Charles Stanley

Outlook 2015: An investor's journey through Wonderland

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University of the West of England, Thursday 27th November 2014

"Would you tell me please, which way I ought to go from here?"

"That depends a good deal on where you want to get to," said the Cat.

"I don't much care where, " said Alice.

"Then it doesn't matter which way you go," said the Cat.

"…so long as I get somewhere" Alice added as an explanation.

"Oh you're sure to do that" said the Cat, "if you only walk long enough".

Alice's Adventures in Wonderland, Lewis Carroll

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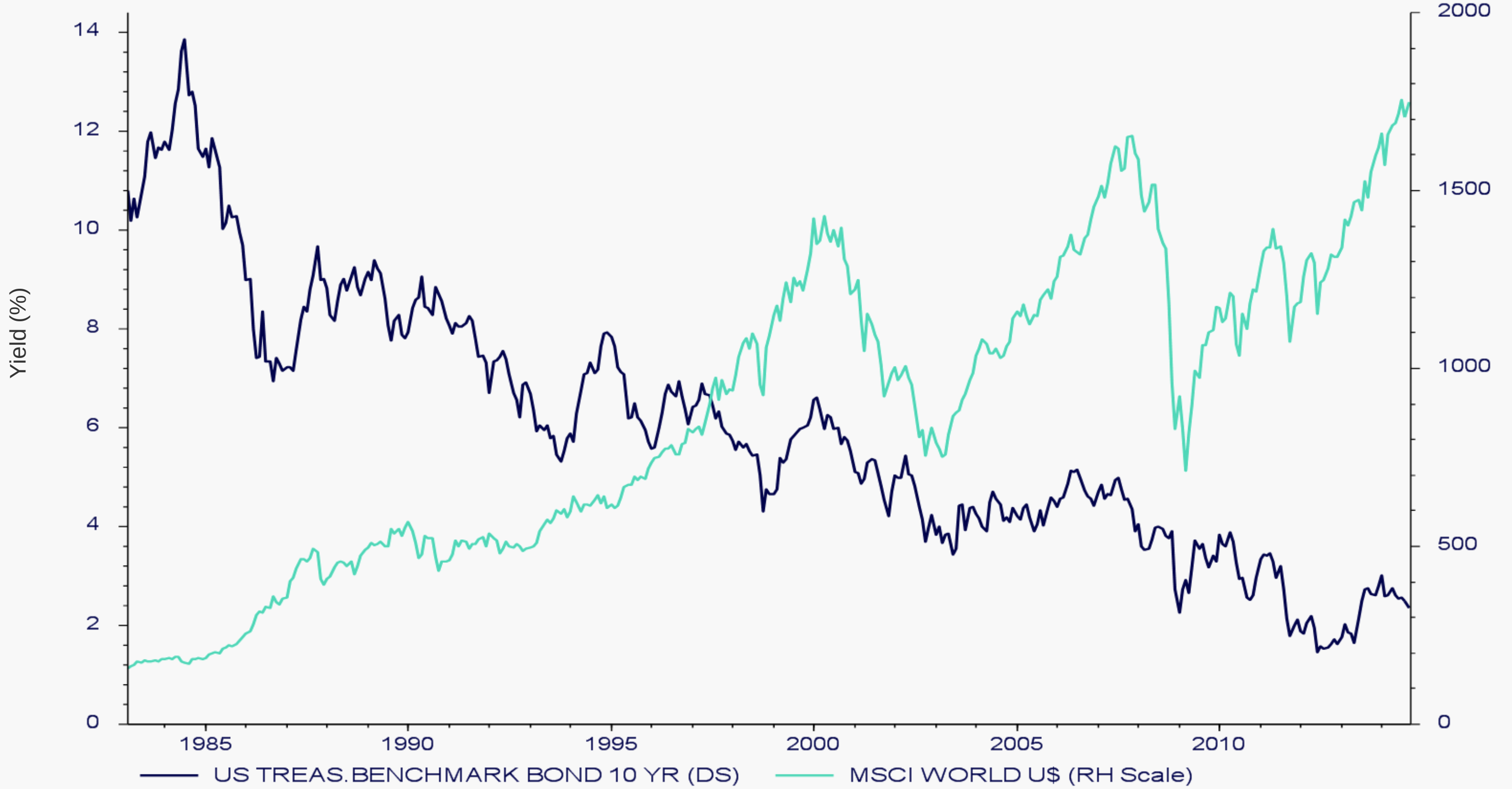
PART 1

Why we are where we are

What drives Western risk assets?

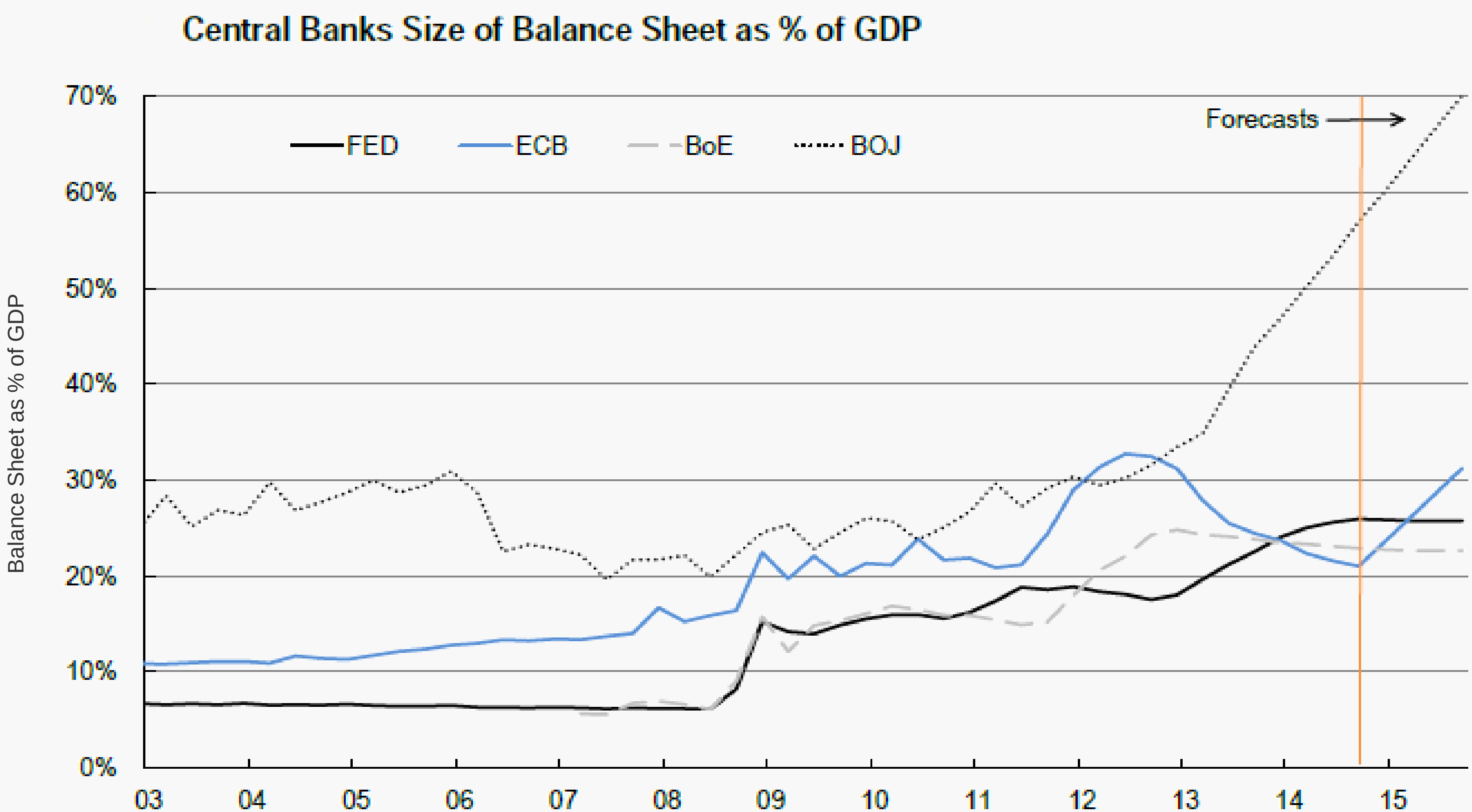
Source: Thomson Reuters Datastream

Life in the "New Normal"



Source: Thomson Reuters Datastream

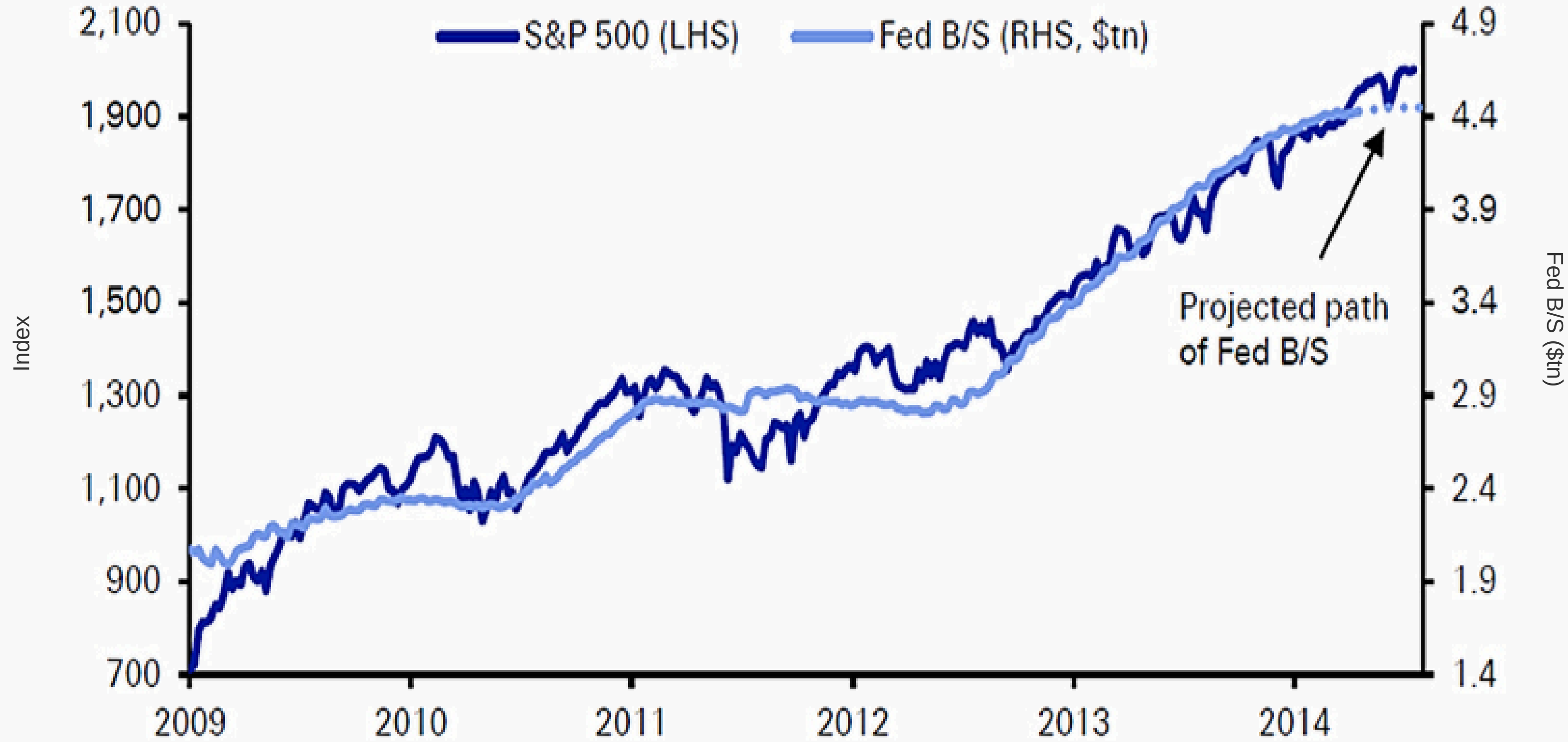
The pivotal role of central banks in one picture



