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# Illumination: Equity strategy and market outlook

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# Global perspectives: Life at the margin

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- **The record-breaking expansion of corporate profit margins in a relatively weak GDP growth environment has been key to equity performance.** We believe there are structural and cyclical elements behind this impressive corporate performance. However, the structural aspects are unlikely to be repeated and cyclical pressures are rising.
- **Increasing consumer indebtedness and the risk of further populism highlight the pitfalls of assuming an endless summer for the corporate sector.** We view current forecasts for US profit margins as offering limited scope for upside surprise and a risk scenario, in which wage pressure in 2018 could pressure margins and lead to tighter US monetary policy cannot be excluded**.**
- **North Korea is a problem not of Trump's making but a solution appears a distant prospect.** All options may be on the table but there are no obvious solutions to defusing the tension in the region. We expect the rhetoric to remain a source of worry for financial markets but see little to gain for either side in terms of any military action, which would lead to sharper declines.
- **A change in Fed leadership during 2018 is now a real possibility in our view.** Trump's Chief Economic Advisor Gary Cohn may have been charged with finding a replacement for Fed Chair Janet Yellen, but now appears to be front runner for the role. This has been reinforced in recent days by Yellen's comments on the undesirability of rolling back post-crisis financial sector reforms, a position that is at odds with the US president.
- **There is no change to our cautious outlook on equity markets.**

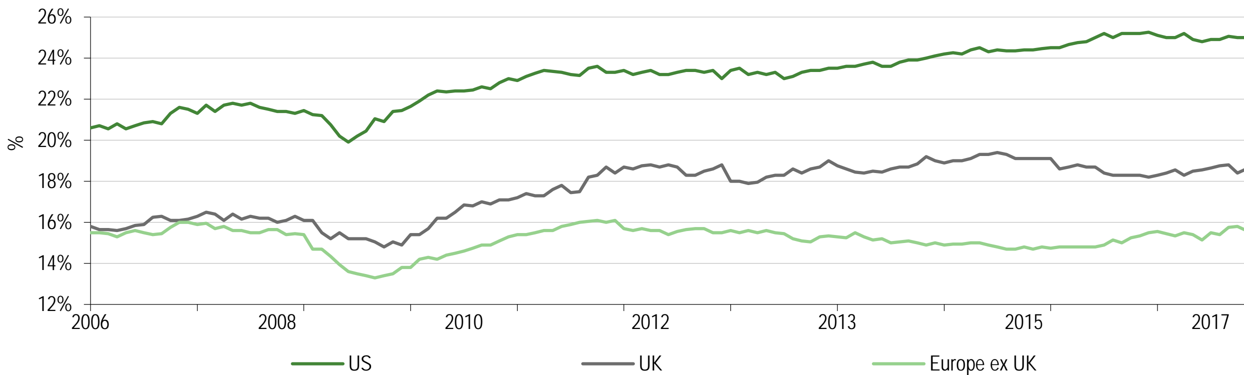
## Life at the margin

### Could we have a double whammy of declining profitability and rising US rates?

Since 2009, one of the key drivers for US and European equity markets has been the strength of corporate margins even in the absence of a historically weak economic recovery. Current 12-month forward consensus EBITDA margin forecasts for non-financials in Europe are close to 10-year peak levels while in the UK and US, forecasts are now significantly higher than the cyclical peak prior to 2008.

We view 12-month forward consensus estimates as a proxy for corporate guidance. It is therefore a reflection of the current confidence within the corporate sector, at least in terms of the sustainability of record-high margins. While margin expectations have trended higher over the last decade in the US and UK, the improvement in corporate confidence is more of a novelty in continental Europe, due perhaps to the still nascent recovery in the region. In Europe, forecast EBITDA margins remain within historical ranges, if at cycle highs.

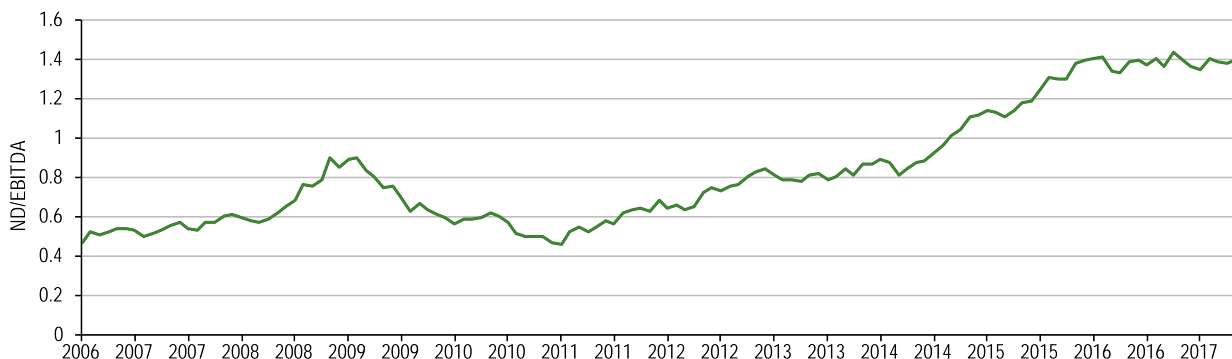
**Exhibit 1: 12-month forward consensus EBITDA margin forecasts**




