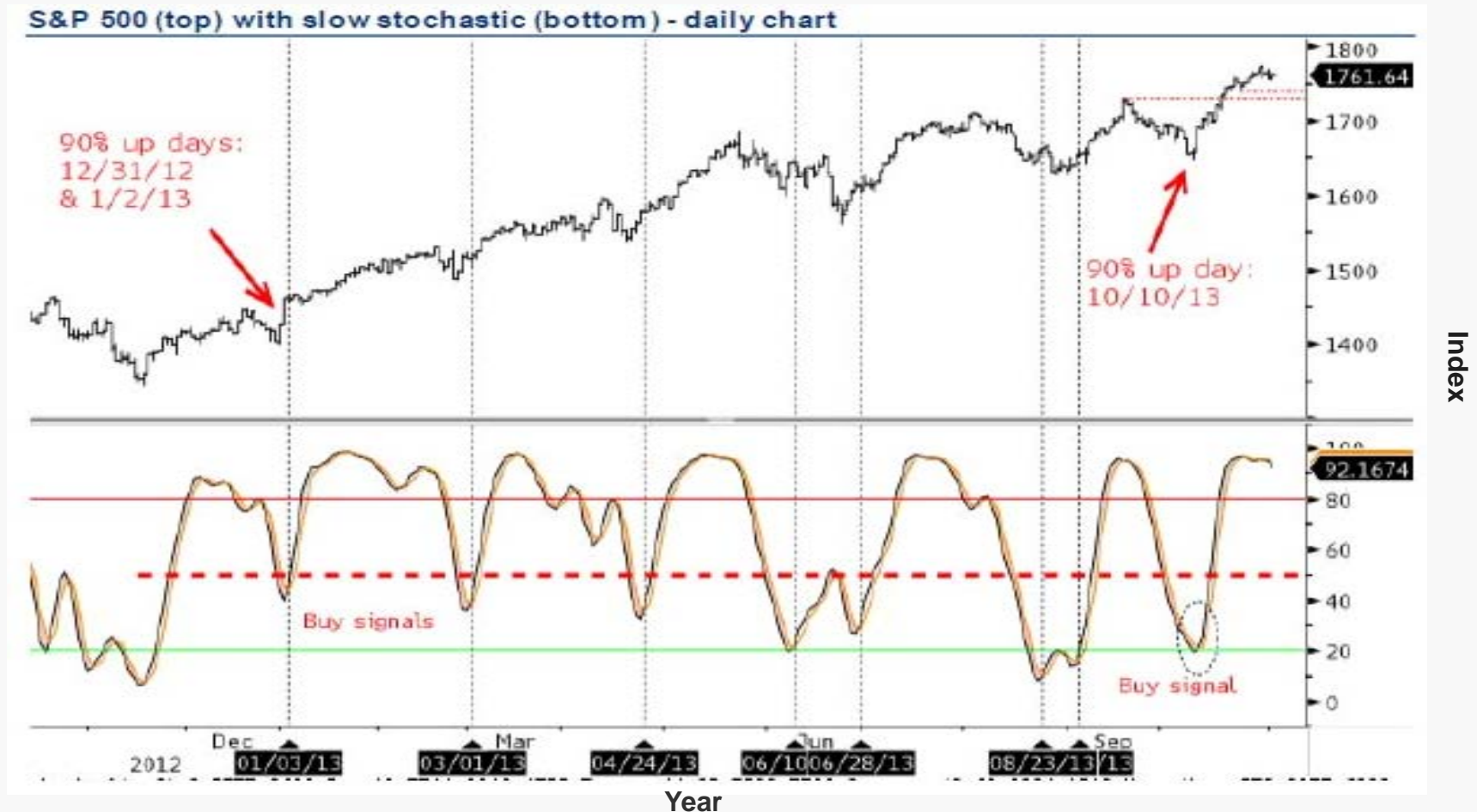
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Source: Various National Sources, Markit, Bloomberg, Morgan Stanley Research

“It’s frothy man!” Equities appear overbought

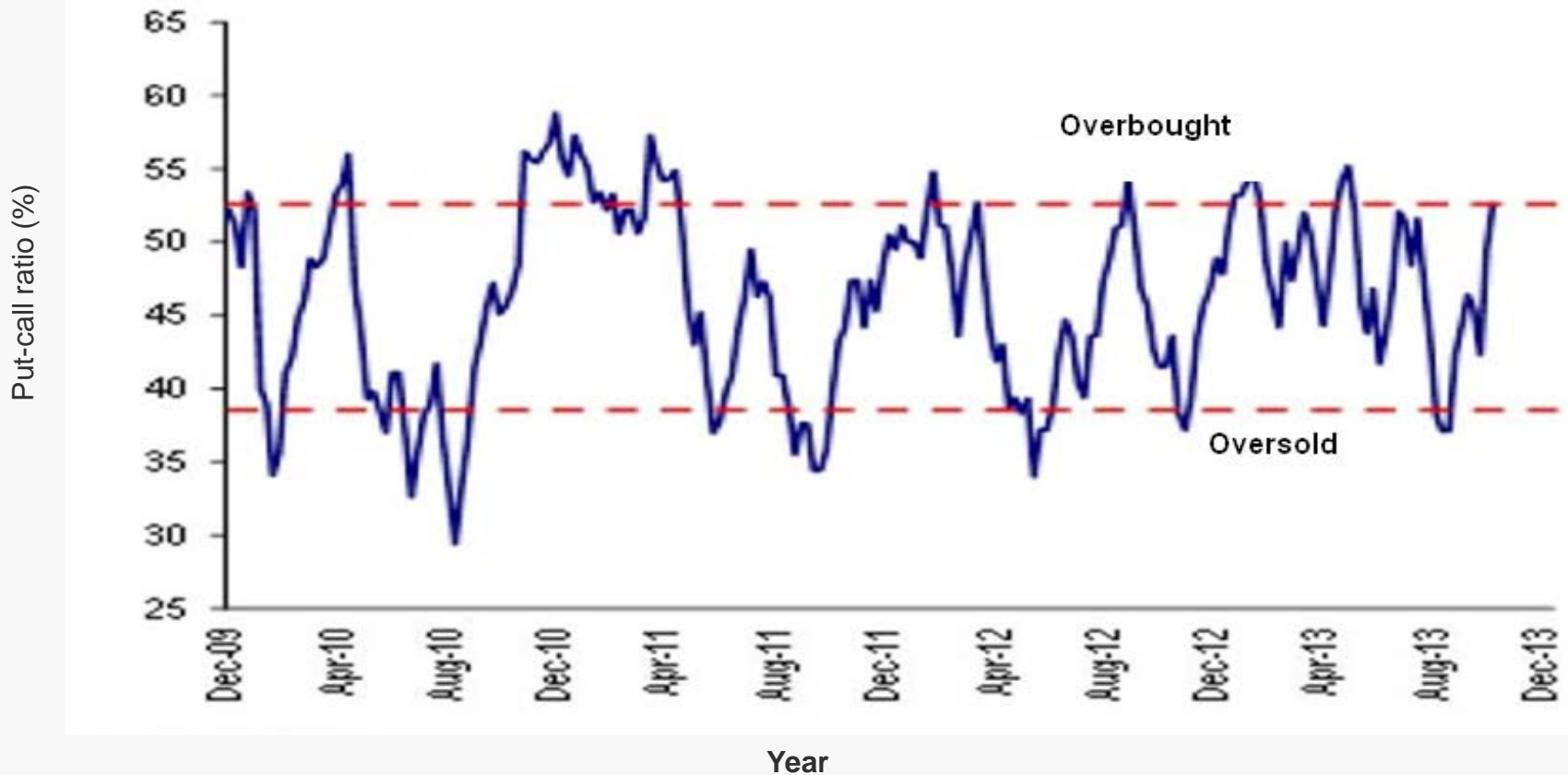
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Source: BofA Merrill Lynch Global Research, Bloomberg

