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Illumination: Equity strategy and market outlook

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Global perspectives: Prepare for the long game

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- **The anticipated resolution to the US/China 'trade' dispute has failed to materialise.** The likelihood of any resolution in the near term appears modest at best and at this point it is closer to an economic conflict, encompassing national security and political desires for economic supremacy. An analysis based on economic considerations and the net benefit to both parties of a resolution may therefore miss the point. Our earlier, more positive views on equities for 2019 were contingent on a US/China trade resolution by mid-year and our outlook has therefore become more cautious.
- **A downward turn in survey data and consensus earnings forecasts has been re-established.** There has been a reduction in global earnings momentum during the past four weeks consistent with ebbing purchasing managers' indices (PMI) and slowing trade data. Short and long-term bond yields have fallen in recent weeks, reflecting market expectations of a slowdown. If a US/China trade deal had been reached, this data would have been less of a concern - but cannot now be ignored.
- **A steady build-up of debt in the corporate sector of China and the US becomes a greater issue if the economy slows.** While the warnings from central bankers in respect of leveraged loans have thus far gone unheeded, we believe investors should now focus on balance sheet quality for equity investments at this point in the cycle.
- **We move to a cautious view on global equities from neutral.** Given the still significant rally since the end of 2018, there is time to reposition portfolios. Investors should focus on specific companies with lower than average exposure to cyclical factors and trade headwinds, given the cautious outlook.

Prepare for the long game

Shifting trade politics should not be ignored

Following the breakdown in US/China trade negotiations in early May, US and Chinese actions since then point to a protracted period of tariffs and economic conflict, in our view. While Trump has placed additional tariffs on Chinese goods, China has allowed the renminbi to depreciate markedly since 10 May. Furthermore, Trump's announcement of restrictions on telecoms suppliers, it is assumed aimed indirectly at Huawei, indicates that the probability of a trade deal in the short term is remote. Investors should, in our view, prepare for a longer period of political negotiation. In the event of a structural shift away from the long-standing consensus that cooperation on trade is beneficial for all sides, this would ultimately have long-term ramifications for the evolution of the global economy.

In our opinion it is becoming increasingly likely that the breakdown in US/China trade negotiations is serious and will take some time to resolve. There appears to be disagreement in principle in respect of any enforcement mechanism. Press reports indicated an unacceptable redrafting of the text of the agreement by China, yet others referred to US demands for an enforcement mechanism closer to that of economic sanctions, which China would be unlikely to agree to. This is likely to weigh on markets where the prevailing consensus still holds out hope for some kind of deal in the short term.

However, the actions of the parties since negotiations broke down are not encouraging. A Chinese delegation sent to Washington left with no schedule for further talks. Since then, the Chinese renminbi, which represents the most direct riposte to new US tariffs, has been allowed to decline sharply, Exhibit 1. Following the breakdown in talks, Trump has followed through with new tariffs on China. In addition, the US executive order implicitly targets the Chinese telecoms firm Huawei by shutting it out of US markets. This is no small matter and cuts straight to the heart of the question of global technological leadership, with the company the second most prolific European patent filer of 2018 after Siemens.

Reports that intelligence-led briefings are being held at US companies detailing China's threat to the US technology sector are also unhelpful. We suspect the actions of the US will have caused significant antagonism within China's administration and have created an environment hostile to any formal agreement.

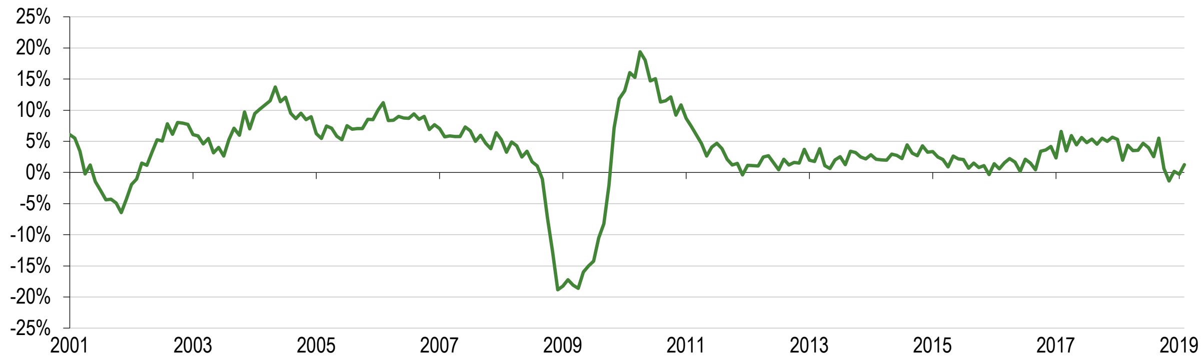
Exhibit 1: China has allowed renminbi to decline which will offset US tariffs

Source: Refinitiv

While financial markets may have moved on from the global financial crisis of 2008, echoes continue to be heard in the political domain in developed markets in the context of populism. Political shifts which have had a much longer time-lag compared to monetary or fiscal dynamics are only now starting to bite the real economy, with the primary example being the pivot in US trade

policy and consequent recent increases in US tariffs. In another example of the lagged impact of populism, the UK is still attempting to negotiate its way out of the free trade area of the EU, following the referendum result of 2016. Although investors may have become inured to talk of tariffs the effects, with the expected lag, are now becoming evident in the data. Global trade volume growth is currently softening at a rate not seen since the global financial crisis, Exhibit 2.

Exhibit 2: World trade volume growth has slowed sharply during 2019



Source: Refinitiv, CBP World Trade Monitor

Being such a recent phenomenon, there is little direct quantitative evidence linking the slowdown in trade to the re-imposition of tariffs. Over many decades, worldwide tariffs have been carefully and technically dismantled, under the auspices of global organisations such as the World Trade Organisation (WTO). The rapid re-imposition of US tariffs therefore represents a dramatic reversal in US trade policy, compared to recent decades of trade liberalisation.

US/China tariffs have now reached a level which will interrupt supply chains in our view as rates of 25% are difficult to absorb in profit margins or by the US consumer. It is unfortunate that in some respects, the success of central banks in engineering an aggregate recovery through innovative monetary policy (albeit with some politically important distributive effects) has created space for sub-optimal government policy on trade. It appears the lack of political ‘ownership’ of the global recovery by governments has created the well-known hire-car risk of not cherishing it.

We believe policy uncertainty in respect of US/China trade in combination with actual tariffs imposed to date are responsible at least in part for a slowdown in global trade. This slowdown may have been masked by the relative resilience of global financial markets during 2019. Markets have been driven by easier monetary policy globally and modest fiscal stimulus measures in China. However, with developed market valuations now significantly above levels prevailing earlier in the year, a resolution to the US/China trade dispute was in our view a prerequisite to maintaining the relatively high level of optimism and confidence implied in financial market prices.

However, the improvement in survey data since the beginning of the year cannot disguise the relatively poor mood amongst global manufacturers and the difficult environment for industrial commodities such as metals. Trade-related profit warnings continue to impact markets. Agricultural machinery manufacturer Deere in a recent trading update blamed ongoing trade uncertainties for causing a much more cautious environment amongst US farmers for equipment purchases, for example.

Current mid-single digit projections for 2019 earnings growth are not, in our view, sufficiently compelling to keep investors in equities regardless of political risks. We have noted the stabilisation of earnings forecasts during Q119 but the very recent data suggest that earnings forecasts are starting to edge lower once more. This is consistent with the poor relative performance of cyclical sectors over the last six weeks and the slowdown evident in the trade statistics. A few weeks’ data may not make a trend but it is discouraging to see profits momentum ebb so quickly.

It is not just in respect of China where the US administration has radically shifted its position on the benefits of global trade. The designation of US car imports as a threat to national security is, on the face of it, barely credible but opens the door to the imposition of tariffs on US auto imports, even if a six-month delay has been ordered. The immediate reaction of the auto industry in the face of this uncertainty will be to slow investment spend. Should tariffs be imposed on a permanent basis, supply chains will have to be re-established within country borders and the absence of skill, cost and scale advantages are likely to lead to inflation in prices for consumers.

Given the Trump administration's increasingly entrenched position on China, we believe a decline in the US stock market or US economy, sufficiently large for it to impinge on the prospects for the 2020 US Presidential election, may be necessary to create sufficient pressure for further negotiation. We would prefer to be in a position to take advantage of this potential trading opportunity and are therefore becoming increasingly cautious on the equity outlook at this stage.