Source: Thomson Reuters Datastream

For some investors, it may look like a rosy picture. High margins have facilitated share buybacks in the US and re-leveraging has supported return on equity and earnings per share growth even as sales growth has disappointed. US corporate debt as a percentage of sales has tripled since 2011, rising from 10% to 30%.

**Exhibit 2: 12-month forward consensus net debt/EBITDA for US non-financials**

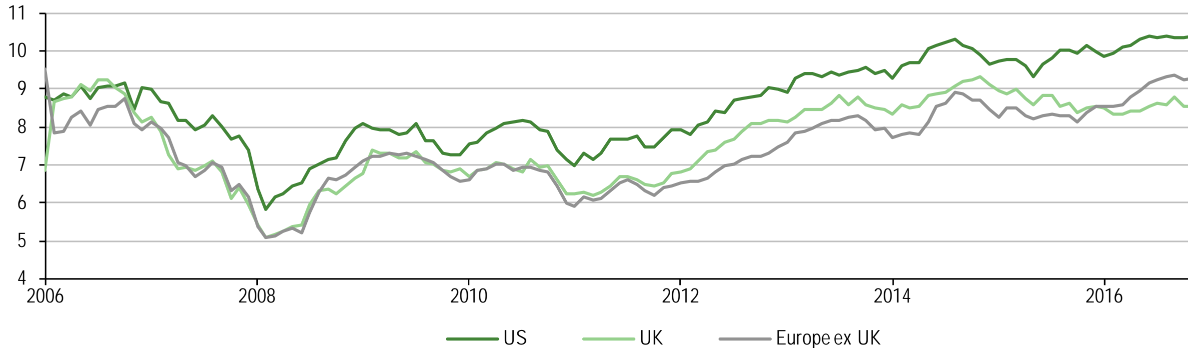



Source: Thomson Reuters Datastream

The growth in corporate debt may not be quite as dramatic in terms of net debt/EBITDA, but there is clearly a new paradigm in play from as recently as 2012. US non-financial net debt/EBITDA has doubled to 1.4x since then, Exhibit 2. We fear the combination of a period of significantly higher

than average profitability, investor confidence leading to ever higher valuation multiples (Exhibit 3), and corporate confidence leading to increased indebtedness creates a significant weak spot in the scenario of a return of pricing power to labour.

**Exhibit 3: Median 12-month forward EV/EBITDA for non-financials**



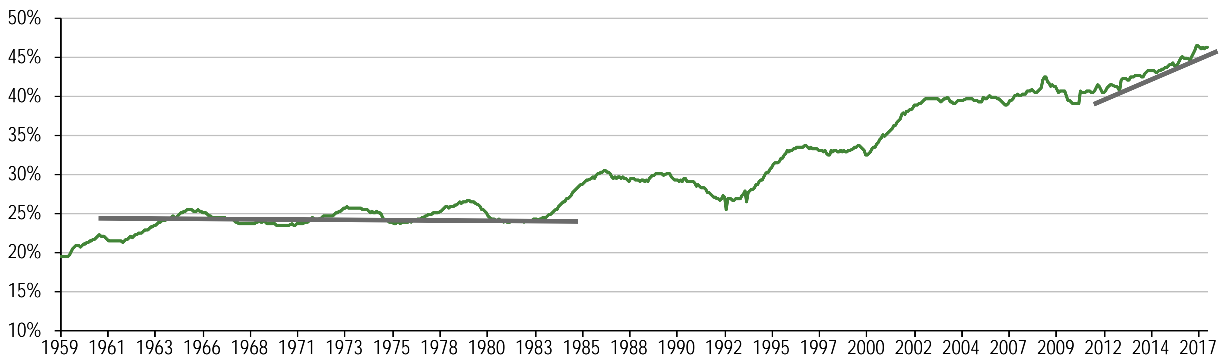

Source: Thomson Reuters Datastream

It is a large topic but in our view record corporate profit margins are a corollary of weak wage growth. The labour share of GDP in developed nations has been declining over many years, restrained by both cyclical and structural forces. Since the 1970s, trade union membership has declined dramatically and unions have effectively become politically irrelevant, with a fraction of the power enjoyed in prior decades.

Furthermore, globalisation has been an enormous benefit to multi-national corporations with the resources to supply consumer markets in developed nations with labour supplied by emerging markets. The rush to create global corporations in the 1990s with such resources was a key driver behind the M&A boom of that era.

In contrast, there was no effective response from the union movement in terms of a globalisation of union power. Perhaps in the US and the UK the threat of international labour arbitrage may have created a sense of irrelevance, which only accelerated the decline in union membership. Within the last decade, further M&A within industries has increased consolidation at a global level, adding further to the market power of the global multinational.

**Exhibit 4: US – total consumer debt to wages, %**



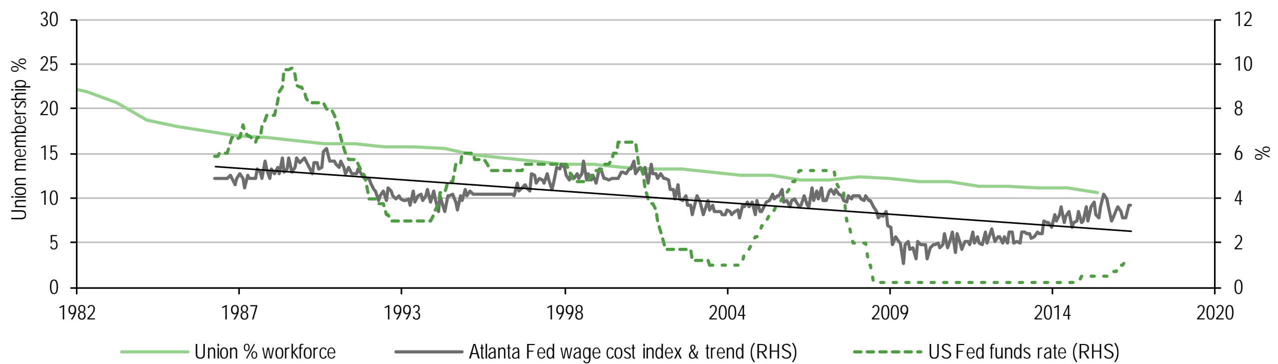

Source: Thomson Reuters Datastream

The declining pricing power of labour and consequent lack of domestic wage pressure in developed markets has contributed to steadily declining short- and long-term interest rates, enabling populations to enjoy an improved standard of living by relying increasingly on borrowing to finance consumption rather than through rising real wages.

For example in the US, total consumer debt to total wages was relatively steady at around 25% from 1962-1983. By the end of the 20th century the ratio had risen to 40% and in only the last four years has surged by a further 5% to 46%, Exhibit 4.

At the same time, union membership in the US (not the only but a significant structural factor in terms of the bargaining position of the workforce) has fallen significantly. From close to 30% at the peak in the 1970s, union membership is now only 10% in the US and just 5% in the private sector. There is still an astonishing premium of close to 50% for unionised labour in the US in lower-skilled occupations; it is therefore of no surprise that economic activity has leached away from older companies with such a competitive disadvantage.

**Exhibit 5: US – waning union influence, declining wage growth and US interest rates**




Source: Thomson Reuters Datastream

However, the current single-digit rate of union participation in the private sector shows this particular downward pressure on aggregate wages may have run its course in the US and the picture is similar in the UK. If anything, the rise of populism and fears over international labour mobility (a key factor in the UK's Brexit vote) point to the limits of the acquiescence of working populations to the diminishing labour share of GDP across developed nations. It may well take some time for these movements to gain traction but the current level of corporate profitability is in our view by no means assured over the medium term.

There are also cyclical factors at work. US wage growth according to the Atlanta Fed wage tracker has been on a downward trend for several decades, albeit with a very strong cyclical component highly correlated to the US interest rate cycle. When the wage tracker is above its trend line, as it is now, US monetary policy has been on a tightening path.

The periodicity of the Atlanta Fed wage tracker (Exhibit 5) is also interesting as it spends on average five years above trend and US interest rates have in the past peaked one year before it falls below trend. In this cycle the tracker crossed the trend line in May 2014, so if past patterns were to repeat themselves, we would expect wage growth to fall below trend in 2019 and the Fed to be reversing course and cutting rates by the spring. If this was to occur, this would be a big surprise to current consensus views in respect of monetary policy.

The preceding discussion may seem a little distant from our usual strategic commentary as it covers very long-term changes to the relationship between the corporate sector and the working population. We believe it is important to understand the reasons why corporate profit margins have been exceptionally high, as equity market valuations appear predicated on this phenomenon persisting. We are not so sure the picture is rosy.

We acknowledge the long-term effects of deregulation, globalisation and the consequent decline of unionisation and workers' bargaining power as legitimate structural trends. The very largest multinational corporations – which dominate stock market indices – have been the prime

beneficiaries of these structural trends and profit margins have expanded as a result. However, these changes also seem to have largely run their course.

Expectations for further gains in profitability should take account of the one-off nature of, for example, globalisation and the introduction of China into the world's trading system. The collapse in the power of organised labour in western markets means that corporate profits are enjoying the tailwind, but the signs of dissatisfaction among electorates with the new economic model are in plain sight.

While new political movements may have retreated from the headlines this year, the populist phenomenon may still yet be in its infancy and could easily return to take a larger share of the popular vote. In any case, investors have the two populist political upsets of 2016 to deal with, in the shape of Brexit and US President Trump.

There is also a concern in our view that in terms of economic stability the pendulum may even have swung too far in terms of corporate profitability at the expense of labour, and benefits neither. We view increasing indebtedness of the US consumer between 2012 and today with concern. This level of debt to income is unprecedented and highlights the challenges of normalising US interest rates due to the increased sensitivity of US consumer spending to interest rates.

Cyclical factors also need to be considered. We note the Atlanta Fed wage tracker, Exhibit 5, is well above trend and it is certainly possible that, despite the structural downward pressure on wages in recent decades, the ultimate bargaining chip is becoming a factor – a shortage of qualified workers. There has been a meaningful degree of upward pressure on US wages since 2015 compared to earlier in the decade.

In previous editions we have highlighted the exceptionally high valuations observable for US equities. It is possible that markets could be pricing in an extended period of peak profitability without strong US GDP or wage growth; and this would also be consistent with currently observed ultra-low bond yields and tight corporate credit spreads. However, this would be at odds with the evidence above of upward pressure on US wages.

In our view such a bullish belief in corporate profit margins misses both the possibility that the structural changes we have noted are one-off in nature and that in the US and possibly UK pricing pressure is returning to the labour market on a cyclical basis. It is clear that there is scope for disappointment in respect of corporate profits given current forecasts in our view, which would be likely to be received very poorly by equity investors at current valuations.

## North Korea: A problem not of Trump's making

### All options may be on the table but there are no obvious solutions

North Korea's recent determination to provoke the US through a successful test of a missile capable of reaching much of the US mainland and a more recent missile flyover of Japan is clearly a concern, but it is not because any pre-emptive attack is imminent or likely. The history of military rocket development suggests that it will still be some years before North Korea could be assured of a successful, let alone multiple, strike on the US or even Guam.

However, in the event of any attack, the overwhelming superiority of US forces would undoubtedly ensure the destruction of North Korea. Therefore in many respects Trump's most aggressive comments in respect of fire and fury were a statement of the obvious and investors accordingly did not overreact, even as volatility rose during thin trading over the holiday season.

The game that is being played is nevertheless increasingly tense due to North Korea's large conventional forces, which act as a deterrent to any pre-emptive military action aimed at halting its nuclear and missile development program.

It is the integration of nuclear and missile technology that is the bigger issue; in World War II enormous resources were ploughed into the German V2 rocket system rather than fighter aircraft, but the military impact of the rocket alone was minimal. Though it is likely to be some years before North Korea can put into production a missile system of sufficient scale and accuracy to be a meaningful threat, the US and international community are clearly in a very difficult position.

The North Korean weapons development program has been on this track for decades and this problem is not one of Trump's making. However, it is obvious why investors are concerned that it has come to a head with such a volatile US president, who currently has authority to launch a nuclear attack without reference to the US Congress should he wish to.

Excluding the Trump factor, investors would normally now expect the international community to coalesce around an initiative to restrain the further development of North Korea's missile and nuclear warhead capabilities through the use of diplomacy, sanctions and incentives for compliance. It is clear the direct risks of an escalation are far higher in South Korea, China and Japan than in the west and such nations will have strong views on how to proceed. In this respect the Chinese and Russian support for UN sanctions in early August was encouraging. Furthermore, the 'tweet' restraint shown by the White House following the Japan flyover shows that childish games have been stopped. Social media is hardly the ideal forum for such strategic communications.

