GLOBAL EQUITY PERSPECTIVES 14 JANUARY 2019

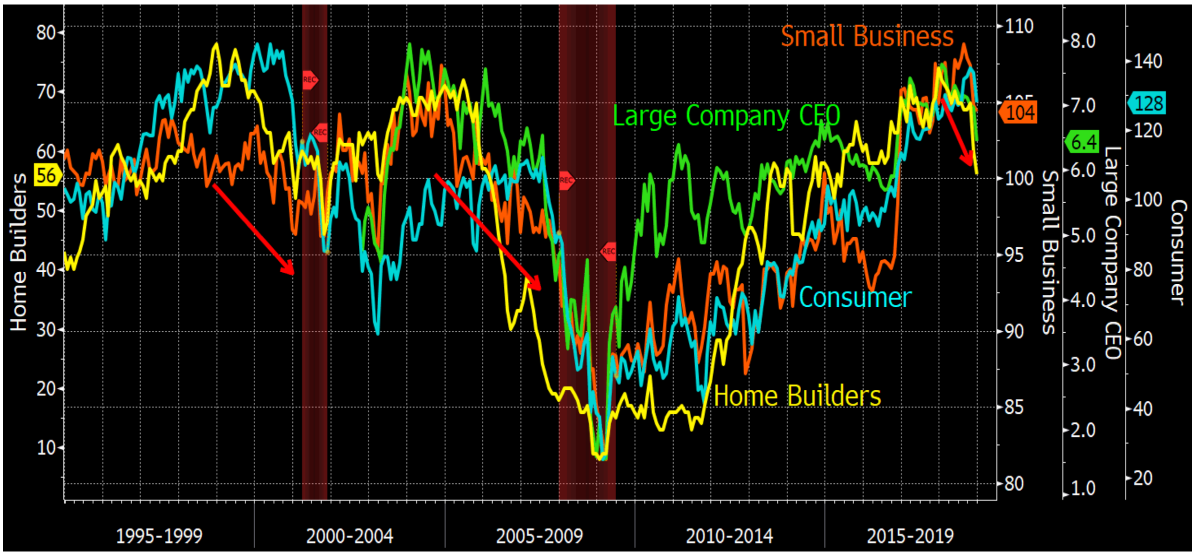
"He who can no longer pause to wonder and stand rapt in awe, is as good as dead."

Albert Einstein

1. MODERATION

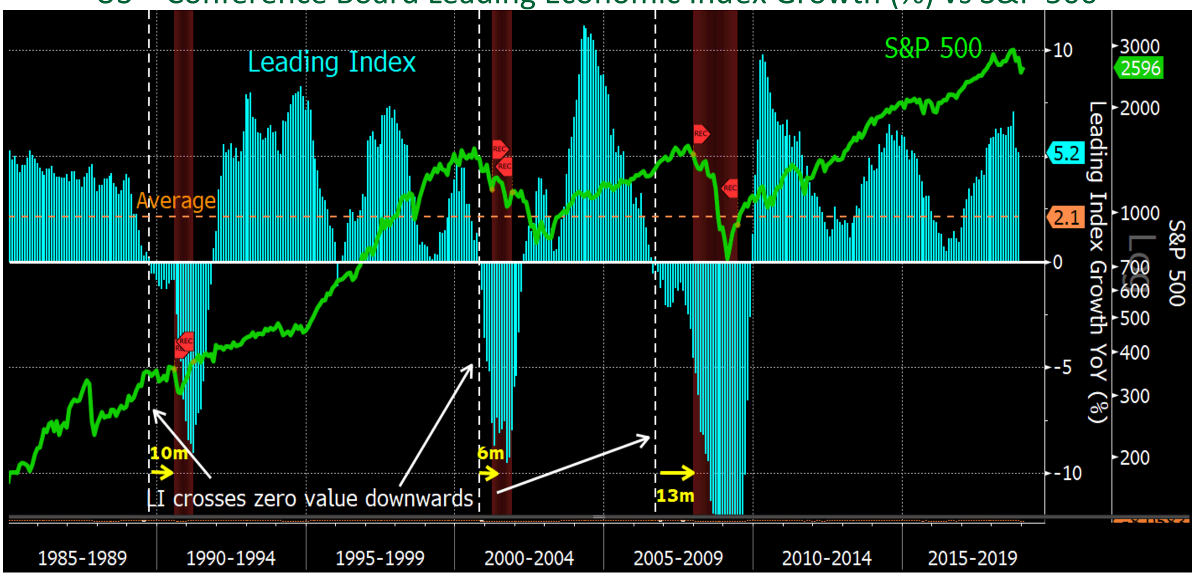
Investors start a new calendar year with a theme of global moderation in the economic outlook following the very volatile markets at the close of last year. The big question is whether the market discounts the outlook deteriorating more aggressively than earlier perceptions.