Source: Haver, Citi Research

A stunning correlation

S&P 500 vs. Size of Fed Balance Sheet around 3 Months Advanced



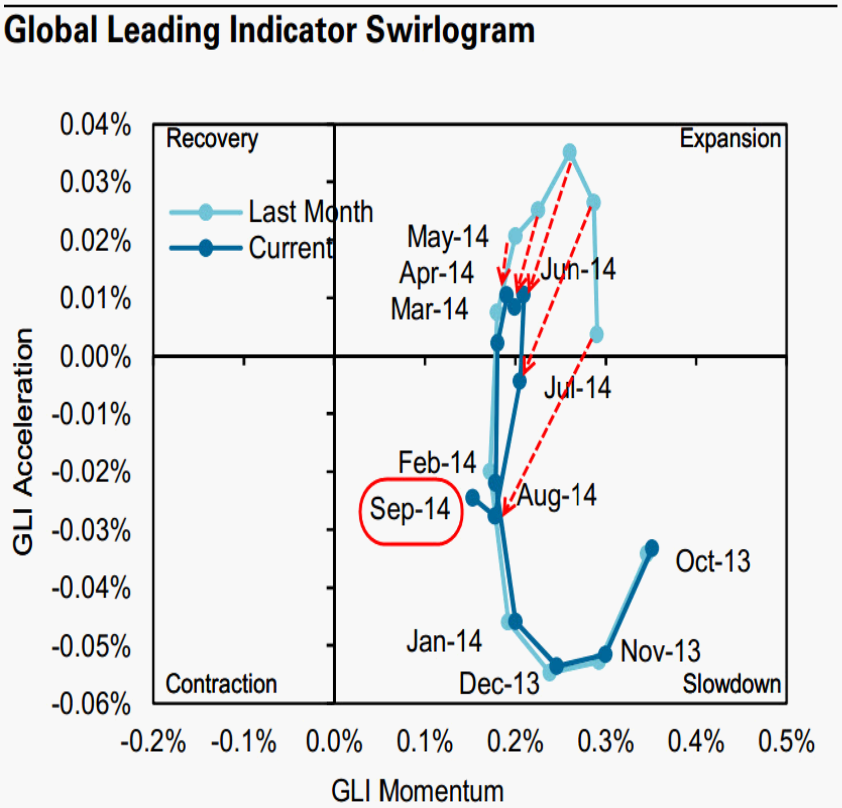
Source: Deutsche Bank, Bloomberg Finance LP

Scenario analysis – 2014 Base Case

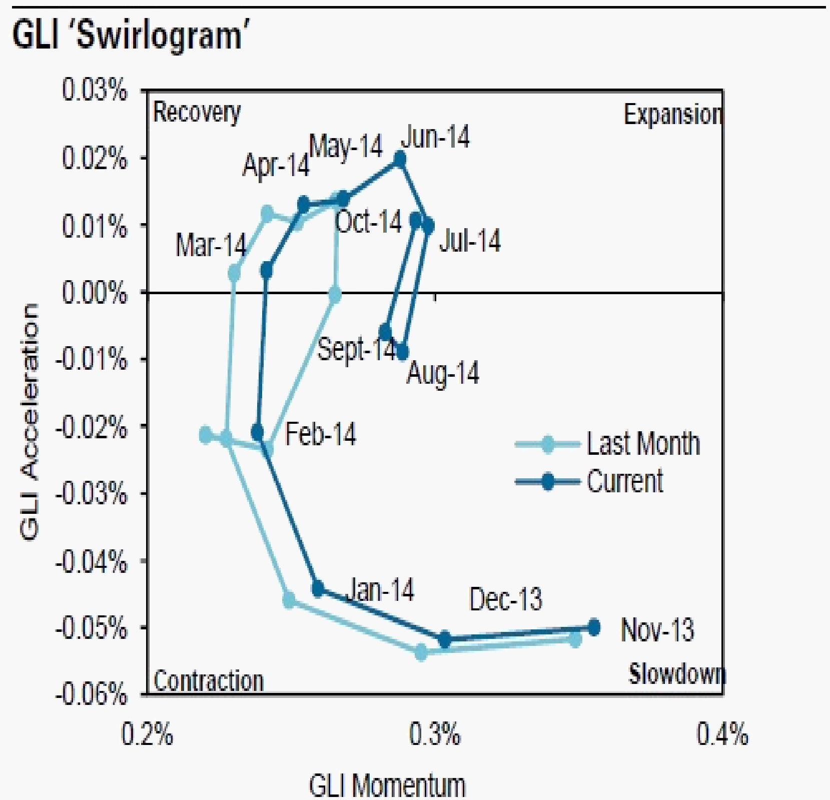
Scenario analysis – 2014 Base Case (60% probability)

- Global growth environment to accelerate but investors question stagnation in 2015
- US to muddle through its fiscal crisis
- Pace of developed economy growth to exceed that of emerging economies
- Inflationary pressure to remain quiescent
- Western developed economy base rates to remain anchored
- Concerns rise regarding timing of possible Fed tapering
- ECB activates "unconventional measures"
- Western developed ERP decline further on reduced fiscal headwinds but limited by absence of structural reform
- Developed equity multiples to make mild additional upside
- Corporate margins bottom out at Q4 / FY2013 results season
- Earnings expectations revive
- Dividends to grow by 6-7%
- "Quality" remains core but pro-cyclical risk may be added progressively

But, but impossible! Growth is slowing, not speeding up.



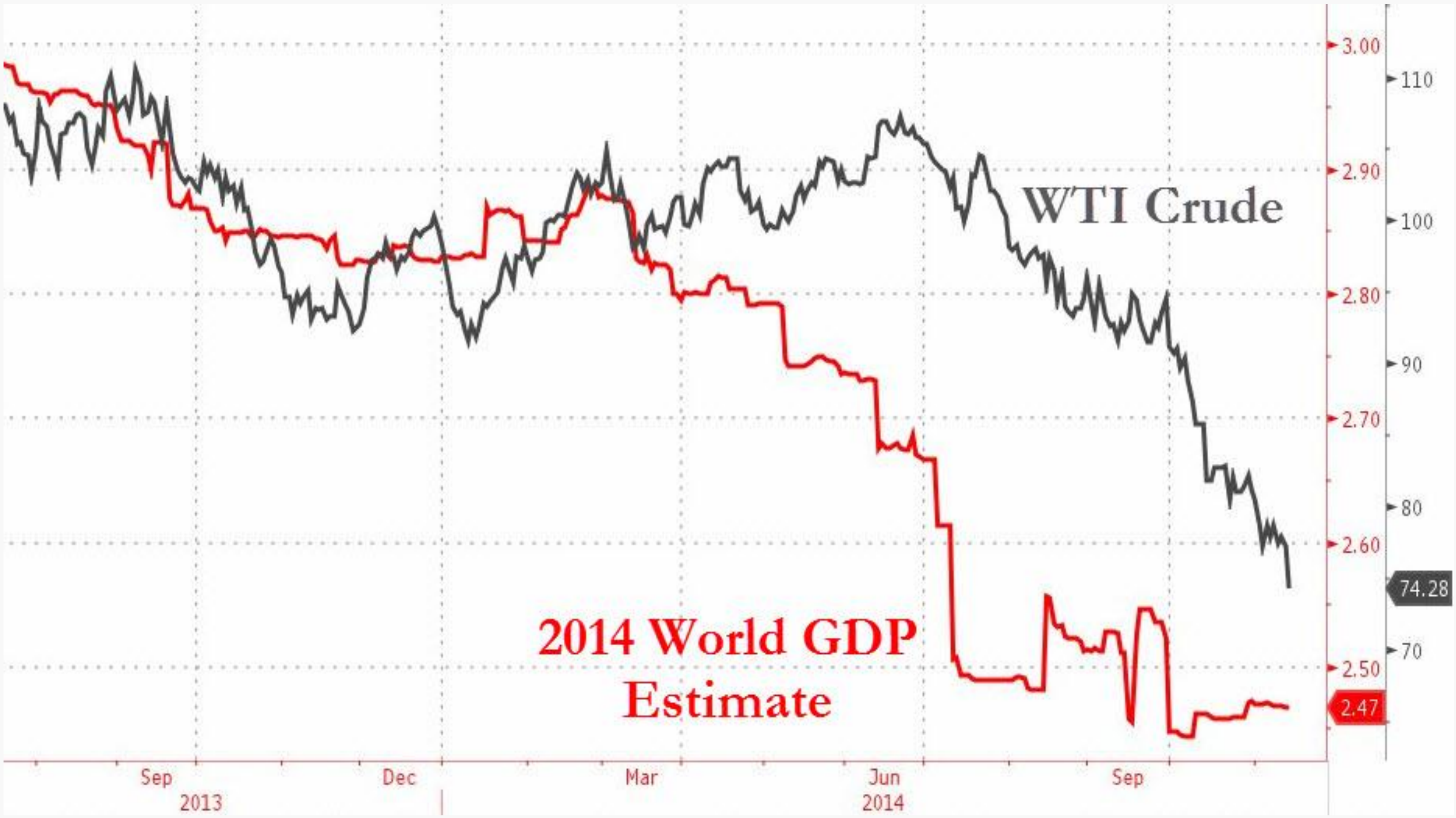
Source: Goldman Sachs Global Investment Research



See *Global Economics Paper 214* for methodology

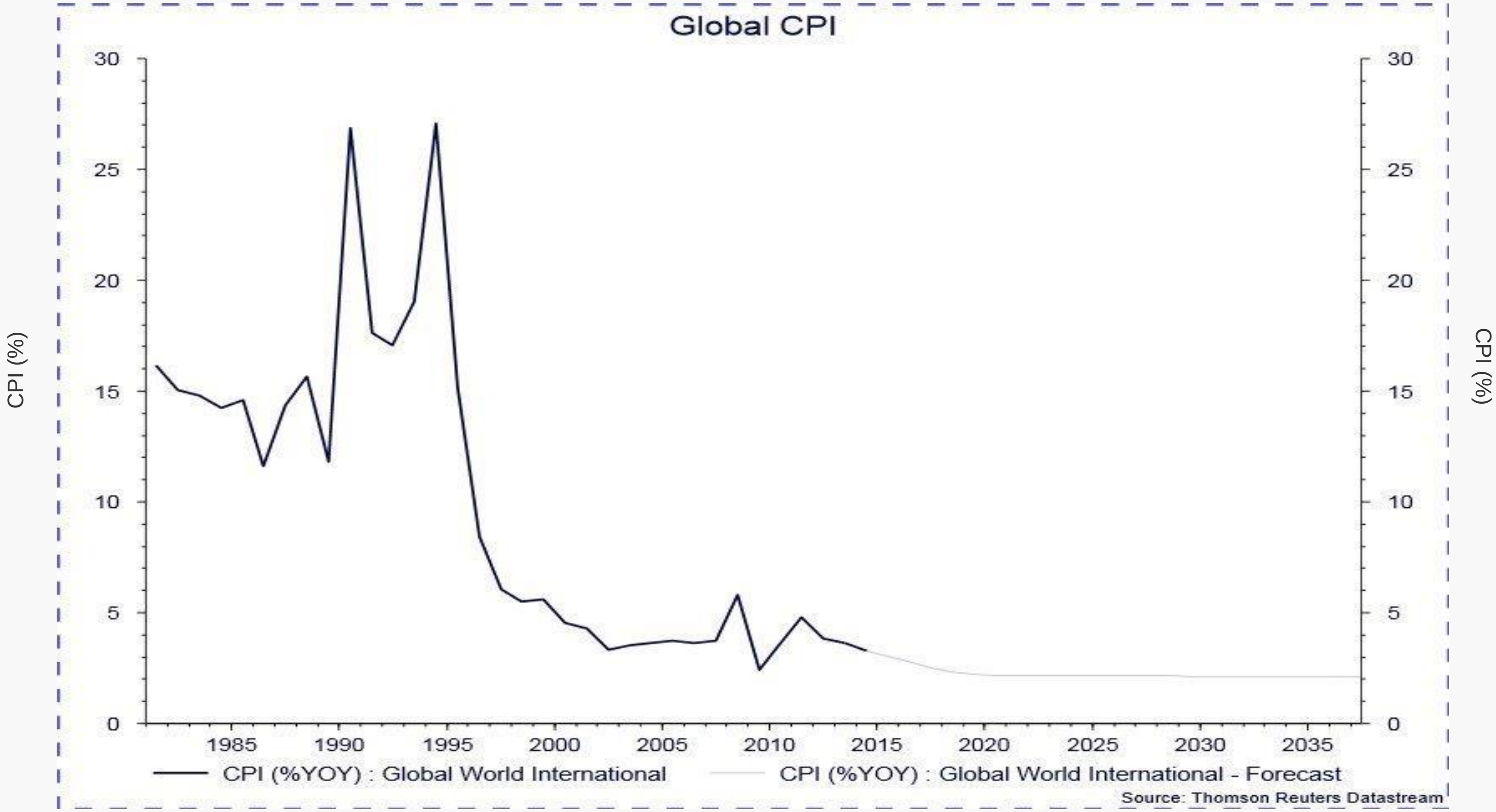
Source: OECD, Goldman Sachs Global Investment Research

Little by little investor expectations have been pared back



Source: Bloomberg

Overwhelming consensus. Inflation under control



What is the “New Normal”?

