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Illumination: Equity strategy and market outlook

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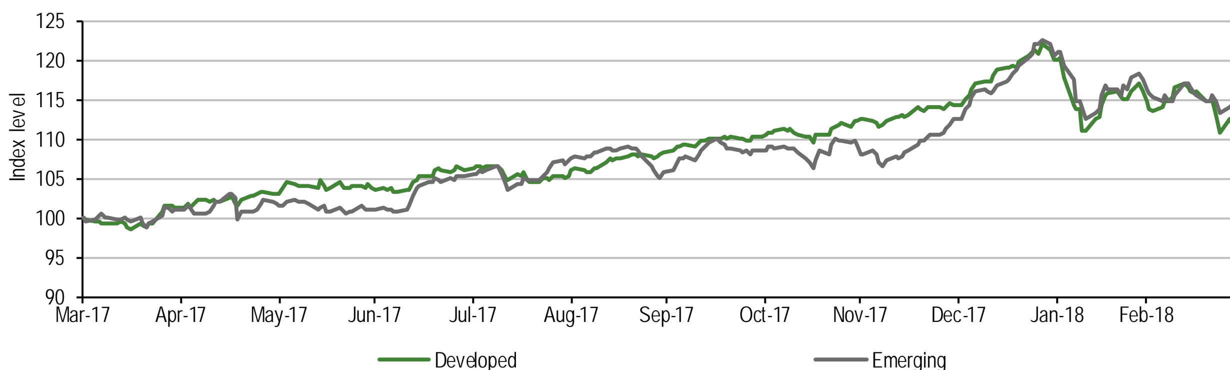
- **Markets may be misinterpreting Trump's need to build a case with voters.** It is very easy to point the finger at US trade sanctions against China as a reason for the recent declines in equity markets. The prospect of a confrontation in the near term, in respect of access to markets and IP protection, is clearly unhelpful for global equity sentiment. Nevertheless, China's transition from a catch-up nation to an economic competitor always had to be addressed at some stage.
- **However, the second dynamic at work during Q118 is a rapid rise in US LIBOR.** At Fed Chairman Powell's 21 March press conference we were surprised this rise in market rates was not mentioned, as it represents a significant extra tightening of financial conditions, on top of rising official rates. Instead, Powell referred briefly to "some" equity prices and "some" commercial real estate being aggressively priced, which suggests any "Fed Put" is for now at least out of the money.
- **The furore over the political use of personal data collected via social media risks fines, regulations and a change in consumer preferences.** The crisis need not be existential for the industry if skilfully handled. Nevertheless, the permissive era when large-scale but still 'cool' digital companies could get a free pass from the rules set for older industries, whether in terms of business practices or taxation, appears to have passed..
- **We are now seeing a trend of weaker economic data in Europe**. Unweighted earnings estimates have continued to fall during Q1, if modestly, and perhaps more importantly economic surprise indices have turned sharply lower. We view this as partly due to Brexit uncertainty in the UK and the recent strength of the euro.
- **The benefits of US tax reform and the tailwind of economic momentum of 2017 are now in the rear view mirror.** US and European equity investors will have to contend with a slowing of economic momentum in Europe, high valuations and tightening US monetary policy, in addition to significant headline risk in respect of a "trade war" over the next quarter. We believe equities are unlikely to make substantial upward progress in these circumstances and that investors should continue to position portfolios cautiously.

Market declines: US LIBOR or US trade war?

Markets may be misinterpreting Trump's need to build a case with voters

It is very easy to point the finger at US trade sanctions against China as a reason for the recent declines in equity markets. The prospect of a confrontation in the near-term, in respect of access to markets and IP protection (moving towards a fair competition zone perhaps rather than a free trade area), is clearly unhelpful for global equity sentiment. However, China's transition from a catch-up nation to an economic competitor always had to be addressed at some stage.

Exhibit 1: Equity markets lose momentum during Q1



Source: Thomson Reuters Datastream

The temptation to tar the new US trade policy for China with Trump's brush should be resisted, in our view. The entry of China into the WTO allowed the nation to trade with the rest of the world, yet structural impediments to foreign competition and investment remained and in recent years were sometimes reinforced.

For example, to access Chinese markets, foreign companies must often have a local partner, such as a state-owned enterprise. At first sight, many of the criticisms contained in the US Presidential Memorandum of 23 March, regarding China's industrial policy in respect of foreign investment and intellectual property, appear well founded.

China has been able to continue to exploit its status as a developing nation in international eyes to maintain tight control of foreign investment and competition in its economy. There is nothing unique in this – in the 1980s the US focus was on Japan, which had followed a similar redevelopment strategy.

The requirement for a level playing field to facilitate the continued operation of a free trade area is also built into the single market in Europe. Within the EU, there have by necessity been strict rules on state subsidies and non-discriminatory access to member state markets – matters which have recently come to the fore during Brexit talks. However, in China, international observers have long complained of the many industries which are largely state owned and subsidised through the financial system, leading to overcapacity and the incentive to dump product on international markets.

In terms of intellectual property Chinese corporates, often with opaque ownership structures and financing sources have in recent years been roaming the globe buying Western assets in future growth industries. Intellectual property has long been a concern of the US and now in Europe, where further scrutiny of Chinese M&A has also recently been proposed.

In the US, the deal-blocking powers of CFIUS (Committee on Foreign Investment in the US) were strengthened as far back as 2007 following an abandoned approach by China National Oil Company for Unocal. The issues raised at the time – national security, intellectual property and the

lack of a level playing field – are the same as those being raised now and are therefore not new. For the trade hawks, China's strategy has been to play a long, slow and non-confrontational game while expertly taking advantage of all of the benefits of the openness of developed markets.

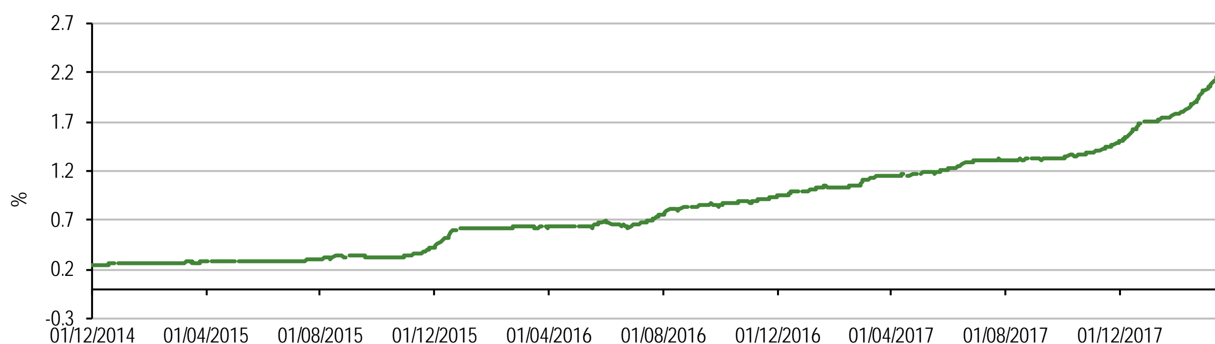
Trump's broad brush has, however, tarred the process with the prospect of 25% tariffs on approximately 10% of China's imports to the US, spooking markets. However, this is typical Trump – others with similar views on Chinese industrial policy such as Europe and Japan have lobbied hard to have issues addressed via the WTO in parallel. However, from the perspective of making a lot of noise for a domestic audience, and thus creating the political capital to come to the negotiating table from a position of strength, Trump's move is not entirely irrational.

The WTO channel may yet be more productive in the long run, offering a carrot to the stick of populist US tariffs. For example, in the case of the recent US steel tariffs, the exemptions for Europe, Brazil, Korea and Canada which cover 80% of US imported steel indicate how much might be for show and of relatively little ultimate economic impact.

Surge in US interbank funding costs is tightening US financial conditions

The second dynamic at work during Q118 is a rapid rise in US 3-month LIBOR, Exhibit 2, over and above that of official US interest rates. This is tightening US monetary conditions rather faster than policymakers may have intended. In the recent market declines we still see the tell-tale signals of tighter monetary policy and easing economic momentum intersecting with relatively high equity market valuations. US 3M LIBOR rates have moved sharply higher during 2018 and significantly faster than expected risk-free rates, and currently stand 2.27%.

Exhibit 2: Surge in USD 3M LIBOR tightening financial conditions



Source: Thomson Reuters Datastream

The relative shortage of US dollars, but the absence of any move in cross-currency basis swaps or the USD exchange rate, is indicative of a domestic US phenomenon. There are a variety of possible explanations, including the steady reduction of the US Fed's balance sheet, but importantly there are for now no signs of distress from US banks. The impact is therefore on floating rate funding costs benchmarked to LIBOR, particularly in the corporate sector.

At Fed Chairman Powell's 21 March press conference we were surprised this rise in market rates was not mentioned, as it does represent a significant extra tightening of financial conditions. The 25bp increase in the Fed funds rate was as expected and an extra rate increase for 2019 was indicated in the 'dot plot' projections. Powell was keen to downplay the weight that should be attributed to the dot plots, further moving away from his predecessor's forward guidance. On a number of occasions during the press conference he emphasised that the only decision that had been taken was to raise the policy rate by 25bp in March.

