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Illumination: Equity strategy and market outlook

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Global perspectives: Choose your narrative

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- **Ten years on from the acute phase of the global financial crisis, investors still fear that markets risk collapse as central bank support is withdrawn.** Yet this is at the same time as the US Fed has successfully normalised monetary policy and the S&P 500 is close to a record high. We also note that during the 2004-05 US rate tightening cycle the stock market rose as US rates increased and the US economy continued to expand.
- **Earnings estimates outside the US have declined only modestly over the past month and US estimates remain stable.** We believe that robust earnings forecasts have been key to the benign de-rating process over the last 12 months, where equity markets (outside the US) have been growing into currently extended valuations by moving sideways as profits increase.
- **A risk premium for UK assets is likely to remain in place due to Brexit uncertainty.** We can see a rationale for a sustained increase in the risk premium for sterling, gilts and UK equities post Salzburg. This is based on the continuing uncertainty and two specific scenarios – hard Brexit with a corporate-friendly right-wing government; and a no/soft Brexit with a populist administration. The uncertainty is likely to remain a concern for the corporate sector and investors until the situation is clearer.
- **We retain a cautious position on developed market equities.** We expect a continuation of the benign derating regime as profits grow while markets underperform traditional hurdle rates for equity investment of around 7-8% pa.

2019: Choose your narrative with care

Is the risk trade, politics or tighter US monetary policy?

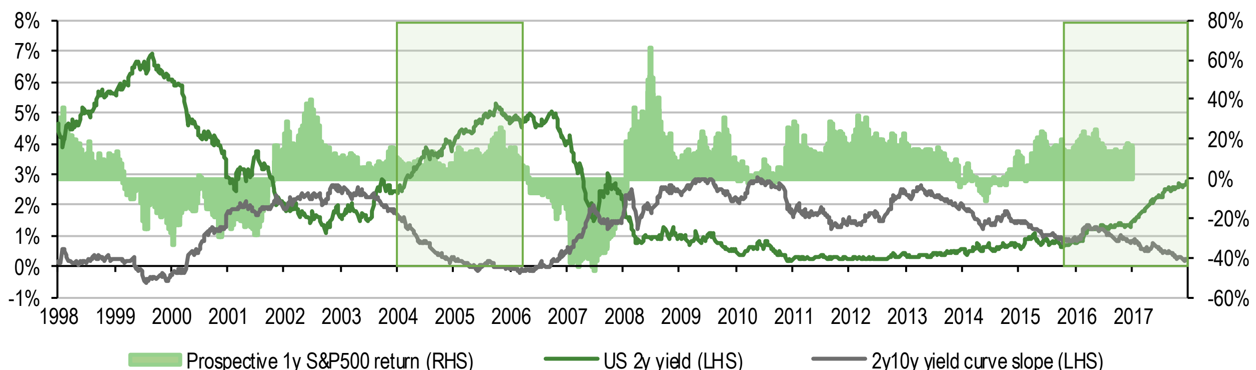
In the 10 years since the global financial crisis of 2007-08 there has been a perennial fear within investors' minds that the withdrawal of central bank support would lead to a collapse in asset values, which had been artificially inflated by ultra-low interest rates and asset purchases. With equity markets outside the US now having fallen by 11% in US dollar terms since the peak in Q118 as US interest rates have risen, it is very easy to become convinced that this is the start of something bigger. While experience is in general an advantage, investors should be aware of the risk of being too quick to make emotive links with the run-up to the 2008 financial crisis and emerging market crises of the 1990s. Notwithstanding the recent market declines, when we look ahead into 2019 we can see scenarios that imply a continued global GDP and profits expansion – and a pause or slowing in Fed rate increases.

Furthermore, time has proved that in the US case at least, asset purchases can be halted and interest rates normalised even as the domestic US stock market remains at all-time highs. We acknowledge that Trump's late-cycle 2018 corporate tax cuts made the transition away from unconventional monetary policy rather easier than it might have been. Nevertheless, investors have at least one case study in how to normalise monetary policy without creating economic disruption as they consider the ECB's next moves.