- The financial crisis and its aftermath
- The roots of deficient demand
- Why trend growth might be lower
- Why isn’t it the “Old Normal”?
    - Output still below 2008 levels and well below where it would have been
    - Short-term nominal interest rates are close to zero
    - Real bond yields are at zero or negative

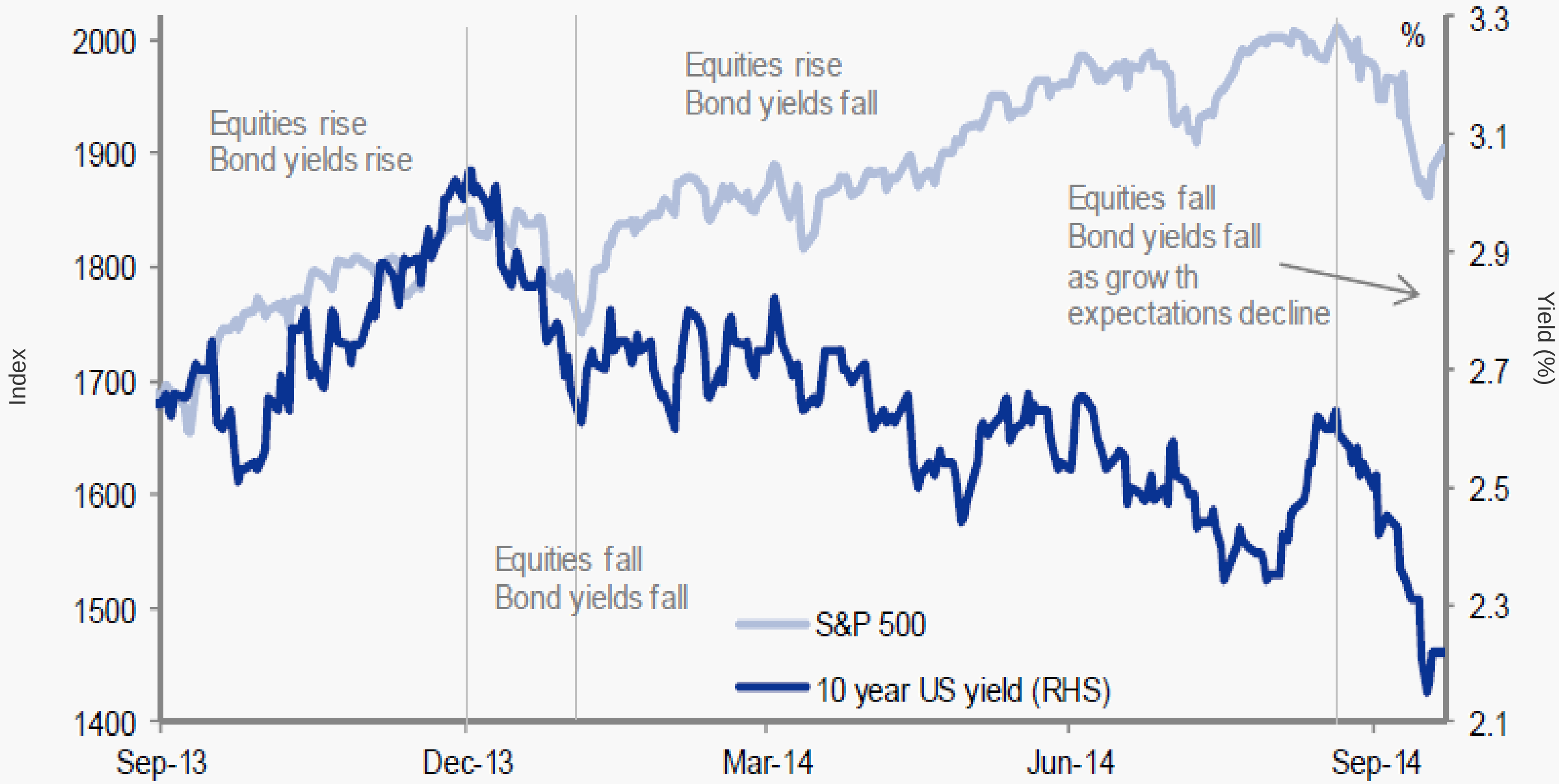
The "New Normal" in the next three years

- **The West is suffering from a chronic shortage of demand because**:
  - Over-saving in the rest of the world
  - Lack of investment
  - Fiscal tightening
  - The Eurozone crisis
- Against this backdrop growth will remain weak, unemployment high and inflation low or negative
- While headwinds persist, the peak level of interest rates is likely to be low: 3.0%-3.5%

Mad as a March Hare? Some stunning facts about the financial markets

- Since the low in the global equity market on 9 March 2009 the MSCI World Index has risen roughly 180% in total return terms, an annualised return of a remarkable 20%.
- 2013 was one of the strongest years on record for global stock markets with US stocks delivering absolute gains of 32%.
- Perhaps even more strikingly, bond markets have continued to perform strongly. Since the 2009 low in equities the JP Morgan Global Bond Index has risen 24%.
- Despite ongoing fears regarding the Eurozone and economic stagnation the EuroStoxx 600 Index has managed a 14% annualised return since its trough in mid-2012.
- The FTSE100 Index is still at levels recorded in 1997.
- EM equities have been weak, despite China's extraordinary growth. The Chinese equity market is some 60% below its 2007 peak.
- The collapse in government bond yields has triggered a historic search for yield. A US fixed income fund with 30% in Treasury bonds would need c.50% of its assets invested below BBB to generate a 4% return.
- The German bund market has an "equivalent P/E" of approx. 120x and the Corporate Bond Index 65x.
- Over 60% of companies in the Stoxx 600 Index have a dividend yield above the benchmark global corporate credit index (IBoxx). Less than 1 in 5 used to be in that position.

Equities or bonds? Only one can be right over the medium term



Source: Datastream, Goldman Sachs Global Investment Research.

Quo Vadis?

- **Secular Stagnation** **-30%**
- **Moderation** **- 60%**
- **“Normalisation”** **-10%**
- There are two likely medium-term scenarios emanating from a Moderation scenario
- **Outcome 1. Equity re-rating:** Backdrop favours risk assets but future return expectations are lower.
- **Outcome 2. Bond bubble bursts:** Any alteration in the interest rate outlook bursts the bond bubble. Significant threat given low risk premia priced into fixed income markets. A real risk that when the risk-free rate adjusts, liquidity across FI markets will disappear.

Source: Centre for Economic Policy Research

"If, when, why, what? How much have you got?"

Financial Crisis

- Oct 2007 – Mar 2009 Phase I: US housing / banks
  - Equities underperform bonds
- Feb 2011 – June 2012 Phase II: European banks / sovereign
  - Equities underperform bonds
  - Europe underperforms US
- May 2013 – Mar 2014 Phase III: EM
  - EM underperforms DM

Cross Roads to Recovery

Option I: Secular Stagnation

- Low returns
- Equities underperform bonds
- Low volatility

Option II: Great Moderation

- Equity valuations rise
- Bonds underperform equities
- Low volatility

Option III: New Growth Engine

- Equities rise
- Bonds fall

Leading to...

Equity Re-rating

- Equities rise
- Bonds stable

Bond Bubble Bursts

- Bonds collapse
- Equities fall (low returns)

What are the financial markets saying?

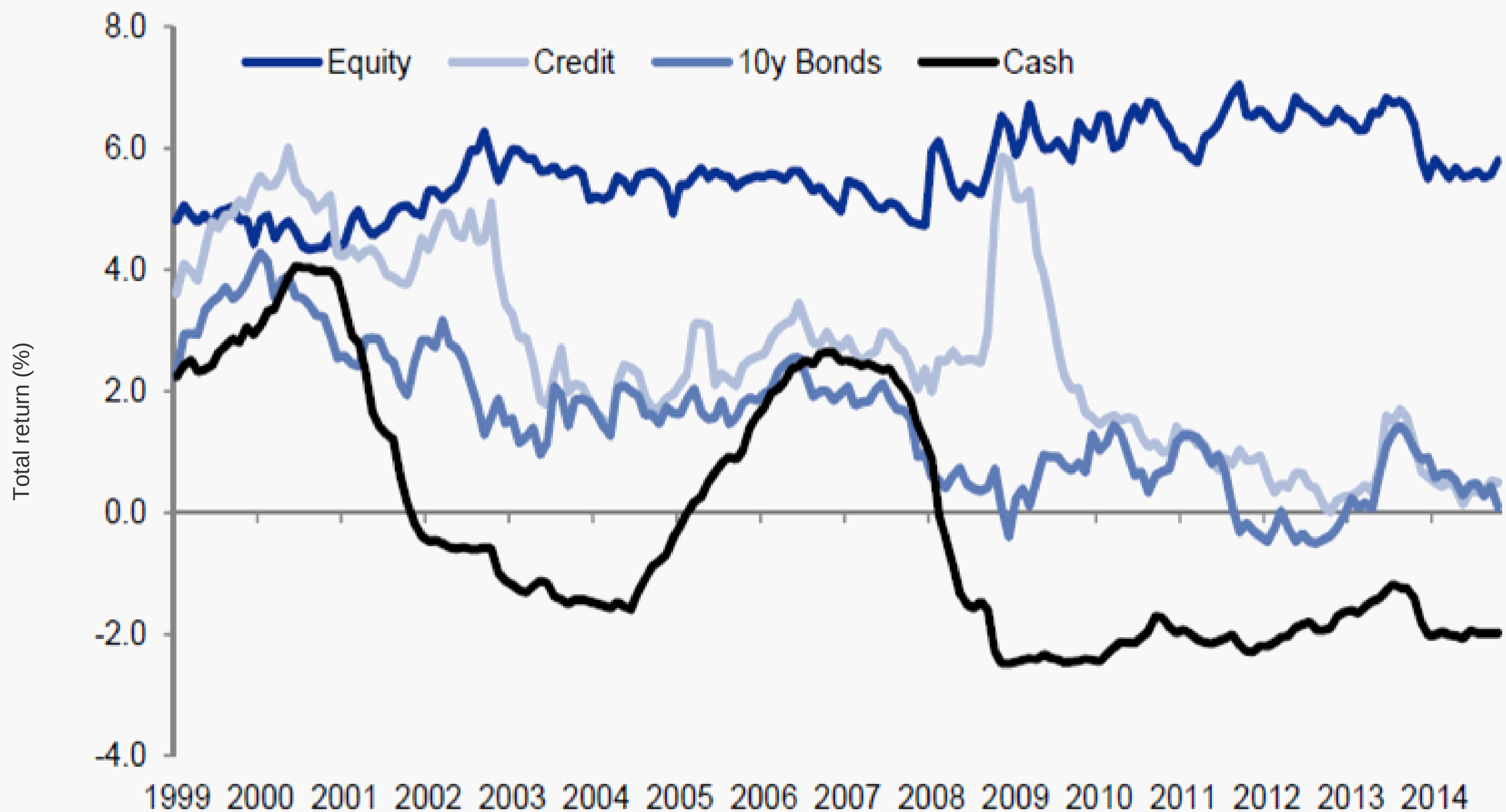
To assess which path the financial markets might take in the future it is important to try and establish which outcome is already priced in.

There is no perfect way of doing this but most analysis starts with the view that there has been a meaningful adjustment (lower) in both growth and inflation expectations. This shift in expectation is reflected in important moves in the market's required return, the risk premium.

Risk premiums and required returns

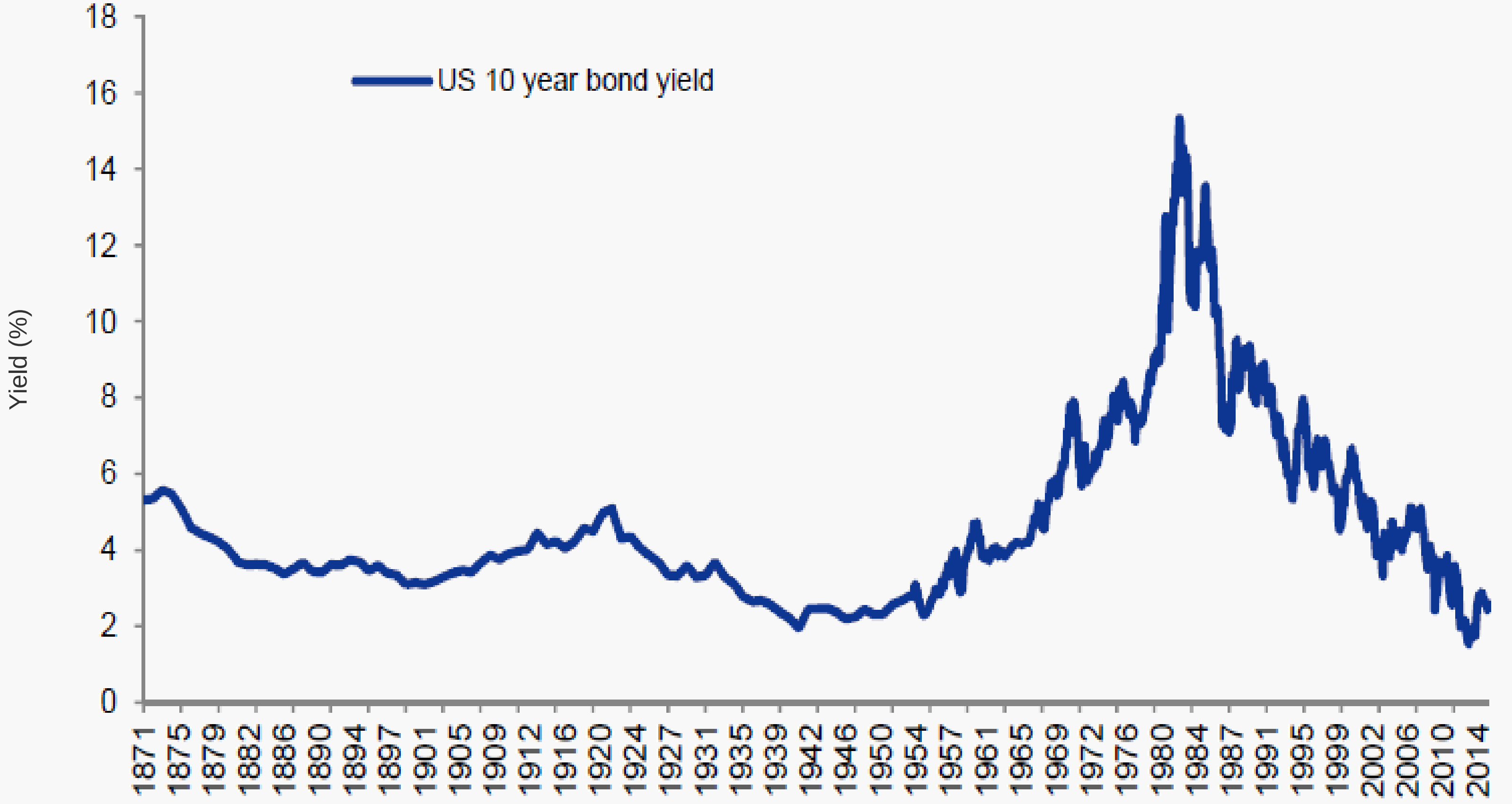
- A quick look at valuation and returns gives a sense of the risk premium investors are being offered.
- The difficulty with cross-asset comparisons.
- Cost of equity constant but expected returns have fallen across competing asset classes
- Investors are clearly demanding a stable and high yield in equities irrespective of the real yield in fixed income markets. This points to a loss of confidence in the growth outlook and is, perhaps, an argument in favour of stagnation.

