

Equities: dividends and deep-value attractive, high beta at risk

Summary

- Low bond yields in DM sustain the valuation case for equities. According to Boost's Market Model, ([see Appendix](#)) equities trade close to fair value relative to bonds
- Dividend and deep discounted equity themes are favored amidst a low appetite for risk. UK equities offer competitive dividend yields. Italian equities are cheap relative to peers.
- Expensive high beta markets are at risk. Tech stocks look vulnerable in an environment where EM growth may succumb to more weakness amid QE stimulus withdrawals
- Investors who share this sentiment may consider the following Boost ETPs (www.boostetp.com/products):

Long equities:

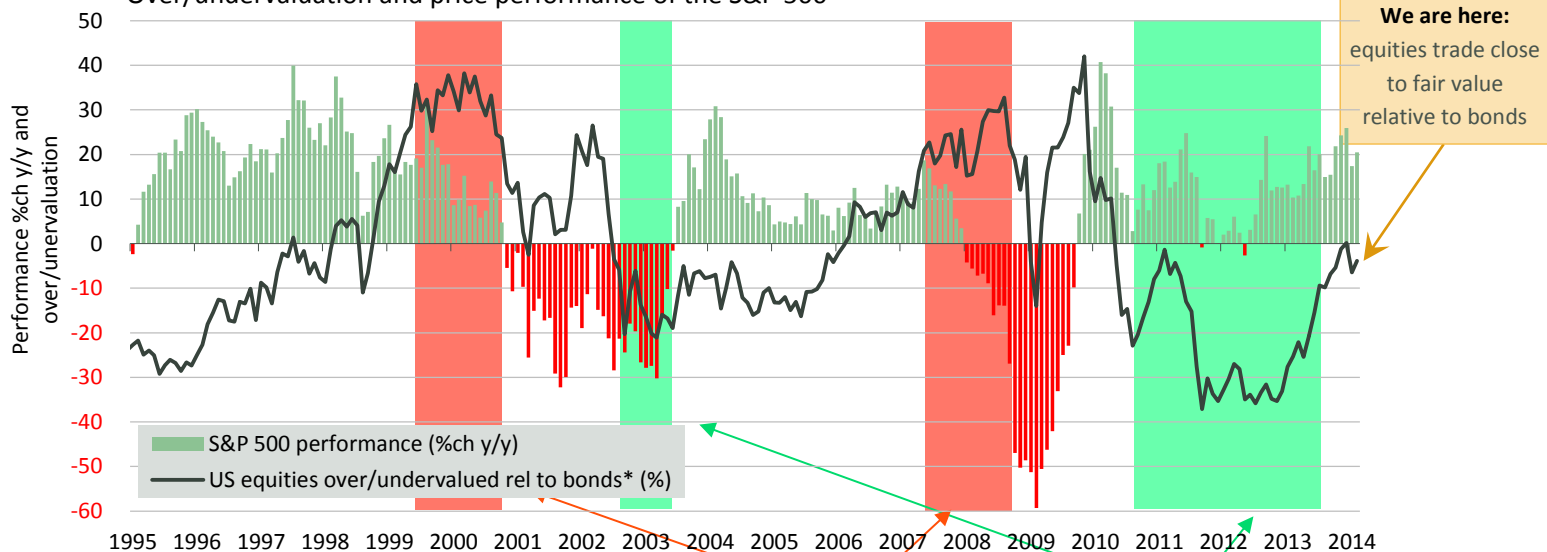
1. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
2. Boost FTSE 100 3x Leverage Daily ETP (3UKL)

Short equities:

1. Boost NASDAQ 100 3x Short Daily ETP (QQQS)

Chart 1: Boost's Market Model suggests equities trade close to fair value with bonds

Over/undervaluation and price performance of the S&P 500



Source: Boost ETP Research, Bloomberg.

Data as at 28 March 2014

* US investment grade corporate credit

Sentiment in risk assets is subdued. However, helping the valuation case for equities are low bond yields in DM. Boost's Market Model ([see Appendix](#)) indicates that, with equities trading close to fair value relative to bonds, the cautious stance of investors may favour selective equity market segments. UK's high dividend yield and Italy's deep discounted equity market stand out as markets around which investors can position defensively. With a more hawkish sounding US Fed as it winds down QE, the potential pressures on EM may dampen the outlook for growth stocks.

High beta and expensive segments of the equity market are at risk to correct lower. Investors who share this sentiment may consider the following positions

Long equities:

1. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
2. Boost FTSE 100 3x Leverage Daily ETP (3UKL)

Short equities

1. Boost NASDAQ 100 3x Short Daily ETP (QQQS)

Despite lower dividend expectations, UK large cap equities still compare favorably to peers

The performance of FTSE 100 has fallen behind other equity market peers this year. Amidst UK bank stocks struggling under tighter regulation, deeper restructuring and more litigation charges, UK insurance stocks have recently been battered following a new pension reform to end the requirement to buy an annuity for DC retirement schemes. As a result, financials have been one of the worst performing sectors in the UK, falling almost 6% this year. Adding to the drag on the FTSE 100 is Vodafone. As the third largest member in the index, the negative sentiment surrounding Vodafone's stake sales and strategic repositioning has caused its shares to fall by 26% this year. The telecom sector is down 9% for the year so far.

The net effect is that FTSE 100 dividend growth for 2014 is expected to fall and that it should regain strength only in 2015 and 2016. However, even when taking into account potentially lower dividends for 2014, the 3.8% estimated dividend yield for this year by consensus still leaves the FTSE 100 as the highest dividend yielding equity market across major continental European and US equity markets. This too partly thanks to UK equities' lacklustre performance for several years. The risks of potentially more tightening by the BoE as UK economic growth accelerates may compell investors seeking income into UK large cap equities that not only offer a better hedge against higher interest rates, but also offer a forward dividend yield that is more than 100 bps higher than the current yields on long dated government bonds.

Significant bank restructuring boosts Italian equities' re-rating potential

Italian banks are taking the much needed restructuring head on. Leading the charge is Intesa Sanpaolo (Italy's largest by market capitalisation) which, following large goodwill writedowns posted a EUR 5.2bn loss for the 4th quarter of 2013, is creating a bad bank where all its non-performing loans will be housed. This will not only provide transparency to investors in terms of which parts of the banks are healthy and which are not, but crucially will enable the bank to raise capital quickly. Unicredit (Italy's 2nd largest bank by market capitalisation, but largest by assets), posted a EUR 15bn loss as it increased loan loss provisions and wrote down goodwill from acquisitions. Together with plans to cut the workforce by 6% to restore

profitability, Unicredit, like Intesa is readying itself for cleaning up its balance sheet ahead of the ECB stress test. Hence, in spite of the large losses, investors' reaction was anything but bearish. Month to date Intesa Sanpaolo is up 7%, while Unicredit is up 13%. Given the strong home presence of both banks, their turnaround is likely to instill renewed confidence in Italy's moribund economy as well. Aside from the restructuring efforts of banks, the corporate sector is showing signs of life as well. While Italy's PMI manufacturing for February is in soft expansion mode for the 8th consecutive month, this is largely due to the ongoing contraction of credit for businesses. But indications are that for at least the large-cap stocks in Italy efforts are made to bypass the banks. Fiat SpA has recently applied for a bank license, replicating the model of several of Germany's large multinationals to obtain access the ECB's cheap borrowing facilities. Nevertheless, despite being up by 13% this year, Italian's equity market continues to trade at deep discounts relative to other equity markets. With price to book valuations of 2.6x, the FTSE MIB trades at a discount of 55% to the S&P 500, 52% to the EURO STOXX and 22% to the FTSE 100. This thanks in part of financial's disproportionate weighing of close to 1/3rd of the Italian equity market.

Tech stocks' high valuations may be driven by too elevated growth expectation

The upbeat Q\$ 2013 GDP numbers of the US, revised up slightly to 2.6% (from 2.4%) comes as an important counterforce to weakening growth in China. The weakening RMB and slumping copper prices are stress signals that may portend to more weaknesses ahead for the world's second largest economy. This, together with the Fed growing more hawkish as it readies plans for policy rate hikes once the last batch of QE stimulus is withdrawn by summer is why risks to growth expectations being paired back may impact high beta equity markets whose valuations may look increasingly stretched. The NASDAQ 100's forward P/E multiple, at 18.8x is the highest since 2010. While the taper talk last year initially helped sentiment in the low (if not negative) financially levered companies that are insensitive to the interest rate cycle, the likes of Apple and Facebook may find their growth environment more challenging as EM succumb to the effects of US QE stimulus withdrawals as their borrowing cost rise and home currencies devalue.

Current valuation of equities is modest and compares favourably to previous market cycles

Our Market Model suggests that equities remain good value relative to bonds. As shown in chart 1 (previous page), which showcases the Market Model's results for the US, equities currently are slightly undervalued relative to the current yields of investment grade corporate bonds. This close to fair value reading compares favourably to the substantial overvaluation seen in the previous two stock market cycles. During the dotcom bubble in 1999-2000 and the the subprime credit splurge in 2007-2008, equities were overvalued to the tune of 20% and more. At the height of the bull run in both episodes, the extent of overvaluation in equity markets was anywhere between 30 to 40% before this triggered a sell-off . As also shown in the chart, the Market Model worked reasonably well in signalling that when the dislocation between rising equity valuations (i.e. higher P/E ratios) and falling bond valuations (i.e. higher yields) reaches such extremes, a marked correction in equities usually followed (see red shaded areas in chart 1).

A 'what-if' analysis may help provide context to the potential risks for equities. To that end, a 'Scenario Matrix (see the chart on the next page) has been developed.

Explaining the Scenario Matrix

The Scenario Matrix shows two matrices that describe scenarios of adjustments needed in order to restore fair value (i.e. equities are neither over nor undervalued relative to bonds) for different levels of bond yields and P/E ratios. The upper matrix describes these adjustments by the required revisions needed in corporate earnings, while the lower matrix describes these adjustments by the required changes in equity market prices.

Shown vertically on the left of each matrix are different levels of bond yields (i.e. of US Investment grade corporate bonds) in incremental 25 bps spreads from current levels. The current level is shown in the centre (as indicated by "current BY (%)"), which is close to 5% (i.e. 4.68%). Rising bond yield scenarios are shown above, falling bond yield scenarios are shown below it.

Shown horizontally and running along the top of the matrices are different levels of P/E ratios which, for the corresponding levels of bond yields, describe

scenarios where equities are fairly valued relative to bonds. The diagonals running from top left to bottom right indicate this with values of 0% (i.e. no over or undervaluation). For example, with current bond yields at less than 4.7% (4.68% to be exact), equities should trade at a trailing P/E ratio of 17.8X in order not to be over or undervalued relative to bonds. This scenario is shown at the centre of the upper and bottom matrix and is also indicated by the intersection of the horizontal and vertically rectangles. Anywhere outside the centre and the diagonals describe scenarios of equities as being either over or undervalued. To restore fair value for given levels of bond yields, a change in earnings or equity prices or a combination of each needs in required.

If earnings growth remains resilient, equities could potentially absorb more yield increases

If current bond yields (at 4.68%) require a P/E ratio of 17.8X in order for equities to be fairly valued relative to bonds, then given the actual P/E ratio of 17.1X (which is somewhat lower than the required P/E), equities are currently modestly undervalued. The upper matrix shows that for a P/E of 16.9X (very close to 17.1X), the earnings of the equity market need to fall by about 5% (5.1% to be exact) in order to justify the slightly lower valuation, provided that bond yields of 4.68% do not change. If earnings expectations are assumed to stay flat, then, without growth in earnings, equity prices need to rise by approximately 5% (5.3% to be exact) to restore fair value with bonds, as shown in the bottom matrix. Consensus estimates show relative upbeat earnings growth expectations of close to 10% this year for US equities. In this context, a -5% growth assumption may look overly pessimistic.

However, more so than earnings, the bond market itself may be the biggest threat to equities. Overhanging it is the end of cheap money, instigated by the Fed's less dovish monetary policy stance as it looks to progressively wind down QE over the course of 2014. The question is if equity markets can absorb a further rise in bond yields. According to the Market Model and as shown in the Scenario Matrix, if bond yields rise by another 25 bps, then the current P/E ratio of 17.1X for US equities can still be justified. However, increases in bond yields beyond 25 bps, say 50 bps or higher may put equities under significant pressure as earnings would need to grow 10% or higher. In the near term, it is unlikely that the climb of bond yields will be that large, not least because most of the tapering may already have been priced in into

equity prices. Evidence for this was the rather muted reaction on the bond market in December last year when the Fed announced its first tapering of USD 10bn. Because bond yields barely moved then, a slow and controlled unwinding is unlikely to surprise equity markets to the downside in a significant way.

Against a backdrop where modest increases in interest rates will not meaningfully hurt risk sentiment near term, the outlook for equities may still be bullish. Defensive positioning is likely to drive equity allocations, potentially helping high dividend income and deep discounted equity markets, even while it may hurt high beta equity sectors.

Scenario Matrix

Fair EYR: 0.83		EPS revision needed to sustain fair value										
Current P/E 12M Trl: 17.1		Fair P/E										
		14.1	14.7	15.4	16.1	16.9	17.8	18.8	20.0	21.2	22.7	24.3
+125bps	5.93	0.0%	4.4%	9.2%	14.5%	20.3%	26.7%	33.9%	41.9%	50.9%	61.1%	72.9%
+100bps	5.68	-4.2%	0.0%	4.6%	9.7%	15.2%	21.4%	28.2%	35.9%	44.5%	54.3%	65.6%
+75bps	5.43	-8.4%	-4.4%	0.0%	4.8%	10.1%	16.0%	22.6%	29.9%	38.2%	47.6%	58.3%
+50bps	5.18	-12.6%	-8.8%	-4.6%	0.0%	5.1%	10.7%	16.9%	23.9%	31.8%	40.8%	51.0%
+25bps	4.93	-16.9%	-13.2%	-9.2%	-4.8%	0.0%	5.3%	11.3%	17.9%	25.4%	34.0%	43.7%
Current BY (%)	4.68	-21.1%	-17.6%	-13.8%	-9.7%	-5.1%	0.0%	5.6%	12.0%	19.1%	27.2%	36.4%
-25bps	4.43	-25.3%	-22.0%	-18.4%	-14.5%	-10.1%	-5.3%	0.0%	6.0%	12.7%	20.4%	29.2%
-50bps	4.18	-29.5%	-26.4%	-23.0%	-19.3%	-15.2%	-10.7%	-5.6%	0.0%	6.4%	13.6%	21.9%
-75bps	3.93	-33.7%	-30.8%	-27.6%	-24.1%	-20.3%	-16.0%	-11.3%	-6.0%	0.0%	6.8%	14.6%
-100bps	3.68	-37.9%	-35.2%	-32.2%	-29.0%	-25.4%	-21.4%	-16.9%	-12.0%	-6.4%	0.0%	7.3%
-125bps	3.43	-42.2%	-39.6%	-36.8%	-33.8%	-30.4%	-26.7%	-22.6%	-17.9%	-12.7%	-6.8%	0.0%

		Price change needed to sustain fair value										
		Fair P/E										
		14.1	14.7	15.4	16.1	16.9	17.8	18.8	20.0	21.2	22.7	24.3
+125bps	5.93	0.0%	-4.2%	-8.4%	-12.6%	-16.9%	-21.1%	-25.3%	-29.5%	-33.7%	-37.9%	-42.2%
+100bps	5.68	4.4%	0.0%	-4.4%	-8.8%	-13.2%	-17.6%	-22.0%	-26.4%	-30.8%	-35.2%	-39.6%
+75bps	5.43	9.2%	4.6%	0.0%	-4.6%	-9.2%	-13.8%	-18.4%	-23.0%	-27.6%	-32.2%	-36.8%
+50bps	5.18	14.5%	9.7%	4.8%	0.0%	-4.8%	-9.7%	-14.5%	-19.3%	-24.1%	-29.0%	-33.8%
+25bps	4.93	20.3%	15.2%	10.1%	5.1%	0.0%	-5.1%	-10.1%	-15.2%	-20.3%	-25.4%	-30.4%
Current BY (%)	4.68	26.7%	21.4%	16.0%	10.7%	5.3%	0.0%	-5.3%	-10.7%	-16.0%	-21.4%	-26.7%
-25bps	4.43	33.9%	28.2%	22.6%	16.9%	11.3%	5.6%	0.0%	-5.6%	-11.3%	-16.9%	-22.6%
-50bps	4.18	41.9%	35.9%	29.9%	23.9%	17.9%	12.0%	6.0%	0.0%	-6.0%	-12.0%	-17.9%
-75bps	3.93	50.9%	44.5%	38.2%	31.8%	25.4%	19.1%	12.7%	6.4%	0.0%	-6.4%	-12.7%
-100bps	3.68	61.1%	54.3%	47.6%	40.8%	34.0%	27.2%	20.4%	13.6%	6.8%	0.0%	-6.8%
-125bps	3.43	72.9%	65.6%	58.3%	51.0%	43.7%	36.4%	29.2%	21.9%	14.6%	7.3%	0.0%

We are here:
 1) At a current actual P/E of 17.1x, US equities require a EPS correction of less than 5% from current trailing EPS levels to sustain fair value with bonds. That is, if current yields of investment grade bonds of ~4.7% do not change...

2)...absent of this modest earnings slowdown, US equities may rise by approximately 5%

3)...The biggest threat to equities is the bond market: a moderate increase of 25 bps in bond yields could still be absorbed by the equity market without requiring stronger earnings. Yield increases beyond 50 bps however may be too much and could spark a sell-off in equities

Source: Boost ETP Research, Bloomberg.
 Data as at 28 March 2014

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