We have been cautious on equity markets on a global basis for some time, an argument based on the absence of upside due to high starting valuations, rather than a fear of an unanticipated slowdown in economic or profits growth. This call has been mostly accurate over the past 12 months, with the notable exception of the US.

A benign de-rating scenario has played out over this period, with markets moving sideways or modestly lower as profits grow and catch up with market prices. Now, the question is how much further this period of muted returns on equity markets has to run. A linked question is whether the recent turmoil at the fringes of the financial spectrum, namely emerging markets, represents an early warning of a threat to the core or is merely a transient period of volatility before growth is re-established.

Exhibit 1: 2004-05 experience – US rates increased, yield curve flattened, but US stocks rose



Source: Thomson Reuters

We believe a comparison with the 2004-05 period is relevant. The similarity to today is that the Fed started tightening policy after the recovery from the dot-com recession while the economy was still growing strongly. US 2-year yields moved from 1.5% to 4.3% and the yield curve flattened considerably before inverting at the end of 2005, Exhibit 1.

The important point to note is that the S&P was rising throughout this rate increase cycle, even after gaining 30% from the lows of 2003. Furthermore, despite the persistent inversion of the US yield curve, US equity markets did not peak until late 2008, almost three years after the curve first inverted.

Admittedly, the market decline in 2008 was calamitous, taking markets back to 1997 levels, but is a good example of markets remaining irrational for longer than the typical fund manager could remain bearish. Those highlighting the currently flat yield curve would appear to need additional indicators to show that a recession or sharp reduction in the availability of credit is imminent.

We highlighted an increase in the relative cost of LIBOR versus secured funding earlier in the year, typically a sign of a shortage of dollars in non-US markets. This measure, which was a very useful symptom of problems in the financial system as early as mid-2007, has however returned to normal levels, Exhibit 2.

Exhibit 2: Libor/OIS spread has fallen since the peak in May 2018 indicating financial sector stress is waning

Source: Thomson Reuters

One data point that might give cause for some concern is the reported slowdown in global trade. The US administration's policy of engaging in trade conflicts has had a negative impact on sentiment and merchandise trade volumes have slowed in recent months. However, global trade volumes have lagged behind the growth rates of the pre-2008 era for most of this decade, even as the US and Europe recovered from recession. Set against this data are economic surprise indices for developed markets indicating that incoming economic data are currently in-line with consensus forecasts.

Given the one-off nature of the fiscal stimulus from US tax cuts, US corporate earnings and GDP growth in 2019 is very likely to be slower than this year. Yet consensus US earnings forecasts in 2019 are still anticipating high single-digit growth in EPS. In addition, we detect from Fed Chair Powell's comments at Jackson Hole indications of a second, more relaxed, phase in the Fed's rate increase trajectory. Powell highlighted the benefits of central bank credibility obtained by firmly anchoring inflation expectations. He suggested that if this credibility is in place, the Fed could consider running relatively easier monetary policy during an expansion (absent signs of a pick-up in inflation), thus reducing the risk of choking off the expansion too quickly. This wait-and-see approach allows for the possibility that data on potential improvements in the growth rate of the economy may not be available in real time.

In addition to this intriguing, doveish possibility, we note that US interest rates have moved a long way from the zero lower bound and are not so far from Fed estimates of the natural (nominal) rate of interest of close to 2.5%. The September FOMC statement has also removed the word "accommodative" from its description of the stance of policy, suggesting to us that policymakers believe much of the US monetary policy slack has been taken up.

During H218 although US 2-year rates have continued to increase, this has been at a much slower rate compared to the start of the year. A signalling of a slower pace of Fed rate increases would in

our view reduce upward pressure on the US dollar and provide respite to emerging markets. Emerging market equity valuations are more attractive than in developed markets due to the recent run of underperformance, although for clarity we note they are not at distressed levels.