US implied total return



Source: Datastream, Haver Analytics

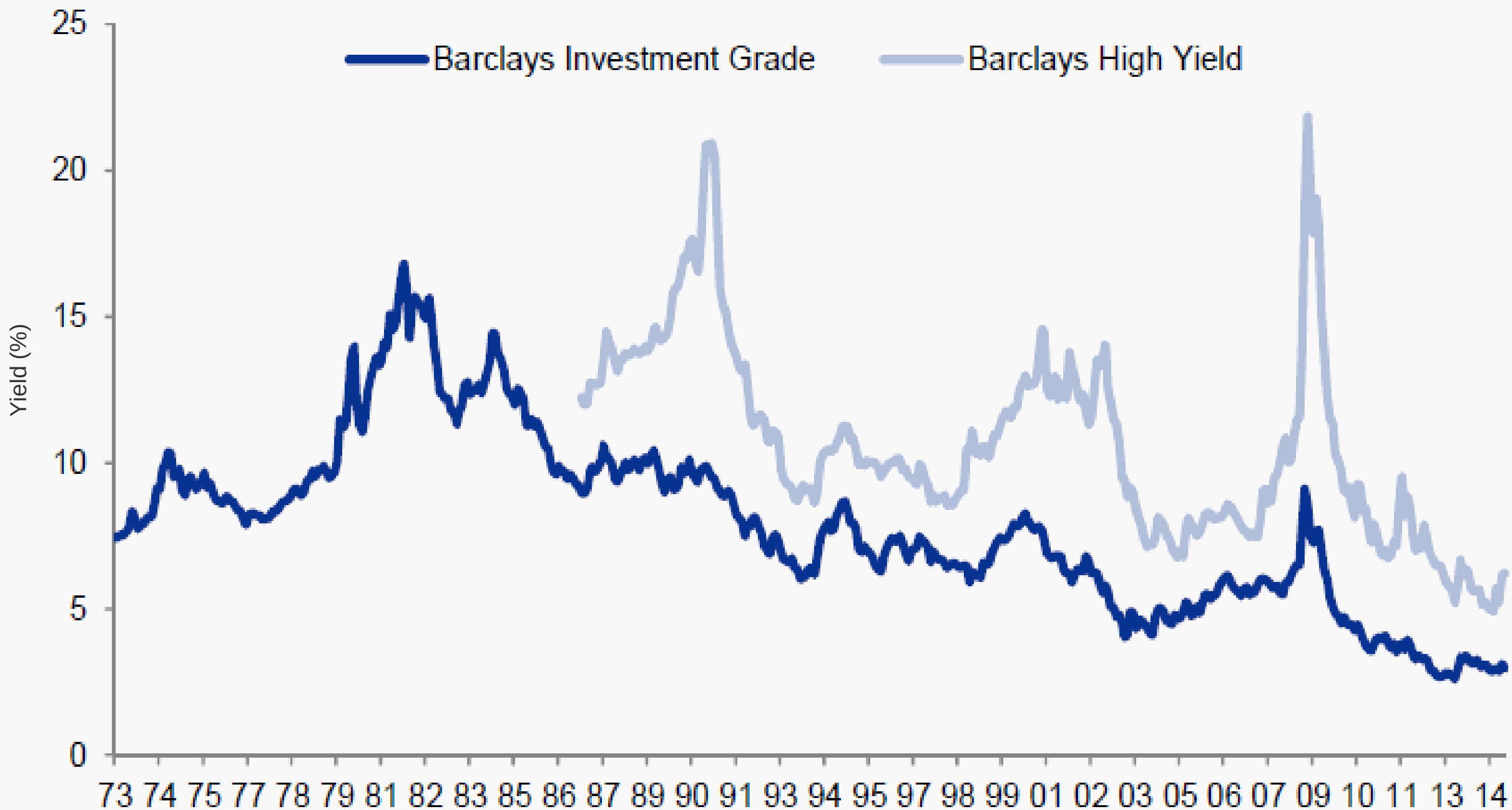
Bond market outlook 2015



Source: Robert Shiller data

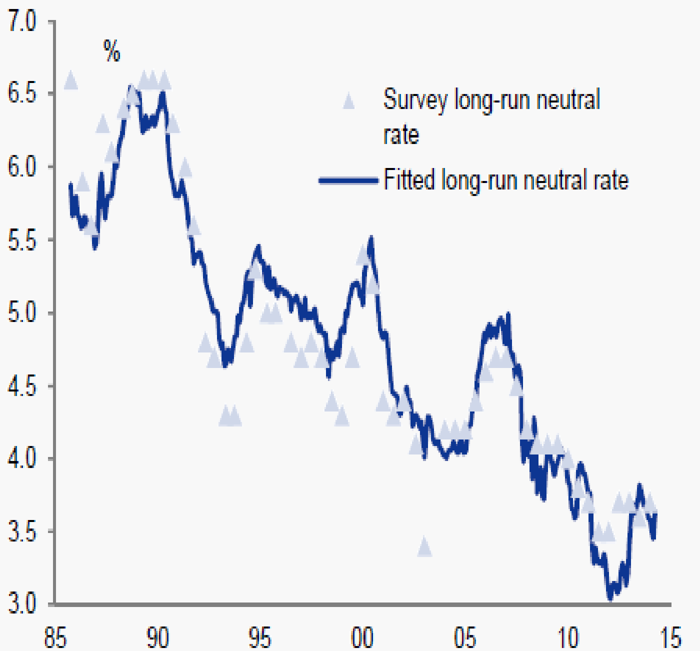
Corporate bond spreads have collapsed

The personal
investment service

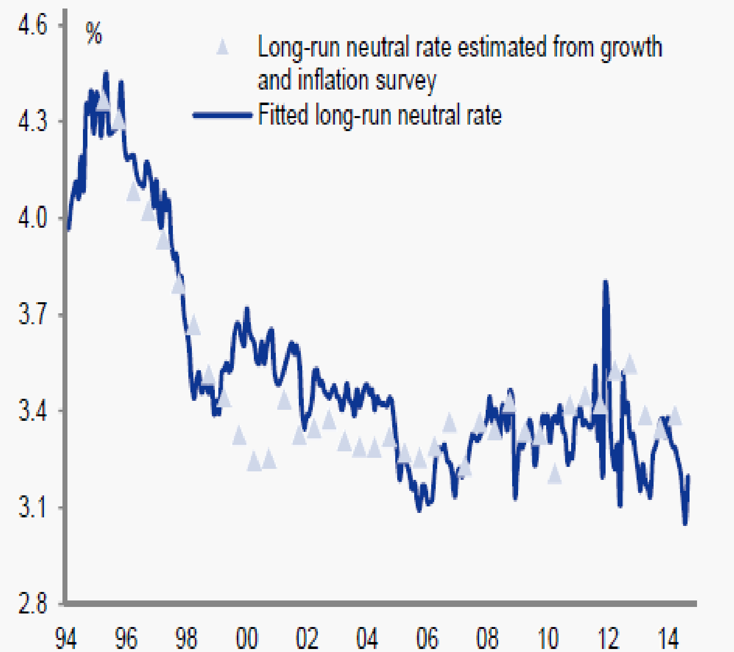


Source: Datastream

Shifting expectations for growth and inflation can be seen from the market's implied neutral rate



Source: Blue Chip Financial Forecasts, Goldman Sachs Global Investment Research.



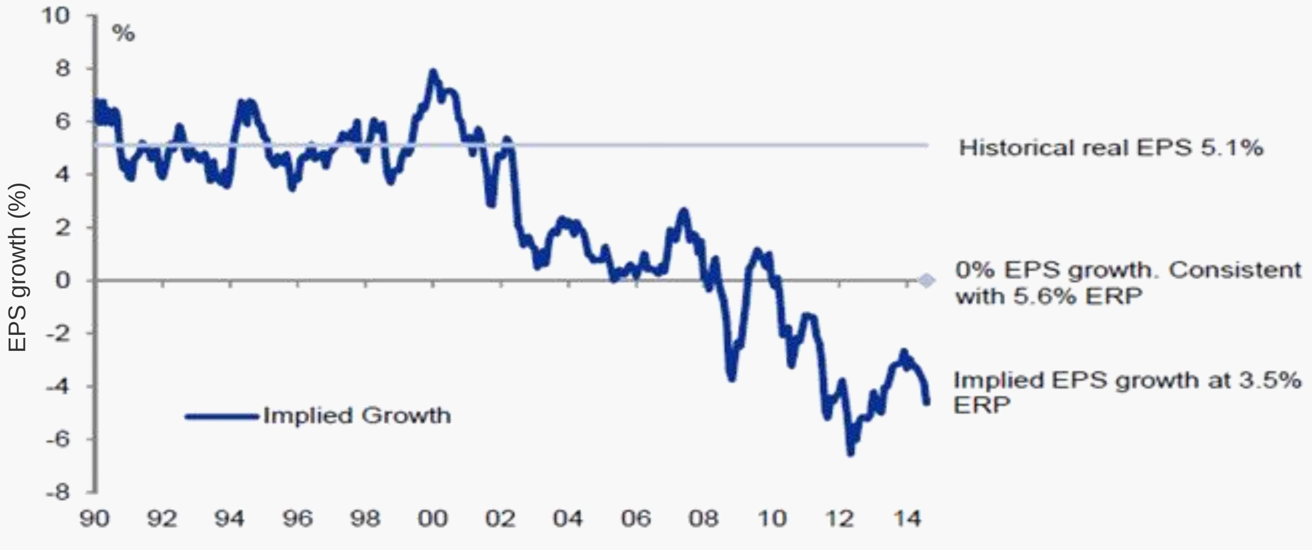
Source: Consensus Economics, Goldman Sachs Global Investment Research.

Equity market outlook 2015

What are stock markets pricing in?

- Just how much have falling growth and inflation expectations been priced into equities?
- The value of a dividend discount model
- Assumptions based on real world observations

We can use valuation to back-out implied growth expectations



Source: Datastream

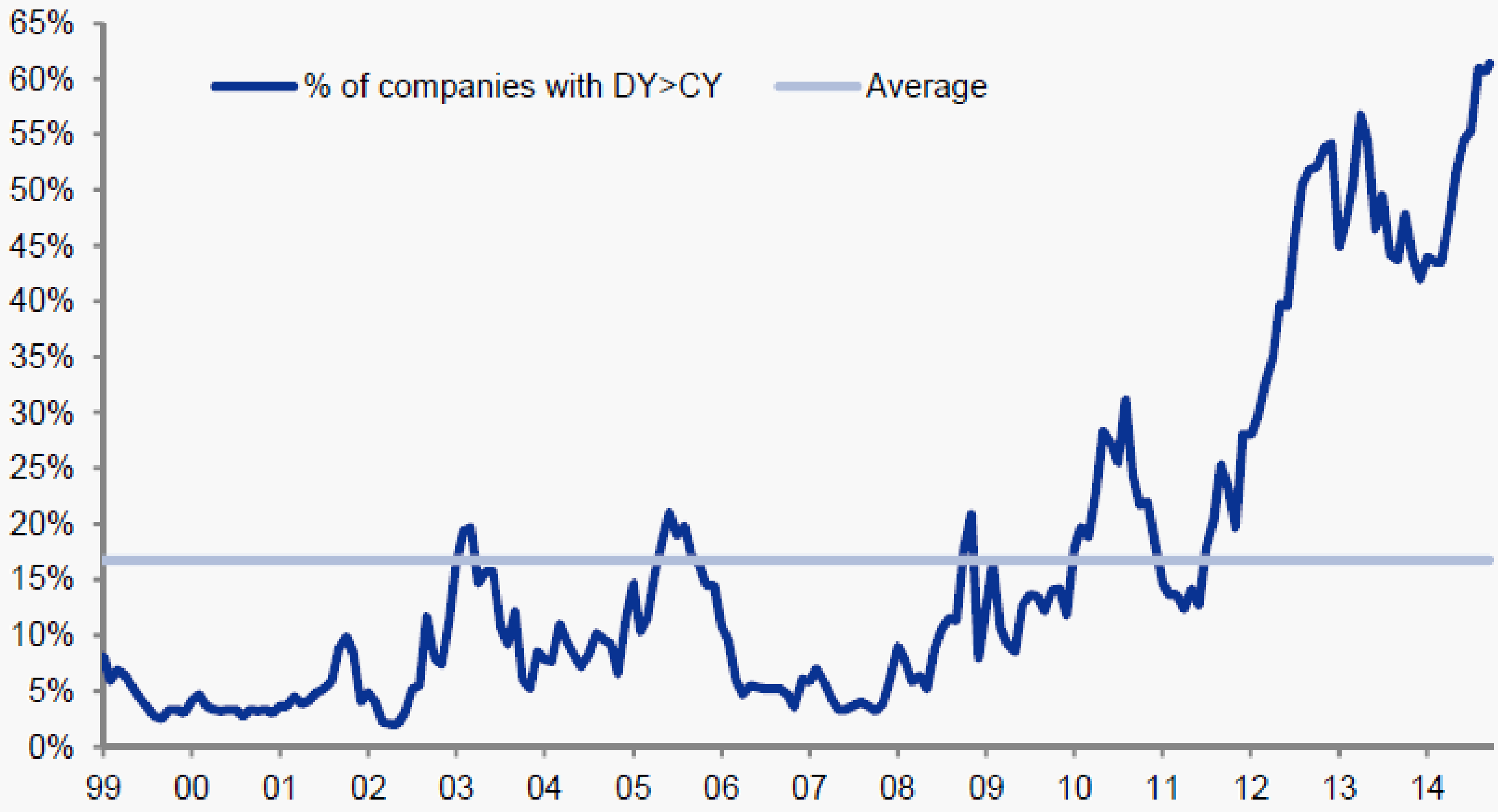
Cross check. How are investors positioned? Cyclicals V's Defensives

Relative rating

Relative rating

Source: Goldman Sachs Research

The quest for dividend income



Source: Datastream

PART 2

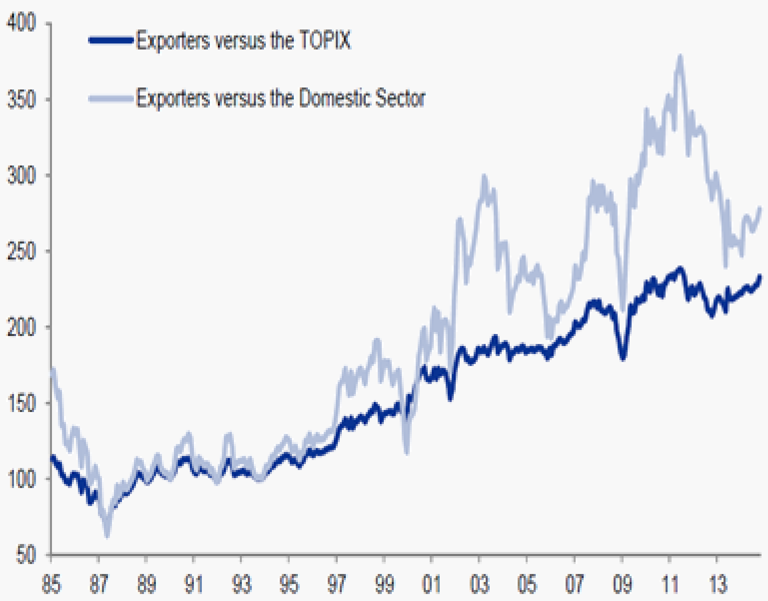
What investment strategy to employ under the varying potential pathways

Secular Stagnation scenario (30% probability)

- Japan provides the Blue Print but it is not alone.

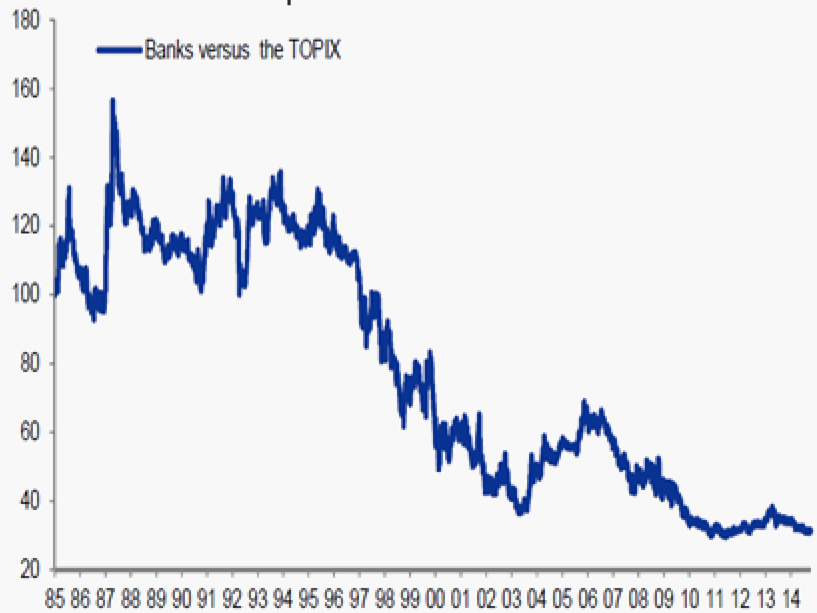
- Japanese equities were massively over valued in 1989 but inflation was low therefore some parallels may be relevant

1. Global exporters outperformed



Source: Datastream

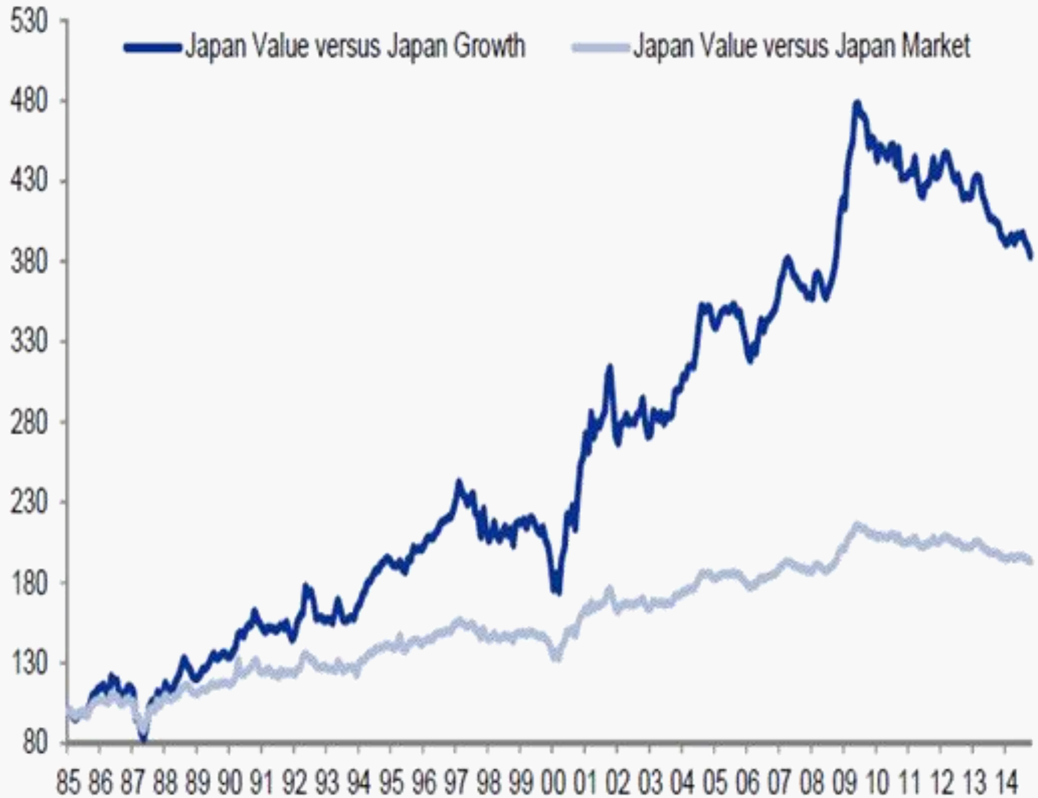
2. Banks underperformed



Source: Datastream

Secular Stagnation Cont'd…

Value investing worked during the Japanese stagnation period



Source: Datastream

What is value investing?

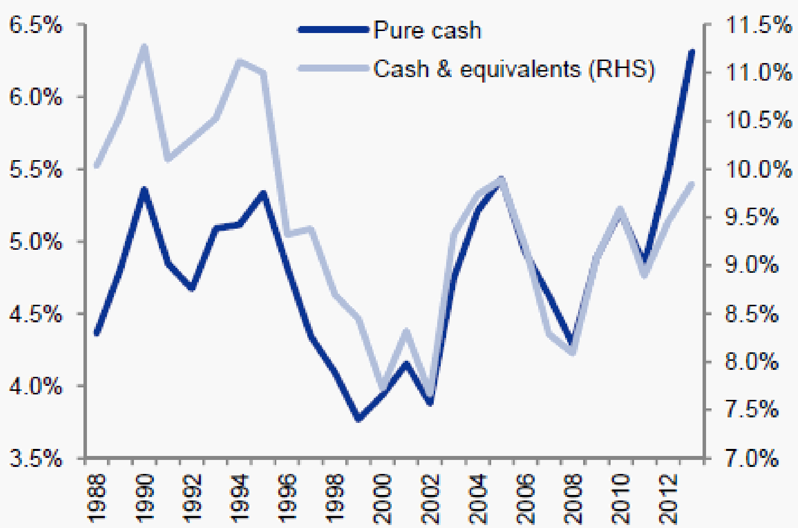
- Cyclically attractive yields (DY*G)
- Surplus Free Cash Flow Yield and strong balance sheet
- Strong earnings momentum
- De-equitisation participation

Further Moderation (60%)

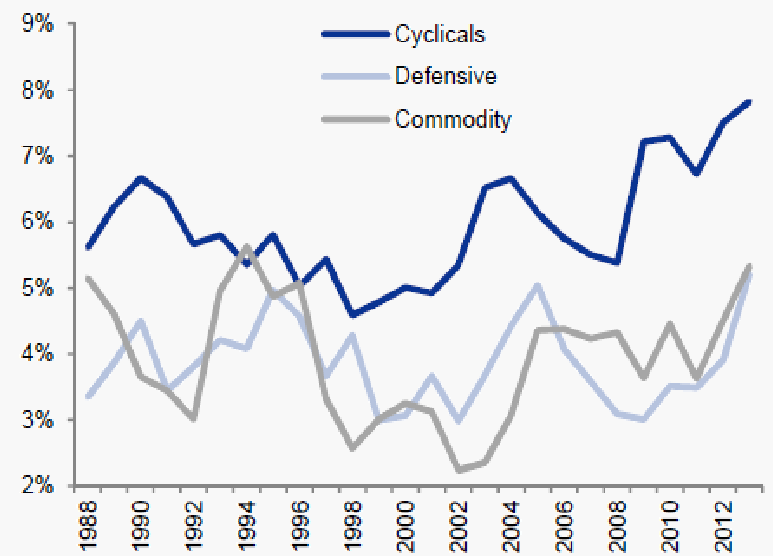
We believe that this is the most likely outcome going forward. There are two clear features on this landscape:

1. Income is scarce
2. Growth is scarce

The scarcity of economic growth opportunities has impacted on CFO decision-making

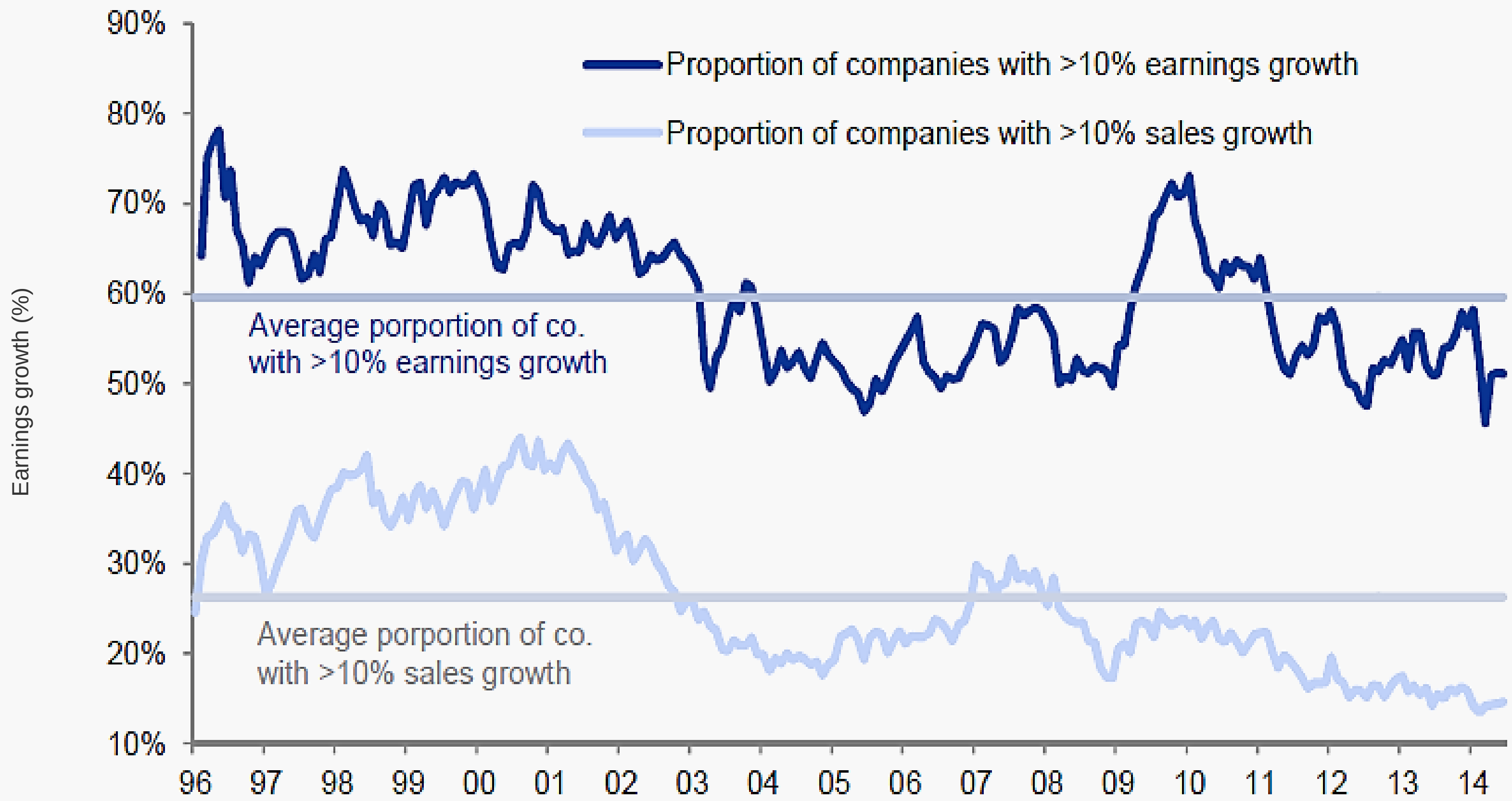


Source: Factset, Worldscope, Goldman Sachs Global Investment Research.



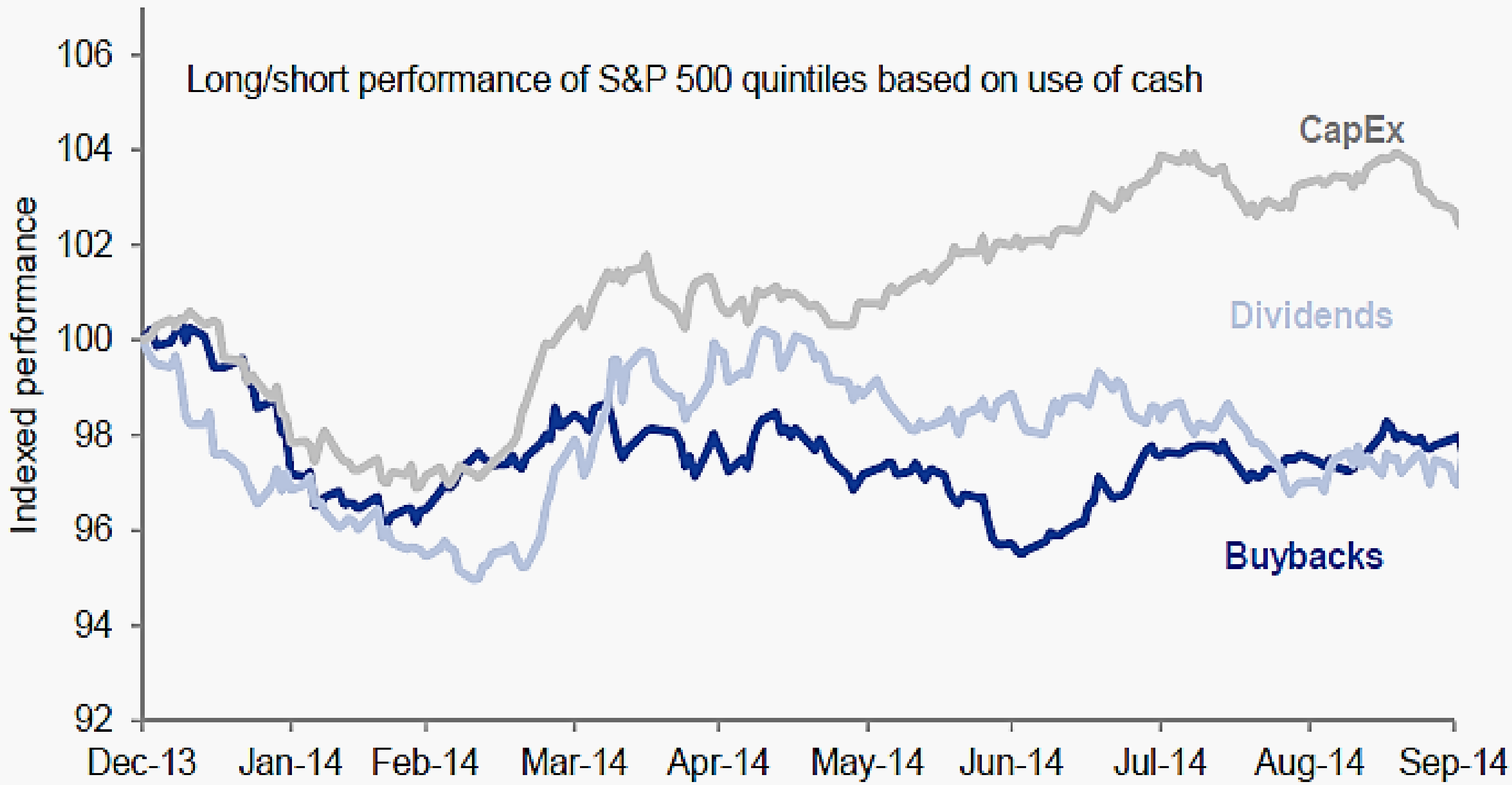
Source: Factset, Worldscope, Goldman Sachs Global Investment Research.

The one picture that confirms that growth has become highly prized by investors



Source: I/B/E/S via Datastream

US investors reward growth based on cash usage

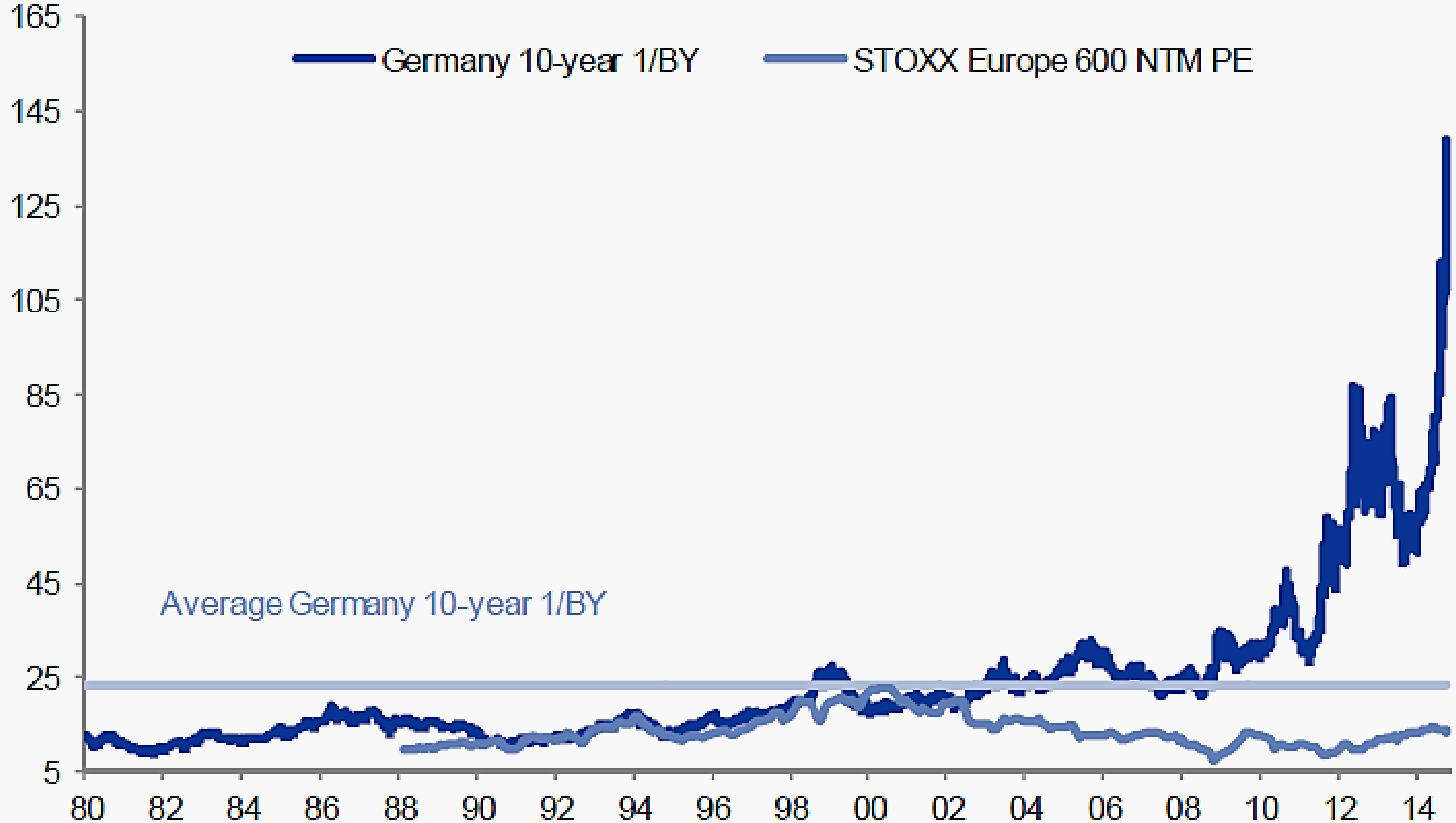


Source: Datastream

Investors should be aware that past performance is not necessarily a guide to the future and that the price of shares and other investments, and the income derived from them, may fall as well as rise and the amount realised may be less than their original sum.

The Scarcity of Income

What is the implied "effective" P/E multiple for government bonds?



Source: Datastream, Goldman Sachs Global Investment Research

What is the implied “effective” P/E multiple for corporate bonds?

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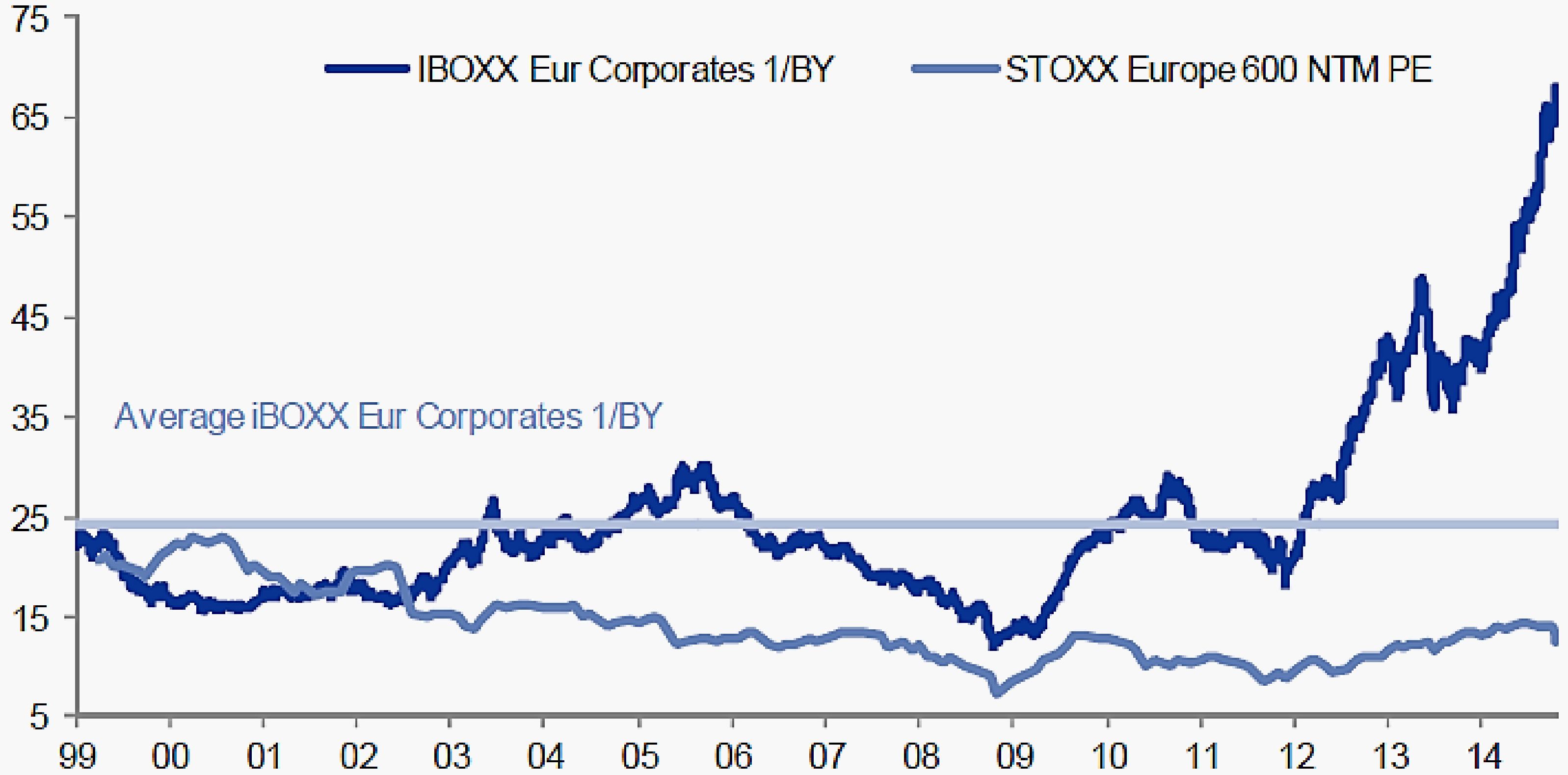
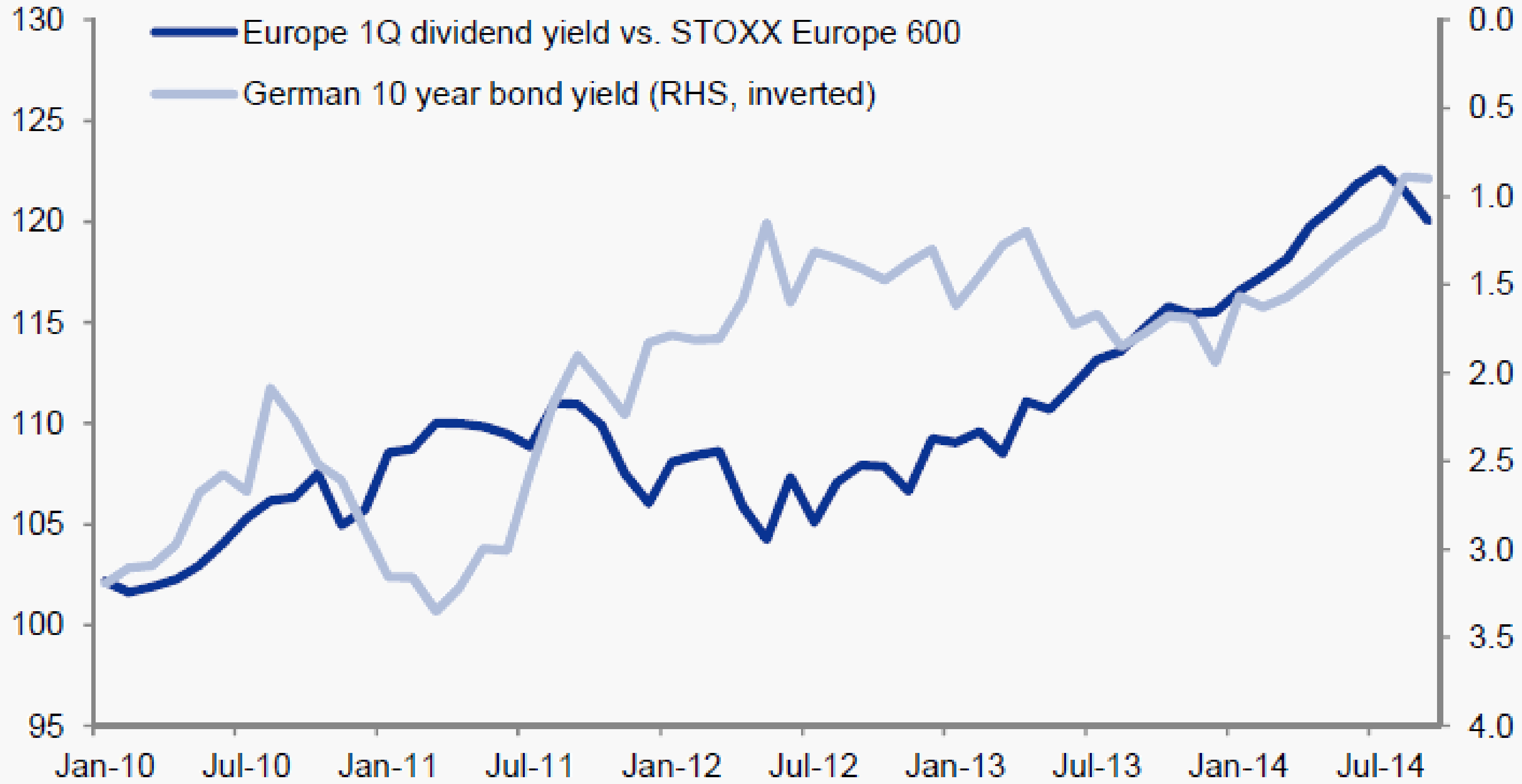


Source: Datastream, Goldman Sachs Global Investment Research

High yielding equities outperform as bond yields fall



Source: I/B/E/S via Datastream

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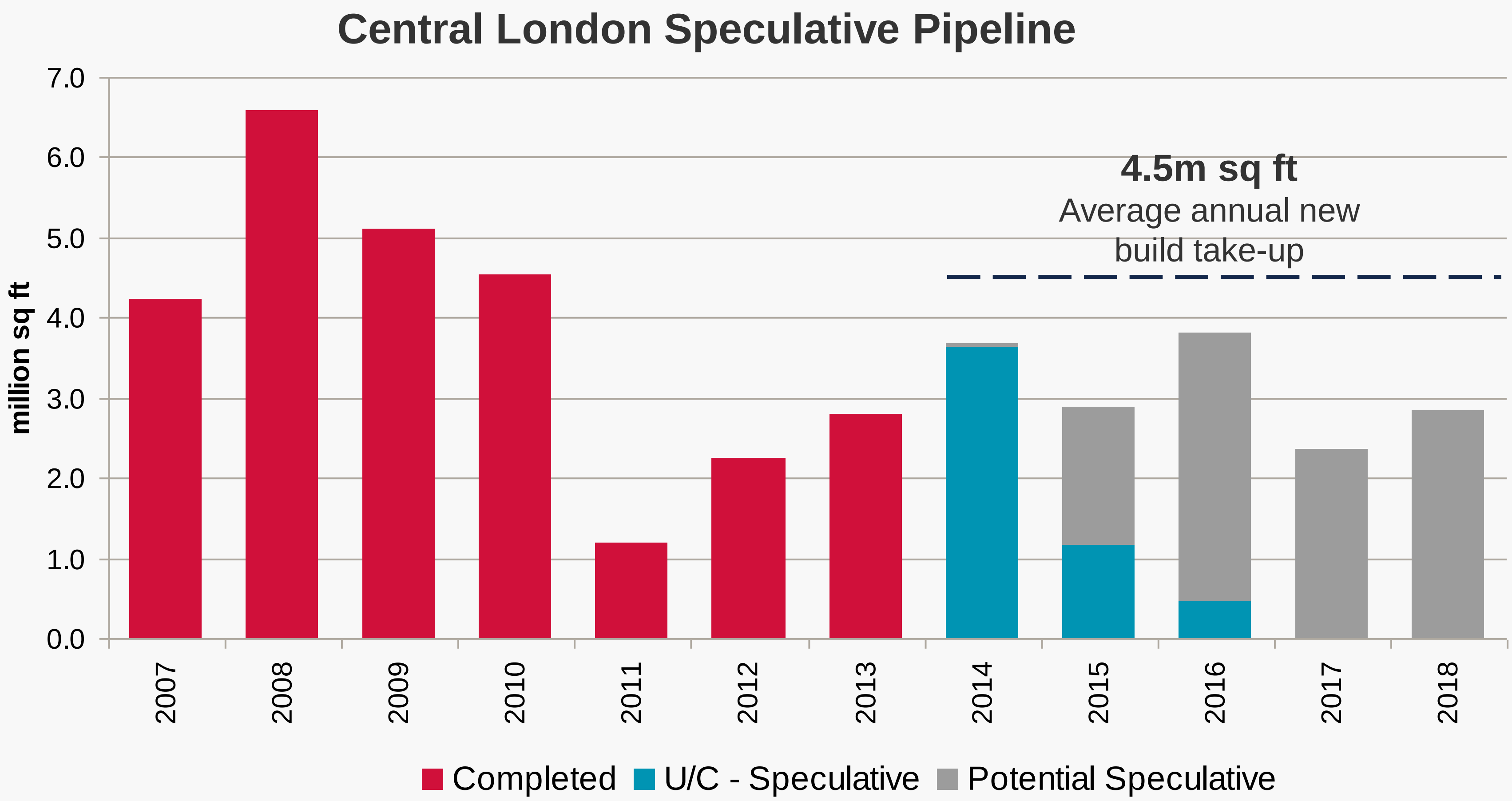
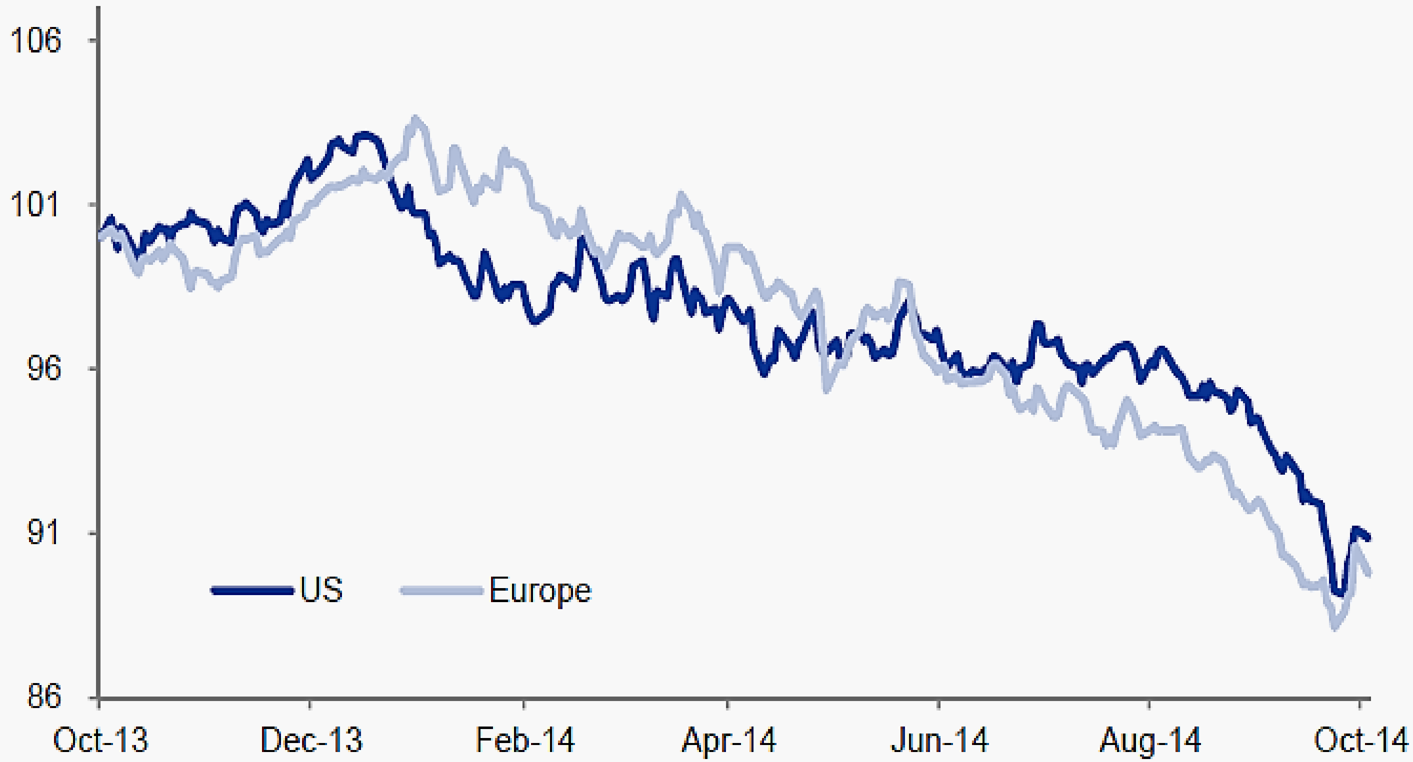
Property supported by a supply constrained market



Source: Knight Frank

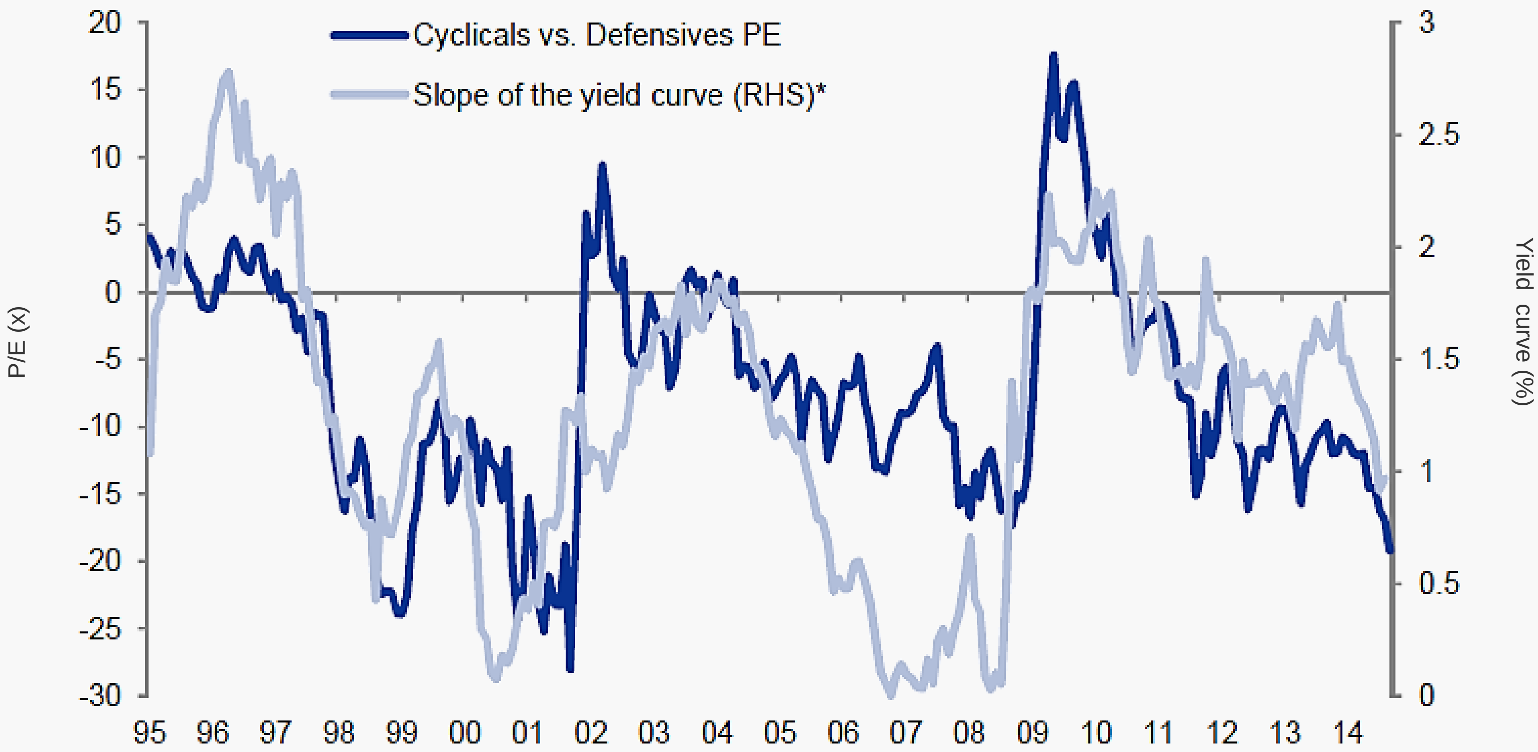
Normalisation (10%)

Significant relative underperformance from cyclical sectors over the past 12 months on both sides of the Atlantic



Source: Datastream

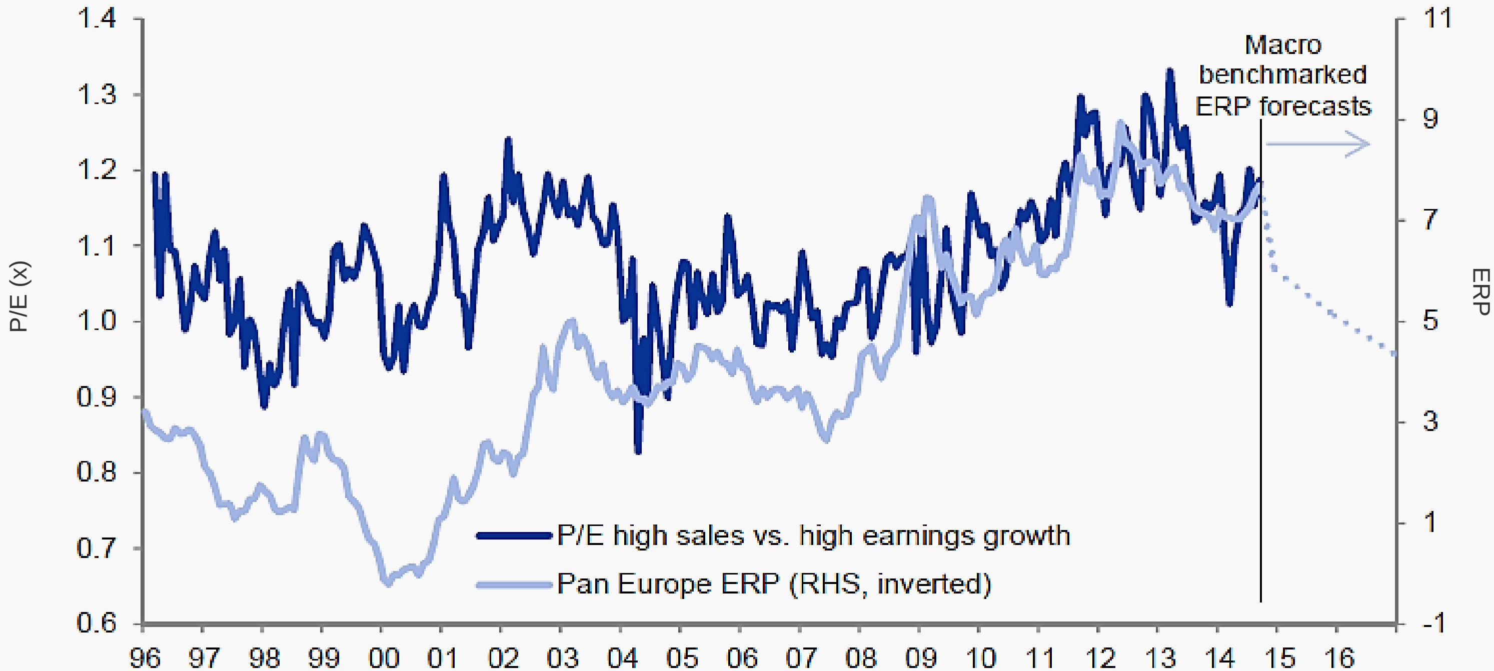
If government bond yields rise then the cyclical de-rating should reverse



Source: I/B/E/S via Datastream

The “dash for trash” as investors add risk at the expense of reliability

- Cyclicals over defensives
- Companies with high expected earnings over those with reliable sales
- Financials



Source: I/B/E/S via Datastream

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APPENDIX

UK Dividend Yield relative to World since1973

Income investing: 12 month forward DY projections

Cheap sectors offering attractive yields:

- **We look at current 12-month forward dividend yield projections V’s 5-years of history**
- Utilities, Oil and Telecoms look cheapest on a relative dividend yield basis
- Oil looks cheap using the 5-year range, but Telecoms and Utilities more expensive
- Basic Resources and Banks look very cheap versus 5-yr dividend yield relative range
- Banks are trading at their highest dividend yield relative in 5 years
- Investors looking for high dividend yield and high dividend growth should look at Banks and Insurance
- Utilities, Oil and Telecoms offer high dividend yield but low growth

Income investing: Free cash flow based recommendations

Which companies have resilient dividend yields with attractive 3-year free cash generation?

- Investors looking for secure dividend yield stocks can cross check with surplus free cash generation, good dividend cover and sound balance sheets.

- Big miners feature here including Rio Tinto and BHP Billiton

- Royal Dutch Shell is a new entrant to the list.

- Other companies screening well include: Persimmon, Royal Mail, M&S, William Hill and BSkyB

Income investing: Switch from high yield to dividend growth

Growth adjusted dividends

- Although high dividend yield strategies have done very well over the past two years, a high yield does not tell the whole story.
- We think that investors should be adding reliable dividend growth to the mix.
- Which stocks screen well here?
- Royal Mail, Rio Tinto, Petrofac, BskyB
- If you want to screen for emerging market exposure the above list drops to just 1 company!
- Rio Tinto

Income investing: Who are the big players in aggregate?

Which are the dividend paying "big guns"?

- A comparatively small group of UK quoted companies account for a large proportion of the total dividend payout.
- Which companies are they?
- HSBC, Royal Dutch Shell, BP, Vodafone, AstraZeneca, BHP Billiton, Diageo, Unilever, Glencore, Standard Chartered

Income investing: Dividend reliability

Who are the "dividend diamonds"?

- Which companies have evolved an enviable reputation for not cutting dividend payouts since 2000?
- …and also offer decent dividend growth prospects going forward?
- Aggreko, AB Foods, Babcock International, Capita, Diageo, Next, Rolls Royce, Sage Grp, Unilever, Weir Grp, WPP

Income investing: Which stocks to avoid?

Which companies look potentially risky?

- Just as investors want to know what to buy, they want to know what *not* to buy!
- High yields are of little use if they prove illusory.
- Here follow a list of companies where dividends appear not to be covered by free cash flow:

National Grid, United Utilities, Inmarsat, Severn Trent, Vodafone, BP, Scottish & Southern Energy, Tesco (!!!), BAE Systems, Centrica, J Sainsbury

Income investing: Income equities over credit

Bonds have done well. Now it's equities' turn!

- One of the simplest valuation screens available (but also one of the most obvious), is when a company's shares yield more than its bonds.
- We throw in dividend cover for additional security.
- Which companies screen well here?
- Royal Dutch Shell, BP, Rio Tinto, BHP Billiton, Glencore, SAB Miller, Anglo American, Rolls Royce, WPP, Compass, BAE Systems, Reed Elsevier, M&S
- A word of warning. High yield may mean high risk…of a dividend cut (Tesco was on this list too!)

Income investing: Where could the nice surprises be?

But we want to go just one stage better for you!

- Where could the nice **dividend surprises** come from?
- Here we define "surprise" as those companies offering better than average balance sheet strength but below average payout ratios. We also want the companies to be generating sufficient reliable cash to cover the dividend payout.
- Some of these companies may pay a higher than expected dividend!
- GKN, SAB Miller, Johnson Matthey, BT Group, AB Foods, Kingfisher, BskyB, ITV, Rangold Resources, Rio Tinto, Royal Dutch Shell, Aggreko, Travis Perkins, Wolseley

Financial market returns Year to Date

	One month	Three month	Twelve month	Year to date
All-Share	-0.7	-1.4	1.0	-0.1
FTSE 100	-1.0	-1.8	0.7	0.0
FTSE Mid 250	1.1	0.8	2.8	-0.5
FTSE 350	-0.7	-1.4	1.0	-0.1
FTSE Small Cap	-0.8	-1.1	1.7	-0.2
Global Equities (FTSE)				
USA	3.7	10.6	17.5	14.6
Japan	-0.1	1.1	0.2	1.1
World	2.0	5.2	8.9	8.5
World ex UK	2.2	5.9	9.6	9.3
Europe ex UK	-1.4	0.0	-0.8	-0.7
Pacific ex Japan	3.5	0.1	1.7	7.9
Gilts - Long (over 15Y)	1.7	6.7	12.1	15.4
Gilts - All Stocks	1.3	4.1	6.4	8.5
Index Linked - Long (over 5Y)	1.9	6.9	10.0	13.1
Index Linked - All Stocks	1.7	6.2	8.9	11.7
Cash	0.1	0.2	0.6	0.5

Source: FTSE International, Datastream and Deutsche Bank calculations

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Q&A

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