Our base case is that there is an escalation of rhetoric, which is likely to persist for some time. For Trump, there is a natural draw to deflect attention from his struggling domestic agenda with a foreign policy crisis. His flagging approval rating has risen from 38% to 44% during August. For North Korea the optimal strategy seems to be to continue to play for time and its domestic audience. Steady development of its nuclear and missile capacities only improves its negotiating position.

Options such as a US-led pre-emptive strike on weapons facilities risk a major conventional conflict in the region with no guarantee of halting the weapons program and as such appear to be unlikely. US-sponsored regime change has, to say the least, a mixed record of success. Further diplomacy is likely to be tried first to build an international consensus on how to contain the threat. This may not be costless for the US as China may seek concessions in respect of its own naval ambitions in the region before agreeing to put pressure on North Korea.

Therefore, despite the rhetoric, the probability of any actual military action remains low due to the lack of tenable military options. The uneasy peace that has lasted 60 years is likely to continue. Hawks may complain tough talk and no action represents "kicking the can down the road" but this may suit domestic politics on both sides, and still be the least bad option.

## Jackson Hole: Increasing speculation on Yellen's replacement

### Gary Cohn looks increasingly well-placed as Fed chair for 2018

In the end, traders looking for news out of the Kansas Fed's Jackson Hole conference were disappointed, with no new insights into the Fed's or ECB's monetary policy outlook. Instead, Fed Chair Yellen's and ECB President Mario Draghi's comments were firmly focused on setting out a public position on financial sector regulation.

This may seems rather academic but is especially pertinent in the US, given Yellen's term is due to expire in early 2018. Yellen's position that new post-financial crisis regulations should remain in place to ensure the safety of the financial system is clearly at odds with the views of President Trump. In our view, this only raises the probability that Trump will want to put one of his own nominees into the Fed chair. We note the most recent surveys from US economists offer Yellen only a one-third chance of a second term.

While Trump's Chief Economic Advisor Gary Cohn has been charged by Trump with finding a replacement for Yellen, US economists see Cohn himself as by far the most likely candidate to succeed Yellen, with close to 50% of a recent poll. Other candidates received only single-digit probabilities. It therefore appears to be a two-horse race.

While it was widely speculated that Cohn might resign due to Trump's reaction to Charlottesville, the carrot of a Fed chair may have kept him on board. Markets see him as an important voice within Trump's policy team, and clear question mark would also have arisen in terms of Yellen's replacement. It has been suggested his fears of market volatility in the event of his departure persuaded him to remain in post.

Cohn would still be an unconventional Fed chair, reportedly an instinctive decision-maker without a PhD in economics – potentially the first Fed chair without this qualification for a quarter-century. However, on the other hand his quarter-century of market experience could be seen as beneficial to an academically driven institution such as the US Federal Reserve.

We believe the greater risk is the perception that Cohn's connections to Trump and Wall Street will compromise his independence. To be clear, this is unlikely to matter in the short term – the balance of probabilities is that a Cohn-led Fed would be bullish for markets, with greater prospects for bank sector deregulation and a more dovish stance on monetary policy.

However, independence risk arises in the medium term, when more difficult or unpopular policy decisions have to be taken that put pressure on either government funding or private-sector profitability. Finally, in the event of a Cohn Fed, we would have to congratulate Goldman Sachs on nurturing a triumvirate of central bank governors, covering the US, eurozone and UK.

## Conclusion

We have observed the steady increase in corporate profit margins over the last decade and believe both structural and cyclical factors are behind the increase. We continue to believe caution is warranted in terms of global equity markets as the larger proportion of the structural benefits of globalisation and declining bargaining power of the working population are behind us, and also appear to be fully embedded in current margin forecasts.

From a cyclical perspective, wage cost pressure in the US has picked up sharply since 2015 and we would be very surprised if global equity markets were able to deliver strong returns against a backdrop of declining margins, slowing growth and tighter US monetary policy.

US President Trump certainly has not created the North Korean problem but it is becoming more pressing as North Korea's decades of research into developing nuclear and ballistic missile capability come closer to fruition. There may be all options on the table but none look especially palatable. We expect intensified international pressure on the regime to back down rather than an escalation of military action.

The probability of Janet Yellen being replaced as US Federal Reserve chair by Trump's Chief Economic Advisor Gary Cohn has risen following her publicly stated opposition to relaxing banking regulation, which puts her at odds with Trump. We would expect a modestly positive market reaction to such an announcement given Cohn appears more dovish than Yellen, but over the medium term running such an academic institution and being perceived as fully independent of the Trump administration would be real challenges.

There is no change to our cautious outlook on equity markets.

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