Illumination: Equity strategy and market outlook

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Global perspectives: Return of the risk premium

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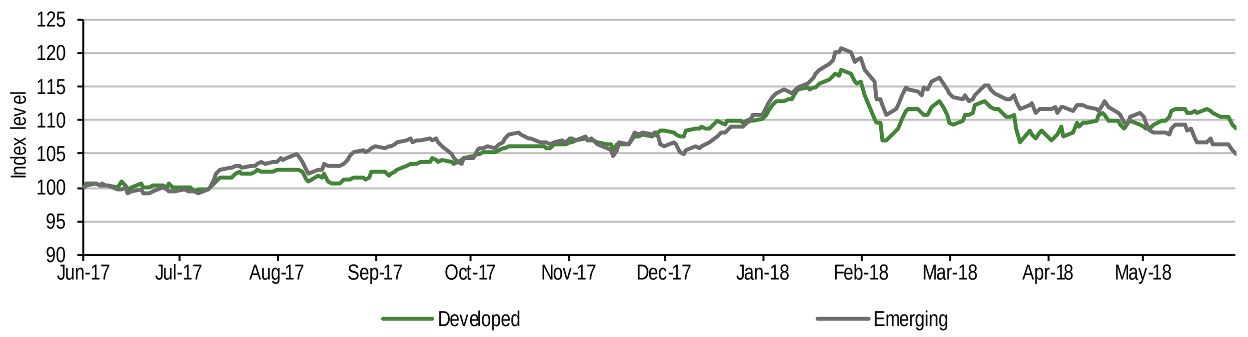
- **In 2018, we observe underperforming emerging markets, a strong dollar, rising volatility and a repricing of fundamental credit risk in Italian bond markets.** These may appear to be disparate narratives but suggest to us that global risk premia are rising as US monetary policy is tightened. We believe the Fed may be reaching the point where questions are raised on just how fast rates can be increased without putting excess pressure on the dollar or inverting the US yield curve.
- **Political developments in Italy have reignited concerns over the sustainability of the euro project.** The long march of populism in Italy has finally knocked on the door of government, only to be turned away. Credit risk premia have surged in Italy and also in other eurozone nations. As market stress has ebbed in recent days, the ECB may have neatly avoided having to reassure investors that euro redenomination risk remains at zero. However, new elections mean that Italian political risk will remain elevated for some months. On the positive side the volatility has led to sharply lower market-implied interest rate expectations on both sides of the Atlantic.
- **Although there has been a notable weakening of economic momentum in Europe, consensus profits growth estimates remain stable.** We believe that, provided this remains the case, there is the prospect of a benign de-rating of currently expensive equity markets as profits grow, while markets move sideways in a volatile trading range. However, the period of outperformance of the energy sector may be drawing to a close following the recent meeting between Russia and Saudi Arabia, which suggests that production increases are on the agenda.
- **US foreign policy is inconsistent and remains a wildcard.** Trade war on, trade war off – then 25% tariffs announced on $50bn of Chinese technology products. North Korea summit on – then off – then possibly back on. While this may yet prove to be genius at work, the appearance for now is of a poorly coordinated administration lacking a unified strategic direction. US foreign policy uncertainty remains at risk of affecting global business confidence.
- **There is no change to our cautious outlook.** We continue to believe equity markets are in a period of consolidation as valuations move closer towards long-run averages as monetary policy is normalised.

Return of the risk premium

Profits growth supports equities as bond yields and political tensions rise

Taken purely from a fundamental perspective, 2018 continues to deliver a strong GDP and profits growth performance in both developed and emerging markets. Yet from a markets perspective, equities have made little headway this year, especially given the positive momentum in corporate profits (Exhibit 1).

Exhibit 1: Global equity markets tread water in 2018

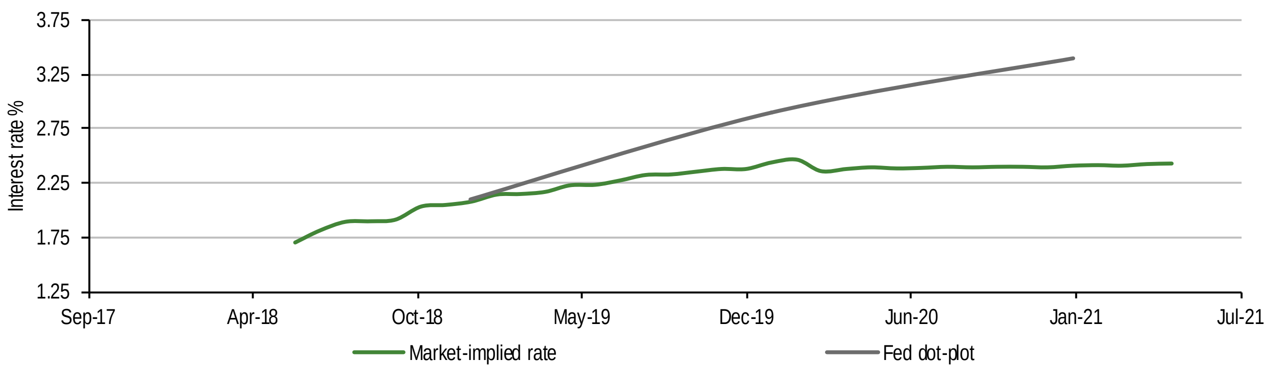


Source: Thomson Reuters. Note: Index level shown in US$

Emerging markets have also underperformed, especially where political risk is evident. Market volatility has risen and the US dollar has also been rising relatively sharply in recent weeks as the trajectory of US monetary policy increasingly diverges from other regions. The very sudden repricing of country risk in Italy is a further example of a situation where the risks were well known, but investors were prepared to ignore them while monetary conditions were loose.

We believe the common factor is the continuing normalisation of US monetary policy. The US Fed may have flagged the trajectory of rate increases and emphasised gradualism but US short-term rates have risen by 1% over the last six months, and just as rapidly as the prior tightening cycle of 2002–06. There appears to be little US policymaker concern at present on the possible risks to the global economy and, in particular, emerging markets, from this normalisation.

Exhibit 2: Market-implied US interest rates diverge from Fed dot plot after 2018



Source: Thomson Reuters

However, looking forward, having already lifted US rates well away from the lower bound without troubling the US economy, we expect international developments such as the rising exchange rate, turbulence in emerging markets and events in Italy to weigh more heavily on Fed thinking over the summer. The knee-jerk reduction in market-implied US interest rates for 2019 following events in Italy may overstate the case in the short term, but at least some policymakers are fearful of inverting the US yield curve or placing excess pressure on the US dollar by an overly large interest rate differential with other regions such as the eurozone. While for the remainder of 2018 interest rate futures are close to the Fed's dot plot projections (Exhibit 2), markets currently have little confidence in US rates significantly above 2.25% in later years. The probability of a pause in US interest rate normalisation, or at least an easing of rhetoric, is rising, in our view, and would facilitate a continued benign derating of equity markets as profits grow.

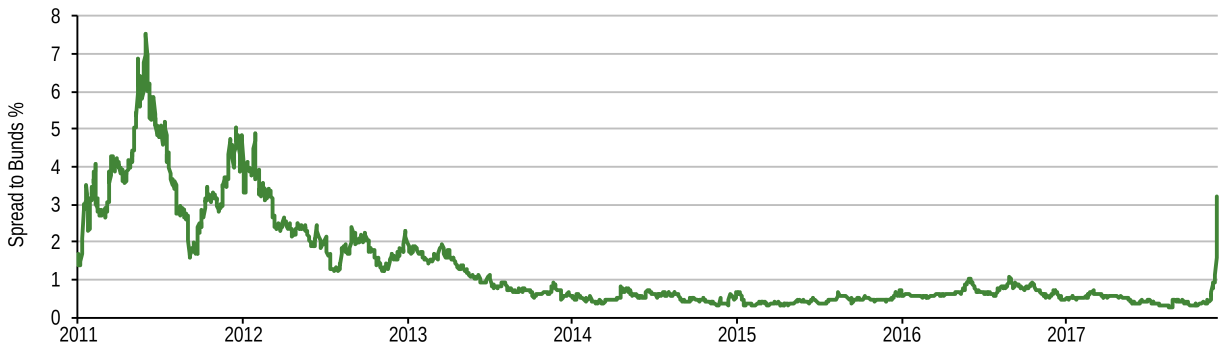
Long, hot Italian summer

New elections may be a referendum on euro and EU membership

Italy's failure over the weekend to form a government was driven by the refusal of the Italian President Mattarella to appoint the hardline Eurosceptic, Paolo Savona, to the position of economy minister. From the perspective of President Mattarella, the recent election was not a referendum on the euro. However, for the Five Star/League coalition the refusal to accept Savona was interference in the democratic process. An incoming caretaker government may have to be put in place but is not the issue; elections either in July or September would in effect be the referendum on the euro. For investors, this creates significant uncertainty over the summer months and into the autumn.

The ECB has been notably silent on developments in Italy, leaving it to Italian central bank head Visco to suggest that only emotional reasons can explain the violent market moves in Italian bond markets this week. It is difficult to understand why he would say this with Italian 10-year bonds showing their worst daily performance in 25 years and short-term interest rates up 50bp since last week (Exhibit 3), unless he had little else to offer.

Exhibit 3: Surge in spread between Italian and German two-year government bonds



Source: Thomson Reuters

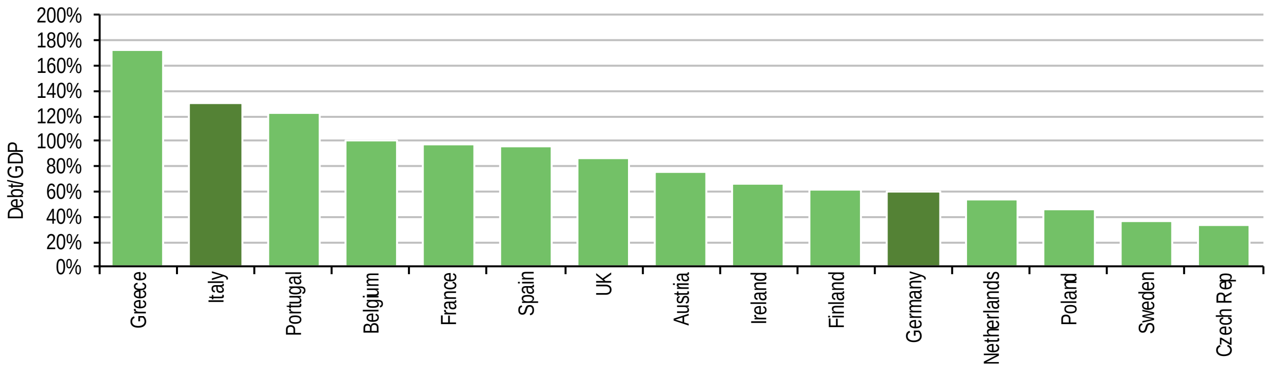
We do not expect the situation to die down rapidly but at the same time would also be surprised if ECB policymakers failed to intervene, should the situation risk getting out of hand. Preventing the break-up of the eurozone has been at the heart of the ECB's and EU's policies for most of this decade. However, these institutions may also privately have an incentive to show the electorate what it feels like to be out in the cold over the summer months. It may have been tactically astute for EU officials to quickly publically distance themselves from comments to this effect by EU budget commissioner Oettinger.

While theoretically the proper transmission of monetary policy is well within the mandate of the ECB, it could yet be seen as advantageous for the ECB to demonstrate the negative effects of an anti-EU vote in Italy, while preventing contagion to other markets. Preventing contagion is a task for the present as credit default swap spreads for peripheral eurozone sovereigns and French banks have surged during the recent turmoil.

There is an inherent conflict in doing whatever it takes to save the euro when the same liquidity support could potentially be viewed in northern European states as enabling free-loading populist politicians. The risk is that conditional support, if necessary, may not soothe markets, which sense a stand-off. Outgoing ECB vice-president Constancio said in an interview this week that any ECB intervention would have to "serve the fulfillment of our mandate" and "meet certain conditions" for any liquidity support.

In our view, the Italian fixed income markets were previously priced on the assumption that the ECB would continue to support the market, making credit fundamentals less relevant, and any Italian government would not ultimately lurch in an anti-euro direction, even if populism was growing at the fringes. Both those assumptions have been challenged. The indebtedness of the Italian government is clearly at the upper end of the eurozone average (Exhibit 4), even if the current account has in recent years moved into surplus.

Exhibit 4: Italian government debt to GDP among highest in eurozone



Source: Thomson Reuters

For investors who were cautiously positioned coming into this volatility, we would highlight that the ECB has still not shown its hand. With redenomination risk rising across the eurozone, careful ECB communication will be necessary to calm markets now that risk aversion has risen to levels which can no longer be ignored and we would not be surprised to see such a communication in the near future.

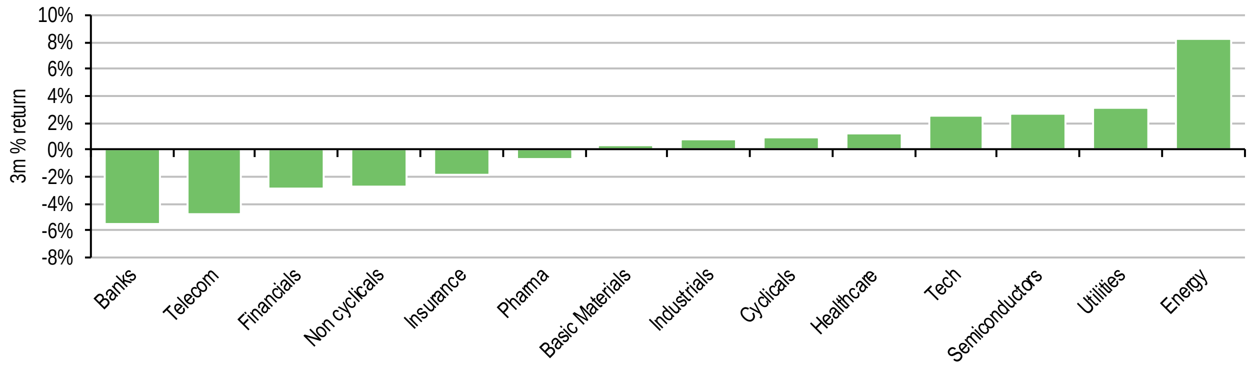
Eurozone money markets have already moved ahead to discount only one ECB rate increase in 2019, compared to three earlier in the year. Ultimately, we believe an Italexit scenario remains unlikely even if the market-implied probability may have risen in recent days. However, the immediate question is the risk of another run on eurozone financial institutions, derailing the economic recovery. ECB President Draghi will have to consider whether he can and will do whatever it takes – all over again.

Energy drives 2018 estimates higher but oil now under pressure

Risks rising as Russia and Saudi Arabia debate whether to turn the taps back on in H2

While it may seem that global investor sentiment has broadly improved over the past three months given the rapid recovery in equity markets, returns have been dominated by the energy sector (Exhibit 5). With Russia and Saudi Arabia now discussing production increases to head off a loss in market share to US shale, momentum in the oil price now appears poised to ease.

Exhibit 5: Global energy sector has dominated three-month market performance



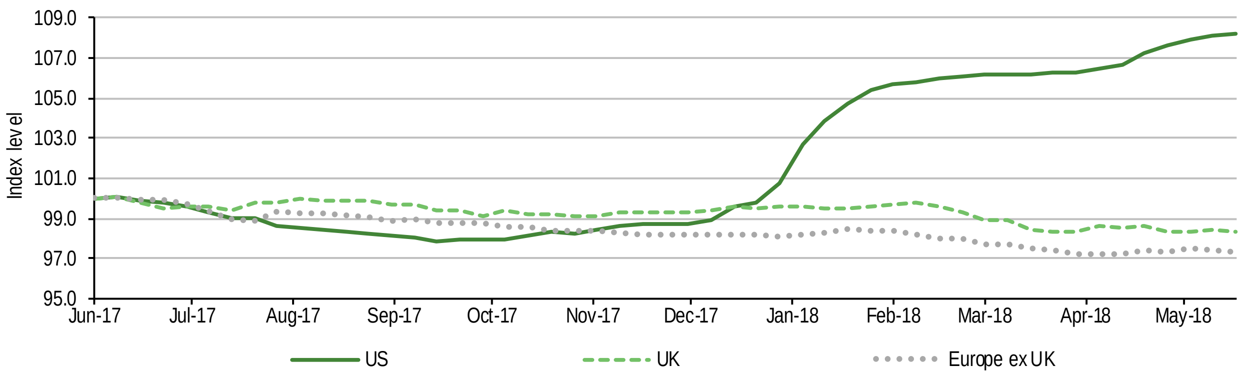
Source: Thomson Reuters Datastream to 27 May 2018. Note: Shown in US$.

Cutbacks in supply and an improving demand picture have led to a remarkable rally in the oil price over the past 12 months. It is by no means clear, however, that the restraint in Russian and OPEC supply is sustainable or even strategically rational in the medium term.

A $20/bbl increase in oil prices since February was, in our view, sufficient to create a dampening of demand and drag on the economic performance of net oil consumers such as Europe. In addition, the Vienna-agreed OPEC supply cutbacks were due to expire after 2018. Press reports indicate that an increase in supply is already under discussion, even before the June OPEC meeting.

With the US staging a considerable production recovery, OPEC members will be concerned not to lose market share. Notwithstanding the upcoming $1.5trn IPO of Saudi state oil producer Aramco, which may suggest a strong incentive for Saudi Arabia to maintain a high oil price, with supply increases under discussion energy equities are unlikely, in our view, to sustain the strong outperformance of the past three months.

Exhibit 6: Median 2018 earnings forecast rising modestly in US, stable in UK and eurozone

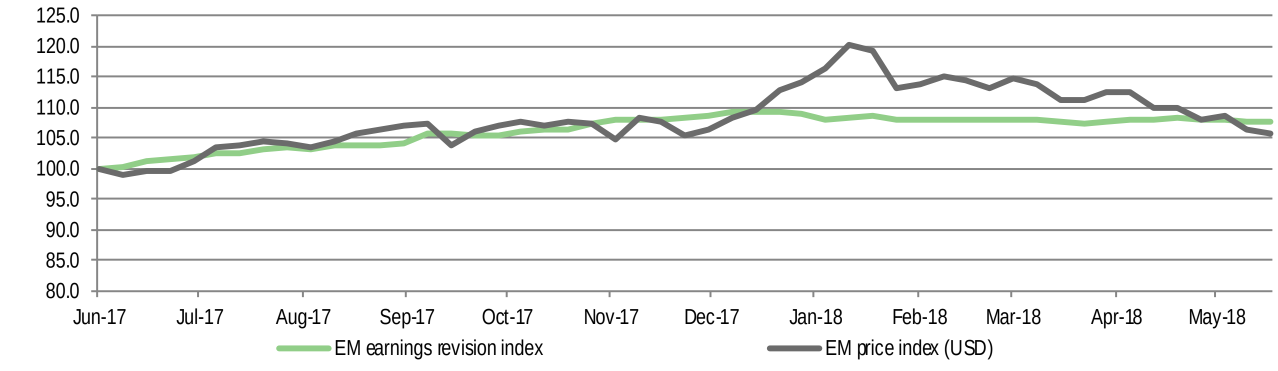


Source: Thomson Reuters, Edison calculations

Outside the energy sector, the median earnings forecast has remained stable in Europe and the UK over the past month and increased modestly in the US. Profits growth forecasts of near 10% for Europe and the UK, and 17% for the US, remain intact even if market volatility has increased in recent days.

For emerging markets, our aggregates show that while there have been very modest declines (1%) since the peak reached in January, consensus forecasts are still indicating 15% earnings growth for the median emerging market equity during 2018, towards the upper end of the range this decade.

Exhibit 7: Emerging market earnings revisions index also stable



Source: Thomson Reuters, Edison calculations

Yet there is clearly concern in the market for the traditional correlation between tighter US dollar funding conditions and emerging market performance. Given the robustness of estimates, recent declines in emerging market assets appear to be a correction from over-exuberance earlier in the year and possibly rising expected returns worldwide as US monetary policy is normalised, rather than any meaningful deterioration in fundamental profits performance.

US foreign trade and foreign policy risks appear haphazard

There may be a method – but it is difficult to discern

The current US administration has delivered a number of mini-shocks to markets during 2018. These include a verbal confrontation with North Korea, threats of trade tariffs on China and pulling out of the international agreement on Iran. Tariffs on European products, most recently autos, are also an unwelcome novelty for traditional allies within the EU.

While this strategy of rattling the tree is highly visible, it remains to be seen whether the long-term strategic interests of the US are being fully served. According to a recent report in the FT, at a recent meeting of influential Chinese officials, academics and businesspeople, the western model of democracy and free-market capitalism was discredited both by the failure to invest in physical and human assets, and the relatively poor quality of elected leaders. On trade, from China's perspective, there was said to be puzzlement by what the US sought to achieve by a trade confrontation. For example, restricting technology-based exports while being unable to produce basic commodities competitively appeared at odds with the aim of reducing the US/China trade deficit.

We expect the Chinese elite will be further confused by the recent suspension of the threat of a trade war without a detailed agreement on trade between the two nations – and then the imposition of 25% trade tariffs on a range of Chinese technology goods one week later. The high-profile US trade delegation, which arrived in Beijing only three weeks ago, delivered a strongly worded list of demands to China, only to return home empty-handed.

The first sign of a change in the US position came in Trump's surprise reprieve for China telecom equipment supplier ZTE following violations of US trade sanctions on Iran and North Korea in April. The US/China statement released the following weekend contained no firm commitments on trade, nor on intellectual property protection or market access. Nevertheless, US Treasury Secretary Mnuchin declared the trade war over.

Disquiet grew rapidly within the US business community about whether the long-term strategic interests of the US were being protected. The surprise imposition of trade tariffs this week shows that public statements from this US administration have to be treated with caution. We are struggling to piece together a coherent strategic position from these events. Even if this may be the intention, we see few signs that the US administration will stop contributing to market volatility through trade and foreign policy.

Conclusion

The fingerprints of tighter monetary policy can be found in rising market volatility, a stronger dollar, underperforming emerging markets and newfound respect for fundamental risks such as those evident in Italy. However, given that at least some US Fed policymakers such as James Bullard have expressed a desire not to invert the US yield curve, the probability of an easing of Fed rhetoric is in our view increasing, thus facilitating a continuation of the benign de-rating scenario for equities.

Although profits growth has to date remained robust, we believe events in Italy should serve as a reminder that fundamental risks remain, even if for a time investors have been more focused on central bank support for asset prices. There is no change to our cautious positioning. In a sideways-moving equity market, investors should remain focused on company- or event-specific ideas to drive portfolio returns.

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