Illumination: Equity strategy and market outlook

August 2018

Published by Edison Investment Research

EDISON

Global perspectives: Towards emerging markets

- **We believe it is now time to look more positively towards emerging markets.** Emerging markets (EMs) have underperformed significantly since the start of 2018, as a rising US dollar and unpredictable trade tensions spooked investors. Now, EMs offer relative value and stronger GDP and profits momentum into 2019. Furthermore, a careful read of Fed chair Powell's Jackson Hole comments opens up the prospect of the Fed moving more cautiously with monetary tightening during 2019, as US rates are closer to the neutral rate of interest. If so, the upward pressure on the dollar would be likely to ease.
- **Earnings estimates outside the US have declined modestly over the past month.** We note that economic sentiment has been improving in Europe as trade fears subside. However, the lack of earnings momentum in the UK and Europe compared to the US has been a key driver of the relative outperformance of the US, in our view. While US earnings momentum in 2018 has been very strong, for 2019 we note that consensus sales growth forecasts on both sides of the Atlantic are at the lower levels more typical of this decade.
- **In the context of a possible inflection point in Fed policy and easing trade tensions, we are modestly more positive on the outlook for global equities in the near term.** Even so, due to relatively high valuations for developed market equities, the risk of below-average returns for the medium term remains in place. In the short term, however, markets are likely to respond favourably if we continue to see fading trade and monetary risks during the remainder of 2018.

Analyst

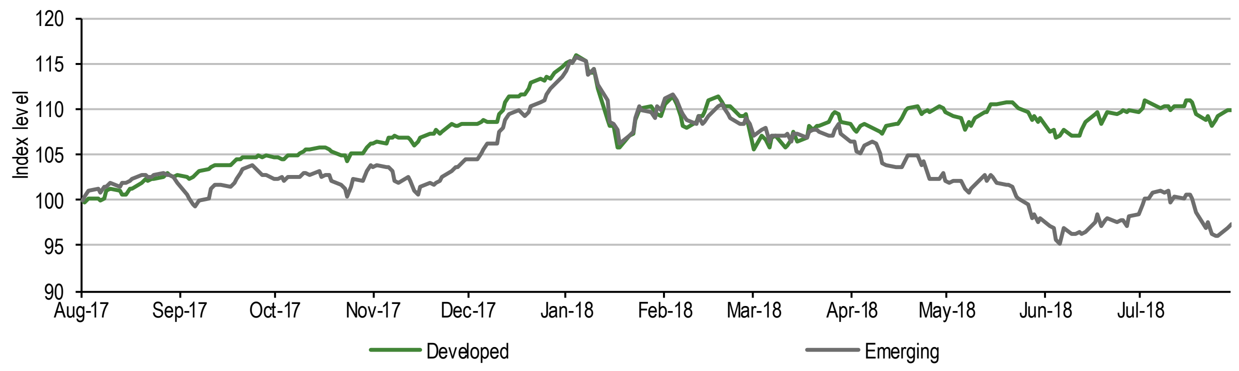
Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

Time to tilt towards EMs?

Potential inflection point in both monetary policy and US trade policy

The underperformance of EMs during 2018 (Exhibit 1) during a period of strong global GDP growth and relatively strong commodity prices has been a striking feature of 2018. We believe that the combination of tightening US monetary policy and significant concerns in respect of confrontational US trade initiatives led to an additional risk premium for EM equities. This was reinforced by the strength of the trade-weighted dollar. As a result, EM equities now trade in line with historical valuation averages compared to still-large price/book and price/sales premiums for developed markets.

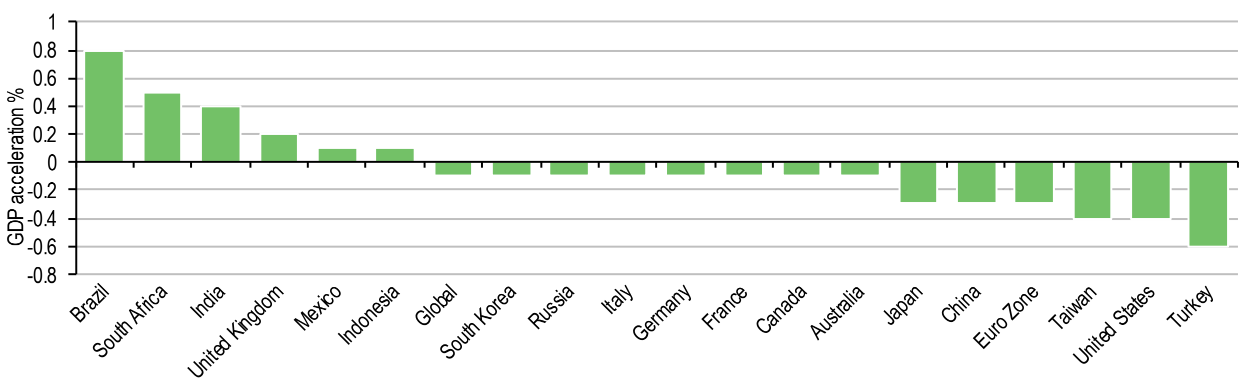
Exhibit 1: EM equities a surprise underperformer in 2018 to date



