Illumination: Equity strategy and market outlook

July 2019

Published by Edison Investment Research

Global perspectives: Stand and deliver

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **Global markets have been promised significant monetary easing and it is now time for central banks to deliver.** We expect both the ECB and the US Fed to demonstrate a commitment to easier monetary policy in coming days – anything less is likely to be received poorly by markets.
- **We remain concerned that using monetary policy to offset trade policy own goals may be storing up trouble for the long term.** On both sides of the Atlantic there has been an obvious U-turn in monetary policymaking, from normalising to easing. While this is beneficial for gold, we believe equity investors are demonstrating a touching faith in the ability of central banks to support the economy and corporate profits.
- **This faith may yet be tested in H219.** 2019 profits forecasts have re-established their trend of downgrades, having briefly stabilised at the end of Q19 when there appeared to be some hope of a US/China trade truce. We have seen no real evidence of progress in respect of US/China trade negotiations since the resumption of talks following the G20 meeting.
- **We believe we remain relatively late in the economic cycle**. Given the longevity of the current global expansion, very low unemployment and rising debt levels in a number of sectors within the global economy we suggest that profits should continue to be taken in equities as valuations rise and expected returns fall. A degree of caution remains warranted, in our view.

Stand and deliver

Onus is on central banks to deliver on promises to ease monetary policy

With expectations running high, monetary policymakers are now under pressure to deliver on the promised easing of monetary policy on both sides of the Atlantic. In our view, the consensus has shifted to the point where all but the most radical immediate measures are likely to be met with a metaphorical shrug of the market's shoulders. On the other hand, while it is unlikely, should central banks fail to deliver the monetary stimulus which has been promised, equities would in our view be at increased risk of a somewhat larger sell-off.

The past six weeks has seen an astonishing rally spanning bonds, equities and precious metals. While government bond yields have plunged, reflecting slower near-term growth prospects, global equities have risen. This could be construed as something of a conundrum although the explanation is a declining risk premium for global equities, reflecting a remarkable confidence among investors in the ability of monetary policy to head off a slowdown in corporate profits.

The spread between junk bonds and risk-free government securities has shrunk by about 50bp since central bankers opened the debate globally on easier monetary policy in coming quarters. The P/E re-rating in US equities is consistent with a similar magnitude reduction in the US equity risk premium, as the US market index has risen even as US earnings forecasts for 2019 are on a declining trend.

Exhibit 1: The difference between junk and US government bond yields has declined by 50bp in recent weeks

Source: Refinitiv

At this point, we therefore believe the prospect of easier monetary policy is more than fully priced into equity markets. Furthermore, a wide range of survey data on a global basis suggests a meaningful slowdown may lie ahead. We are not as sanguine as the markets imply on the ultimate impact of lower economic growth on profits forecasts for 2019.

This very strong late-cycle performance in risk assets such as equities and high yield bonds has masked weakening trends in the economy, corporate fundamentals and disturbing political developments, all of which we have witnessed during the past six months.

In the UK, US President Trump this week hailed the 'tough and smart' 'Britain Trump', also known as incoming Prime Minister Boris Johnson. It remains to be seen what room for manoeuvre he has given a slender parliamentary majority and many in the UK will be grateful that the government in the UK does not have the free rein of the US administration for foreign policy decisions. However, the stalemate on Brexit has not been broken.

While PM Johnson has spoken brave words in terms of the preparedness of the UK for no-deal, it remains to be seen whether his government would survive the run-up to a no-deal outcome if the

EU refused to budge from the current Withdrawal Agreement. In the circumstances, and despite the change of individuals within the UK government, uncertainty for the UK economy and sterling remains elevated over the near term.

Within the eurozone, the lack of resolution to the Brexit question is also weighing on sentiment indices. Furthermore, the apparent lack of progress in US/China trade talks is now clearly affecting Europe's exporting nations. US President Trump is demonstrating strong political skills in pointing the finger for the slowdown in the US and world economy at everyone but himself.

Furthermore, Trump's running tweets and commentary with respect to the actions of the US Federal Reserve may play well to his domestic electoral support. However, he may be playing with fire in terms of the longer-term international perceptions of the qualities of the dollar as a safe reserve currency.

While the risk of 'emergification' of the US dollar and, potentially, the loss of independence of the US Federal Reserve is clearly a longer-term question, the recent strength of the gold price is instructive. Lower long-term rates may support the gold price due to the lower cost of carry but there may already be an element of tail-risk hedging in the current surge of interest in the metal.

Exhibit 2: Renewed interest in gold reflects both declining rates and rising tail risks for the US dollar

Source: Refinitiv

Over the past six months asset allocators have seen a comprehensive U-turn in monetary policy, from a path of steady normalisation to a near-panic level of declining long- and short-term rate expectations on a global basis. One scenario, which may be low probability but would be strongly beneficial for gold, would be a period of ineffective monetary policy, leading to a further extended period of financial repression. What is clear is that central banks will in any case need to design policies carefully to avoid impacting bank sector profitability through an extended period of low or negative interest rates. It is the prospect of ineffective monetary policy which may have been driving the gold price, in our view.

2019 earnings forecasts continue to decline

Faith in policymakers' support for corporate profits may yet be tested

Consistent with the weakness in global PMI survey data, 2019 earnings forecasts are also starting to falter. Nevertheless, we recognise that for many investors corporate fundamentals will matter less than the near-term direction of monetary policy at the present time.

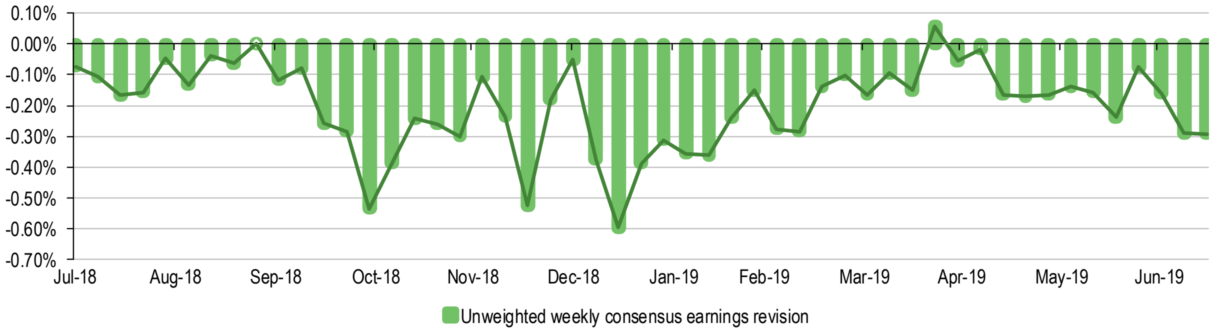
However, slowing growth does appear to be having a detrimental effect on profits momentum. On an unweighted basis, 2019 forecasts are now 10% lower than a year ago in the UK and eurozone and nearly 15% lower in emerging markets. The US has held up better with a 3% decline in earnings forecasts over the same period.

It is notable that having stabilised during Q119, earnings estimates in both emerging and developed markets are now back on a declining trend in the absence of the anticipated resolution to the

US/China trade dispute during May. This has been reflected in weakening trends in PMI survey data and this is now feeding into corporate guidance and consensus earnings forecasts.

While market direction appears dominated by the prospect of easier monetary policy at present, we note that historically equities have more typically struggled in an environment of downgrades, seen as recently as Q418. We are concerned that investors are not properly taking into consideration the strong likelihood of lower profits in a scenario of lower economic growth, which is implicit in expectations for meaningfully looser monetary policy. Even as earnings forecasts are now falling at a similar rate to that seen in Q418, equity market sentiment has, for now, remained remarkably robust.

Exhibit 3: Budding recovery in confidence in 2019 earnings forecasts has receded as downgrades dominate



Source: Refinitiv, Edison calculations. Note: US/UK/Europe ex UK.

Conclusion

We remain concerned in respect of equities as we are in an environment where bond yields are falling, reflecting lower inflation and growth prospects, while equity market valuations are rising and market sentiment remains robust. We understand this is based on an expected monetary policy easing in the near term, but it also suggests a touching level of faith in monetary policy for curing all ills in respect of the economic cycle and ensuring stable corporate profits growth.

We are not alone as even central banks have at times admitted to being less than all-powerful in this regard and have also highlighted the need for fiscal measures and structural reforms, notably within the EU, to provide balanced support for the economy. Such balanced support is also less likely to create adverse distributional side-effects.

It is unfortunate that the little dry powder in terms of conventional monetary policy available to central banks is, arguably, being squandered on addressing a global slowdown that might have been avoided with a better US approach to address the known issues in US/China trade. In addition, Brexit – a phenomenon also related to the rise of populism – continues to loom over the EU area.

Given that investors also find themselves late in the cycle due to the longevity of the global expansion, very low unemployment and rising debt levels in a number of sectors within the global economy, we suggest that profits should continue to be taken in equities as a degree of caution in our view remains warranted.

General disclaimer and copyright

This report has been prepared and issued by Edison. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

The Investment Research is a publication distributed in the United States by Edison Investment Research, Inc. Edison Investment Research, Inc. is registered as an investment adviser with the Securities and Exchange Commission. Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas,
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia