Illumination: Equity strategy and market outlook

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Global perspectives: Tide lifts all boats, for now

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- **Global markets have risen as central banks match earlier expectations for easier monetary policy.** While the decline in government bond yields since early May has been significant and, in our view, correctly reflects falling inflation pressure, investors seem oblivious to the risks to profits from slower economic growth at present.
- **Profits forecasts for 2019 are back on a weakening trend, following softer incoming PMI survey data.** Despite a brief stabilisation of 2019 forecasts at the end of Q1, the drumbeat of downward revisions is getting louder.
- **Gold is likely to remain in favour.** We can see the attractions of gold currently, such as markedly lower expectations for future US interests and rising geopolitical tensions. Furthermore, there will be appeal for UK-based investors seeking to diversify sterling risk given the domestic UK political uncertainty over the coming six months.
- **We stick with a cautious view on global equities despite the recent mini rally.** We acknowledge that we have been surprised by the recent level of excitement in equity markets in relation to some quite predictable shifts in the official outlook for interest rates in the US and Europe. Nevertheless, we remain of the view that global equity markets are unlikely to make material progress without the fundamental support of confidence in profits expectations for 2019.

Rising tide lifts all boats for now

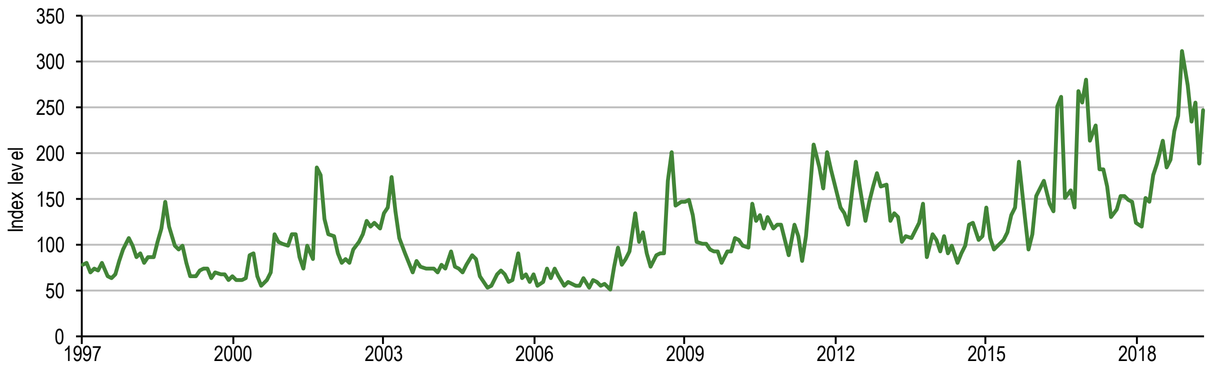
Rational bond rally but equities ignoring prospect of slower profits growth

Dovish statements and commentary during the past month have in effect validated a very sharp decline in global bond yields. In response to these comments, global equities have also rallied. Yet it is hardly a surprise that policymakers would respond to lower growth and inflation prospects with lower rates. However, while bond markets are correctly in our view discounting lower prospective interest rates, equity investors should also factor in lower profits expectations for 2019 as the effects of the trade war bite. In particular, it makes us uneasy from a longer-term perspective to see monetary policy being used in effect to counter the self-inflicted harm from an arguably suboptimal US policy on trade.

The seemingly quaint concept of moral hazard, in which bailouts incentivise further risk-taking, is now becoming relevant in the realm of international politics. Following the bailouts of the financial crisis, central banks addressed moral hazard with an enormous global effort to reduce bank sector risk and improve resilience in the form of increased capital buffers and supervision. Furthermore, new macroprudential regulation enabled regulators to rein in excess lending should the need arise. Central banks may have offered bailouts, but at least they tried to collar the banking system for the future.

In contrast, in the political domain we are seeing increased levels of risk-taking in terms of policy, with no obvious mechanism for restraint or correction other than periodic elections in developed markets. This risk-taking also appears correlated to the sharp rise in policy uncertainty indices seen in recent years, Exhibit 1. Such policies include the US/China economic dispute, Brexit and Italexit. The US/China dispute may be the single largest issue for markets at present but in the background, the US has also engaged historical allies in Europe in a second and significant trade confrontation.

Exhibit 1: Global economic policy uncertainty index remains close to 20-year high



Source: www.policyuncertainty.com

It could well be argued that Fed and ECB policymakers are only following their technical mandate of promoting price stability (in the US full employment) by countering a US trade policy-led slowdown. It could also be argued, however, that by allowing monetary policy to absorb the negative short-term shock this may enable the US trade conflict to continue for substantially longer than it might otherwise.

We suspect long-term equity investors would prefer to see a shift back to a US presumption of the benefits of global free trade policies, as unlikely as this may be at this point, rather than another short-term palliative in the form of lower interest rates. For this reason, the bounce in global equity markets is unlikely to represent the start of a bullish trend in our view, unless somehow a continued trade war can coexist with global growth.

Followed to its ultimate conclusion, the US policy of using tariffs to improve its terms of trade seems likely to prove damaging to the global economy. US policy also ignores the experience of Europe, in the relatively quiet technical progress achieved in terms of common standards of product, production and limits on state support. These have lowered the risks of unfair competition and all within the confines of a tariff-free single EU market.

The institution of the EU can be criticised in other regards, but during the Brexit process it is evident this single market has significant value to all parties. If the US had engaged in a low-profile but sophisticated technical approach to ensuring fair competition in return for access to US markets, it may have had a better chance of success in achieving its strategic objectives, and with fewer risks to the economy.

The current confrontational US trade policy also now carries the risk that China and the EU may take the opportunity to develop regional champions, especially in newer technologies where the US has historically had a large lead. For example, European proposals for digital taxes, which would be largely borne by the US technology sector, are likely to be easier to implement in an environment of trade tariffs. Increased taxes, combined with the inefficiency of a fragmented global market and the resulting improved negotiating position of labour, would be likely to pressure corporate profit margins over the longer term.

Political developments have come a long way, but not in a good sense since the start of 2019. Our more positive views on global equities earlier this year were driven by a belief that the US/China trade conflict would be resolved by mid-year, with an eye to the US presidential election in 2020. Since then, the parties' positions have become entrenched and the negative economic effects in terms of slowing trade and survey data have become clearer.

On the surface, the rhetoric from the US administration in terms of China has softened somewhat over the past week and it appears that a meeting at the G20 later in the month will now include a presidential meeting between the US and China, at the request of the US.

However, the incompatibility between the positions of the US and China, particularly in respect of any US willingness to allow China to compete for global leadership in high-tech industries, remains a glaring obstacle to meaningful progress in talks. While uncertainty on trade may have contributed to a slowdown in global trade volumes, US tariffs are now in place and the corporate sector, both in China and the US, is already taking steps to reconfigure supply chains to avoid the risk of supply disruptions.

Slower growth and inflation are now correctly embedded in short- and long-term interest rate markets. The recent confirmation that the US Fed will respond to a weakening economy with lower rates may offer a brief respite to global equity markets (and we expect the ECB to follow suit) but is hardly a surprise. In the worst case, accommodating suboptimal policy may delay any resolution to the US/China conflict by insulating politicians from the costs. We therefore remain cautious on global equities at current valuations.

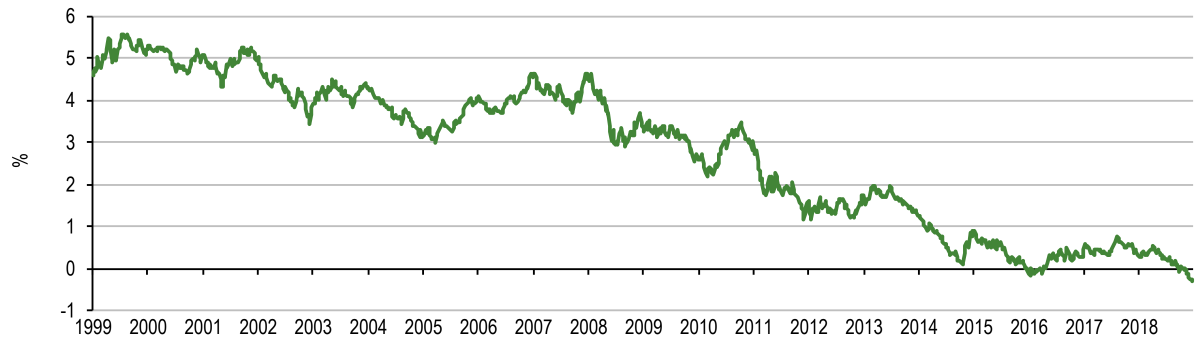
Whatever it takes…all over again!

With eurozone core inflation falling to 0.8% year-on-year in May and five-year forward inflation expectations falling to less than 1.2% in recent weeks, indications from the ECB that all options are on the table to return inflation to below but close to 2% can hardly be a surprise. Adding to a steady flow of sourced and unsourced press commentary by ECB policymakers, outgoing ECB President Draghi in a speech in Sintra effectively promised to do whatever it takes – all over again – to bring eurozone inflation back to target. This is unambiguously positive for eurozone bonds, negative for the euro and, in combination with an expected easing of monetary policy in the US, supportive of gold. However, despite the comforting rebound in equity markets since central banks largely confirmed earlier market expectations of easier policy later in 2019, there has been a very marked slowdown in PMI survey data on a global basis in recent months. The very weak 47.7 reading for the flash eurozone manufacturing PMI during May follows a steady loss of momentum dating from early 2018. We believe the lurch towards US protectionism is to a large degree to blame for the most recent ebbing of economic momentum in the eurozone.

Comments from US Commerce Secretary Wilbur Ross suggest the best that can be expected of the upcoming G20 Trump/Xi meeting would merely be an agreement to restart talks. The US/China trade war therefore remains likely to continue for the foreseeable future. In this regard, US President Trump's tweets, criticising Mario Draghi's comments and the corresponding fall in the euro, highlight the risk of a race to the bottom in terms of escalating tariffs and offsetting monetary policy.

In this scenario, central banks effectively engage in competitive interest rate cuts to offset the impact of tariffs on the real economy. This would not, in our view, ultimately be a positive situation for global equities and adds weight to our cautious stance on sectors exposed both to cyclical factors and global supply chains as resolution of the trade war still appears a distant prospect.

Exhibit 2: 10-year German Bund yields touch record lows as further ECB easing anticipated



Source: Refinitiv

The sensitivity of markets to changes in ECB policy also highlights the open question of the imminent replacement for Mario Draghi as ECB president. The ECB may be governed by its council, but the president remains responsible for communicating policy moves to the market and is the most influential voice by far. In this regard, while he may have wished to have provided his successor with a blank canvas, Draghi may instead have felt compelled, given the deterioration in the data, to raise market expectations of further monetary easing now. However, later press reports indicated that there is at the present time limited consensus on a way forward within the ECB's governing council.

Despite US President Trump weighing in on the ECB's predictable policy response to slowing growth and inflation data, we expect the resulting decline in the euro to be at most modest as the US Fed's most recent statement signals a cut in interest rates in July. With central banks on both sides of the Atlantic likely to be in easing mode for the remainder of 2019 and global political tensions unresolved, government bonds and gold are likely to continue to find favour among investors, in our view.

Exhibit 3: Gold benefiting from likelihood of simultaneous easing of US and eurozone monetary policy

Source: Refinitiv

Minimal capitulation from the FOMC

July's FOMC statement and Fed Chair Powell's press conference may have satisfied those looking for US rate cuts later in 2019. However, we see in both the statement where rates were left on hold and the press conference an uncharacteristic reluctance to react pre-emptively. This is despite a lowering of the central projection for inflation by 0.3% to a below-target 1.5% for 2019. It would have been relatively straightforward to have argued for a cut now, in our view.

During the press conference, Powell consistently highlighted the need to respond to actual data rather than mere changes in sentiment, which could prove transient. Notably, he also linked the state of trade negotiations between the US and China as driving sentiment. It may frustrate the current US administration that by implication the Fed is implicitly leaning against the golden stock market scenario of sharp cuts in interest rates, quickly followed by an agreement on US/China trade, just in time for the 2020 US presidential election.

The weakness in the actual data was described as a very recent phenomenon, with all but one of the voting members of the FOMC governors opting to wait rather than cutting rates. Powell indicated that FOMC policymakers as a whole wanted to have confirmation of how much the economic risks would weigh on the actual outlook, before taking action.

Challenged on the academic research, which indicated that central banks should act quickly and decisively when faced with the prospect of a downturn with rates close to the zero lower bound, Powell chose to re-emphasise the recent nature of negative events (a likely reference to the breakdown in US/China trade negotiations), and instead suggested that the risks of waiting too long were not at this point prominent.

Given the high expectations for this FOMC meeting, where an early cut to rates was an outside possibility, the tone of the FOMC statement, which emphasised rising risks and uncertainty rather than any actual change to the outlook, was on balance less accommodating than we would have expected in the circumstances.

Softening survey data for the more cyclical manufacturing sector on a US and global basis might have been sufficient reason to cut rates now, given the rapid decline in the outlook for US inflation acknowledged by the FOMC. Instead of the relatively benign US equity market reaction, which was effectively unchanged following the statement, we would look to the US bond market where yields fell sharply at the 10- and 30-year maturities overnight, indicating that fixed income investors believe the Fed may have to cut rates deeper and for longer by not taking action now.

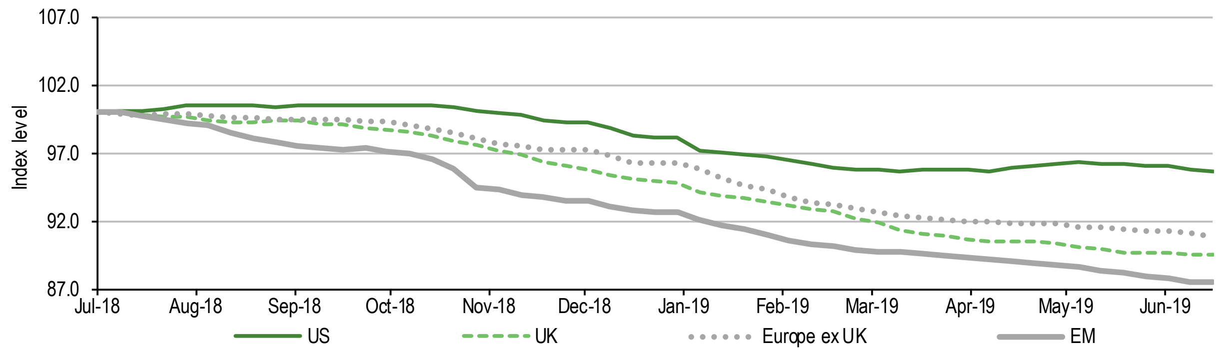
2019 earnings forecasts losing momentum

Following the recent sharp declines in PMI indices on a global basis, 2019 earnings forecasts have once again started to decline. Despite prospects for easier monetary policy, we believe investors also need to pay attention to weakening trends in corporate profits, which are likely to persist in our view, at least until PMI indices turn higher.

Until the end of Q119, the equity market rally had been built on easier financial conditions, in terms of lower interest rate expectations in Europe and the US but, importantly, also a recovery in confidence for corporate earnings prospects for 2019 as estimates stabilised after falling for six months starting from October last year.

This improvement in profits expectations is now at risk of proving unsustainable, in our view. We believe investors will have to see real progress in respect of the key political uncertainties of the US/China trade conflict and the UK's exit from the EU for positive momentum to be restored.

Exhibit 4: Unweighted consensus earnings are now being revised lower after stabilising end-Q119



Source: Refinitiv, Edison calculations

Brexit may at this point have been pushed out of the headlines, as the UK's ruling Conservative party selects a new leader and prime minister, but the issue of the UK's exit from the EU remains wholly unresolved and is likely to create increased market volatility later in 2019. We note, for example, that the median UK earnings forecast is a full 10% lower than at this time last year, at least in part reflecting Brexit uncertainty.

The relatively open eurozone economy is suffering from both these negative political developments, with recent PMI readings well below the 50 level, which separates contraction from expansion. It is unfortunate timing for the ECB, as no successor has yet been anointed to replace the incumbent ECB president, Mario Draghi. Both growth and inflation expectations have been on a downward trend in the eurozone since mid-2018, which may have somewhat forced Draghi's hand to deliver a very dovish speech in Sintra.

We remain uncomfortable with near-term equity market dynamics being driven almost entirely by short-term changes in the outlook for monetary policy when profits growth is the larger component of equity returns in the longer term. Corporate profits are now forecast at a rather pedestrian 5–7% growth for 2019 in developed markets. Emerging market growth forecasts for 2019 have now fallen to 9%, compared to 15% a year ago.

Conclusion

We acknowledge that we have been surprised by the recent level of excitement in equity markets in relation to some quite predictable shifts in the official outlook for interest rates in the US and Europe, which in large part adjust policymakers' views towards earlier market expectations.

Nevertheless, we remain of the view that global equity markets are unlikely to make material progress without the fundamental support of confidence in profits expectations for 2019. Equities remain at risk from further reductions in profits forecasts in our view, reflecting the declining momentum in global survey data.

However, we would not doubt the willingness of central banks to ease monetary policy as the economy slows and believe that lower government bond yields and higher gold prices are a rational response to evidence of a slowing global economy.

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