GLOBAL EQUITY PERSPECTIVES 19 NOVEMBER 2018

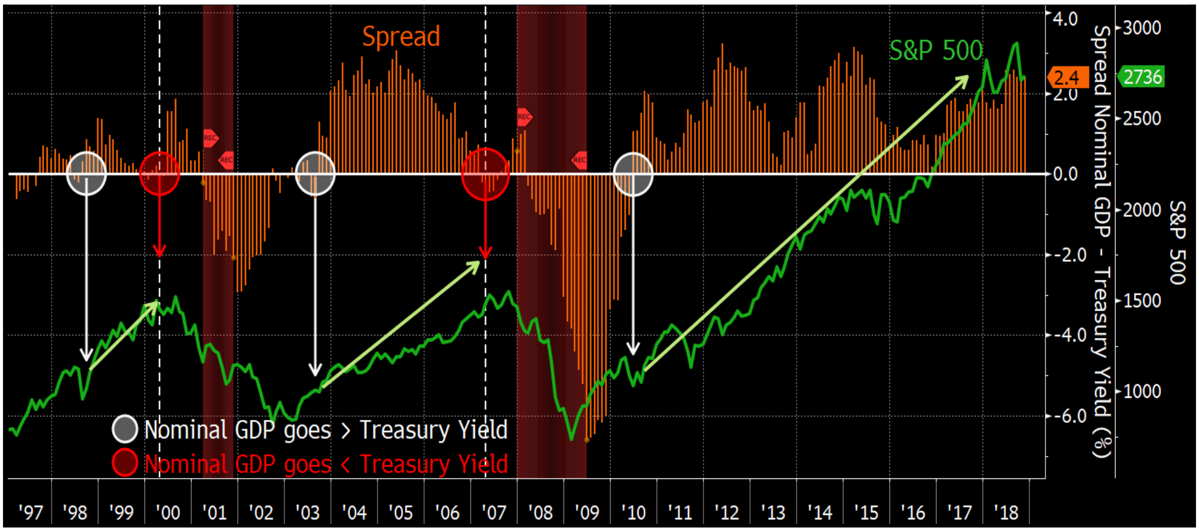
"It's not that I am so smart, I just stay with problems longer."

Albert Einstein

1. RECESSION RISKS

It is our impression that we would need a relatively high probability of an imminent US recession to fear the formation of a bear market in equities and therefore a structural peak in share prices. The following charts provide information in this context:

US – Spread Between Nominal GDP and Treasury Yield vs S&P 500



The peak in share prices is usually preceded by the level of the Treasury Yield rising to levels in excess of the nominal GDP (the vertical lines in the above chart). We currently have a reverse situation with this spread being well in excess of the Treasury Yield. US economic performance currently does not seem at risk in this regard.

NY Fed Probability of a Recession within One Year vs S&P 500

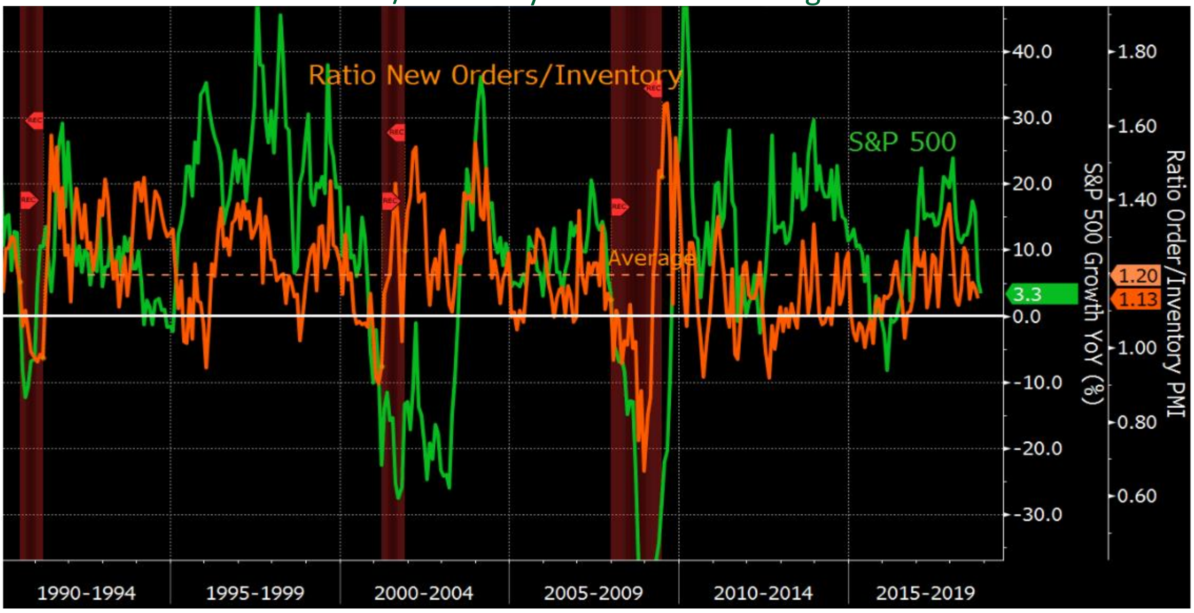
Share prices usually peak a few months before the start of a new recession. The NY Fed's chart of the probability of a recession within one year is a useful tool in this context. We show in the above chart the previous periods between the current level of this probability reading and the following structural peak in the S&P 500. The shortest period of these readings is 1½ years. On this basis, we cannot yet see the current market weakness as the beginning of a new bear market.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. November 2018. Past performance should not be used as a guide to future performance.