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

The question has, however, been one of timing. With the recent calls from EM central bank heads for the US Fed to take note of financial conditions outside the US, we sensed that the concern that a crisis was brewing in EM FX was being felt at the highest policymaking levels. Furthermore, the widely reported recent difficulties in Turkey led to a degree of contagion across other EMs, even if in many respects Turkey is clearly a country-specific political and economic problem. The situation in Turkey remains challenging, although with both the currency and equity valuations trading at long-term lows, this appears largely discounted by the market.

Exhibit 2: Many EMs rank highly for GDP momentum in 2019 compared to the US and eurozone

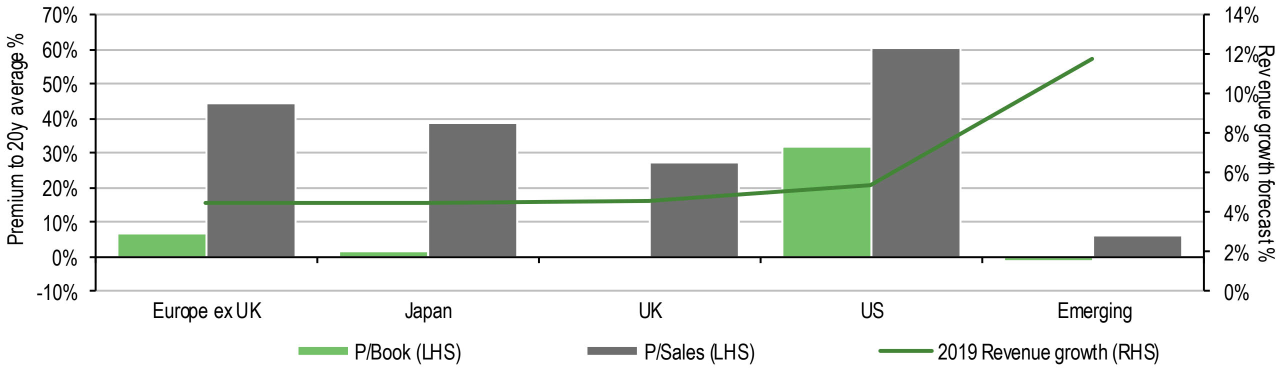


Source: Thomson Reuters, Edison calculations. Note: GDP acceleration defined as 2019 less 2018 consensus forecast GDP growth.

We have continued to monitor earnings revisions for EMs since the sell-off began in April and believe that although both the median and weighted-average 2018 estimates have been falling (Exhibit 3), the downgrades are modest in the context of 15% forecast earnings growth. In fact, EM earnings projections have been falling only at a similar pace to those in Europe and the UK in recent months. While we think a precautionary discount for EMs in the context of US monetary and trade risks was understandable up to now, company fundamental performance does not appear to justify such a significant sell-off, at least to date.

Furthermore, while contingent on the absence of a full-blown EM FX crisis, consensus GDP forecasts currently suggest that economic momentum will favour EMs over developed markets in 2019 (Exhibit 2). The US in particular is likely to show a slowing of growth compared to 2018, potentially providing the room for the US Fed to slow the pace of rate increases next year.

