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Illumination: Equity strategy and market outlook

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Global perspectives: Cautious, not bearish

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- **Even if some calm has now returned, the recent increase in market volatility is disconcerting, having occurred with no obvious single trigger and following an extended period of very low volatility.** The equity market declines to date are however very modest and we stick with the view that the risk/reward balance suggests investors should exercise caution in terms of equity allocations, even if the absence of panic suggests the market is relatively well-supported in the short term.
- **Strong survey data and market prices remain at odds with much more modest improvements in hard economic data and earnings forecasts.** The question remains as to how this gap will be closed. The indications are tentative but in the US and UK an easing of economic momentum appears underway and China is tightening policy at the same time as the US Fed.
- **US interest rates increases underway**. A deft nudge to market expectations prior to the Fed's interest rate hike earlier in the month sets the stage for further increases later in the year. Notably, Fed policymakers have not incorporated a significant US fiscal stimulus into their expectations, which makes two more rate increases the baseline, even if the Trump administration continues to struggle to implement its agenda during 2017.
- **Moving towards a cautious rather than bearish stance on equities.** While our reservations on the timing and scope of a US fiscal stimulus through reform of corporate taxation and infrastructure spending have only been reinforced, global markets appear well-supported in the near term, as the first US rate increase was easily absorbed by the market. We are therefore no longer bearish in the short-term, even as we retain a cautious medium-term view.

Market wobble? Still time to re-position portfolios

No clear trigger for recent market declines - but no panic

Even if some calm has now returned, the recent increase in market volatility is disconcerting, having occurred with no obvious single trigger and following an extended period of very low volatility. The declines to date are however very modest and we stick with the view that the risk/reward balance suggests investors should exercise caution in terms of equity allocations, even if the absence of panic suggests the market is better supported than we expected in the near term.

Despite the lack of a specific trigger, we have however highlighted in recent months the following combination of factors which seemed likely to challenge equity markets over coming quarters:

- Significantly above average valuations in developed markets.
- Tightening monetary policy in the US.
- Tightening monetary policy in China.
- Doubts over the timing and ultimate size of Trump's policy initiatives.
- The lack of follow through from positive economic surprises into earnings forecasts.

All of these concerns remain valid today. If anything, the recent increase in inflationary pressure in the US, UK and Eurozone makes the risk of tighter monetary policy an even greater concern now compared to earlier. We also note the recent surge in inter-bank funding costs in China, only a week after the central bank tightened policy.

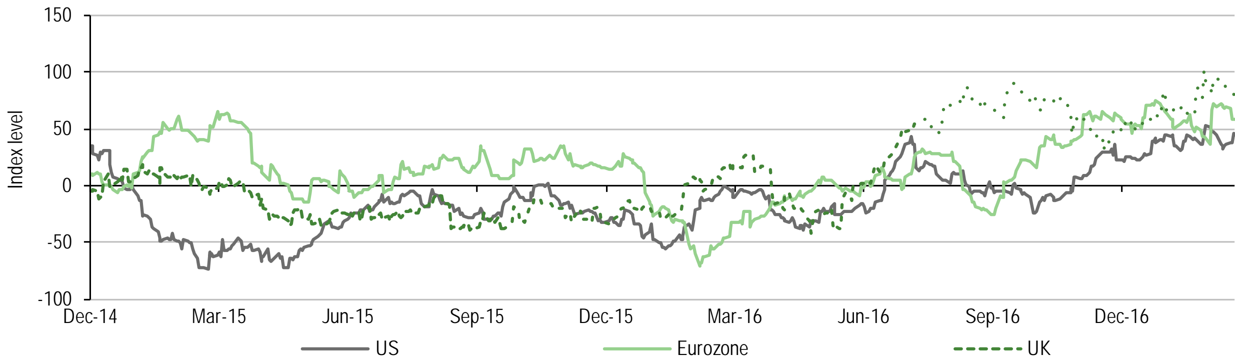
The very modest declines from the highs for developed markets over the last week does not move us from our cautious medium-term view on global equity markets, but in the short term the absence of panic following the Fed rate increase and Trump's healthcare defeat at the hands of Congress suggests that the market is relatively well-supported at present. With two of the most obvious factors in favour of lower market valuations fully spotlighted by recent events, we believe it is now time to step back from our earlier view that markets are vulnerable to larger declines in the near term; still cautious therefore, but not outright bearish.

Ready for the rollover?