2. PMI SCARE

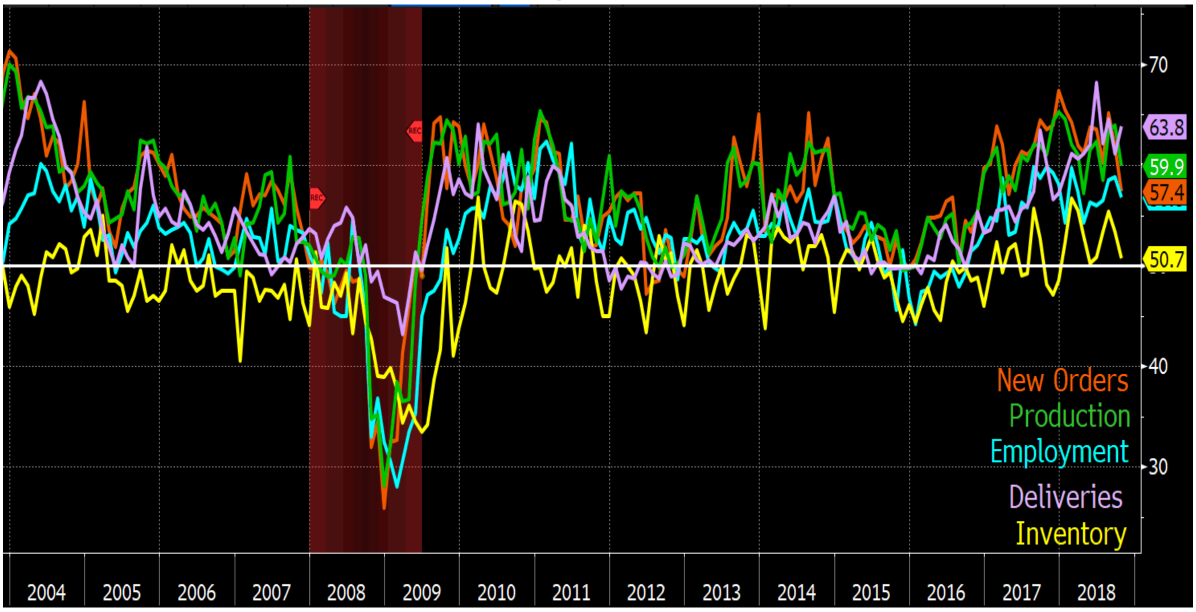
The ratio between the New Order and Inventory readings of the popular PMI economic strength data concern some investors. The following chart reflects this ratio along with the S&P 500 growth:

Ratio New Orders/Inventory ISM Manufacturing PMI vs S&P 500



The correlation between the above mentioned ratio and the S&P 500 seems quite high and one can understand the investor nervousness in this context. On further reflection, the following chart provides better perspectives:

ISM Manufacturing PMI – Sub Indices Data



Both the New Orders and Inventory readings are currently at economic expansionary (>50) levels, while the latter was at contraction levels for more than a year before the previous recession. The current ratio (1.13) between the two series is therefore less alarming.

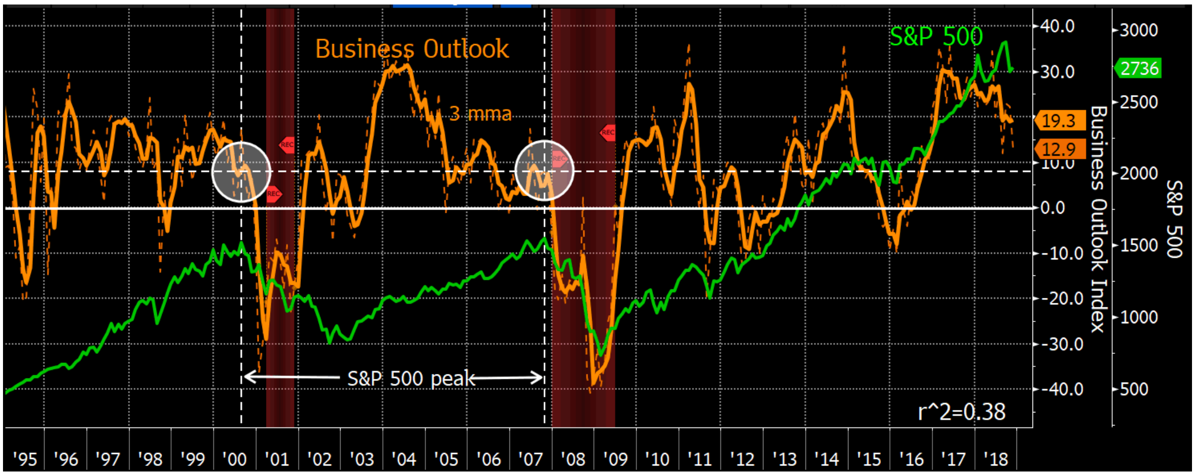
We can also make the point that the Inventory data are often below the 50-index level, illustrating the effectiveness with which businesses manage the cost of carrying stock.

The following chart reflects the overall PMI index along with the growth in the S&P 500 index. There has historically been a strong correlation between the two series. This correlation seems to have broken down this year with the S&P 500 being much weaker than the PMI data suggests.

ISM Manufacturing PMI vs S&P 500

We do expect the PMI data to start sliding, but the current gap with share prices (illustrated by the yellow arrow) seems somewhat excessive and we won't be surprised to see the two series 'meeting halfway' sometime.

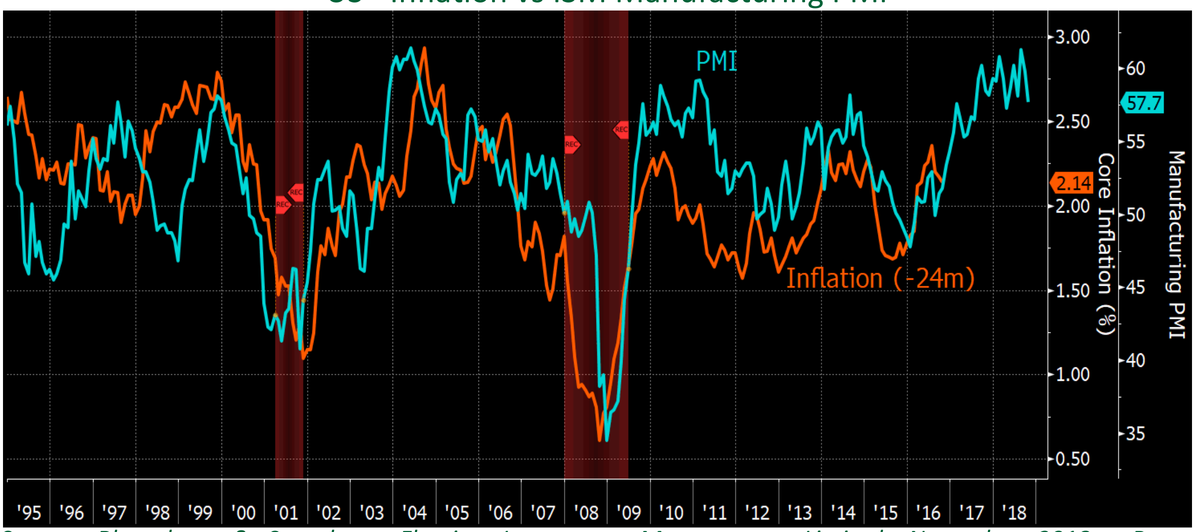
Philadelphia Fed Business Outlook Index vs S&P 500



The above chart reflects the Philadelphia Fed's business outlook index along with the S&P 500 price index. The structural peaks in share prices historically occurred at a reading of 7.5 for this business outlook index. The index does not yet provide such a warning.

3. INFLATION AND VALUATION

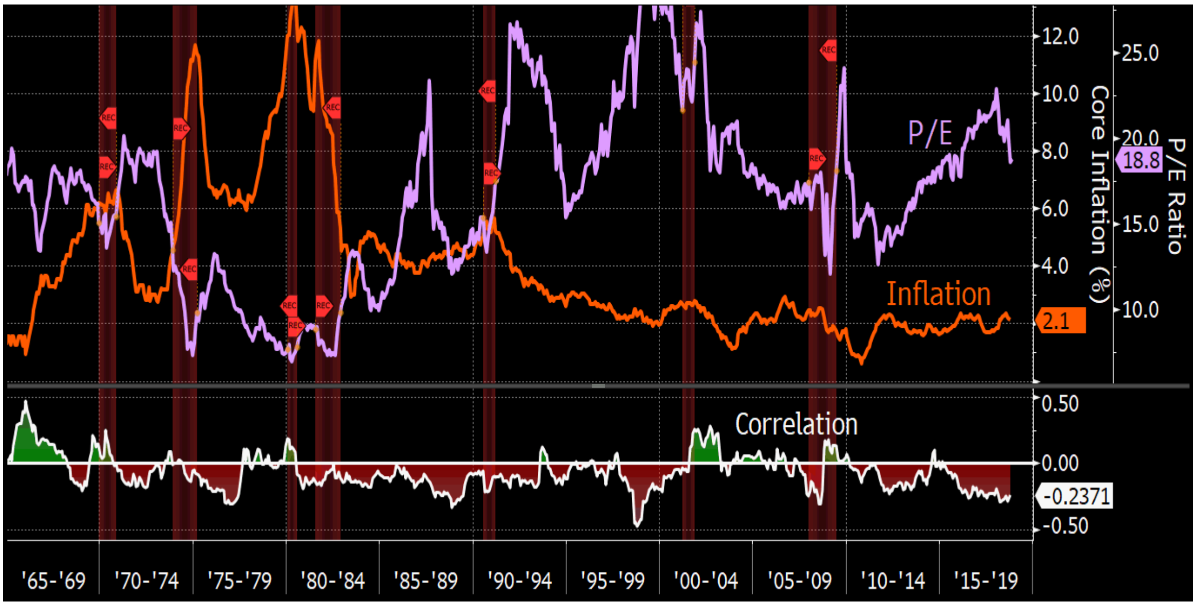
US - Inflation vs ISM Manufacturing PMI



Source: Bloomberg & Stonehage Fleming Investment Management Limited. November 2018. Past performance should not be used as a guide to future performance.

As reflected in the preceding chart and with the low US unemployment and further expected increases in wages, we can expect US inflation to increase further. It is challenging to forecast precise levels of inflation, but according to the chart levels around 2.5% won't surprise us. Rising inflation causes many uncertainties, amongst others the potential effects on company valuations.

US – S&P 500 P/E Valuation vs Inflation (%)

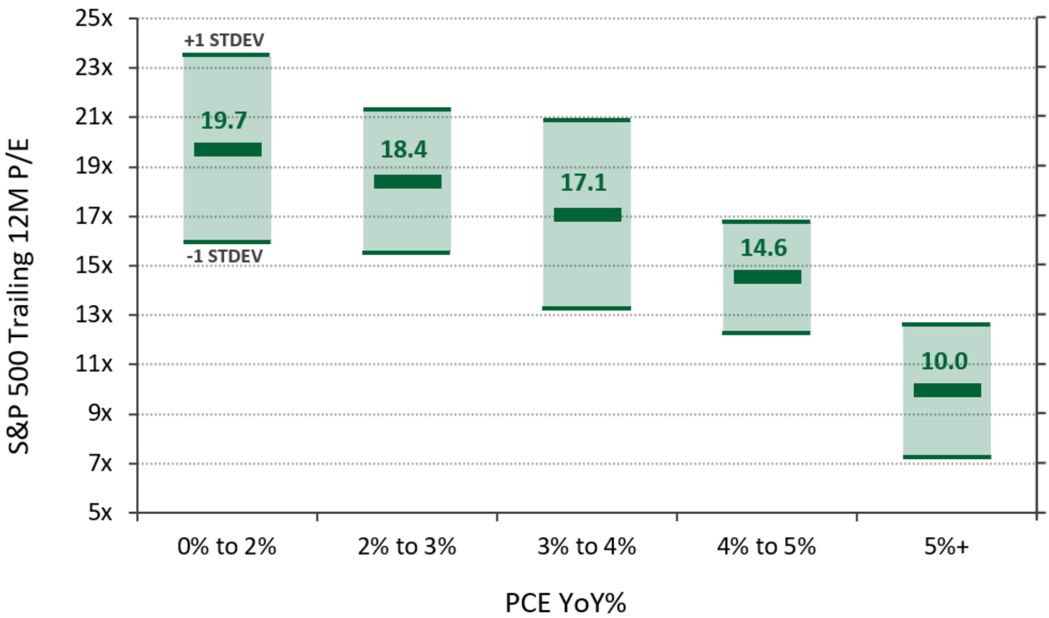


The US economy has enjoyed inflation levels of below 3% for all this century. Equity valuations predominantly have a negative correlation with inflation levels and the lower inflation levels have favoured valuation levels.

We did an analysis of the valuation levels that have historically corresponded with categories of certain inflation levels. It is presented in the following chart:

S&P 500 P/E Valuation Levels in Inflation Brackets

March 1960 – September 2018



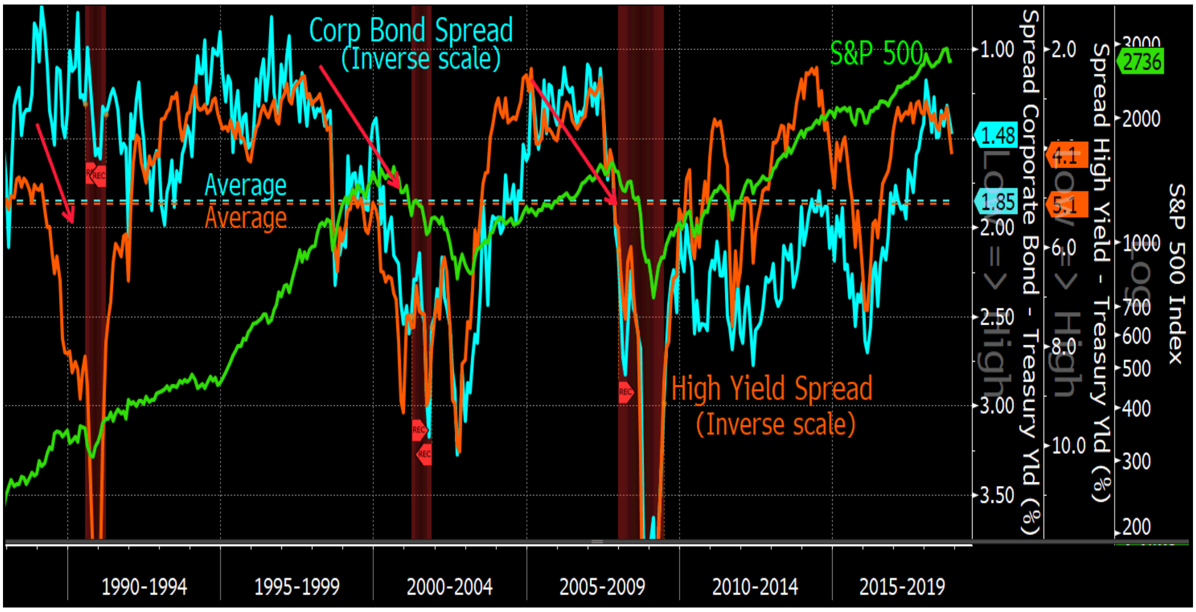
We have been in the 'sweet spot' of the most favourable inflation category (0%-2%) with respect to equity valuation levels and may well be entering the next category (2% - 3%). Whilst the peak valuation levels in this category were lower than in the previous category, the average and lower levels do not differ materially – the current valuation level of 18.8 is close to this category's average level already. A sharper devaluation in terms of average valuation levels is more associated with inflation levels above 4%. On the basis of these historic correlations we do not yet perceive it prudent to expect lower valuation levels to compensate for rising inflation.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. November 2018. Past performance should not be used as a guide to future performance.

4. HIGH YIELD RISKS

The high yield space (junk, corporate and emerging market bonds) is in our view more vulnerable than quality equities in an environment of rising interest rates (because equities' earnings yield spreads against these yields are in their favour). Along with this, high yield spreads against treasury yields seem to be rolling over (presented on an inverse scale in the following chart along with the S&P 500):

High Yield and Corporate Bond Yield Spreads (%) vs S&P 500

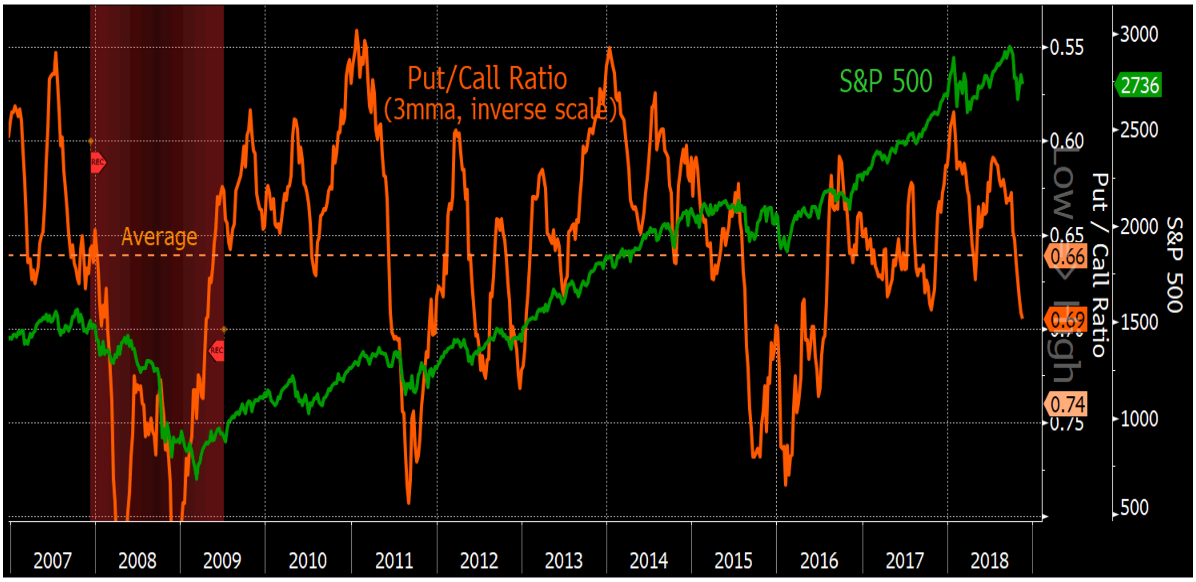


These spreads have historically started rolling over more than two years before the inception of US recessions and the structural peaks in share prices. On this basis we do not seem to face an imminent US recession or a peak in share prices yet.

5. TECHNICAL PICTURE

The Put/Call ratio on the S&P 500 provides some indication on overall investor sentiment and hedge fund activity. We present it on an inverse scale on the following chart:

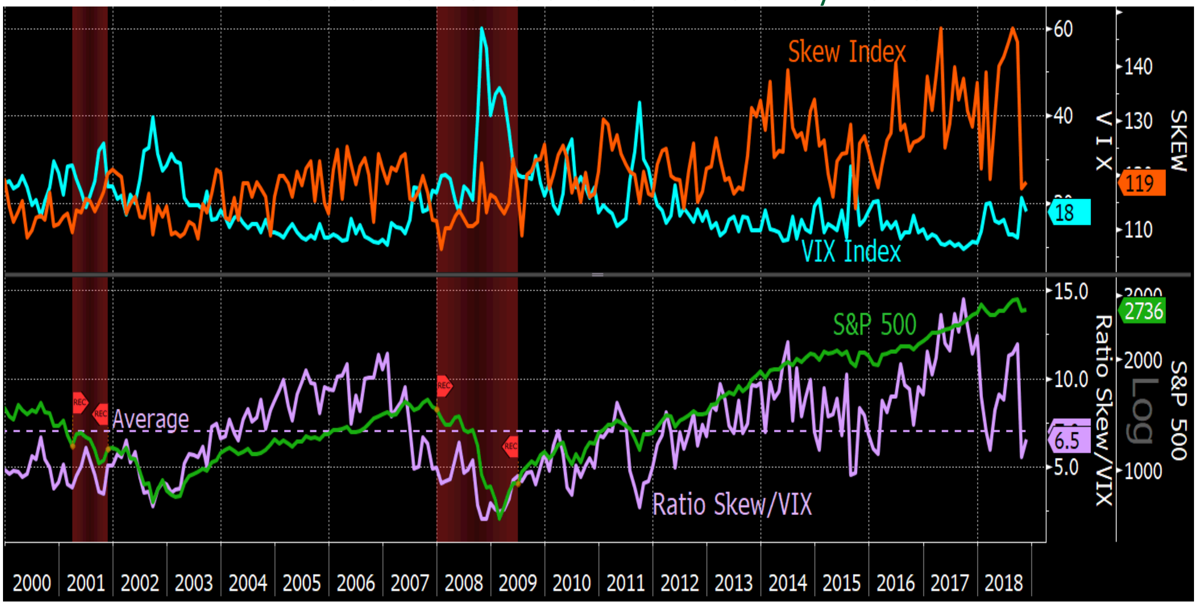
S&P 500 vs Put/Call Ratio



The ratio reflects weak overall sentiment currently, even weaker than with the strong market correction in February. It is approaching levels that have since the Credit crisis indicated buying opportunities – of course on the condition that we do not face an imminent recession.

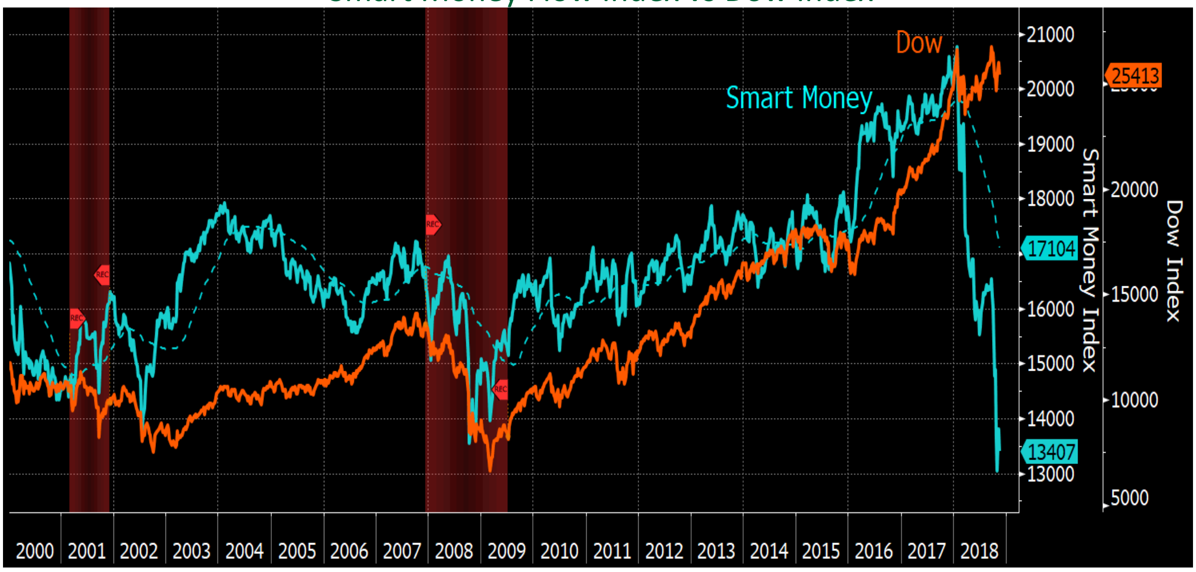
Source: Bloomberg & Stonehage Fleming Investment Management Limited. November 2018. Past performance should not be used as a guide to future performance.

S&P 500 vs CBOE Skew and VIX Volatility Indices



The Skew volatility index often leads the VIX index. The ratio between the two indices often provide good early tactical stock market indications (the bottom section of the above chart). The ratio is currently below its average and signal better stock market stability.

Smart Money Flow Index vs Dow Index



The Smart Money index reflects the influence of heavy hitter activity at the opening and close of the stock market every day when prices are more vulnerable. The index reflects high exuberance in January and currently the most distraught levels this century, even worse than in the Credit Crisis. This seems to be an extreme level and begs the question whether the fundamental economic outlook can really be this bad.

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