Exhibit 3: EM valuations more attractive than developed markets and 2019 sales growth markedly stronger

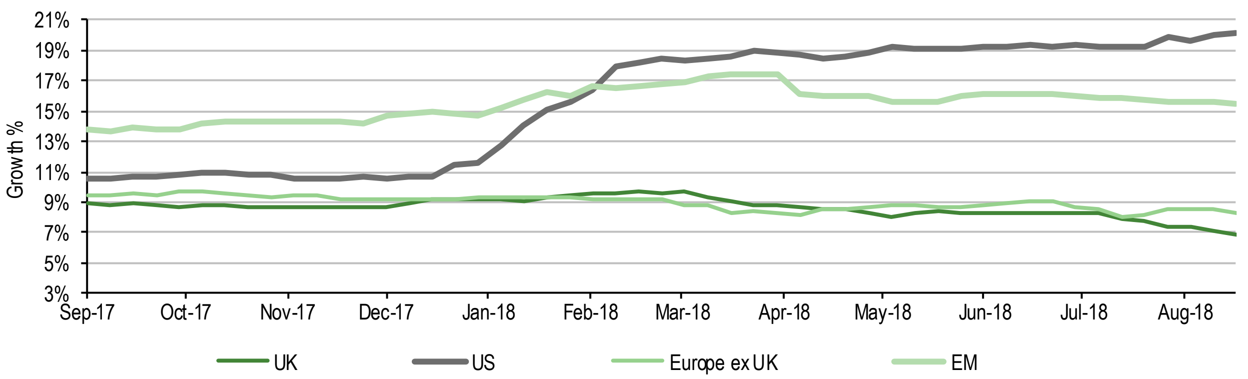


Source: Thomson Reuters, Edison calculations

Finally, we estimate that EM valuation multiples remain close to long-term averages on traditional multiples such as P/E, price/book and price/sales. The absence of a re-rating in terms of price/sales is especially notable when compared to developed markets. As investors turn to prospects for 2019, we believe 11% sales growth for the median EM equity will warrant close interest when compared to growth of less than half that figure for developed equities. As an added bonus, EM non-financial EBITDA margins may be at the high end of a tight cyclical range over the last seven years, but there is no evidence of an upward drift requiring not entirely irrational but novel models of 'superstar' firms (such as those that dominate US tech and extensively discussed at the Fed's Jackson Hole conference) to explain excess profitability.

We are not, however, suggesting that allocating assets towards EMs now is a once-in-a-lifetime opportunity or that it is without risk. EM valuations are only close to average rather than cheap, compared to their history over the past 20 years. Furthermore, there remain risks in terms of the possibility of newly heightened trade tensions and US monetary policy, which we discuss below.

Exhibit 4: Median 2018 earnings growth forecasts continue to decline outside the US



Source: Thomson Reuters, Edison calculations

Fed chair Powell: Jackson Hole speech suggests a risk managed approach

While at first sight the comments of Fed chair Powell at Jackson Hole appeared in line with both the recently released Fed minutes and his previous comments, his speech contained new material specifically addressing his views on decision-making under uncertainty. The uncertainty relates to the estimates of both the natural rate of interest and unemployment. By drawing a parallel with Greenspan's intuition during the 1990s that productivity was growing faster than real-time forecasts could capture and interest rates could stay lower for longer, Powell has certainly caught investors' attention in recent days, as US equities make new highs and the dollar falls.

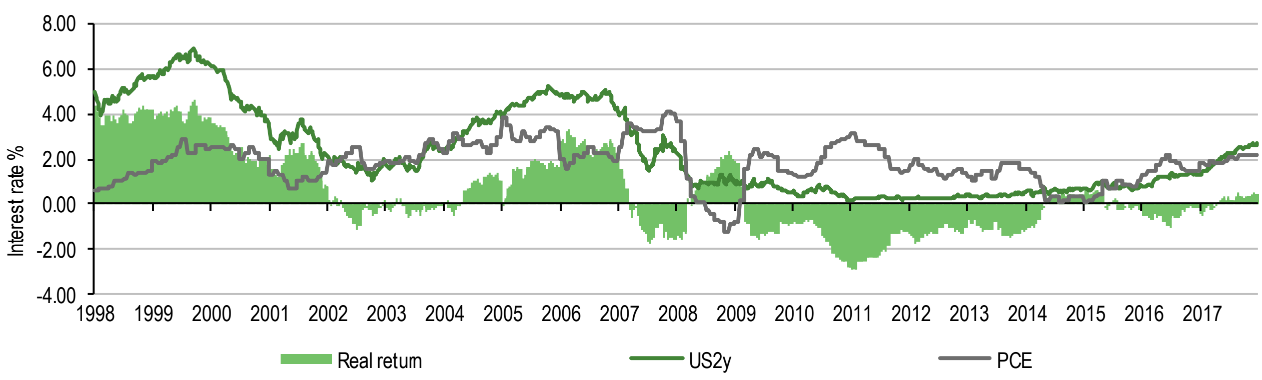
Powell also drew a distinction between circumstances where a central bank has to act forcefully – such as during a financial crisis or when inflation expectations have lost their anchor – and more typical conditions. In times of crisis, the risk is to move too slowly. However, when, as is the case now, inflation expectations are well-anchored and there is uncertainty in the economic parameters, Powell clearly favours Greenspan's wait-and-see approach. His definition of an adverse inflation outcome of more than 5% is also noteworthy, as it suggests a tolerance for higher reported inflation provided that the Fed's other data sources indicate an absence of inflationary pressure.

One speech does not of course change the entire landscape of future monetary policy and we continue to expect 75bp of further tightening over the next 12 months. Powell's speech may, however, represent an inflection point in terms of US monetary policy – and US two-year rates have in recent weeks been moving higher but at a slower pace.

We would also highlight that with US two-year rates close to inflation, Exhibit 5, the most perilous part of the market journey to interest rate normalisation – which historically is the period when real rates rise from being substantially negative to zero – has now been successfully navigated. In our view, Powell has reassured markets that from this point the US Fed can take a wait-and-see approach, which will become more in evidence in coming quarters. Such an approach is also consistent with a likely slowing of US GDP growth during 2019, due to the one-off benefits of US tax reform this year.

In respect of longer-term bond yields, the willingness to look-through temporarily higher inflation would on balance be expected to lead to higher bond yields. While US short-term rates by mid-2019 would be offering a real return of around 0.5%, close to long-run historical averages, US long-term real rates still appear anomalously low. Powell's comments were, in our view, positive for US growth and negative for the dollar (and also beneficial for EMs). If these comments do ultimately translate into US monetary policy, we would expect to see the yield curve steepen after flattening significantly over the past 12 months.

Exhibit 5: US two-year rates finally above US PCE inflation



Source: Thomson Reuters

US trade policy: First EU then NAFTA gives investors hope on trade

Only a few months ago, the Trump administration's controversial and confrontational trade tariff initiatives were raising fears of a breakdown in the global trading system. However, the recent truce between the US and the EU has already had a positive impact on business sentiment in Germany, with the IFO index scoring its largest gain this year during August.

Adding to the sense of a de-escalation in the US trade war has been the announcement of a proposed deal between the US and Mexico to replace the current North American Free Trade Agreement (NAFTA). Details of this proposed agreement are not yet available and a final agreement is still pending, making an assessment of the likelihood of ultimate success of this initiative difficult. Any final agreement would also require congressional approval. The conspicuous absence of Canada points, in our view, to negotiation dynamics and congressional leaders have already hinted that a deal that did not include Canada would be unlikely to be approved.

Even if these two developments in US trade relations represent preliminary moves, they deliver a significant reduction in the negative rhetoric from the US administration towards the rest of the world. While the dispute with China continues, the precedent of Mexico and the EU increases the perception that trade wars are more for the benefit of a domestic US audience and the popularity of President Trump. Trump's recent actions fit the theory of an opportunistic and populist agenda; should an accord be reached with China, we believe markets would quickly move to price in the end of what would have been a largely phoney trade war.

Conclusion

We take heart from Fed chair Powell's most recent comments that indicate a preference for having a bias (with the proviso of inflation expectations remaining properly anchored) towards a wait-and-see approach, due to the uncertainties present in the incoming data. This is, in some respects, forward guidance on what happens after the currently priced-in Fed rate hikes have been implemented. As a result, the upward pressure has eased on the dollar and it is now, in our view, time to look again at EM equities. For bonds, a more dovish Fed may create upward pressure on US 10-year bond yields, steepening the yield curve. We believe US 10-year yields remain too low in this context and also because of increased net issuance of US Treasuries in coming years to finance Trump's fiscal stimulus.

Emerging equities have underperformed so far this year but consensus forecast earnings growth both this year and in 2019 is well above developed market peers. Furthermore, valuations for EMs, while not inexpensive, are no higher than historical averages compared to relatively expensive developed markets. It is early days, but the apparently improved US trade relations with NAFTA members and the EU is also likely to lead to improved growth sentiment, if sustained.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
United States

Sydney +61 (0)2 8249 8342
Level 12, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia