Illumination: Equity strategy and market outlook

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Global perspectives: Ticking the boxes

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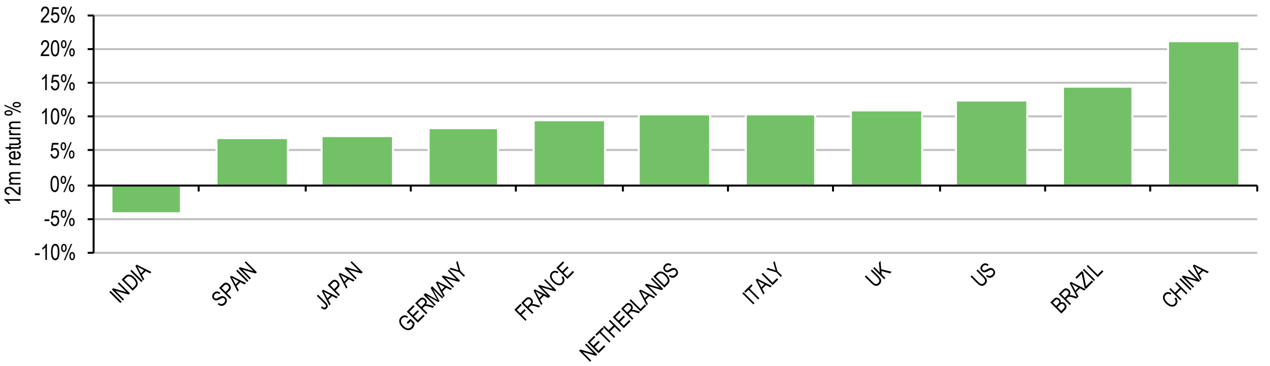
- **A snap-back in risk appetite in 2019 to date has surprised the over-cautious.** A relatively benign evolution of the risks in respect of US/China trade, Brexit and US monetary policy in our view offer support for equity markets even at current levels, with the bias remaining to the upside.
- **Progress in US/China trade talks is steadily reducing a key risk for markets.** With US President Trump now declaring substantial progress in trade talks and a delay to increasing tariffs on Chinese goods, an entente appears increasingly likely. Should an accord be reached, Trump has little incentive to re-open trade hostilities at least until after the 2020 Presidential election. This appears to be perceived by investors as a box ticked, for now.
- **Brexit appears headed for a soft-Brexit deal, or delay.** UK PM May has had to concede that in the event Parliament will not support her Withdrawal Agreement, a delay to Brexit will be on the table, rather than no-deal. Global markets would in our view suffer limited impact from either soft Brexit or any delay – another box ticked.
- **It is early days but the pace of earnings downgrades has eased markedly in recent weeks.** This is the final box to be ticked for equity investors, in our view. 2019 earnings estimates appear, tentatively, to have stabilised in recent weeks but it take a little more time to be certain.
- **Yet with most of the risk factors ticked off we only expect markets to be supported at current levels in the near term rather than make further strong gains as valuations are now meaningfully higher than at the start of the year.** We believe volatility is likely to decline over the coming quarter as improving economic data (merely) validates the sharp move higher in equity and credit markets, improving the prospects for corporate activity such as mergers and acquisitions.

Ticking the boxes

A strong start to 2019 as risks roll in investors' favour

There has been a remarkable recovery in global equity markets during the first few weeks of 2019 as many of the key risks and uncertainties have either been resolved in investors' favour or significant progress has been made. The sharp swing towards positive sentiment was in our view primarily driven by the US Fed pausing interest increases in January, but this is not the whole story. US/China trade talks appear to be progressing, bringing into prospect the possibility of an entente between the two parties, at least until after the 2020 US Presidential election. Furthermore, the implicit choice now between an agreed UK departure from the EU or a delay to Brexit is far more business- and market-friendly than the prospect of no-deal.

Exhibit 1: Global equities surge in 2019 to date, led by China



Source: Refinitiv, USD price return, 31 December 2018 to 26 February 2019

Weak economic data in contrast to the recovery in risk appetite

Weak incoming data in respect of profits forecasts and the global economy is in sharp contrast to the strong performance of risk assets such as equities and corporate credit during 2019. Conflicting narratives can certainly create angst. However, in this case the apparent divergence reflects investors' belief that central banks have acknowledged the slowing global economy and we concur.

Easier financial conditions means relief from negative economic surprises may be possible by mid-year. Despite having risen sharply in the first few weeks of 2019, on balance we believe global equities now have the prospect of volatile but still upward progress, as political events unfold.

In January, we outlined the reasons for shifting from a cautious to neutral position on global equities. Valuations had softened – and for the UK had even become cheap relative to history. We viewed central banks as highly likely in time to respond to the evident weakness in the incoming economic data. Furthermore, a fiscal response to slowing growth in China was likely to be forthcoming.

In terms of politics, re-election dynamics suggested US President Trump is under pressure to agree a deal on US/China trade this year. Similarly, China is also incentivised to find a route out of the current trade conflict, given the slowing Chinese economy in recent quarters. Finally, the absence of support for a no-deal Brexit in the UK Parliament suggested a delay or a soft Brexit remained the most likely options. These factors comprised our view of 2019's wall of worry for markets to climb.

In terms of soft economic data such as purchasing managers' surveys, we recognise these can be misleading in terms of exaggerating the ultimate extent of a downturn at times of political uncertainty. Nevertheless, there has been a consistent flow of weak data worldwide, ex US, indicative of a meaningful slowing of activity and not just in nations exposed to Brexit.

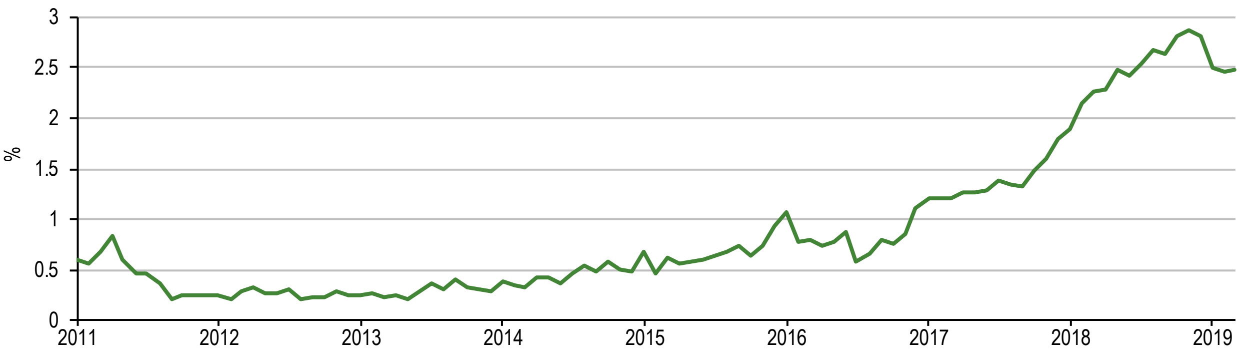
Chinese growth has continued to slow and domestic policymakers appear at this stage to wish to avoid creating incentives for further wasteful investment in overcapacity, real estate or infrastructure. For this reason, while we expect VAT and income tax cuts in China over coming quarters to add to 2019 GDP growth by supporting the consumer and SME sectors, we are not expecting another sudden credit-led resurgence in industrial output which would meaningfully support growth globally.

However, while the narrative of a US/China trade conflict creating uncertainty and a decline in business investment is currently very popular, we believe that near-term economic activity is more strongly linked to the actual and expected path of global monetary policy over the last 18 months. For example, the fingerprints of higher US funding costs were all over the strength of the dollar, weaker emerging market currencies and poorly performing global equity markets in 2018.

Lagged effect of easier monetary policy likely in coming quarters

In particular, US interest rates were rising sufficiently quickly in H118 for emerging market policymakers to (unusually) warn about the effect of tighter US dollar funding on emerging market growth and capital flows. For a period, these warnings were ignored by Fed policymakers. However, while the Fed may only recently have paused rate hikes, the period of monotonically rising US interest rates is already some way behind us.

Exhibit 2: US two-year rates peaked in H218



Source: Refinitiv

Exhibit 2 shows that US two-year rates are unchanged from H118 levels, after peaking in Q4. This suggest to us that the drag from tighter US monetary policy may already be fading and the effect of looser than expected global monetary policy may start to be felt in the real economy during the second half of 2019. This loosening is the primary reason for the recent recovery in investors' risk appetite in our view.

Outside the US, the Bank of England has recently followed the Fed in the direction of looser monetary policy by significantly downgrading its UK GDP growth forecasts for H119. The UK picture is however complicated by the path of Brexit. It is unfortunate but only logical for the BoE to keep its no-deal planning private at this stage – but we would expect determined action in this event which appears even less likely following UK PM May's acceptance of the possibility of a delay to Article 50 in recent days.

The ECB has been the laggard in terms of recognising the persistence of the shortfall in activity on its own eurozone doorstep but is likely in our view to shortly do so when new economic projections are presented in early March. It is also helpful for ECB policymakers that the Fed has thrown out the "autopilot" idea of steady balance sheet reduction, potentially allowing the ECB to consider a more adjustable balance sheet policy, should that prove necessary in terms of forward guidance, or even actual policy steps.