It is however the case, in our view, that markets cannot rely on a "Fed put" (the theory that should markets fall sufficiently the trajectory of monetary policy will be adjusted to make investors whole) at

present. Powell referred briefly to “some” equity prices and “some” commercial real estate being aggressively priced, which suggests that a fall in either of these markets would be unlikely to change the path of monetary policy. The modest increments in growth forecast by Fed policymakers are attributable to changes in fiscal policy and the Fed’s room for manoeuvre is in any case limited by the current very low level of US unemployment.

Technology: Social Media’s Dieselgate?

Risks include fines, regulation and a change in consumer preferences

The recent controversy over social media and the use of its user data is likely to persist. Many users may not understand that researchers can accurately profile individuals on something as simple as their Facebook “likes”. The potential for influencing in subtle ways both consumption and more controversially, political behaviours through targeted advertising should be clear.

Multiple investigations across jurisdictions may now cast a harsh light on business practices which may otherwise have continued under the radar. Global digital titans, which have become in effect brokers of user data, are therefore under threat on another front, in addition to a recently proposed digital revenue tax.

VW’s “Dieselgate” was also in part about giving customers something they wanted without paying for it, namely fuel economy and performance. The externality of lower air quality took years to surface and many individual consumers may not even have cared. However, it was a breach of regulations and perhaps more importantly, consumer trust which ultimately proved very costly.

In some respects, “Free” social media platforms have taken the hidden cost model into the digital dimension. While Facebook may be centre-stage today, all free to use/use my data social media businesses are at risk of increased regulation or a change in consumer preferences. After Dieselgate, VW pivoted towards electric cars, not because diesel was banned but because that is what customers demanded. The combination of a loss of brand credibility, significant fines and increased investment in the company’s new direction contributed to a two-year period of share price underperformance.

In situations such as BP’s Deepwater Horizon catastrophe, the initial corporate response is often to downplay or deny the magnitude of the situation. This strategy is high risk because if it does not succeed, there is every incentive for regulators, lobby groups and politicians to amplify their complaints in respect of a firm’s failure to acknowledge wrong-doing. The turn in investor sentiment is more likely to come when management accepts that business practices will have to change, enabling them to start to influence the process and create a strategic plan to exit the penalty zone.

We have had reservations in terms of taxation and data usage or privacy risks in respect of the larger digital companies for some time, as this was not being widely discussed or priced into valuations. Notably excluding highly valued Netflix, the average forward EV/EBITDA for a number of the best known US technology stocks has risen by 25% over the last three years to peak at over 17x in early 2018, a valuation level which offers limited scope for disappointment.

The concerns over the use of user data stem in a large part to just how valuable it is to marketers and the political process, particularly if voters are micro-targeted with advertising or selected news feeds. For consumers, the wake-up call is that these data can influence their behaviour in very subtle ways which they may not be aware of, and is not necessarily in their best interest as they are users, rather than customers or clients.

However, this crisis need not be existential for the industry if skilfully handled and with recognition of the duty of care owed to societies which have generated these vast digital databases. Nevertheless, the permissive era when large-scale but still ‘cool’ digital companies could get a free

pass from the rules set for older industries, whether in terms of business practices or taxation, appears to have passed and we believe valuation norms also still apply.

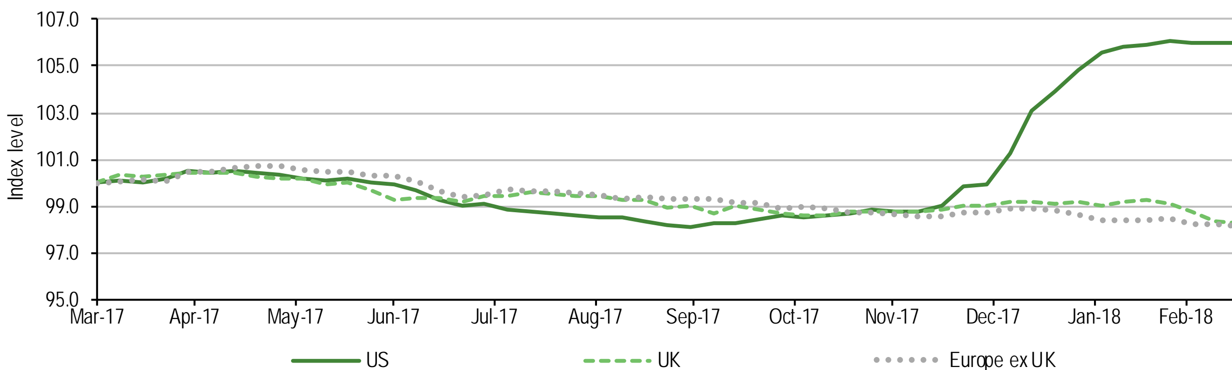
2018 Earnings forecasts: US stable, modest declines in Europe

Watch for ebbing economic momentum as survey data peaks

In the US, earnings forecasts for 2018 have stabilised following the tax-reform induced step-change over the turn of the year. US corporate tax reform is also an interesting data point for future reference, as it shows how the full effect of a well-publicised event has taken as much as eight weeks to be incorporated into consensus expectations. As US markets have fallen modestly at the same time as earnings forecasts have risen, this has for value investors at least been a helpful de-rating of the US equity market.

Consensus forecasts for US equities call for earnings growth of 17% during 2018. It is critical in our view that earnings forecasts remain stable in order for there to be a realistic prospect of a 'soft landing' for US equities. This is the scenario in which markets move sideways and valuations move closer to long-term averages as underlying profits grow (and interest rates are re-normalised). The relative weakness of the dollar has also been helpful in this regard and we would note that while survey data have eased from recent highs and economic surprise indices have softened somewhat, the recent pick-up in equity market volatility appears to have had no effect on US corporate fundamentals to date.

Exhibit 3: 2018 earnings forecasts: Stable in US, modest declines in UK and Europe



Source: Thomson Reuters Datastream, Edison Investment Research calculations

In Europe – and notably both in the UK and on the continent – there has however been no one-off benefit from tax reform and the unweighted average 2018 earnings forecast for companies in the region has continued to soften during Q1, albeit modestly.

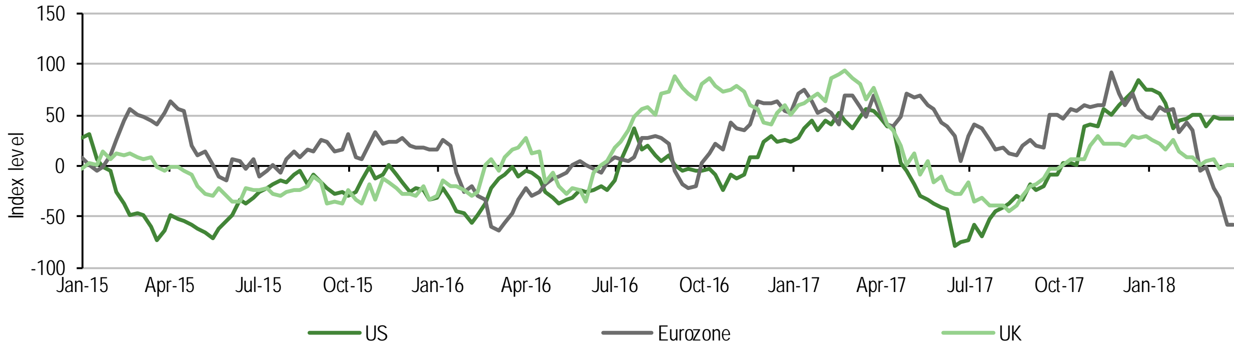
In the UK, the uncertainty over Brexit is now in our view making a tangible impact on the financial services and real estate sectors and recent economic data is now tracking in-line with consensus forecasts rather than continuing to deliver the marginally positive surprises seen over the last six months.

In theory, Brexit should have proportionally less effect on continental Europe, but we note economic surprise indices have fallen faster and from a higher level. In our view, this is likely to be at least in part due to a dampening effect on activity from the rising euro exchange rate.

The strength of the euro is also likely to be uppermost in the minds of ECB policymakers as unconventional monetary policy is withdrawn later in 2018. Given the exchange rate movements and slowing European momentum, it is not a surprise that US short-term interest rates have been rising significantly faster than in Europe over the last three months. We believe it continues to be

unusually important in a top of cycle environment to keep abreast of indicators which may reveal a turn in economic momentum.

Exhibit 4: Notable decline in eurozone earnings surprise index



Source: Thomson Reuters Datastream

Conclusion

We see a continuation of the themes established at the start of the year. Economic momentum is now weakening in Europe and 2018 profits forecasts are on a modest downward trend. Trump's corporate tax reform has boosted US profits forecasts earlier in the year but his proposals on trade have added to uncertainty both for investors and chief executives. A confrontation between the US and China on trade is a negative for markets in the short term.

However, the sharply rising level of US LIBOR points to a relatively rapid tightening of US financial conditions in recent weeks. US equity markets are still highly valued and it is likely in our view that a renormalisation process, in terms of valuations as much as market volatility, is underway.

Investors in the technology sector are re-learning that when technology interacts with society there are business norms in respect of regulation and taxation which will ultimately apply to their businesses.

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