Illumination: Equity strategy and market outlook

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Global perspectives: Good news in the price

- **Global equity markets have only moved sideways year-to-date, even as profits growth remains strong and a number of worst-case political scenarios have failed to materialise in Europe.** In our view, the impact of the positive effect of strong corporate performance remains balanced by high global equity valuations which are easing as US interest rates increase. Emerging markets have notably underperformed since April, reflecting a combination of trade fears, rising US interest rates and a slowdown in China.
- **Earnings estimates outside the US have declined modestly over the past month with the majority of sectors downgraded.** The robustness of earnings estimates has been critical to investor confidence this year, as headline risk in terms of US trade policy has increased markedly. In contrast, US estimates have remained stable over the same period reflecting the positive near-term momentum in the US economy due to fiscal stimulus.
- **There is no change to our cautious outlook.** We continue to believe developed equity markets are in a period of consolidation. Valuations are moving closer towards long-run averages by markets simply trading sideways as profits grow while US monetary policy is normalised.

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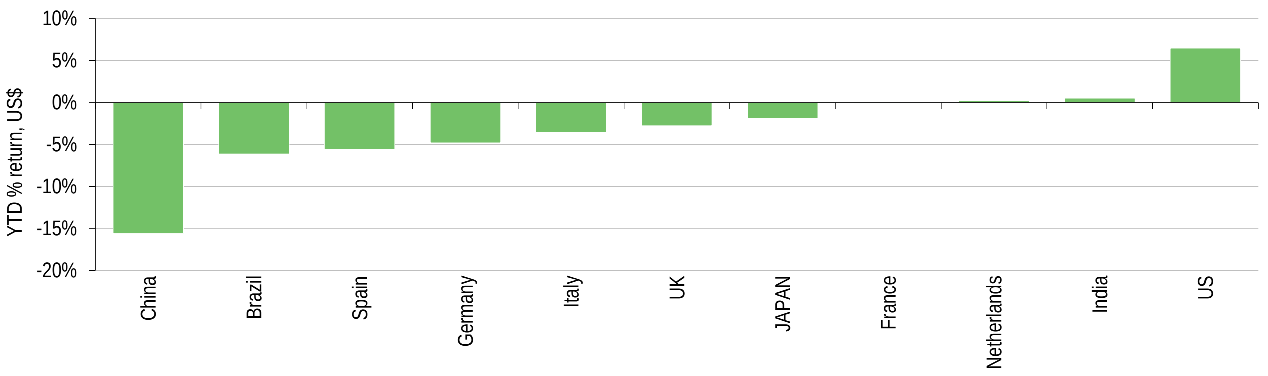
Good news is in the price

Strong profits growth offset by expectations of tighter monetary policy

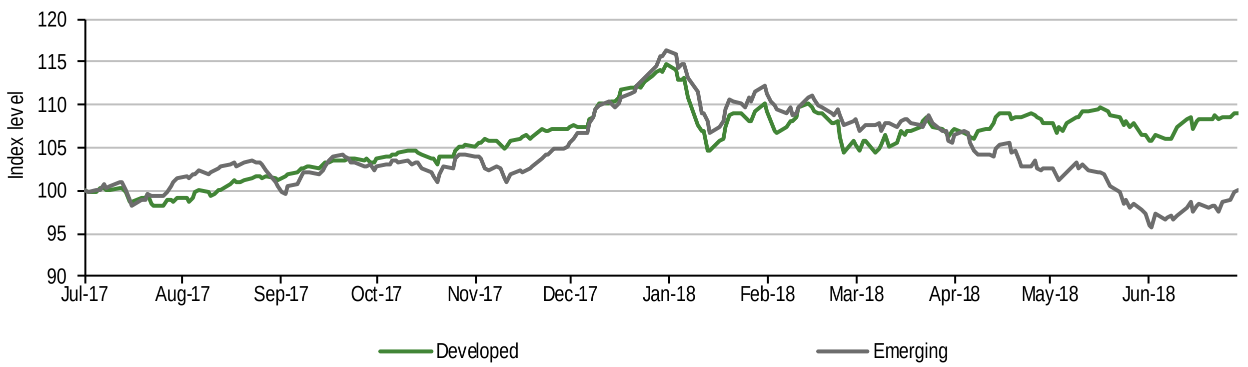
Year-to-date, global equity markets outside the US have delivered a rather subdued performance in US dollar terms, Exhibit 1. The year may have started well but the resurgence in market volatility early in the year has been followed by an escalating trade conflict between the US and the rest of the world. Expectations of tighter monetary policy have pushed both US bond yields and the US dollar higher, contributing to a material underperformance of emerging markets. The start of the period of underperformance also coincides with the escalation of the US trade war, which suggests this may have also been a factor.

Exhibit 1: Subdued global equity market performance in 2018 year-to-date



Source: Thomson Reuters. Note: Returns shown in US$ to 25 July 2018.

Exhibit 2: Emerging markets underperforming significantly since April



Source: Thomson Reuters. Note: Returns shown in US$.

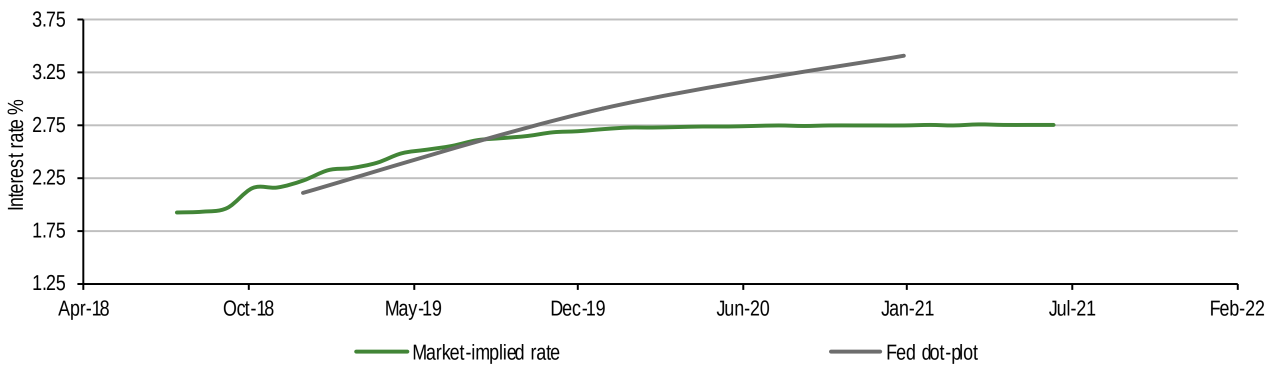
US rate normalisation to continue for next 12 months

Market-implied rates and the US Fed dot-plot forecasts suggest that the Fed has a further 80bp of tightening over the next 12 months, which would leave US interest rates close to 2.5% by the end of the period. At the same time, increased issuance of US government bonds to finance Trump's fiscal stimulus and the decline in the Fed's balance sheet may yet lead to meaningfully higher US bond yields. We continue to believe that the Fed will not be blown off course, absent a meaningful change in the US economic environment despite concerns over the flattening of the yield curve.

There has been a pointed lack of response from US Fed policymakers to either the calls from emerging market central bank heads for the Fed to ease off, or the more recent comments on US monetary policy and the strength of the dollar from President Trump. We believe the Fed has invested significantly in signalling policy normalisation and is arguably only a few quarters away from heralding success, following a decade of exceptionally loose monetary policy, with US unemployment low, growth strong and inflation close to target.

The implication for investors is that with two-year US Treasury bonds already yielding 2.5%, investors have a risk-free asset offering a return above inflation for the first time in a decade, and a rate which is also above the dividend yield on the S&P500. Investors who “reached for yield” in terms of risk or duration in order to obtain income now have an incentive to move back towards prior asset allocations, as the distorting effects of ultra-low interest rates and QE are gradually removed.

Exhibit 3: Market-implied expectations and Fed dot-plot aligned at +80bp to mid-2019



Source: Thomson Reuters

Global equity valuations ease from 2017; EMs now trading at a discount

Due to strong earnings growth and return on equity in both 2017 and 2018, while equities may not have made significant progress in price terms, the benefit has been felt in terms of declining valuation levels. It is not the case that all markets remain at above-average valuations; on a price/book basis emerging markets are trading at a modest discount to their 20-year average for example.

Exhibit 4: Valuation comparisons becoming easier outside the US, EMs no longer expensive

	Current 12m trailing			Premium/(discount) to average			Average
Region	P/E	P/Book	P/Sales	P/E	P/Book	P/Sales	pmm
Europe ex UK	16.8	2.2	1.7	9%	8%	47%	21%
Japan	18.2	1.6	1.2	-24%	-2%	37%	4%
UK	15.7	2.1	1.8	10%	-2%	30%	13%
US	21.2	3.2	2.8	23%	24%	56%	34%
Emerging	13.4	1.6	1.5	6%	-11%	9%	1%

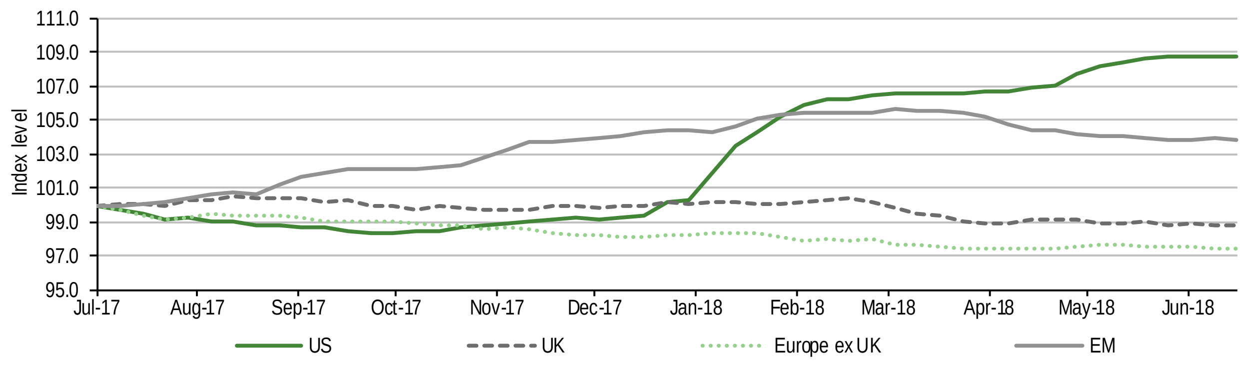
Source: Thomson Reuters, Edison calculations based on median stock in index