Critical for the effectiveness of monetary policy is the continued absence of financial stability and inflation risks. In terms of financial stability, the significant sell-off during Q4 in both credit and equity markets means that the market has already discovered weak hands, or in other words over-leveraged and otherwise unstable positions. Interbank funding costs remained stable during December and the sell-off in leveraged loans did not escalate into a corporate funding crisis despite a number of well-placed warnings. Leveraged loan markets have staged a strong recovery in recent weeks, in line with the improvement in risk appetite elsewhere.

For inflation, inflation expectations appear very well-contained worldwide, with the risks skewed towards a further period of below-target inflation in the event of a sustained downturn and therefore present no immediate constraint on monetary policy.

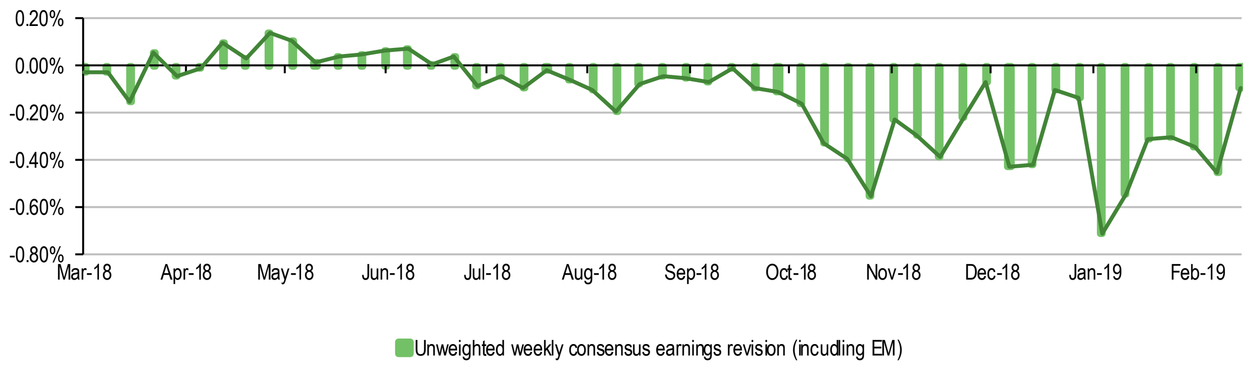
However, in terms of the "wall of worry" for 2019, easier monetary policy is a necessary but not sufficient condition to deliver on our original expectation of a normal year of 7–9% growth in global equity markets. At this point however we believe there are reasons to become increasingly optimistic in respect of the political developments necessary to keep the recovery on track.

President Trump has indicated that increased tariffs on Chinese goods will not be imposed on 1 March and a leaders' summit to resolve the trade conflict is within view. A satisfactory resolution of the Brexit impasse for markets includes a soft Brexit or a delay and these two scenarios are becoming increasingly likely as a no-deal Brexit has to a large degree been taken off the table.

Global earnings: Pace of downgrades slowing

In a welcome development for global equity investors, the pace of 2019 earnings downgrades has eased markedly during the first three weeks of February, Exhibit 3. Furthermore, while 2019 consensus corporate profits growth has fallen from initial expectations of around 9–11% in developed markets to 6–8%, and from 12% in emerging markets to 10%, a profits recession on a year-on-year basis still appears unlikely. It is still in our view a little early to have conviction that this easing of downgrades is the start of a sustainable trend. However, if it proves to be the case that earnings forecasts have stabilised it will in some respects represent the last box to be ticked, validating the recovery in markets since the lows of December.

Exhibit 3: Early signs that global consensus earnings downgrades have eased during February



Source: Refinitiv, Edison calculations

Conclusion

By remaining mindful of the lags between changes in financial conditions and economic fundamentals we keep our neutral stance on equities. While incoming data remains weak and markets have risen, economic activity is likely to improve later in the year. In our view, it is too late to be overly cautious on equities. As we believe the primary cause of the slowdown in H218 was the earlier tightening of financial conditions globally, we would argue the easing of financial conditions should similarly become evident in the real economy by mid-2019. Added to the scope for resolution of the headline political risks during H119, on balance the risks still seem biased modestly to the upside even if uncertainty remains relatively high.

With most of the risk factors ticked off however, in the short term much of the equity market's 2019 "wall of worry" appears to have been scaled. We do not expect significant further gains in the short term, as the majority of the good news on the monetary and political fronts has already been discounted. Equity valuations are now meaningfully higher than at the start of the year. However, volatility may continue to decline over the coming quarter as improving economic data (merely) validates the sharp move higher in equity and credit markets earlier, improving the prospects for corporate activity such as mergers and acquisitions.

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