Tentative evidence of slowing economic momentum

Despite buoyant global asset markets, we are however seeing increasing evidence of declining economic momentum. In the US, bank loan growth has slowed significantly since Q416 and the Atlanta Fed's GDP nowcast is only indicating 1% US growth for the current quarter, compared to over 2.5% as recently as early February. In the UK, the services PMI peaked in January and is now declining, while in Europe - a bright spot in terms of economic surprise – disappointing German factory orders contrast with strong PMI survey readings for the region. China's M2 money supply growth has also ebbed since Q116, suggesting an easing of basic materials prices, should prior correlations still hold.

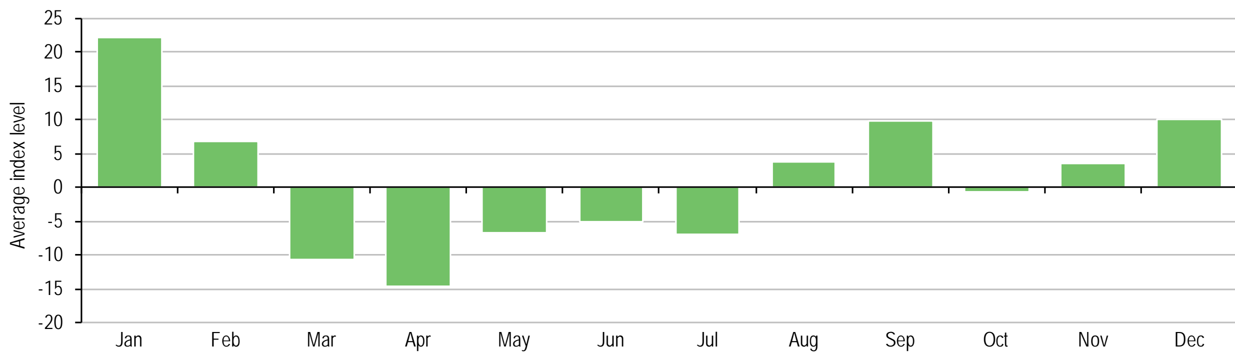
Exhibit 1: Economic surprise indices



Source: Thomson Reuters Datastream

Although the recent run of economic data has certainly surprised to the upside (Exhibit 1), this is in part both seasonal (Exhibit 2) and mean-reverting over a period of three to six months. The seasonality may be relatively modest but it does appear that positive surprises have typically been concentrated at the start of each calendar year, with easing momentum over the following six months. Based on the seasonality and the mean-reverting nature of economic surprise indices, we believe the recent momentum may ebb as we enter Q217.

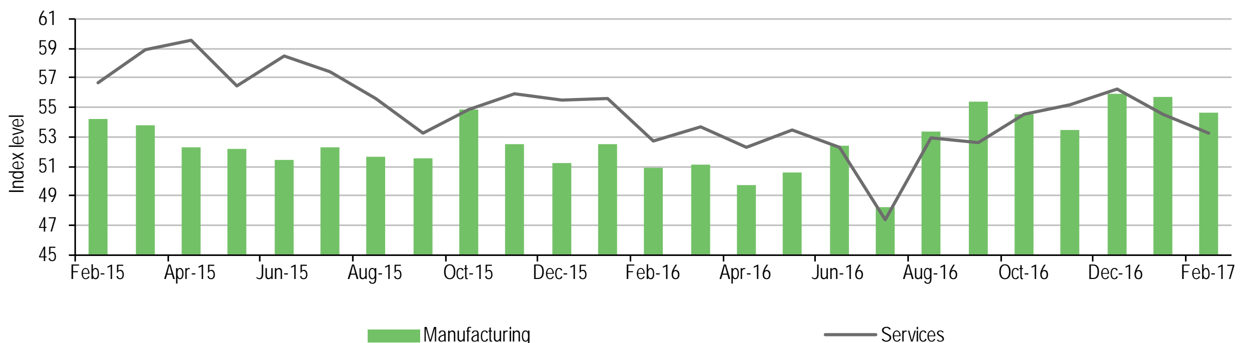
Exhibit 2: Seasonality in US economic surprise – average by calendar month



Source: Edison calculations. Data show the tendency for positive data in January/February followed by weaker sentiment later.

Survey data in the UK have already softened in the most recent data releases, such as the services PMI index (Exhibit 3). The recent cautious outlook from supermarket chain Morrison's reinforces the Bank of England's current view that a meaningful squeeze on the consumer may be underway by H217 as consumer price inflation outstrips wage growth.

Exhibit 3: UK – softening PMI survey data

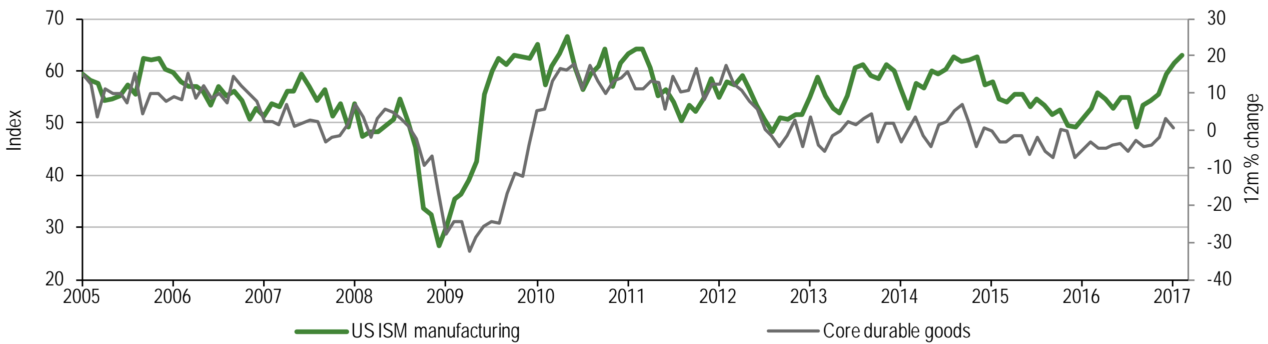


Source: Thomson Reuters Datastream

In the US, core durable goods orders, in a similar manner to consensus US profits forecasts, have not shown nearly as much of an uptick as increasingly optimistic ISM survey data, Exhibit 4. In addition, credit growth in the US appears to have stalled in recent weeks, Exhibit 5.

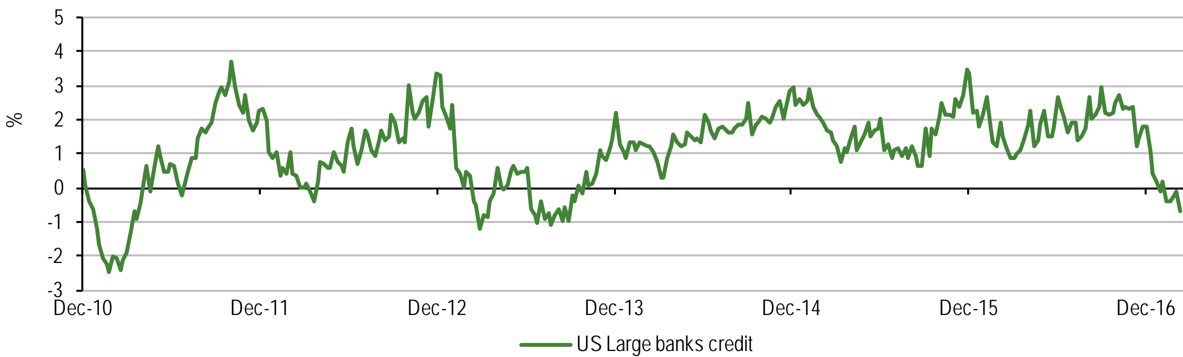
There is certainly nothing like the acceleration shown in the US stock market evident in the real US economy; the Atlanta Fed's GDP nowcast is only indicating 0.9% US growth for the current quarter, compared to over 2.5% as recently as early February. We continue to believe that Trump's infrastructure spending plans and changes to the US corporate tax code are a 2018 earnings story at the earliest – and there remains significant uncertainty over the ultimate form and size of these fiscal measures, especially following the debacle in respect of the failure to repeal and replace Obamacare.