Investors are bullish on equity risk

Investors Intelligence Bulls (in %) - weekly chart

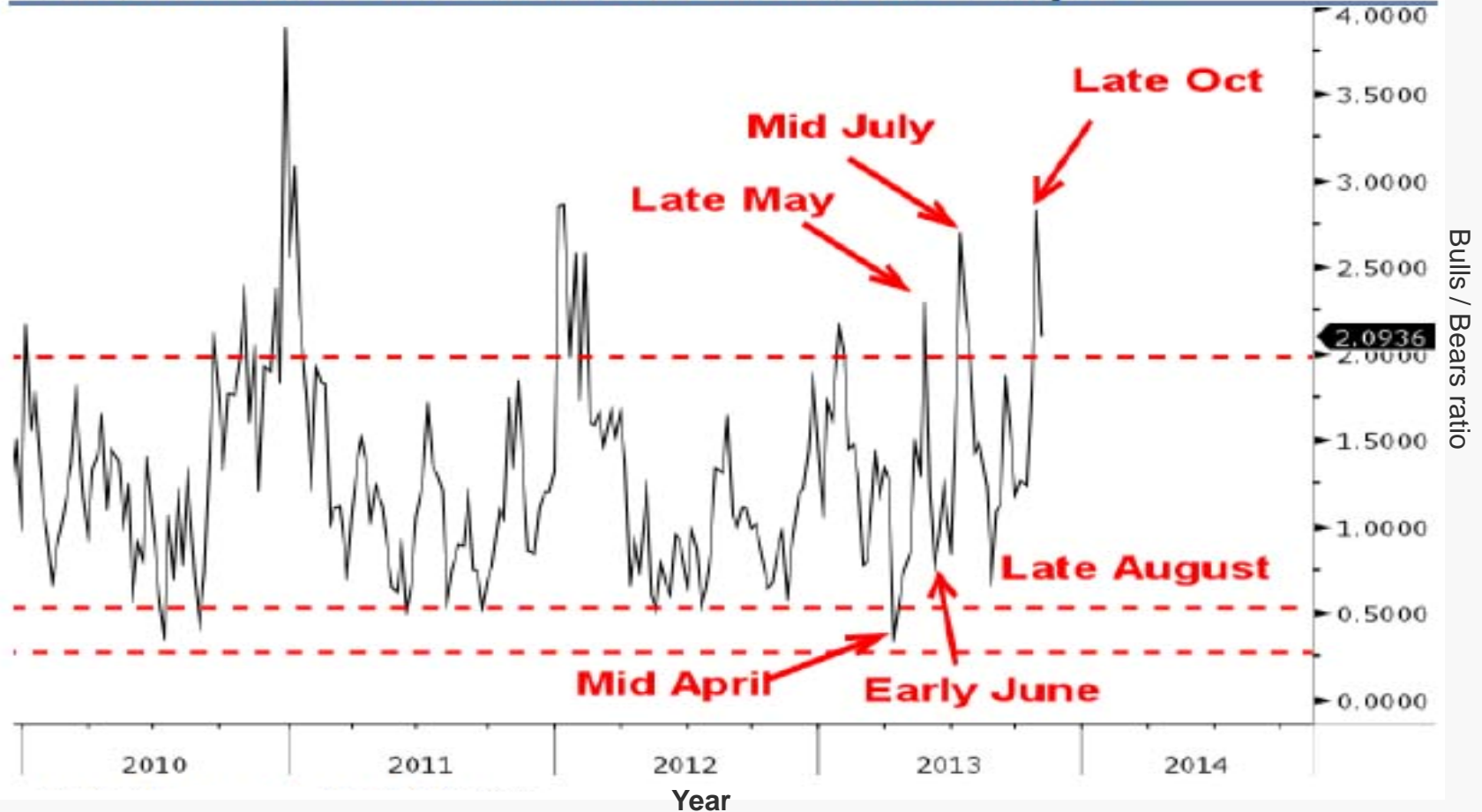


Source: Investors Intelligence

Is consensus optimism complacency?

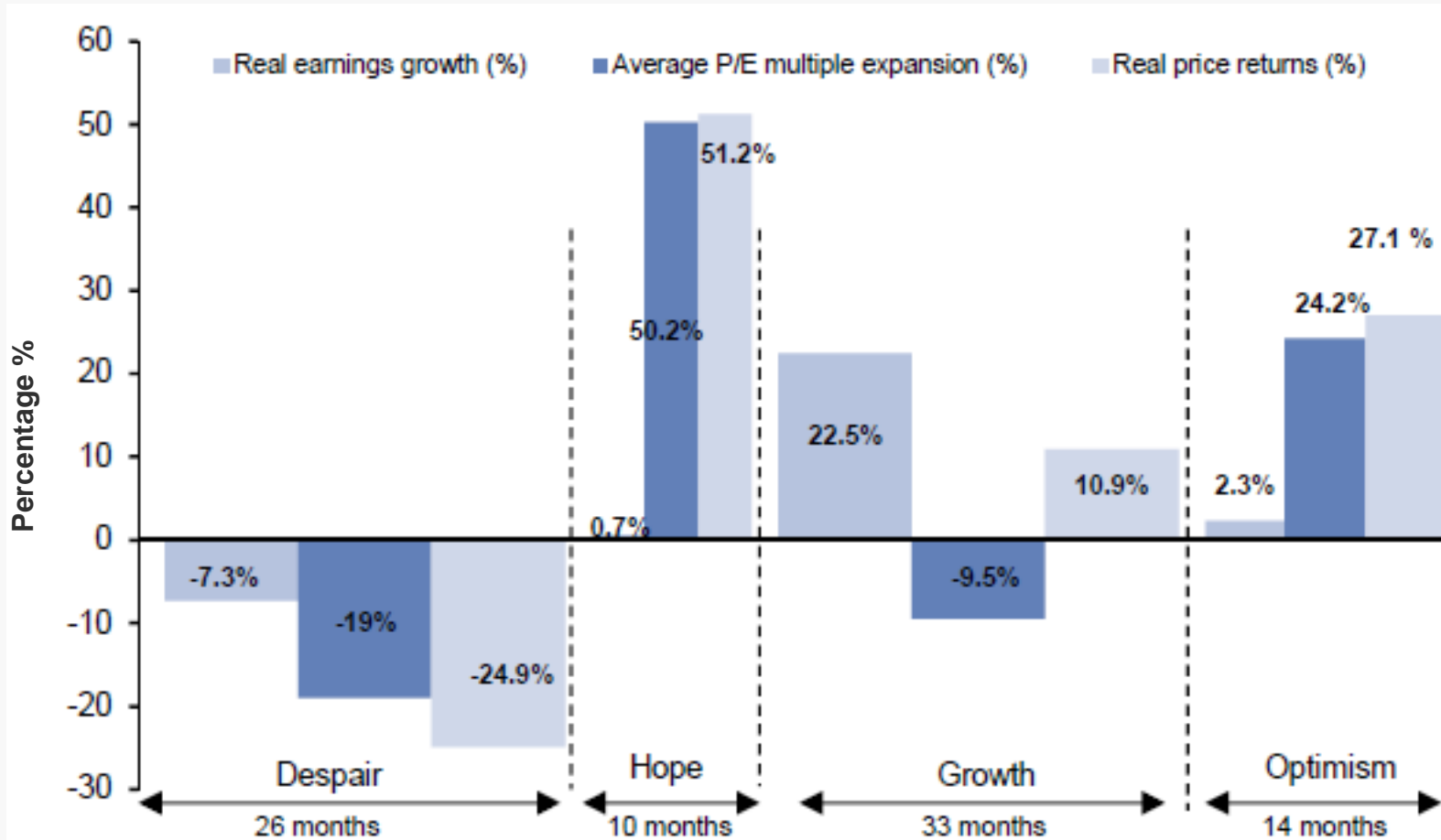
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American Association of Individual Investors Bulls/Bears ratio – weekly chart



Source: BofA Merrill Lynch Global Research, Bloomberg

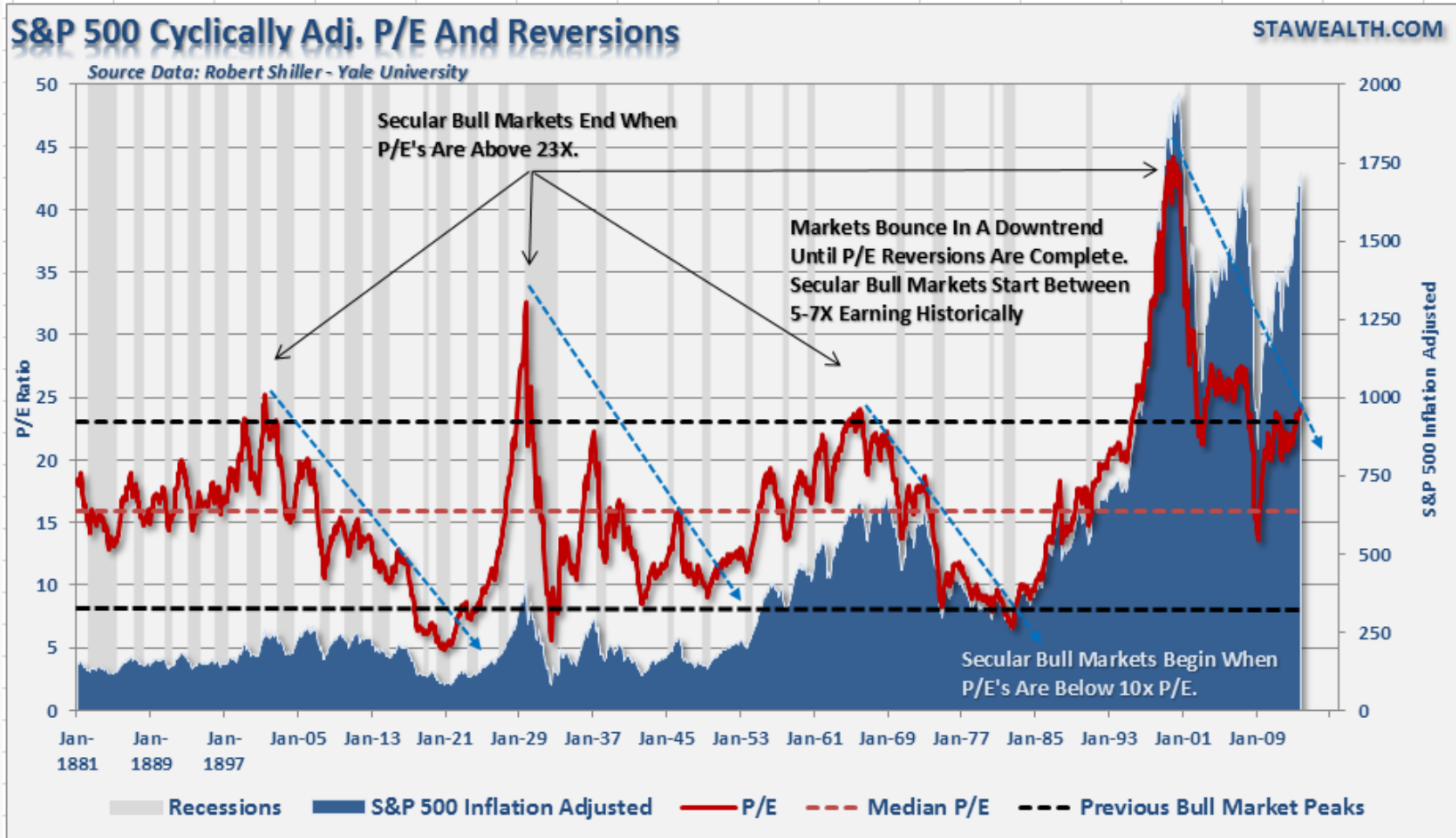
Phases of a 'typical' equity cycle



Source: Datastream, Goldman Sachs, Global Investment Research

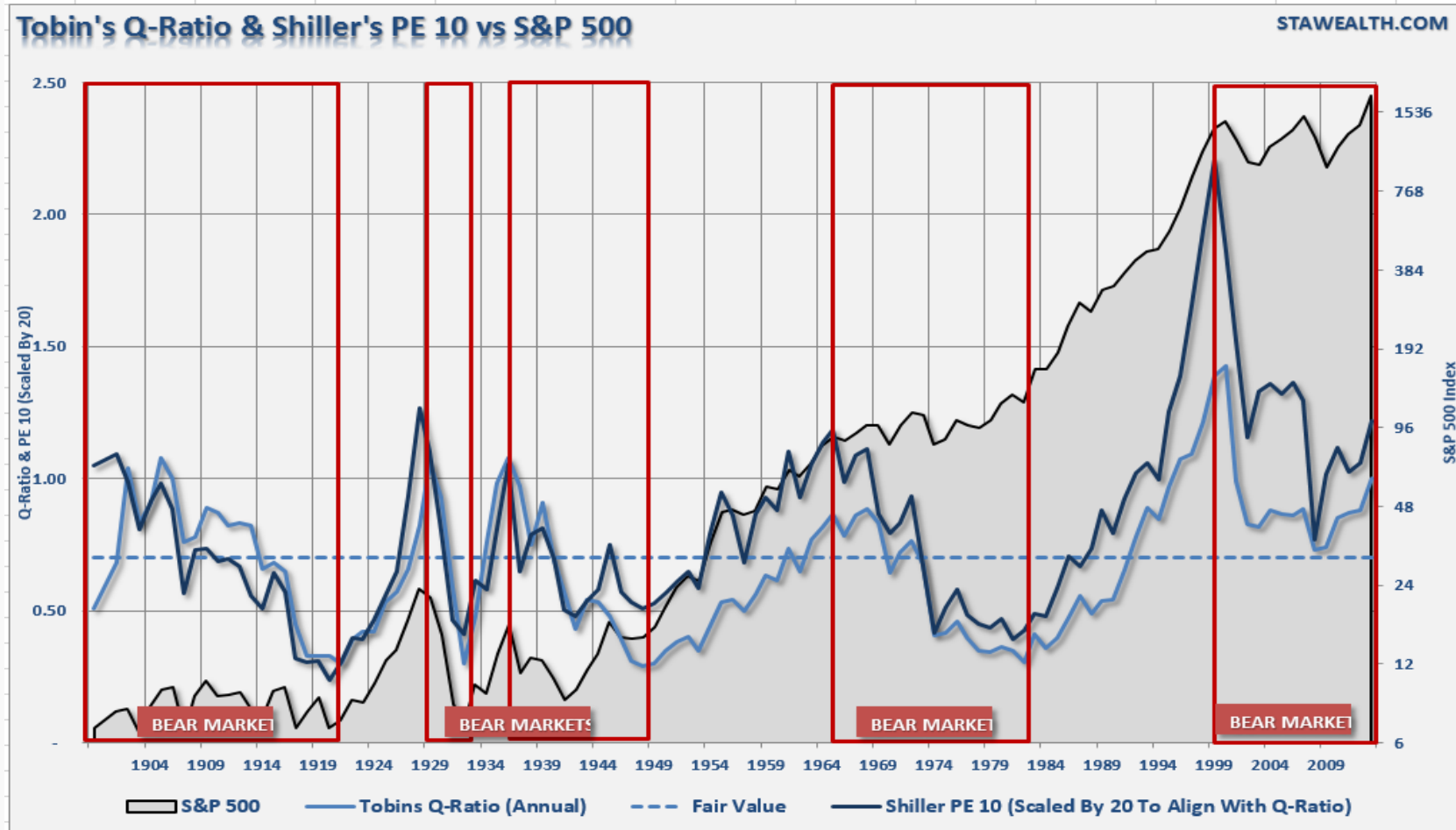
Time for a pause in the equity re-rating story

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Other valuation measures flash warning signals

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Source: www.STAWEALTH.com

Will earnings deliver?

Central Scenario and upside / downside risks. MSCI World

| | 2014 EPS est | 2015 EPS est | P/E | Index Target | Current Value | % upside/ downside |
|-------------------------|--------------|--------------|------|--------------|---------------|-----------------------|
| Central Scenario | 14% | 9% | 14.0 | 460 | 393 | 17% |
| Bull Case | 19% | 12% | 15.0 | 525 | 393 | 33% |
| Bear Case | 0% | 5% | 12.3 | 341 | 393 | -13% |

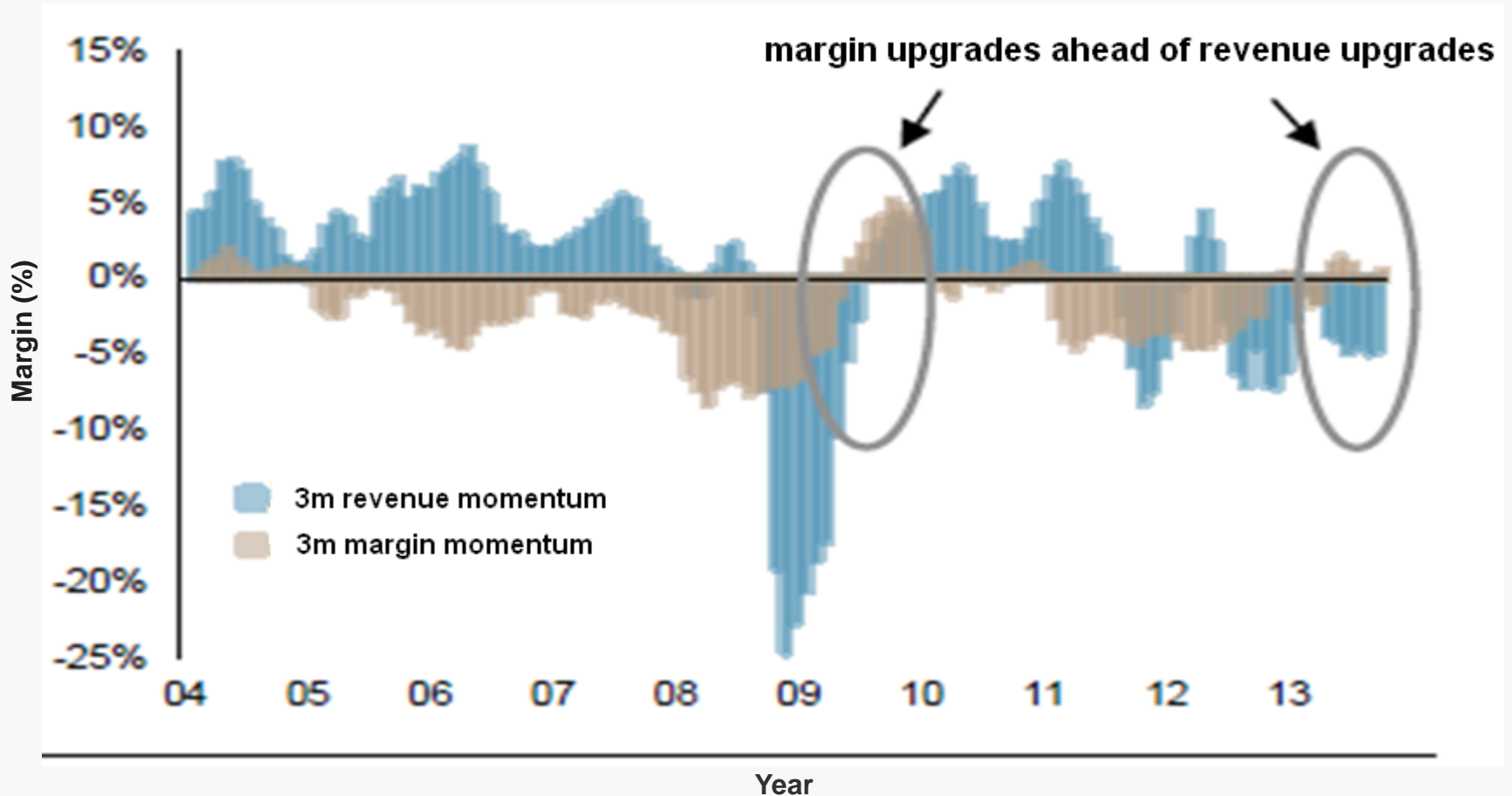
- Will there be a revenue revival
- What about capex?
- Further margin expansion?

Will margins expand again in 2014?

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| Region weight | | EBIT Margin | | What if? | |
|-------------------------|--------------|--------------|--------------|--------------|--|
| By revenues | | 2013e | 2014e | | |
| 30% | USA | 12.5% | 13.4% | 13.1% | EBIT margins return to peak levels |
| 26% | Europe ex-UK | 10.4% | 11.1% | 11.2% | EBIT margins expand half way back to peak (12.1%) |
| 18% | GEM | 9.6% | 10.0% | 10.3% | 75bp margin expansion (2007-12 avg 13.0%) |
| 16% | UK | 11.9% | 13.3% | 13.4% | 150bp EBIT margin expansion (2007-12 avg 14.2%) |
| 7% | Japan | 6.5% | 7.1% | 7.1% | EBIT margin to expand half way back to peak (7.7%) |
| 4% | RoW | 9.6% | 11,7% | 11.6% | 200bp EBIT margin expansion |
| 100% | World | 10.8% | 11.7% | 11.7% | = 90bp global |
| margin expansion | | | | | |

Global revenue vs. market momentum

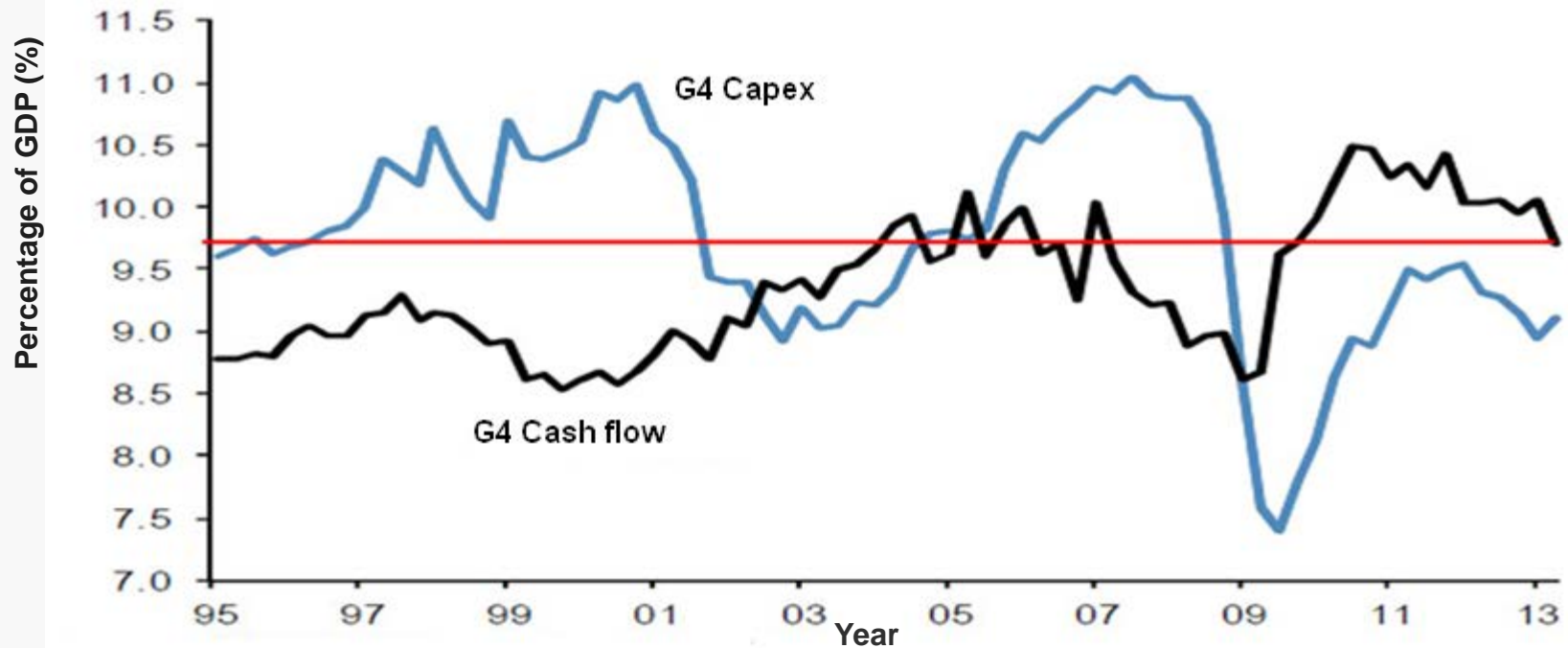


Source: IBES, Thomson Datastream, UBS Global Equity Strategy

“Show me the (lack of) money”

G4 non-financial corporate capex and cash flow as % of GDP

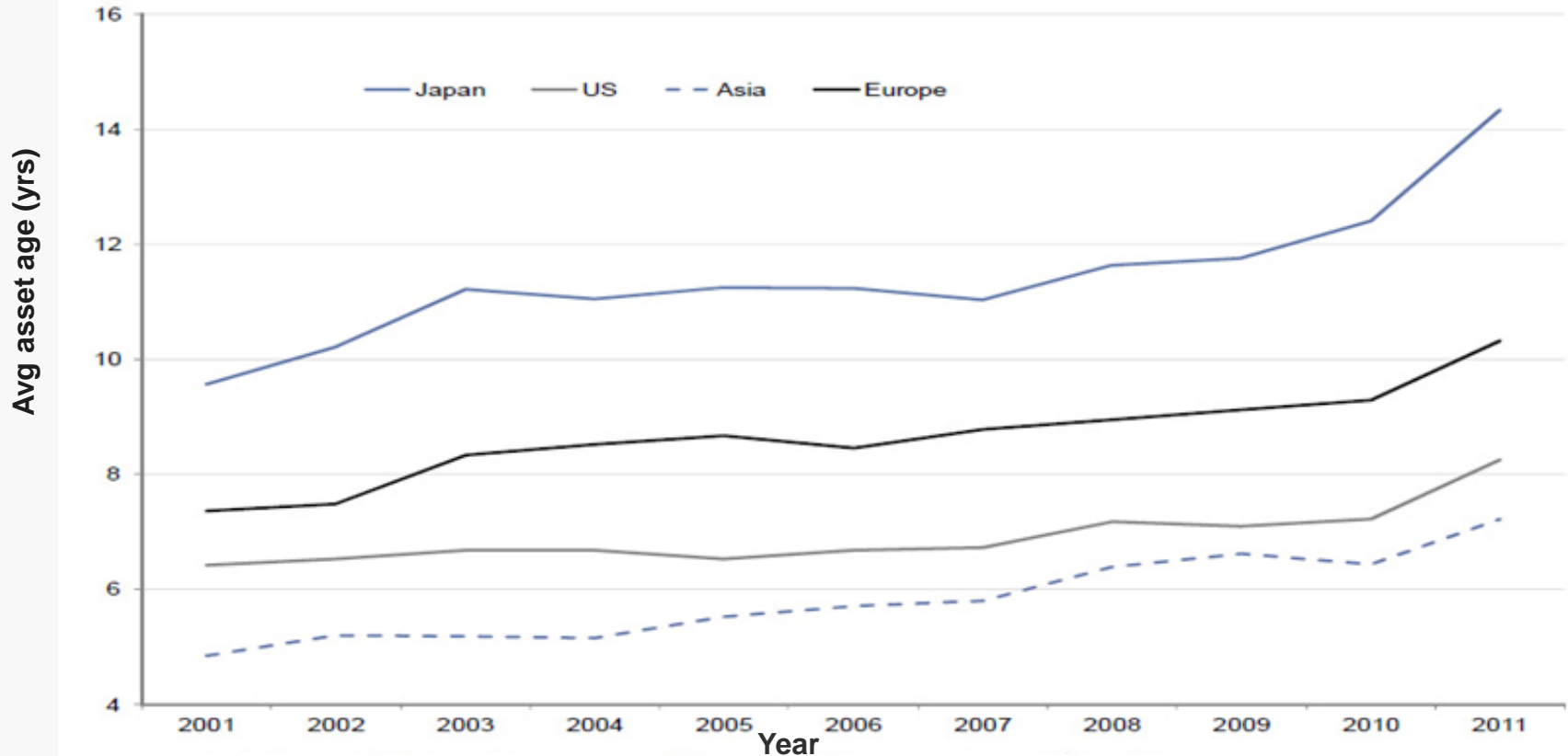
% of GDP, G4 includes the US, the UK, the Euro area and Japan. Last observation as of Q2 2013.



Source: ECB, BOJ, BOE, Federal Reserve flow of funds

Land of the rising asset age

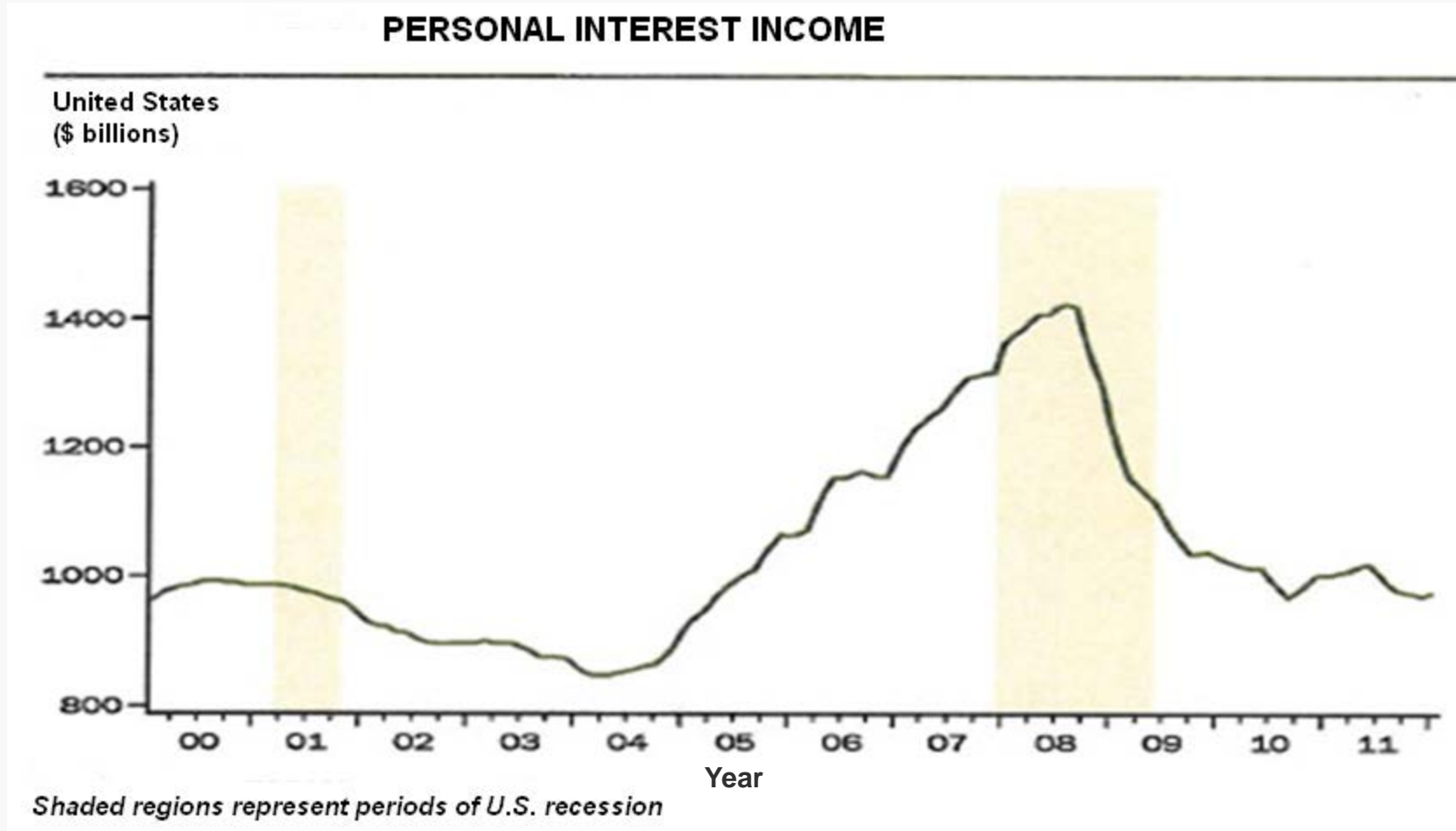
Land of the rising asset age
Average asset age, in years



Source: Goldman Sachs Research estimates, Datastream

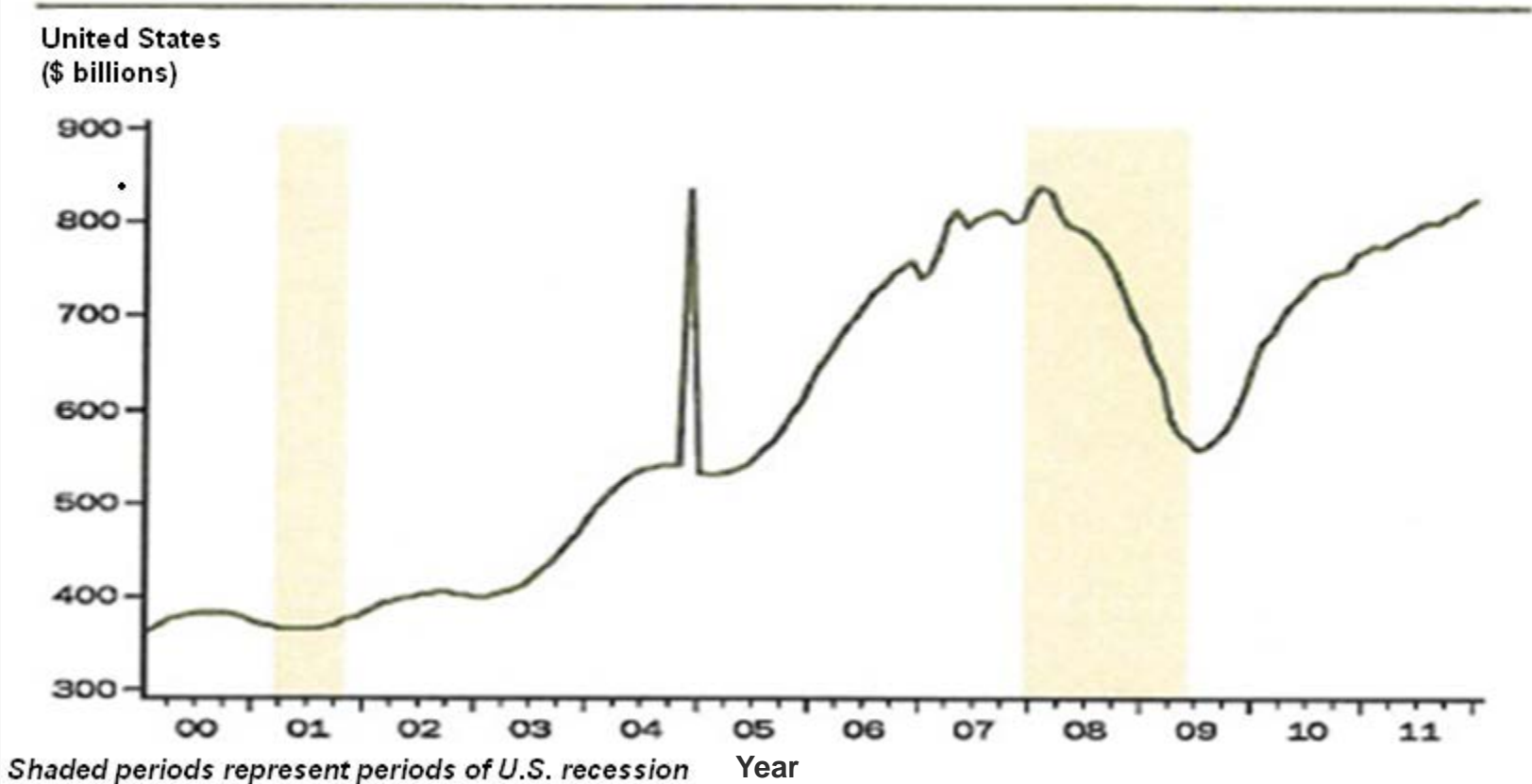
Personal interest income is falling

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Source: Haver Analytics, Gluskin Sheff

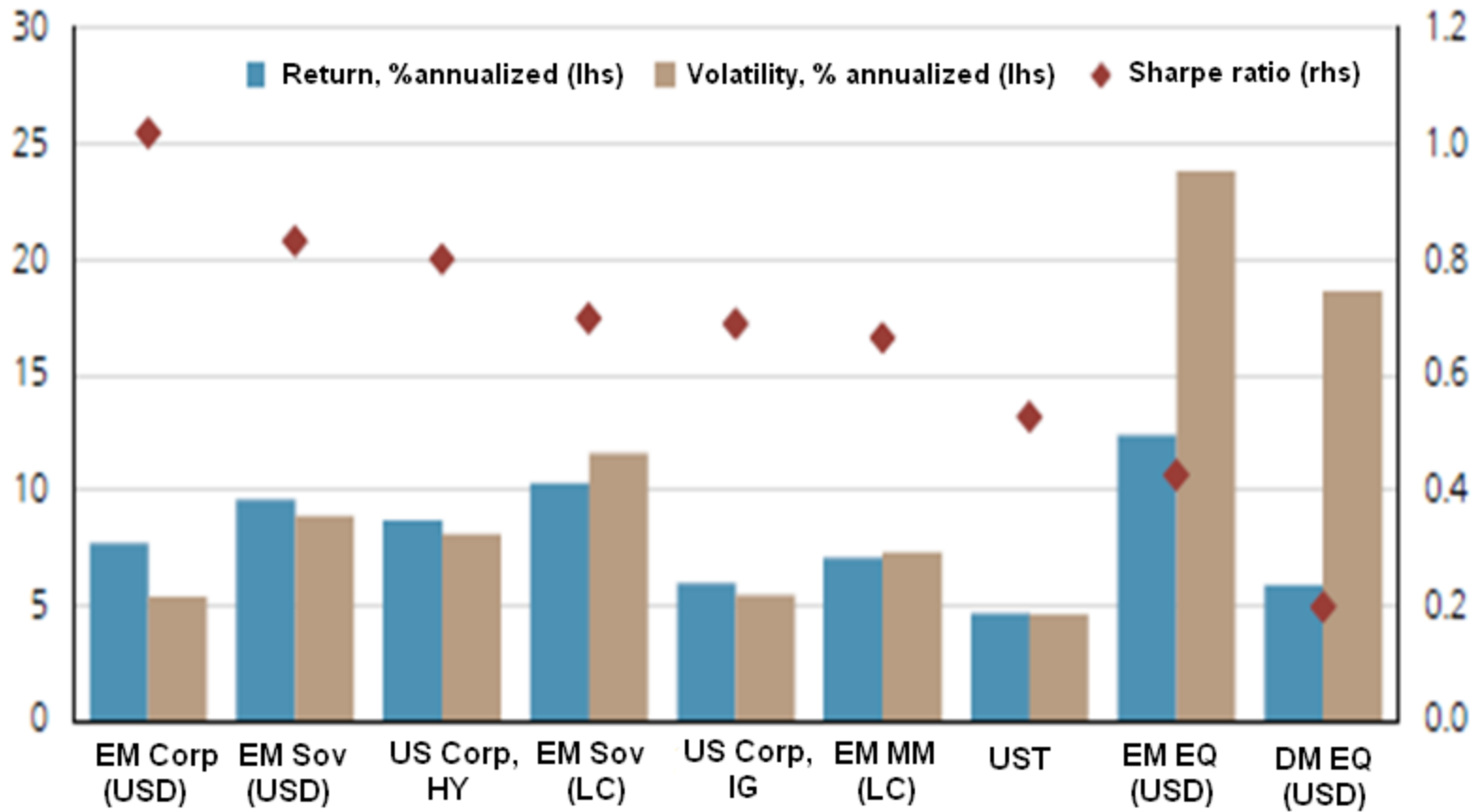
PERSONAL DIVIDEND INCOME



Source: Haver Analytics, Gluskin Sheff

Another challenging year for emerging markets?

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Source: Datastream, Bloomberg, UBS estimates

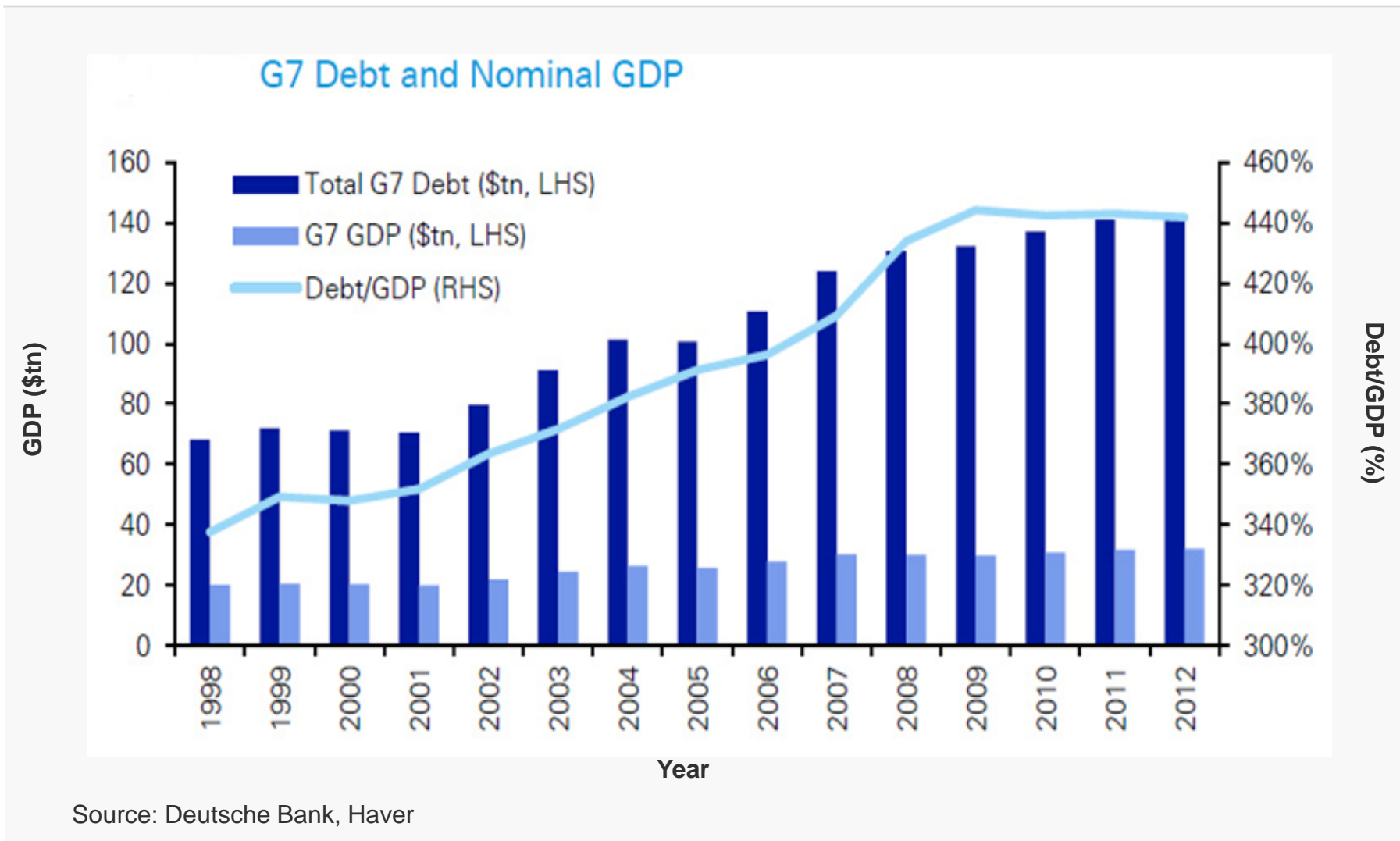
Global FX forecasts

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| | Latest | Dec 2014 | Dec 2015 |
|-------------|---------------|-----------------|-----------------|
| EUR/USD | 1.35 | 1.25 | 1.20 |
| USD/JPY | 98.5 | 110 | 115 |
| USD/RMB | 6.09 | 6.10 | 6.10 |
| EUR/JPY | 133 | 137.5 | 138 |
| GBP/USD | 1.61 | 1.55 | 1.60 |
| EUR/GBP | 0.84 | 0.81 | 0.75 |
| Brent Crude | \$107pb | \$100pb | \$95pb |
| Gold | \$1280oz | \$1200oz | \$1150oz |

Five years on: \$18 of debt for every \$1 of GDP growth

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What could surprise in 2014?

- Treasury market collapse
- Market accident in EM debt
- ECB Asset Quality Review proves disruptive
- Chinese credit burst
- Japanese yen plunge
- Delayed surge in M&A
- Pension funds pressured by losses on bond holdings
- Gold price down to three-digits
- EM equity surge
- Geopolitical risk

- Base Case foresees a slow return to macroeconomic normality (60% probability)
- Sub trend growth and sub trend inflation
- Monetary policy to remain highly accommodative
- Corporate margins can grow, underpinning an earnings improvement
- Muted fixed interest returns at best
- Positive returns from equities, but not as good as 2013
- Core focus remains on DM equities over EM
- Bull Case: Growth emerges stronger than expected (10% probability)
- Bear Case: Growth is weaker than expected / Fed exits (tapers) QE (30% probability)

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