The idea of a market swoon followed by an agreement on trade is in some respects a least bad outcome. A re-acceleration of global growth even as tariff conflicts escalate is of course possible but is difficult to visualise. We also believe the probability of a much longer trade stand-off is rising, given the political 'prisoner's dilemma' dynamics of trade negotiations and the muddling of genuine trade concerns with the long-term strategic position of the US and China in the geopolitical order. Trump's steady drumbeat of criticism of US Federal Reserve monetary policy could even represent a harbinger of further political interference in monetary policy, should the economy slow because of US government policy.

Adding to the risks on trade, we note the recent escalation of tensions in respect of Iran, which are also unhelpful for global sentiment, including the sending of an aircraft carrier to the Persian Gulf, US embassy evacuations and evidence of alleged Iranian provocations. It is unclear how much of this activity merely represents psychological pressure on Iran's regime, but later comments by John Bolton, the US national security advisor, suggests that this may have been the case. Any actual intervention may distract public attention from the difficulties of resolving the US/China conflict but would only add to the risk premium for global equities.

Brexit: New Conservative leader a deckchair on the Titanic?

We believe the choice of a new UK Prime Minister by the incumbent Conservative and Unionist Party is likely to achieve little as the previously insurmountable challenge of breaking the UK parliamentary deadlock on Brexit remains in place. That there is a total split on the way forward in the UK's Parliament is probably the only certainty, having been confirmed by the process of indicative votes earlier in the year. In addition, the new Conservative leader is likely to be constrained by a leadership election that prioritises the scenarios of no-deal or a hard Brexit, to counter the alarmingly rapid rise of Nigel Farage's six week-old Brexit party in the polls. The rise of the Brexit party has contributed to the sharpest fall in election polls for the Conservative Party in the last 20 years.

It would be a remarkable political achievement for any new Conservative leader to amass a parliamentary majority for no-deal given the current composition of Parliament. Such a scenario is therefore in our view unlikely. However, a new UK leader could entertain the thought of an election in order to implement such a policy. While it is perhaps too early to speculate, failure of the "remain" Change UK party to garner any meaningful support in the recent European elections may open the door to a Brexit/Conservative alliance that could consider the option of no-deal. The very poor performance of Change UK also highlights the depth of feeling amongst Brexit supporters, who have felt compelled to switch away from both the traditional Labour and Conservative parties by their views on this single issue.

In terms of market expectations, we believe the relative weakness of sterling will continue due to the persistent uncertainty. Regardless of the choice of a Conservative leader, the UK government

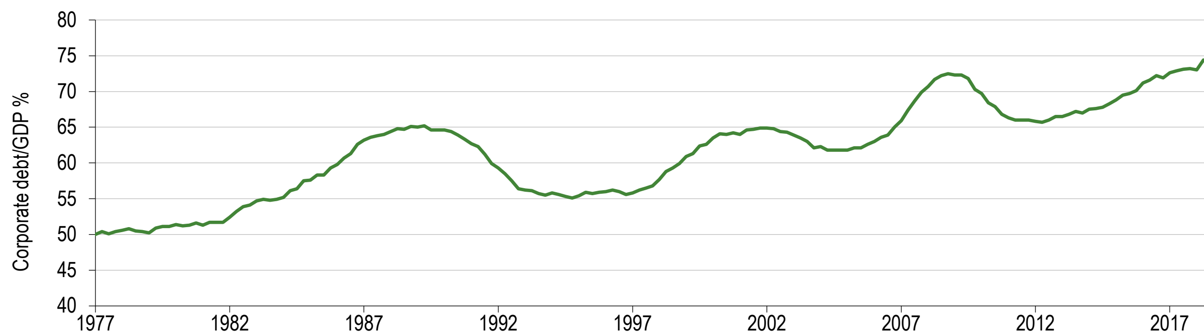
remains in a precarious position due to Brexit policy paralysis and a general election later this year cannot be ruled out, nor a further extension to Article 50 in October. UK economic activity has surprised to the upside in 2019 so far but this has in part been attributed to no-deal stockpiling, which is necessarily one-off in nature. In the absence of a decisive government stimulus, we would not anticipate further positive surprises for the UK economy as 2019 unfolds.

Debt burdens rising in the non-financial corporate sector

Ultra-low interest rates and the demand for less volatile income streams have in recent years led to strong demand for US corporate debt. We believe this increased debt burden should be on investors' radars, given the increasing likelihood of further market volatility and declining global economic momentum as the US/China trade war continues without any prospect of resolution.

In particular, US non-financial corporate leverage has reached peak levels of US GDP, Exhibit 3. Other regions where corporate debt loads have risen markedly during this decade include China (Hong Kong) and France. However, nations such as Spain and Portugal have seen corporate debt burdens decline following the excesses of the prior cycle.

Exhibit 3: US non-financial corporate debt/GDP



Source: Bank of International Settlements

For the US, in addition to the increase in the debt burden as a percentage of GDP, the riskiest segments of the investment grade market have seen the strongest increases in issuance. We believe this is due in part to low-investment grade debt hitting the sweet spot for investors, in terms of offering an appreciable pick-up in yield while still maintaining a sufficient credit rating to qualify for inclusion in lower-risk portfolios.

As highlighted recently by the US Fed however, this clustering of issuance in the lower tiers of investment grade credit risks a rapid increase in the number of "fallen angels" (bond issues which have been downgraded to below investment grade) in the event of any downturn in corporate profits.

In addition to the evident risks for investors in corporate credit, we believe equity investors should pay attention to the possibility the tide may be turning away from highly leveraged corporate structures as central banks start to pay attention to this type of lending. The risk is that company managements return to equity finance, either by cutting dividends as Vodafone has recently done, issuing equity or a combination of the two. Given the rise in corporate leverage and at this point in the economic cycle, we would therefore be favouring companies with stronger than average balance sheets.

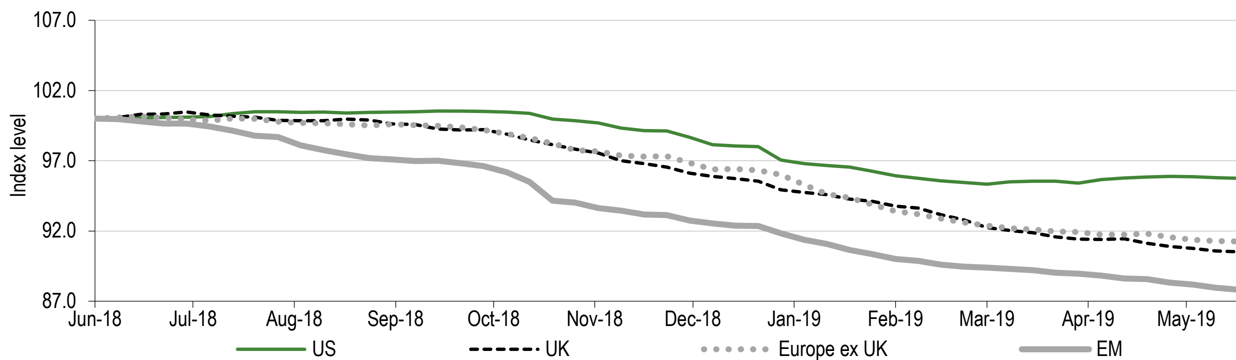
Consensus earnings forecasts for 2019 back on a downward trend

We have to acknowledge that the easing of downward pressure on consensus earnings forecasts appears short-lived. Despite a period of stabilisation during Q1, global profits expectations are

again being scaled back outside the US, Exhibit 4. Short-run market performance is often closely linked to the direction of earnings forecasts and this data should not be ignored in our view.

Falling profits expectations are also consistent with declining global trade volumes and a declining global manufacturing purchasing managers' index. We also note that the oil price has moved lower since it became clear a US/China trade deal was an unlikely short-term prospect; industrial metals have also moved modestly lower in recent weeks.

Exhibit 4: 2019 earnings forecasts slipping outside US

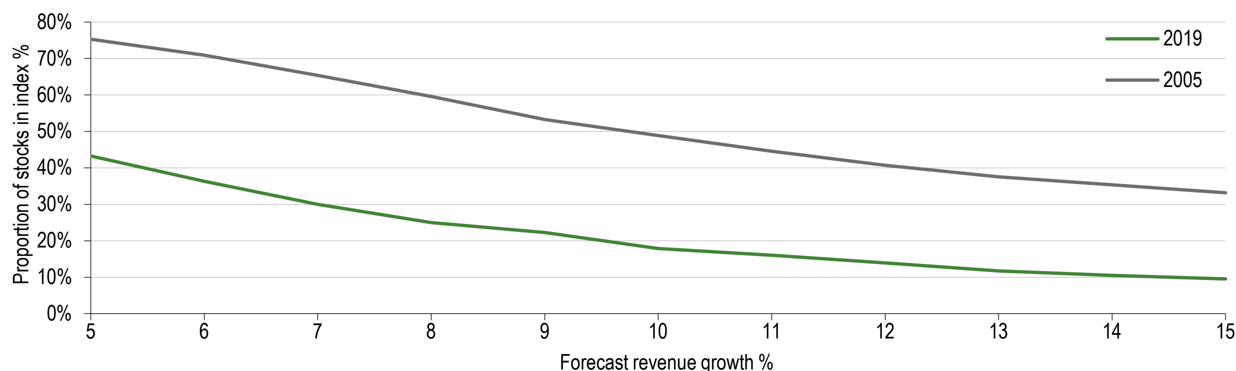


Source: Refinitiv, Edison calculations. Note: Equal-weighted average. EM = emerging markets.

Separately, one-year ahead consensus revenue forecasts are now hovering close to the lows of the last 15 years. We believe it is an under-reported statistic that for both US and European stock markets, median public company revenue growth has effectively fallen 50% from the pre-crisis era of 2005–08, or from close to 10% to below 5%. For equities, a significantly lower growth trajectory has to be made up with higher returns from dividends or dividends plus buybacks to deliver the same level of return to investors. Following the snap-back in valuation metrics earlier in the year, we believe equity valuations are now rather high in the context of a much lower growth trajectory for revenues and consequently corporate profits.

The problem for public equity investors is that the decline in median revenue growth leaves the genuine growth stock as something of a rarity. As Exhibit 5 shows, in 2005 75% of US large cap stocks had revenue growth projections in excess of 5% and 50% were expected to benefit from revenue growth of over 10% over the coming year. In 2019, the picture is very different. Less than 50% of US larger companies are expected to achieve 5% revenue growth in the coming year and only one in five are expected to achieve more than 10% growth. Similar reductions in investors' 'growth' universe can be observed in the UK and Europe.

Exhibit 5: Genuine growth stocks have become much rarer in US public markets



Source: Refinitiv, Edison calculations. Note: Chart shows proportion of stocks with revenue growth at least equal to that on x-axis.

The reasons for this decline in forward revenue growth include the late-cycle nature of the current economic expansion and the rise of the unicorn private company phenomenon where public

markets are eschewed in favour of private capital until growth rates have slowed. However, the reduction must also be a reflection of slowing growth rates within developed markets, in-line with the reduction in long-term nominal bond yields compared to the previous cycle. When interpreting valuation metrics, investors should, in our view, take into account not only lower funding costs but also the offsetting factor of lower growth prospects for the market as a whole.

Conclusion

At the start of the year, we viewed both the US/China economic conflict and the Brexit process as potentially resolvable by mid-2019. Our view on the timing on both these issues now looks rather over-optimistic. However, they were – and remain – key to sustaining the global equity rally into H219. Furthermore, the substantial rally in both equities and credit since December is now behind us and this has pushed yields and valuations to levels which are much less compelling compared to the start of 2019.

In our view the early signs of slowing economic momentum in trade and PMI data, together with an easing of consensus profits forecasts, are consistent with the continued lack of resolution of the US/China economic conflict. Over recent weeks the political conflict has escalated significantly rather than diminished and technology supply chains – including software and IP – can no longer be taken for granted. Such a fracture of economic activity, combined with the persistence of trade tariffs, is qualitatively likely to act as a drag on growth.

We believe there is still time for investors to re-appraise portfolio risk given the strong start for global equities in 2019. Due to the increased likelihood of a longer period without resolution of the US/China economic conflict, we believe underweight positions are warranted in sectors exposed to global trade. The ebbing of profits forecast momentum also suggests that a lower allocation to cyclical sectors is warranted, even following recent relative underperformance. We continue to believe that a highly targeted approach to equities is key to portfolio outperformance at present as benchmark indices may come under further pressure if there is increased evidence of a trade-induced slowdown.

While we recognise that the current US administration remains especially unpredictable, at present there is insufficient market pressure on President Trump to change tack. It is therefore not in our view tenable to ignore the increasing evidence of an impending slowdown at current equity valuations. We move from a neutral to cautious outlook on global equities.

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