While further emerging market volatility cannot be ruled out in the short term, potentially induced by either higher US rates or trade war rhetoric, from a valuation perspective long-term investors may be warming to EMs following the recent underperformance. For developed markets however, while UK and European equities appear modestly overvalued, US equities are notable for being expensive on every measure shown. We believe this is at the root of why US equities are only up 5% this year while profits forecasts have been revised up by 9% over the same period.

Earnings estimates: Marginal declines could point to trouble ahead

Outside the US, most equity sectors have suffered modest downward revisions to 2018 earnings forecasts over the past four weeks. In the US, 2018 earnings forecasts are effectively unchanged over the same period. In our view, it is too early to be certain that this loss of momentum in non-US estimates is the start of a downtrend, but it is consistent with the recent sharp declines in industrial commodities. The good news for 2018 – such as US tax cuts and continuing Eurozone expansion – were always H1 phenomena in our view and now trade war uncertainty has reached a new peak.

Exhibit 5: 2018 US profits estimates still at year highs but other regions peaked in Q1



Source: Thomson Reuters, I/B/E/S, Edison calculations. Note: Index calculated using median revision.

Median 2018 forecasts for Europe ex UK, the UK and emerging markets have ticked lower during the past month. While we would not read too much into a single month's data the clear majority of sectors in these regions have suffered downgrades over the period. In addition, industrial metals prices have been falling, lending weight to the idea that a modest loss of momentum in the near-term cyclical direction of the global economy may have occurred. The very poor performance of China's stock markets so far in 2018 and recent weakness of the renminbi are developments which all investors should be watching, in our view.

These early suggestions of a decline in economic momentum outside the US coincide with increasingly elevated uncertainty in respect of a trade war. In recent weeks there has been escalation of tariff rhetoric from president Trump. He has threatened to place punitive tariffs on all China's imports to the US and has also commented negatively in terms of trade between the US and Europe. It is now the case that the trade war is having a chilling effect on business activity and this is most evident in sectors such as autos where tariffs are being blamed for lower earnings guidance.

Trade war: Political incentives likely to override economic factors

Unfortunately for investors even if Trump's behaviour appears to be economically irrational and ultimately damaging to US interests in the long term, they are part of the package of populist measures which appeal to his supporters and are therefore unlikely to be given up easily.

Trump's recent comments on US interest rate policy and the strength of the US dollar characteristically break previous conventions on the independence of the Fed and refraining from commenting on the currency. Instead of projecting strength, they hint at the weak link in his negotiating position. At present, the US stock market is the best performer year-to-date. It would be reasonable in our view to assume that domestic support for a lengthy trade confrontation would weaken considerably in the event of a correction in the S&P500.

In this regard, the recent cease-fire in trade hostilities between the US and the EU could be seen as a win for both sides. A concerted approach would also place significant pressure on China. Subject to the sometimes unpredictable swings in US trade policy, it would appear that the EU has persuaded the US to at least attempt to work together to address some of the long-standing concerns in terms of unfair trade practices such as intellectual property theft, subsidies and distortions created by state-owned enterprises. The most puzzling part of the US trade war in 2018 was the targeting of supposedly allied nations who shared many of the same concerns as the US in respect of China. We are encouraged by this initiative but believe markets will be also mindful that

US Treasury Secretary Mnuchin declared the US trade war with China “on hold” in Q2, with hostilities resuming only weeks later.

Strong profits growth has been a key part of the resilience of equity markets in 2018 even as monetary policy is normalised and a US trade war has materialised. Although one month’s data is insufficient to determine a trend, we see no reason to move away from a cautious positioning on equity markets which year to date have, outside the US, only moved sideways or lower in US dollar terms.

Conclusion

We believe global equity markets remain in a period of consolidation while US interest policy is normalised. Looking ahead into Q3, further US rate increases and the end of QE within the eurozone, combined with trade war uncertainty are likely to balance the good news on profits and US growth. Furthermore, US bond yields still appear too low given the prospect of increased issuance, a reduction in the Fed’s balance sheet and strong US growth. In respect of the US trade war, we believe the recent comments on monetary policy and announcement of additional subsidies for US agriculture underscore the resolve and political incentive for the current US administration to maintain a confrontational stance with respect to China despite the positive recent EU/US announcement. We remain cautiously positioned on equities.

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