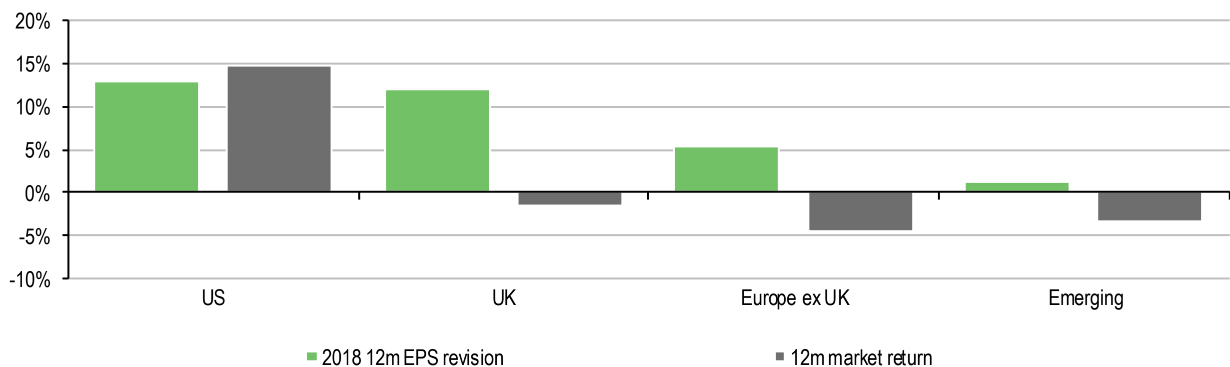
With US trade and Brexit headlines dominating the headlines, we believe it is easy to lose sight of the fact that many of the negative market events of the last six months ie higher volatility, a stronger dollar and underperforming emerging markets, could equally have been attributed to tighter US dollar funding conditions. We may be a little early to highlight the possibility of a more relaxed pace of Fed interest rate increases but if inflation remains well-contained, a self-sustaining period of growth supported by higher wages in the US for 2019 remains a possibility. For the rest of the world, if the Fed shows further signs of a switch to wait-and-see mode during Q4 the pressure on emerging markets may ease.

2018 earnings forecasts stable over the summer

Only marginal declines in EM suggest fears of an imminent crisis are overblown

There is a relatively strong correlation between the direction of earnings forecasts and the short-term relative performance of equity markets. Over the last 12 months, US markets have outperformed peers as Trump's corporate tax reductions and fiscal stimulus have provided a tailwind for US earnings. In the UK, although weighted earnings forecasts have risen UK stocks have trailed behind, in our view due to the negative domestic sentiment in terms of Brexit. Similarly in continental Europe, market sentiment has been affected by international and domestic political events. Intriguingly, emerging market forecasts are holding up over the summer, suggesting fears of an imminent crisis are not at present feeding through to the corporate sector.

Exhibit 3: 12-month weighted average earnings revision and market performance, 2018

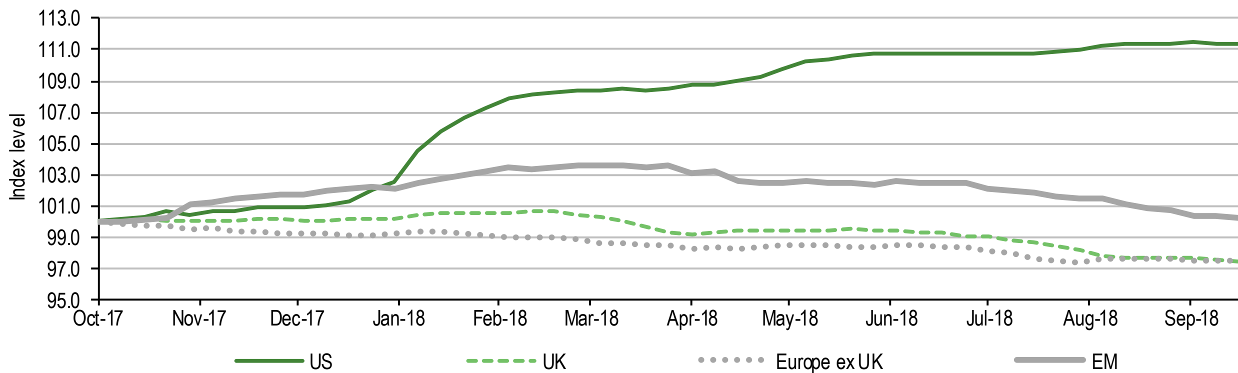


Source: Thomson Reuters, Edison calculations. Market performance in local currency

In addition to calculating weighted average earnings revisions shown in Exhibit 3, we also pay attention to the median earnings revision index. Both indices are useful and for active fund managers the median measure is often closer to the experience felt on the ground. In the UK for example, the high weighting towards oil and resources equities means that the progress of domestic stocks is largely hidden in a weighted average.

Exhibit 4 shows median earnings revision indices. We note that US estimates on this basis remain over 10% higher than a year ago, suggesting a broad-based impact from Trump's tax reform. The initial impact from corporate tax cuts was followed by additional support from the acceleration of the US economy during Q2 as activity was boosted by the fiscal stimulus. In all other markets, the median earnings revision has been falling since Q1, albeit at a modest pace.

Exhibit 4: Median earnings revisions trends in 2018 show modest declines outside the US



Source: Thomson Reuters, Edison calculations

In the UK, there is the clear and present danger of a difficult Brexit process, which may yet cause significant political disruption and appears to have led investors to place something of a risk premium on UK equities, as discussed later. Brexit has also fuelled a significant increase in sterling volatility during the summer. The post-Brexit decline in sterling has not delivered a significant increase in exports but instead created a squeeze on domestic consumers, which may be behind the negative momentum in the median earnings revision index.

In continental Europe, the elevated level of uncertainty with respect to global trade may be having an impact on Germany, although it is noteworthy that the decline in the euro has not had a more positive effect. For emerging markets, although the possibility of serious problems developing as the US dollar strengthens have been well-flagged (and it is clear that this region is in the cross-hairs of US policy on trade), median earnings forecasts have fallen no faster than in the UK or continental Europe over the last six months. Median earnings growth for emerging markets is still expected to be 15% for 2018 and in 2019 is forecast at 13%, ahead of all major developed regions.

Therefore, despite the recent falls in emerging market and industrial commodities prices, forecasts for earnings growth globally are neither at very low levels nor declining at a rate that would be consistent with rapid declines in equity markets.

We believe that robust earnings forecasts have been key to the benign de-rating process over the last 12 months, where equity markets (outside the US) have grown into currently extended valuations by moving sideways as profits increase. There has been little change to 2018 earnings forecasts over the summer, which to us suggests a surplus of analyst commentary rather than actual damage to fundamentals, either from talk of a trade war or the risks of tighter US monetary policy.

Brexit: Extra UK risk premium likely to remain in place

Investors face continued UK uncertainty and polarising outcomes post Salzburg

The unproductive summit of European leaders in Salzburg this week has highlighted the lack of substantive progress on finding any solution to an exit agreement for the UK that will satisfy the EU, Ireland, Northern Ireland, the UK government and UK parliament. Most importantly the declaration by EU council president Tusk that the UK's "Chequers" plan will undermine the single market highlights an objection in principle to the UK's initiative for a free trade area in goods during any Brexit transition period. This principles-based roadblock suggests that tinkering at the edges, such as customs checks in the Irish Sea, are irrelevant details. We see elevated political risk in the UK potentially polarising the outcome between a hard Brexit and no Brexit. Investors will also need to consider the increased risk of a populist UK government.

It may have been a negotiating tactic, but the only solution the EU appears to be proposing that provides any preferential terms for the UK over a third country is continued EU membership. In this sense, UK prime minister Theresa May would be right to feel ambushed at Salzburg, as she has previously made clear that it is not the UK's policy to walk away from the results of the UK referendum.

It is also difficult to discern whether the EU leaders' intent was to draw her in, offering the possibility of warm words to take to the UK Conservative party conference to consolidate her leadership – only to switch to a position that makes her position increasingly difficult domestically. We therefore suspect that trust between the parties will have been severely affected.

With respect to the focus on the Irish border question, in the 21st century an effective goods border is, in our view, potentially possible without physical controls such as a "hard border". This suggests other reasons are behind the impasse. Land borders with other non-EU nations are far from perfect. For example, the Swiss border is minimally manned on all but major goods routes, making it effectively porous except for larger goods vehicles. For individuals, a border may in future be defined increasingly not on physical location but in more terms of eligibility to government services, payments and rights to work, where proper documentation would be rigorously checked.

There is however no greater red line for the UK and Ireland than avoiding the prospect of a recurrence of the violence of the previous century. A thought that the EU could achieve an effective "annexation" of Northern Ireland territory in return for Brexit also seems far-fetched, at least in terms of its acceptability to the UK or the population of the region.

What has increased markedly with the EU's switch to rejecting the UK's "Chequers" solution in principle is the risk of political change in the UK. The "Chequers" deal was always at risk of rejection in the UK parliament before any further concessions were made to appease the EU. Now, a weakened UK prime minister appears at risk of a leadership challenge, in our view.

If this succeeds, it is likely to be a polarising event, leaning towards a hard Brexit if the new leadership can maintain the support of parliament. On the other hand, the political volatility would be such that another general election would be a distinct possibility, which would be actively welcomed by the opposition Labour party whose primary objective at this point would be to seize power. In this event, all possibilities would have to be envisaged, including behind-the-scenes EU support for a second referendum (not without precedent in EU affairs), or an agreed revocation of Article 50.

For the corporate sector and investors, a populist and socialist UK government is unlikely to be welcomed, even if a hard or indeed any Brexit would in those circumstances be less likely. A hard Brexit under a right-wing Conservative leadership would on the other hand have short-term economic repercussions offsetting the potential benefits of an otherwise private sector-friendly regime.

We have noted the decline over the summer of both sterling and the FTSE 100, breaking the typical negative correlation between the currency and the equity market and highlighting the additional risk premium international investors are placing on UK assets at present. That there are potential solutions to the future relationship between the EU and UK which are not apparently being considered is suggestive of a different agenda among EU leaders, in our view.

Whether or not this is the case, the position of the current UK government has been weakened by recent events and this creates increased political risks. Should there be political volatility, we can see a rationale for a sustained increase in the risk premium for sterling, gilts and UK equities. This is based on the continuing uncertainty and two specific scenarios – hard Brexit with a corporate-friendly government; and no/soft Brexit with a populist administration. The uncertainty is likely to remain a concern for the corporate sector and investors until the situation is clearer.

Conclusion

As investors turn to 2019, trade, populism and geopolitics will remain drivers of market volatility. We view the renormalisation of US monetary policy as a risk for 2018. The evidence is that it is possible to gradually allow interest rates to rise without having adverse effects on financial markets or a reversal in the economy. With a stronger US dollar, emerging markets have underperformed but we have not yet seen the declines in earnings estimates or tightening of EM financial conditions to suggest a widespread crisis is around the corner.

Ten years on from the global financial crisis, the unfortunate legacy may have been to transform a quantifiable private sector economic challenge into a much less well understood popular political movement on both sides of the Atlantic. In some respects the rise of the Brexit movement and the UK's resulting political difficulties is just one example. We expect a Brexit risk premium to remain in place for UK assets until the political uncertainty has diminished.

We retain a cautious position on developed market equities due, in our view, to a continuation of the benign derating regime as profits grow while markets underperform traditional hurdle rates for equity investment of around 7-8% pa.

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