Illumination: Equity strategy and market outlook

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Global perspectives: Stuck in neutral

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- **Earlier in 2019, the key risks were tighter monetary policy leading to an economic slowdown, a US/China trade confrontation and resolution of Brexit.** For months, progress on these issues has at best been halting, although during H219, advances have been made. Central banks have now acted on signs of slowing growth and eased monetary policy. Political risks are shifting. Brexit could be in the rear-view mirror by the end of January, while the US and China appear to be stepping back from the brink.
- **It has become consensus view to fear a recession in 2020.** We recognise that over recent weeks economic momentum is hardly encouraging, though it is likely still too early to expect any meaningful benefit from the loosening of monetary policy in the eurozone and US this year. However, we believe markets will move before the economic data. Investors may also gain confidence from the US Fed's recent willingness to expand its balance sheet to offset funding stresses, even if policymakers try to insist it is not a reintroduction of QE.
- **The UK now appears likely to exit the EU with a deal on 31 January following the election, in our view.** Nevertheless, the relief rally in UK domestic equities is likely to be on pause until then. Despite the easing of political risk, we note that UK earnings momentum has weakened since the summer. Median earnings growth for UK-listed equities for 2019 has fallen to just 2%.
- **At times during October, it has been difficult to keep up with the progress being made on investors' risk lists.** Yet the final piece of the jigsaw of improving economic data has thus far proved elusive. With the risks balanced, we stick with a neutral view on equities despite some disappointment that Brexit was not concluded during October.

Stuck in neutral

US/China trade and Brexit risks: Progress, finally

For over a year, investors have had to incorporate a risk premium for adverse political developments into global asset prices. A US challenge to the long-established consensus on the benefits of free trade has been a novel and unwelcome development, especially in the context of a very benign environment for the multinational corporate sector over the past several decades. Furthermore, the uncertainty surrounding the form and timing of any departure of the UK from the EU has had a dampening effect on investment and profits on both sides of the English Channel.

US/China trade policy shows signs of softening

It may have been some time coming but the recent détente between the US and China in terms of a prospective 'Phase 1' agreement on trade is consistent with attention turning to Trump's re-election prospects next year. Naturally, in the era of the Trump administration this preliminary 'deal' has been announced long of fanfare and short on detail. The actual text is still under negotiation but is due to be signed off between Trump and China's President Xi in mid-November.

Nevertheless, the proposed agreement opens the way to a de-escalation of the tariff war currently underway, even if the negotiations appear to favour China at present. The rationale for prioritising farm products over the arguably much more important issues in respect of intellectual property theft or forced technology transfer hint at domestic US political drivers. From a negotiating perspective, this 'phasing' has echoes of the manner in which the EU boxed in the UK at an early stage through the use of pre-commitments, prior to negotiating the more contentious parts of the Brexit deal.

We also note US Commerce Secretary Ross's recent public comments that indicate the proposed tariffs on the European autos sector may be replaced with talks between the two sides next month. The situation is clearly unpredictable but the direction of travel on US tariffs appears to have shifted to a more conciliatory approach as the economic damage of the policy – and perhaps to Trump's re-election chances – has become clearer.

Should the initial agreement between the US and China be formalised in November, we believe it may signal the end of the chapter of Trump's rather experimental use of US trade policy to achieve domestic political goals, which would be welcomed by markets. Any reduction in international policy uncertainty may also release business investment which has been put on hold pending clarity on the US/China trade conflict, further supporting the global economy in coming quarters.

Brexit: Big steps towards a conclusion but risks remain

The UK's Brexit question may still be open but the situation has moved on significantly since only September when many doubted that PM Johnson would be able to re-open the Withdrawal Agreement. It was, in our view, a material positive to have finally obtained a Parliamentary majority in favour of this revised agreement. However, a rejection of the timetable paused the passage of the legislation.

A further extension to Article 50 to 31 January has now been granted by the EU and an election called for 12 December. While the position can still be argued in a partisan manner momentum has appeared to build behind this new Withdrawal Agreement, which gives some hope that a new Parliament may be able to ratify the deal.

While there are still significant risks ahead, the specific risk of no-deal on 31 October has passed without incident. Instead, attention now shifts to the composition of the new Parliament at the end of the year. Based on polling which currently indicates a Conservative majority, we view the highest probability scenario as the passage through Parliament of the current Withdrawal Agreement in the first few weeks of 2020 and Brexit on 31 January.

As a result, uncertainty at that time will diminish significantly and the transition out of the EU would be relatively smooth when it occurs. Political risks will shift to the longer-term (where the market impact will be minimised) as attention turns to the UK's future trade agreement with the EU.

In recent years, UK profits growth has suffered from Brexit uncertainty but this is hardly a surprise to investors; for example, business investment growth has been lacklustre since the referendum. For 2019, the median profits growth forecast has fallen to just 2%. However, we may be reaching the point where it just takes the removal of the uncertainty to see a pick-up in corporate investment spend, which at least in part will be catch-up spending deferred from prior periods.

Added to this, we believe the UK government will be determined to add fiscal stimulus over the Brexit period while the Bank of England will be on hand to offer monetary support. Despite the recent rally, sterling still appears good value on a trade weighted basis and UK equity markets remain relatively inexpensive. If Brexit is complete by the end of January, we believe 2020 could be a better year for UK markets than the consensus expects.

In our view the outperformers in a bullish scenario of Brexit-with-a-deal would be domestically focused UK equities, which may benefit twice over – first from a reduced Brexit risk premium, and second from a UK fiscal stimulus. On the other hand, UK-listed exporters may face a stronger currency headwind.

Getting Brexit done may re-centre UK politics

Over the last 20 years the UK's political dynamics have steadily shifted from a battle for the centre to appeal to fringes of the political spectrum. In recent years the UK is not alone in this regard and similar dynamics are evident in both continental Europe and the US. Increased popular support for ideas away from the mainstream has manifested itself in a weaker showing for the main UK parties and wafer-thin majorities, achieved through coalition politics.

The lurch towards Euroscepticism within the UK's Conservative government under PM Johnson is one example of previously fringe ideas gaining ground. However, a distinctly corporate-unfriendly set of Labour policy initiatives lurks in the background for now, but remains a political risk for investors.

The UK's Labour party has, for example, proposed extensive re-nationalisation of privatised industries and increased rates of corporation tax. More radical proposals include the seizure of 10% of public company equity for the benefit of workers in 'inclusive ownership funds', together with new rules to ensure one third of company board seats are comprised of worker representatives. Furthermore, potential changes to the inheritance tax regime may yet target AIM-listed securities which currently benefit from extensive reliefs. The first salvos of Labour's election campaign, which named certain wealthy individuals as targets for taxation, is indicative of the direction the Labour election campaign is likely to take.

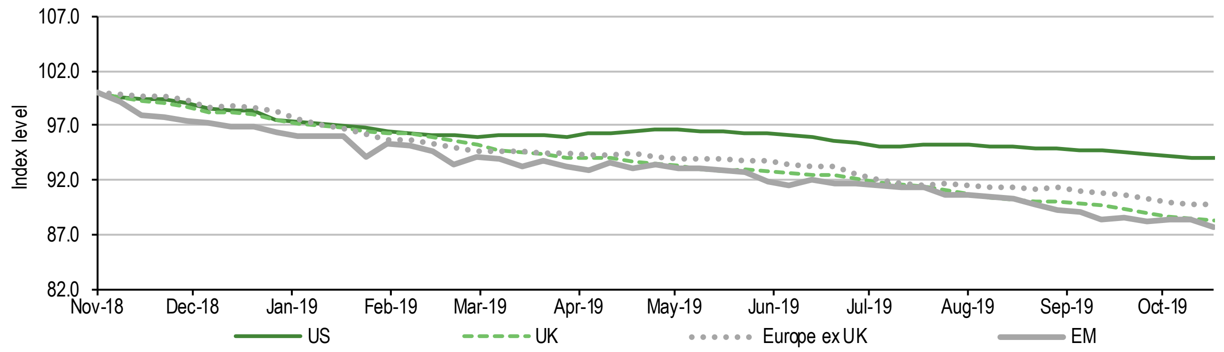
For now, the weak performance of the Labour party in the polls since mid-year may give investors some comfort that a Labour government remains only a theoretical possibility and these unconventional policy ideas will never be implemented. For investors, the benefit of getting Brexit done is not just the reduction in economic uncertainty however, as a battle for the currently vacated middle ground of UK politics could then restart. This would further reduce the UK risk premium which has been evident in valuation terms, relative to other markets, in UK equities.

Still neutral on equities as risks are balanced

While a neutral position on European equities may be uncomfortable for some, we believe the risks are balanced. On the risk side of the ledger is the undeniably weak economic survey data as global economic momentum ebbs, particularly in sectors and countries exposed to global trade flows. The notable decline in China's services PMI in recent months highlights that there is still limited evidence of a turnaround in the data.

Furthermore, in terms of 2019 profits forecasts there is in truth some difficulty in spotting any reversal in the trend for steady, if relatively modest, downgrades observable since mid-year. Similarly to the trends in the economy, downgrades have been focused on nations such as the UK which have suffered from Brexit-related political risk. Eurozone equities have also suffered consistent downgrades this year, suffering both from Brexit-related and trade risks.

Exhibit 1: Trend of 2019 profits downgrades shows few signs of reversal



Source: Refinitiv, Edison calculations

Within the eurozone, manufacturing survey data continues to point to a contraction in output during the second half of 2019, even if the position in the eurozone is now no worse than during the summer. We note also the recently recorded 3% decline in US business investment evident in the US Q3 GDP figures, which highlights that the US economy also remains at risk from trade uncertainty

On the positive side for markets, central banks have been active in cutting rates and guiding for a period of lower rates in future. Both the ECB's and Fed's balance sheets are in expansion mode, Even though the Fed has repeatedly claimed its US Treasury bill purchases are not to be aimed at providing further monetary accommodation, in our view this will be perceived by investors as a form of QE.

This is a sea-change from earlier in the year when there was hesitation from central banks as academic debates raged over whether the 2019 slowdown was temporary, or likely to be quickly reversed as politically-driven trade uncertainty alleviated. The US Fed has now cut rates by 0.75% this year, having originally guided for increases.

Following this easing, some investors may also take comfort that the inflection point in economic activity may already have been reached; economic surprise indices suggest that incoming economic data are now in-line with consensus expectations in the UK and US at least, while PMI survey data are no worse in the eurozone than they were early in the summer. We would concur with this view in theory but do not at this point expect markets to rise materially from current levels, until there is supportive actual data.

Resolution of political risks is not a panacea for markets

It is important in our view to assign the correct level of uncertainty to the common narrative that political risks such as US/China trade dynamics and Brexit have been wholly or largely responsible for the slowdown in global economic momentum observed over the past 12 months. We would highlight that China's growth trajectory has been slowing since at least 2012 as just one counter example.

The absence of slack in the US economy, with US unemployment at cyclical lows, may also have contributed to a fading of momentum, especially in contrast with the fiscal boost given to the US economy from Trump's tax cuts in 2018. Median 2019 year-on-year EPS growth rates for the US corporate sector have fallen sharply to only 6% compared to 2018 as there was no further corporate tax giveaway this year, nor is one expected in 2020. It may attract relatively little attention at present, but Trump's tax reforms have significantly worsened the long-term outlook for US fiscal deficits. Trump's tax cuts also do not, so far, appear to have generated the promised boost to US activity or business investment which, it was claimed, would offset their fiscal cost.

Therefore, while we do suggest that political risks may have peaked, both in terms of Brexit and US/China trade negotiations, this does not necessarily represent an all-clear for markets in 2020. Cyclical risks remain. In addition to the US, which appears to be operating at close to full capacity, inflation in the UK remains stubbornly high. Bank of England policymakers may seem almost exclusively focused on Brexit but will yet be concerned that the scope for monetary accommodation is somewhat restricted given the record low levels of UK unemployment at present.

Any further reduction of the Brexit and UK political risk discount is now, in our view, contingent on a working majority for a Conservative administration at the beginning of December - and from then by speedy resolution of the Brexit question, per the revised published Withdrawal Agreement. UK voter polling currently indicates this is the most likely outcome, but fluctuations in voting intentions will in our view dominate other factors in terms of the short-term outlook for UK asset prices.

Conclusion

It remains the case, in our view, that the impact of the easing of monetary policy during 2019 is only likely to start to feed into the real economy by early 2020. This still has the potential to drive a substantial improvement in investor sentiment – where current positioning among institutional fund managers still remains bearish for now, according to recent surveys.

However, we remain neutral on equities as in our view the risks are balanced. At this stage in the cycle it would not be appropriate to invest aggressively in global equity markets. In some respects, activity may have stabilised at a subdued level, but this would be a generous interpretation of the recent incoming data at this time. The US/China and Brexit political risks remain unresolved, even if for now there have been some significant positive steps and some of the more extreme scenarios appear less probable in the short term.

In the absence of substantive fundamental support from profits trends, markets continue to look to central bank balance sheets, having been conditioned to associate balance sheet expansion with stable or rising markets over the past decade. With both the ECB and the US Fed now purchasing assets and on watch for further deterioration in the data, markets are likely to be supported in the near term while waiting for the final resolution of the outstanding political risks.

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