Illumination: Equity strategy and market outlook

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Global perspectives: At a fork in the road

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- **Political factors create a fork in the road for the short term.** Purely economic considerations would not have created a US/China trade confrontation, Brexit or Italian budget stand-off. Therefore, the short term outlook depends on the evolution of a number of very political developments. For Brexit in particular, uncertainty remains elevated. In respect of the US/China trade relationship, the stakes are also high and the longer-term implications potentially significant, even if the market has grown used to the ebb and flow of comments from the US administration.
- **Brexit dynamics still very uncertain.** It is far from clear at this point that UK PM May will win the necessary parliamentary support for her EU Withdrawal Agreement. We expect volatility for UK assets including sterling to remain elevated up to the vote on 11 December.
- **Outside the US, valuation risk is being replaced by growth risk**. Declining consensus profits forecasts for 2019, while still calling for growth of approximately 10% for each region, suggest to us that part of the softness of global equity markets can be attributed to the downward adjustment of over-optimistic profits expectations, in addition to valuations normalising from previously high levels.
- **We retain a cautious position on developed market equities.** On balance, earnings risk keeps our cautious view on global equities in place even if markets are desperately hanging on to any suggestion of an easing of Fed rhetoric. We are mindful of the 2015 experience where the resources and energy sectors continued to decline despite attractive valuations, and at least until earnings forecasts stabilised. We can also see the relative merits of a risk-free 2.8% annual return on US two-year Treasury notes in the circumstances.

At a fork in the road

Rolling global equity declines offer few directional signals

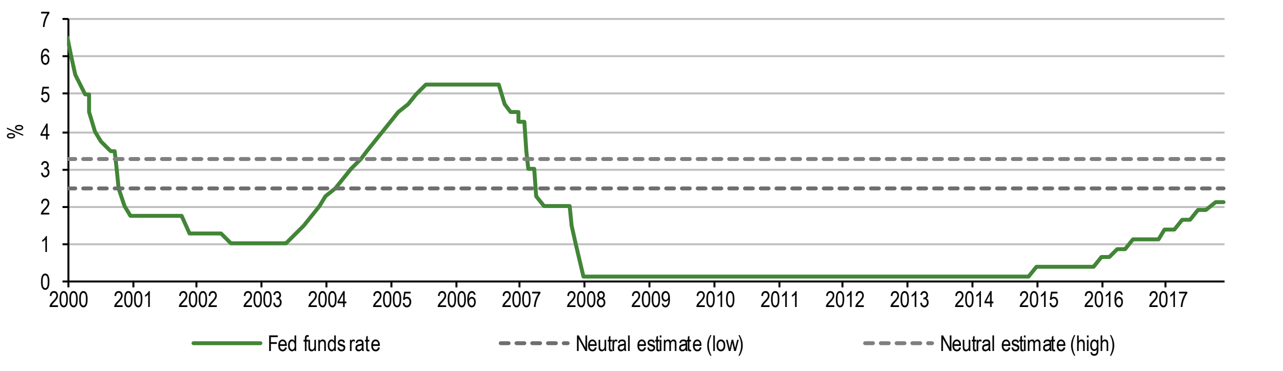
Following a difficult autumn, investors are likely to be weighing whether 2018's risks are almost in the rear-view mirror. In one scenario, Brexit could be settled by January, with minor changes to the Withdrawal Agreement easing the way through a currently hostile UK Parliament. During the past week, the Italian government has indicated some flexibility in its position on the budget deficit which may resolve the stand-off with the EU. In terms of financial conditions, the Fed may raise rates in December but could then guide to a pause, reflecting softening recent economic data outside the US.

In turn, the ECB could acknowledge that the weakening trend in eurozone data warrants a continuation of QE, or at least very dovish forward guidance. Finally, after the mid-term elections, Trump's trade war with China is now without a political cause, at least in the short term. Speculation of a US/China trade "deal" at the upcoming G20 meeting in Argentina is rising, which could perhaps at least represent a cease-fire in hostilities.

We understand that many will regard the possibilities in the previous paragraph as a Christmas fantasy. Certainly for Brexit, we think it is much too soon to assume UK parliamentary support for the current Withdrawal Agreement, even if EU officials cannot resist gloating over the leverage it will offer in future trade negotiations, according to one notably revealing FT report this week.

However, in terms of monetary conditions, the US Fed is a long way through its policy of normalising interest rates, Exhibit 1. The ECB is also clearly mindful of the slowdown in Eurozone economic data, even if it is sticking with its intention to end QE in December for now. Furthermore, the sudden decline in the oil price in the last six weeks will be feeding into monetary policymakers' internal forecasts for headline inflation on both sides of the Atlantic.

Exhibit 1: Fed rate increases and FOMC* neutral range



Source: Thomson Reuters. Note: *Federal open market committee.

There are bearish scenarios which should be given low probability, in our view. One scenario is that central banks would deliberately or negligently continue to tighten policy given clear evidence of a slowdown. We note the upward march of the US 10-year yield has been interrupted and over the coming quarter we would be surprised if long-term rates moved markedly higher, even if in the longer term a higher rate might be justified by the unwinding of US QE and higher US Treasury issuance. The recent flight to safety into the US 10-year Treasury is likely to remain in place until there is less uncertainty in respect of the direction of the global economy.

In contrast to the monetary policy function, which in terms of interest rate policy has remained largely outside the political domain (Trump's recent public comments and reported behind-thescenes pressure on Fed policy notwithstanding), the political issues directly ahead of investors are much more uncertain by comparison. It is by no means clear that at the upcoming G20 meeting any progress will be made in respect of resolving the differences in trade policy between the US and China. On balance, a breakthrough at this point appears less likely following recent comments from the US President Trump. There have also been rumours that tariffs on imports on autos from the EU are in the pipeline.

From an economic viewpoint, which is where many professional investors have their original training, current US trade policy would appear to make little sense. As a result, the risk is a bias to assume that a continuation of the trade war is a low probability event. We believe Trump firmly believes in his political agenda of America First, subject to the constraint of adverse market volatility and job losses sufficiently material to impinge on his political popularity. In 2019, the theme of a protectionist-induced slowdown in global trade still bears close attention.

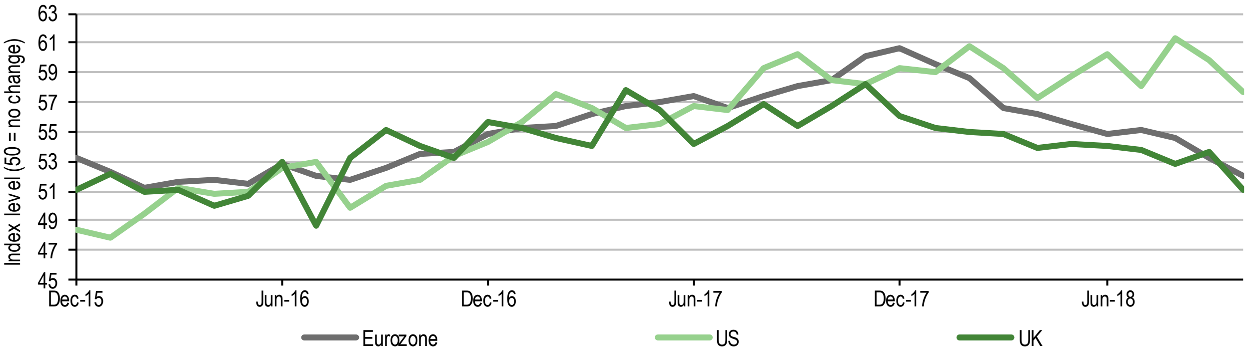
In respect of equity market valuations, these are not in our view now the primary risk for investors as outside the US price/book valuations are close to long-term averages and consistent with the double-digit return on equity still forecast for the non-financial corporate sector. The primary risk to equities has shifted from high valuations to a slowing outlook for economic and earnings growth.

Economic survey data on a weakening trend outside the US

The fly in the ointment for investors trying to look through political developments

In the context of current consensus earnings growth forecasts for 2019 of approximately 10% globally the market could, if the political developments above could be set aside, be set for a rally. However, the fly in the ointment is the meaningful slowdown in economic survey data outside the US in recent months; combined with the large decline in the oil price over the last six weeks, this means that earnings forecasts remain at risk.

Exhibit 2: Manufacturing PMI survey declining in the UK and eurozone during Q4



Source: Thomson Reuters

November's flash manufacturing PMI for Germany and the eurozone overall adds to the pessimism shown in Exhibit 2, indicating that growth has stalled over the summer, with the current month's final eurozone reading now likely to be just above 50. There may be a one-off impact of new regulations within the auto sector but the slowdown appears to be more broadly based.

Similarly, business optimism in China, Germany, Japan and the UK is on a declining trend. Global trade fears may be partly to blame but for investors the data are consistent with weakened earnings momentum over coming months and increased profit warning risk in energy and cyclicals, rather than a bounce in markets.

In these same surveys, inflation pressure has been sustained, despite the perceived slowdown in end demand. The data therefore make for mixed reading for central bank policymakers, who in the

US at least appear still focused on normalising policy, although futures markets point to a possible short pause in rate increases in Q119. The ECB has been tight-lipped about the end of QE but the data raises real questions about the strength of the eurozone recovery, in our view.

Brexit: A decisive step into the fog

Limited parliamentary support for UK PM May's Brexit deal creates further uncertainty

UK PM May's Brexit deal has achieved the unlikely honour of uniting both pro-EU and Brexiteers in rejecting it. Despite challenging House of Commons sessions in recent weeks, May has continued on her pre-planned path to finalise the text of the political declaration and bring it back to Parliament for a vote in December. At this point it is difficult to see how May's Withdrawal Agreement will gain Parliamentary approval, in our view. We are surprised to see reports in the FT quoting EU sources, indicating the likely brutality of future trade negotiations because of the weakness in the UK's negotiating position due to the backstop arrangements. While this risk is evident from the Withdrawal Agreement, this suggests EU officials believe it is mission accomplished.

One of May's key rivals has failed to secure the 48 letters required to challenge her leadership, to date, which has eased the immediate political pressure. In any case without an election, any new PM would have the near-impossible task of renegotiating the current deal – and would have to create from scratch a credible no-deal deterrent to succeed. Furthermore, an election risks a Labour government less accommodating to the corporate sector.

Both these scenarios are likely to be unwelcome for financial markets. The probability of sufficient change to the draft agreement to pass the UK Parliament on 11 December appears slim, but would in contrast be welcomed by investors. The current strategy of PM May to go "over the heads" of MPs and appeal directly to the electorate and business appears in concept so similar to running a virtual referendum campaign, it is effectively in conflict with her insistence on no actual second referendum process. The success of this strategy is also in question as one recent poll indicates May's deal has less support than either no deal or no Brexit.

This is a charged political environment, with personal ambitions interwoven into policies, in addition to the UK national interest. There are material drawbacks to the deal PM May has negotiated with the EU, notably the possibility that the UK could remain in a permanent customs union, unable to exit unless prepared to offer a better scenario – for the EU. It is difficult to argue against the view that this appears to be a sub-optimal position from which to start negotiating a new UK/EU trading relationship.

Given the expressed view of the UK government that it must deliver on the result of the referendum, its failure to develop a credible no-deal plan over the past two years is surprising. A palatable no-deal scenario would have given the UK's negotiators increased leverage and possibly avoided the political crisis that is now unfolding. The EU has long established its reputation as a smart and ruthless negotiator, most recently in the eurozone debt crises of the past decade. If the electorate is minded to punish the current UK administration in future it will be for this lack of foresight, in our view. A credible deterrent has significant value, even if it is never used.

While we note at the time of writing that there have been insufficient letters of support to call for a vote of no-confidence in the PM, a failure of Parliament to approve the Withdrawal Agreement is highly likely to re-ignite a leadership challenge, in our view. Should PM May ultimately fail to win support for her deal, any new PM would have to win parliamentary and public support for a much tougher negotiating position to attempt to amend the existing Withdrawal Agreement.

To be credible, this would have to include substantive preparations for a realistic possibility of a no-deal as it is difficult to see why the EU would materially change its position otherwise. Adding to the uncertainty, earlier suggestions from EU officials that delaying or withdrawing the Article 50 notification would be possible can no longer be assumed to be valid given the ready support for the

Withdrawal Agreement in its current form. For financial markets, the uncertainty and risks of a no-deal Brexit are hardly likely to enthuse financial markets or the non-financial corporate sector.

If the UK Parliament remains split on the Brexit question, a general election becomes likely in Q119, which in effect would represent a second referendum on a strategy for Brexit and the current Withdrawal Agreement. In these circumstances investors would have to contend with the meaningful probability of a Labour administration, which would be likely to be significantly less accommodating to the corporate sector, a situation also unlikely to enthuse UK financial markets. Within this scenario there may be further calls to extend Article 50 and/or remain in the EU, thus increasing uncertainty. In contrast, the probability of sufficient change to the draft agreement to pass the UK Parliament appears slim, but would be welcomed by investors.

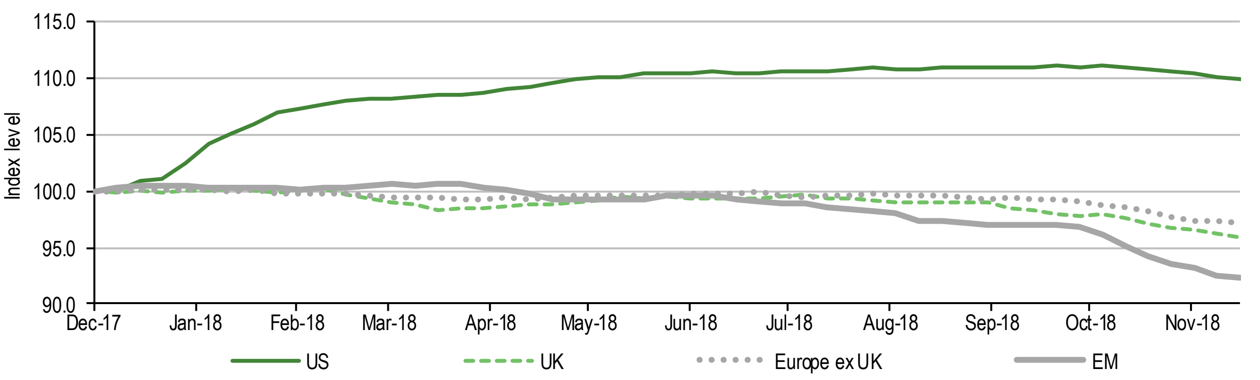
The binary outcomes on offer for investors in respect of Brexit mean UK markets are likely to remain volatile in the circumstances and sterling may come under increased pressure leading up to the parliamentary vote on 11 December. If the Withdrawal Agreement is passed, a significant relief rally would be in store for any betting on this happening now, but we believe it is risky to gamble on it at this stage.

2019 earnings forecasts soften

Q4 market declines coincide with falls in 2019 profits outlook

For the UK and continental Europe, 2019 estimates have been falling at an accelerated pace during October with a total decline of 2.5% since August, Exhibit 3. In addition to signs of ebbing economic momentum within the eurozone, the specific Brexit and budget risks in the UK and Italy respectively appear to have pincered investor sentiment.

Exhibit 3: Consensus forecasts falling at an accelerated pace outside the US during Q4



Source: Thomson Reuters

Italian budget deficit stand-off could be resolved by compromise

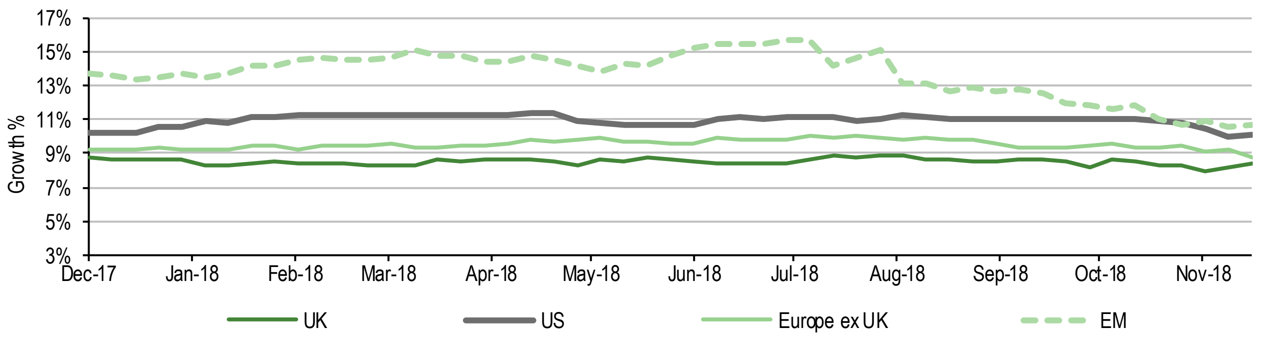
For Italy, the difference of opinion between the EU and the Italian government over the level of the primary budget deficit in 2019 remains in place. This is not in our view an economic issue – the situation would be likely to be irrelevant for markets if either the EU supported Italy's plans for greater fiscal stimulus or Italy moved towards the EU's wishes for greater austerity.

It is instead a political issue in respect of the autonomy of the populist Italian government to deliver a budget, set against the constraint of the necessity of approval from eurozone partners (and in particular the ECB) in supporting the Italian bond market. While the rhetoric continues to escalate, investors are likely to continue to proceed cautiously, and we note that in recent days a softening of the Italian position has led to lower yields on Italian government bonds. Unlike Brexit, a solution is likely to be found, provided there is the willingness to compromise modestly on each side.

2019 emerging market estimates have fallen materially during H218

For emerging markets (EM), there has been a quite pronounced change in the profits outlook, as the median 2019 profits growth estimate has fallen by one-third to a below-average 11% since August.

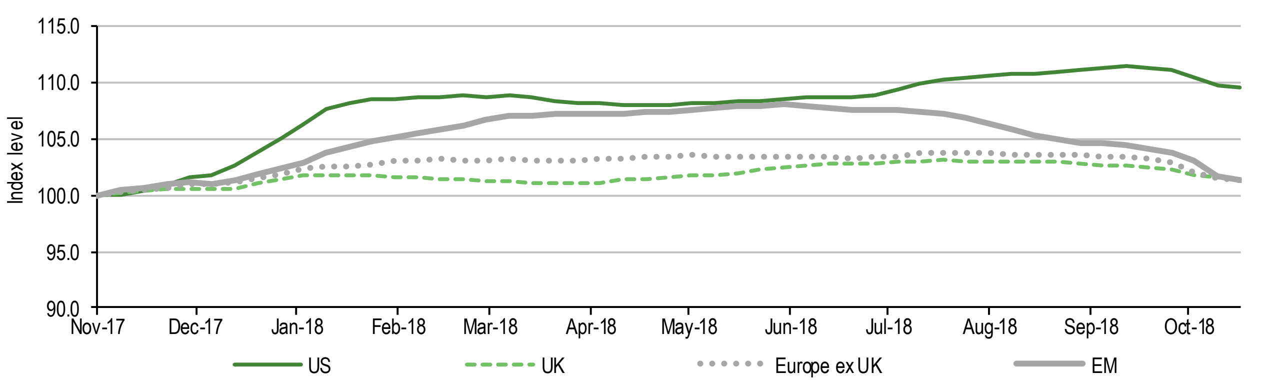
Exhibit 4: 2019 median consensus profits growth has fallen to below-average 11% in EM



Source: Thomson Reuters

It is also surprising to see such negative earnings momentum in emerging markets when commodity prices have until only very recently remained relatively robust over the same period, in contrast to 2015. While we have noted that emerging market valuations have over the summer become relatively attractive, at least compared to developed market peers, in the short term we believe the rapid decline in prospects for profits growth will put many investors on pause, at least until estimates have stabilised. For example, we expect the recent decline in the oil price to lead to further reductions in related equity sectors in coming weeks.

Exhibit 5: Analysts' price targets undershooting typical 8% pa growth rate during Q2-Q418



Source: Thomson Reuters, Edison calculations

Analysts' price targets have only trod water since Q118

We have also examined the progression of target prices for equities in each major region, Exhibit 5. Since the one-off "Trump bump" in US estimates (resulting from corporate tax reform in January), analyst target prices for developed markets have effectively been static for much of 2018 and have fallen over the last four weeks.

Unlike earnings forecasts for a specific year, as price targets are in effect a rolling measure of company values, price targets normally grow over time. Therefore, 2018 has been an exception to the long-term annual growth rate for target prices since 2013 of 8%. This implies a bottom-up analyst consensus from earlier this year that valuations were somewhat over-extended, matching our top-down views.

Conclusion

2018 has been the year that the US Fed normalised US monetary policy. Evidence of this is in the restoration of normal market volatility, lower global equity valuations and a strong US dollar, in addition to higher US interest rates. With Fed chair Powell suggesting in recent days that US rates are just below the broad range of the Fed's estimates of the neutral level, expectations of a pause in US rate increases have risen, even if this observation is only consistent with previously published Fed projections.

Even given the possibility of a further easing of Fed rhetoric in coming weeks, the investment outlook remains difficult to read in our view due to key political risks directly ahead, the most significant of which are the potential for a no-deal Brexit and US trade policy with respect to China.

On balance, earnings risk keeps our cautious view on global equities in place. We are mindful of the 2015 experience where the resources and energy sectors continued to decline despite attractive valuations, until earnings forecasts stabilised. We can also see the relative merits of a risk-free 2.8% annual return on US two-year Treasury notes in the circumstances.

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