Illumination: Equity strategy and market outlook

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EDISON

Global perspectives: A January mini-cycle

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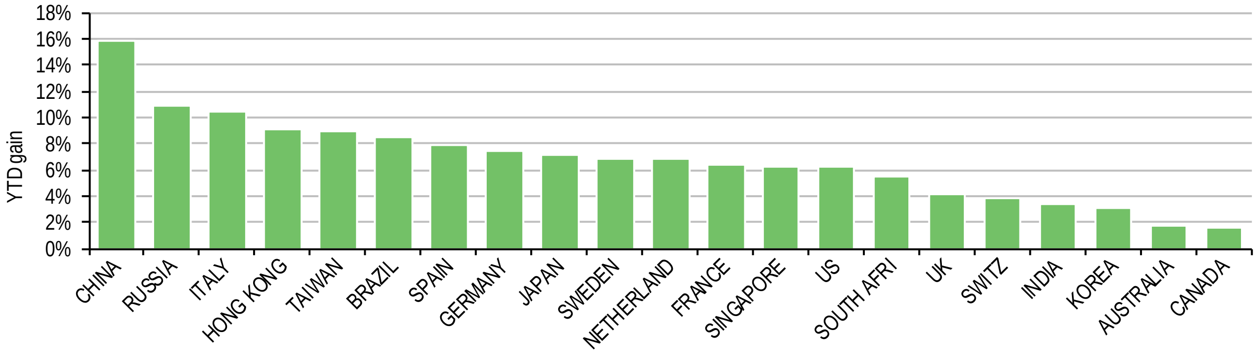
- **The first few weeks of trading in January have highlighted the themes for the remainder of 2018.** Strong economic sentiment and earnings upgrades resulting from US tax reform initially pushed equity markets higher. However, the same factors are now pushing the entire yield curve upwards, creating competing demands for investors' capital. We continue to believe that in the short term, the still-strong growth dynamic will have the upper hand and risk assets will continue to perform. Over the longer term, however, the re-normalisation of monetary policy may bring stretched equity valuations into sharper relief.
- **The weakness of the dollar is a puzzle unless considered in the context of declining growth fears in Europe and China**. Over the past three years, both of these regions have been subject to speculation that excessive debt burdens carried the risk, at its most extreme, of a further financial crisis. As these fears have melted away and speculative positions unwound, the euro and renminbi have been in greater demand. The strength of sterling has also been remarkable and, in our view, is more reflective of a Brexit being easier in a supportive global economic environment, rather than any positive surprise in the political process.
- **US corporate tax reform has boosted 2018 US EPS estimates by approximately 4% during January.** On our estimates, this represents the majority of the benefit of the lowering of US corporate tax rates. In continental Europe and the UK, 2018 earnings forecasts have been stable year-to-date.
- **The implementation of tax reform and a lower dollar keeps the US Fed on track to raise rates in 2018.** We note that US short-term interest rates have been rising at an accelerating pace over recent weeks and market-implied inflation expectations have also been increasing.
- **We continue to believe this is a top-of-cycle investing environment where for cyclical sectors the risk/reward is less attractive.** While recognising the growth dynamic is strong for the moment, we continue to believe equity portfolios should now be tilted towards sectors that have offered a degree of resilience. Specific growth or event-driven situations should still be favoured over broad market exposure, in our view.

A January mini-cycle

Rally in equities and rising bond yields highlight themes for 2018

Since the beginning of 2018, global equities have enjoyed strong returns as positive economic momentum has continued to support investor sentiment. In US dollar terms, China's equity market is now up over 15% in just three weeks, with Russia and Italy also delivering returns in excess of 10%. This is, in our view, the nature of top-of-cycle investing, whereby the most cyclical or high beta sectors deliver the strongest returns, but also carry the greatest risk once the cycle turns.

Exhibit 1: Strong gains in global equities during January

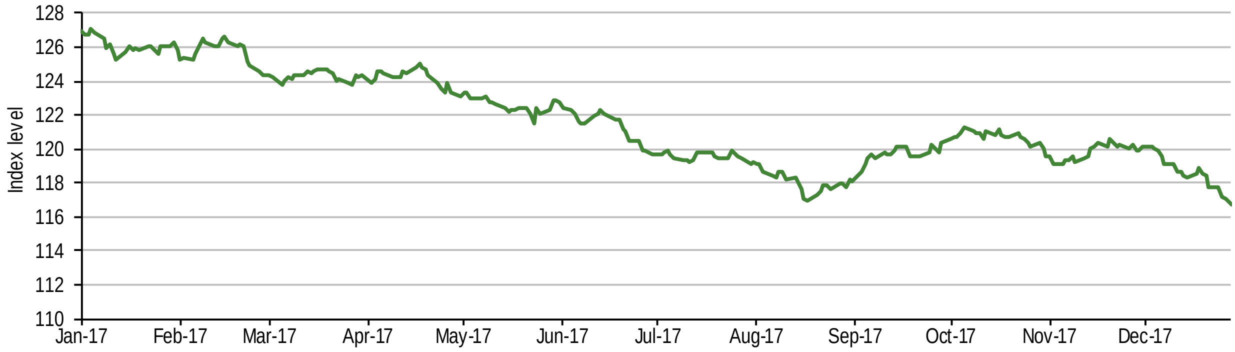


Source: Thomson Reuters Datastream. Returns calculated in USD from 31/12/17 to 23/01/18.

The reduction in risk premia for higher beta equity markets is also reflected in foreign exchange markets as the US dollar has fallen significantly against other major currencies. The decline in the US dollar is down to external factors, in our view. Domestic US politics has only recently delivered substantial corporate tax reform likely to support US growth over the next 18 months and lead to incrementally higher interest rates. We believe investors have taken note of the very strong rebound in eurozone economic activity and increasingly realised the ECB is now on a parallel track to the US Fed, in terms of scaling back unconventional monetary policy.

While plausibly deniable, US Treasury Secretary Mnuchin's recent Davos comments suggest that the US no longer feels the need to maintain even a token commitment to its "strong dollar" policy of the past 30 years. The relaxed attitude of a key policymaker to the fall in the dollar has only accelerated its decline. It is much too early for any firm conclusions on whether this represents a meaningful shift in US policy. However, speculation is already developing in terms of the use of the US dollar as a bargaining chip in US trade negotiations. This could potentially be an unanticipated source of significant FX volatility in 2018.

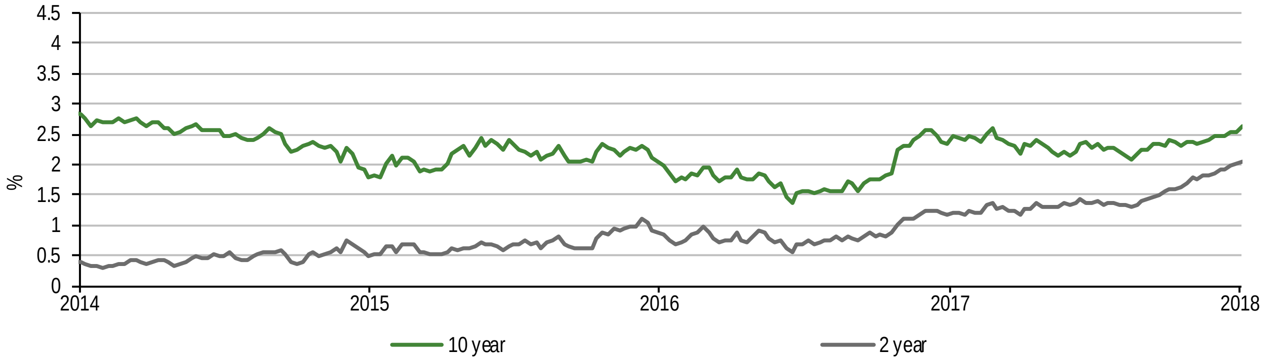
Exhibit 2: Declining trade-weighted US dollar contributing to easier global financial conditions



Source: Thomson Reuters Datastream

Improving economic sentiment has also led to rising global bond yields and rising market-implied inflation expectations in the US, which has given developed equity markets something of a brief pause in mid-January. We believe the themes of strong short-term growth, which is positive for risk assets and rising bond yields and interest rates, but negative for risk assets, are likely to bounce back and forth in investors' consciousness during 2018. The growth dynamic for now, however, clearly appears to have the upper hand. Bond yields have risen sharply (Exhibit 3), yet equity performance remains robust.

Exhibit 3: Rising US bond yields and interest rates



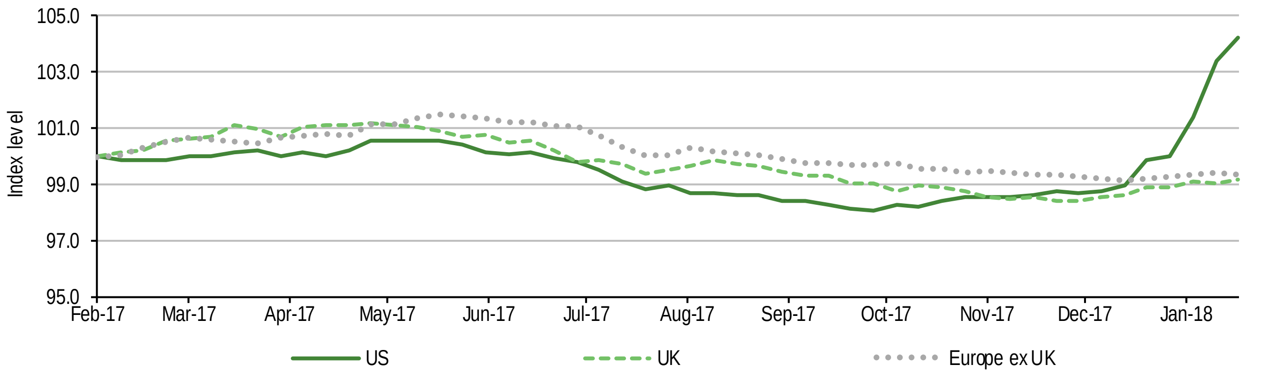
Source: IMF, Edison weights and calculations

Earnings: The real Trump bump

Median per-share earnings growth for S&P 500 upgrade of 4% following tax reform

Analysts' profits forecasts have edged modestly higher in the first month of the year in continental Europe and the UK, as would be expected during a period of above-consensus global economic data. The situation is strikingly different in the US, where tax reform has added to the cyclical economic strength, pushing median 2018 profits forecasts dramatically higher. The increase in 2018 estimates of 4% over the past month already represents two-thirds of our total expected benefit from tax reform.

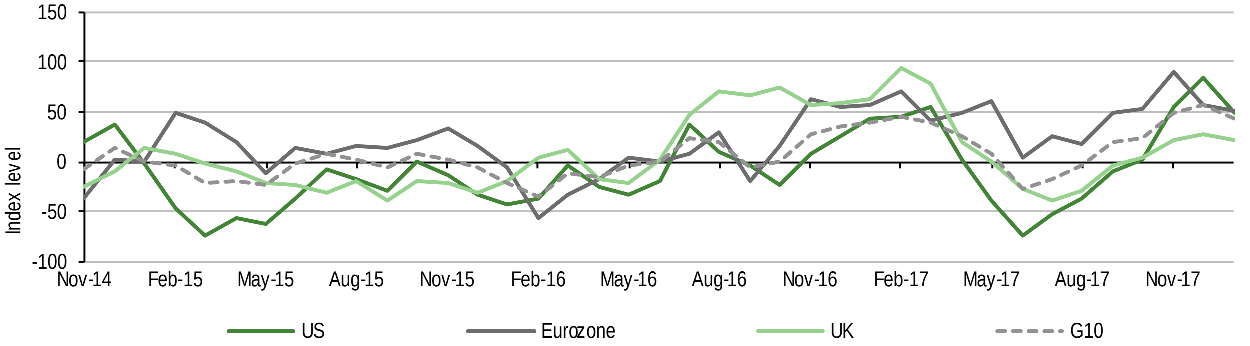
Exhibit 4: Unweighted consensus EPS index for 2018



Source: Thomson Reuters Datastream, Edison calculations

Median consensus earnings growth is now 8% in the UK, 10% for continental Europe and 13% for the US, where the impact of US tax reform is again clear. Though such profit growth expectations are helpful for equities at present, estimates can be volatile and tend to fall modestly over the full calendar year, absent continued positive economic surprise.

Exhibit 5: Global economic surprise indices



Source: Thomson Reuters Datastream

We do note, however, that economic surprise indices (Exhibit 5) show a very modest easing of momentum during January. The key to market performance over the full year will, in our view, be the extent of the lagged effect of monetary tightening of 2017 on the economy during 2018. While there is no reason for panic in respect of the real economy at present, equity valuations remain stretched, in our view, and a period of consolidation to allow earnings to catch up with high market multiples cannot be excluded.

Conclusion

For 2018, we continue to believe that as we may be late in the cycle investors should combine a relatively modest level of market exposure with carefully selected holdings in specific company- or event-driven situations. The first few weeks of 2018 have highlighted the competing forces of stronger growth and the renormalisation of monetary policy.

While recognising the growth dynamic is strong for the moment, we continue to believe equity portfolios should now be tilted towards sectors that have offered a degree of resilience.

In terms of bond yields, 10-year yields still seem to us inconsistent with the current pace of economic expansion, particularly in Europe, despite the recent increases. We therefore remain underweight duration risk.

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