Exhibit 4: US – core durable goods orders lagging ISM optimism



Source: Thomson Reuters Datastream

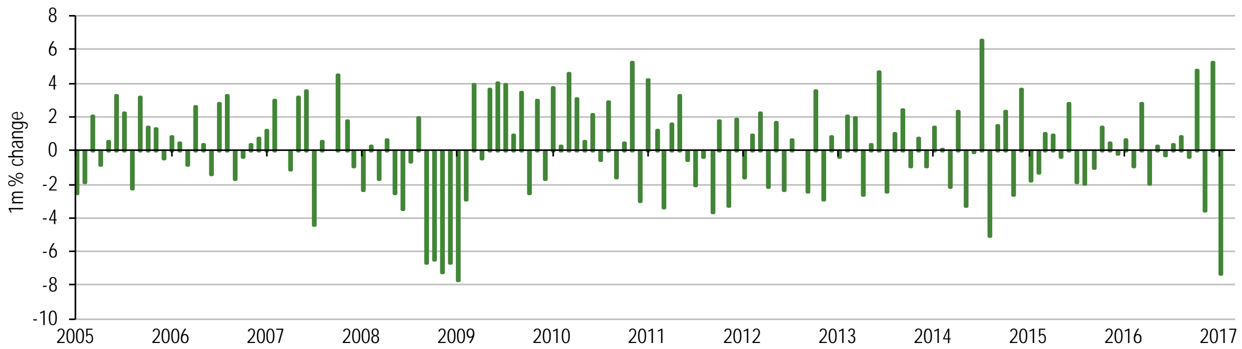
Exhibit 5: US – large bank loan growth declining sharply over last three months



Source: US Federal Reserve

For Europe, a recent bright spot in terms of positive economic momentum, the question since 2012 has always been the durability of any recovery. In this regard, with optimism still strong we would highlight German industrial orders which showed a significant softening in January, Exhibit 6. As in the US, survey data paints a rather more positive picture but it remains to be seen how the gap between expectations and reality will be closed.

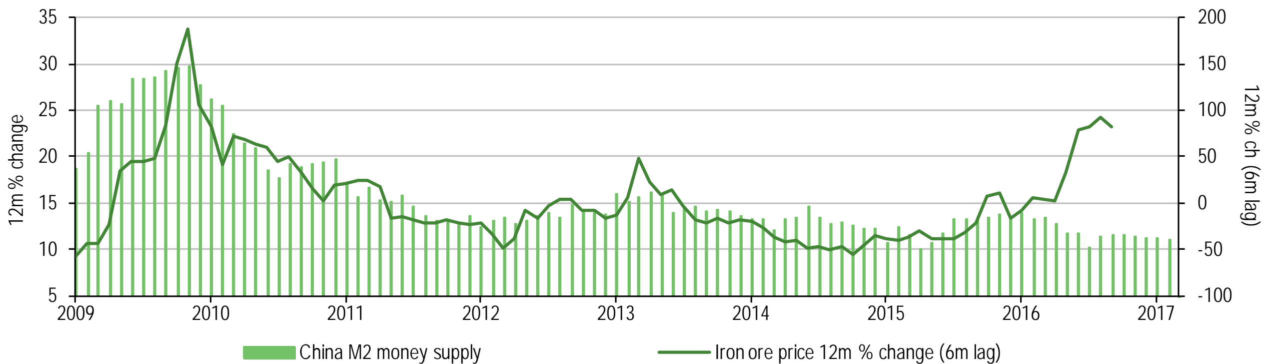
Exhibit 6: German industrial orders month-on-month



Source: Thomson Reuters Datastream

In China, the growth of the M2 money supply has historically been correlated with industrial metals prices, which have lagged the change in the money supply by six months. We note a slowing of M2 since the rebound in Q216, Exhibit 7, even as for now China's PMI indices remain in positive territory and iron ore prices are only a little lower than their highs for the year. We still maintain the view that the commodity and energy bounce was a 2016 phenomenon and from an oversold position rather than representing a new bull market. The recent correction in the oil price also raises further questions over near-term demand.

Exhibit 7: China – slowing M2 money supply growth and iron ore spot price



Source: Thomson Reuters Datastream

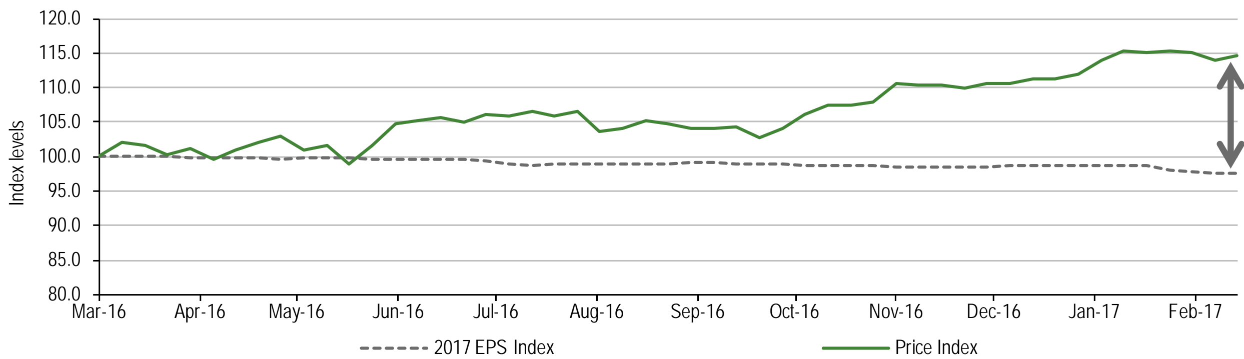
Earnings trends: Gap risk endures in US

As US markets rise, US earnings forecasts fall

Equity investors took significant comfort from Trump's address to the US Congress. While the speech was delivered with unanticipated polish, there was in our view little new policy detail and we were surprised by the resulting surge in global equity markets. In our view, investors and the corporate sector will struggle to incorporate Trump's fiscal initiatives into capital spending plans and profits expectations until more detail becomes available.

Since mid-February median US earnings estimates for 2017 have fallen by 1%, Exhibit 8. On a weighted average basis the decline is less at 0.5% but the direction is the same. These declines in profits forecasts seem at odds with the near-euphoria evident in the strong performance of the S&P 500, which has risen by 5% over the same period. The gap between fundamentals and market prices therefore continues to widen.

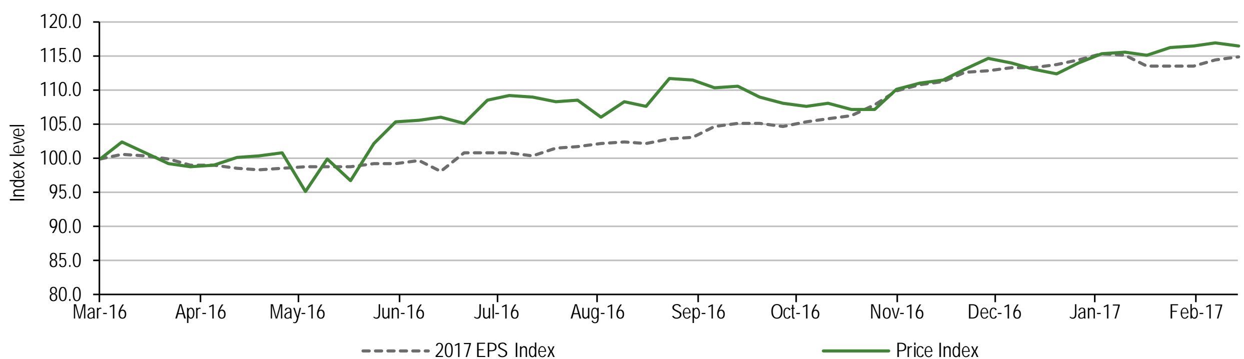
Exhibit 8: US earnings estimates lag equity market



Source: Thomson Reuters Datastream, Edison calculations

The situation is different in the UK where the FTSE100 has been supported by a rising trend in earnings forecasts, in part due to the decline in sterling. While Exhibit 9 suggests there is no 'gap risk' in the UK, we note that the momentum in earnings estimates has faded since the end of 2016, with forecasts unchanged year to date. We suggest investors are watchful for a change in the direction of UK earnings forecasts, as UK PMI indices move lower.

Exhibit 9: FTSE100 closely tracking sterling-supported 2017 estimates



Source: Thomson Reuters Datastream, Edison calculations

In continental Europe, there has been something of a rebound in earnings forecasts, with the median for 2017 rising by 1% since the start of the year. However, this seems fully priced into European equities, which have risen by 10% over the same period.

Just what the Fed wanted

A rate increase and a rising market – but was it really dovish?

Having primed markets to fully expect a US rate increase, the FOMC followed through on 15 March. If the aim was to deliver a rate increase without abruptly causing tighter financial conditions (code for declining equity and credit markets), then it was mission accomplished. Following the FOMC announcement the dollar eased against other currencies, bond yields fell and equity markets gained. However, despite comforting language within the statement we detected a more strategic, rather than data dependent, direction for US interest rates in the press conference Q&A.

The first point of interest was Yellen's frequent reference to the appropriate neutral real interest rate when setting monetary policy. During the press conference she confirmed that in the long-run the FOMC expected this rate to be 1%, consistent with its current expectations for 3% interest rates at the end of 2019 and 2% inflation. She also highlighted some estimates which suggest this neutral

real rate is currently close to 0%. Therefore, a gradual tightening of interest rates in the region of 75bp per annum between now and late 2019 would certainly fit her thoughts on this matter.

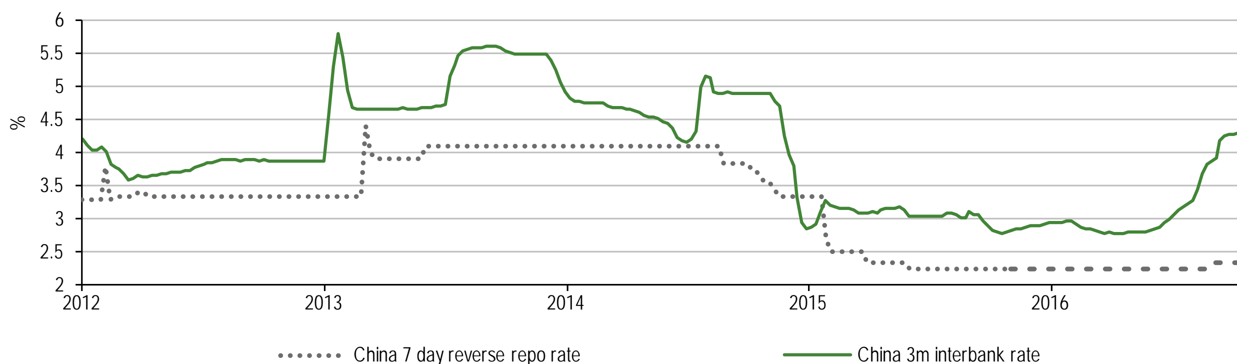
Second, while the statement was widely seen as more dovish than expected, during the press conference a journalist challenged Yellen by observing that, for example the Atlanta Fed's nowcast model for GDP had fallen to 0.9% for the quarter, yet the Fed was increasing interest rates.

Here the response was not so dovish; Yellen indicated that quarter-to-quarter GDP was "noisy" and should be viewed in a longer-term context. Furthermore, there was some reluctance in her reply to shift focus away from low unemployment and signs of improving wage growth. Even if she later confirmed that Fed policy remains data-dependent, her responses may indicate the Fed currently has a bias to gradually tighten on its stated dot-plot trajectory, unless incoming data are sufficiently adverse to meaningfully affect the lagging economic variables of employment and inflation.

It is notable that when Fed officials talk of financial instability they do not seem to be talking about a crash. The instability they refer to seems to be the *risk* of a crash. "Financial instability" therefore appears in Fed-speak to be a synonym or code word for an asset bubble. Therefore, by stating the need to avoid financial instability, Fed officials including Fed Chair Yellen have this year put markets on notice that further gains in asset prices may be viewed by policymakers as undesirable.

We highlight the People's Bank of China following the Fed by increasing interbank borrowing costs by 10bp, the third increase since the start of 2017. This highlights not only the interconnectedness of the global financial system with respect to the US dollar funding costs, but also the shift to tighter monetary policy in China over the coming year, in contrast to the significant easing which benefited markets in 2016, Exhibit 10.

Exhibit 10: China's monetary policy turns tighter, after easing in 2015/16



Source: Thomson Reuters Datastream

Conclusion

In our view, the data tentatively indicate that the gap which has arisen between optimistic survey data, actual economic performance and consensus earnings forecasts will be closed with an ebbing of optimism. For equity investors, the coming quarters may become more difficult as slowing economic momentum is juxtaposed over rising US interest rates and significantly above-average equity market valuations, even if investor optimism has survived the Fed rate increase and Trump's healthcare defeat.

Our cautious views on equity markets are coincident with those expressed in the FOMC meeting minutes and more recently the OECD interim economic outlook which refers to "disconnects between the positive assessment of economic prospects reflected in market valuations and forecasts for the real economy." Based on the current outlook for profits growth, current equity market valuations highlight a further disconnect between financial market prices and the likely

evolution of corporate profits. In addition, corporate credit risk premia also appear unusually compressed at present, a dramatic reversal from only 12 months ago.

The question remains as to how far investors are prepared to 'look through' this period. History suggests that if the Fed continues to tighten policy monotonically then equity markets would perform poorly. However, that is only one scenario; policymakers' reaction to the softening incoming data is still an unknown. Given the benign reaction to both the Fed rate increase this month and the evident difficulties of implementing Trump's policy agenda, we now believe that caution rather than short-term bearishness is warranted in terms of equity allocations.

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