US – Confidence Indices



US confidence indices are starting to roll over from elevated levels. It is still too early to confirm a negative trend, but odds seem high to be the case. This has historically started years before a recession, and we can on this basis therefore not yet forecast an imminent recession.

US – Conference Board Leading Economic Index Growth (%) vs S&P 500



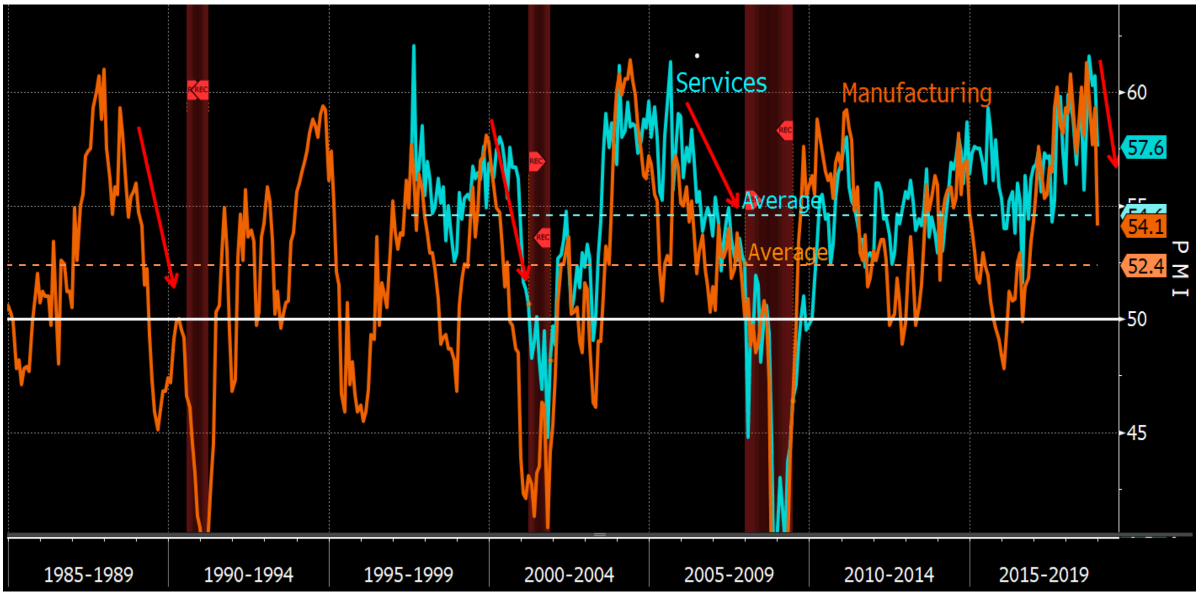
The leading economic index in the above chart provides a similar observation. The growth trend is rolling over, but is still at an elevated level. This index has been effective in providing early warnings of a market peak (when growth stagnates) but seems to be far from currently.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

2. MANUFACTURING SCARE

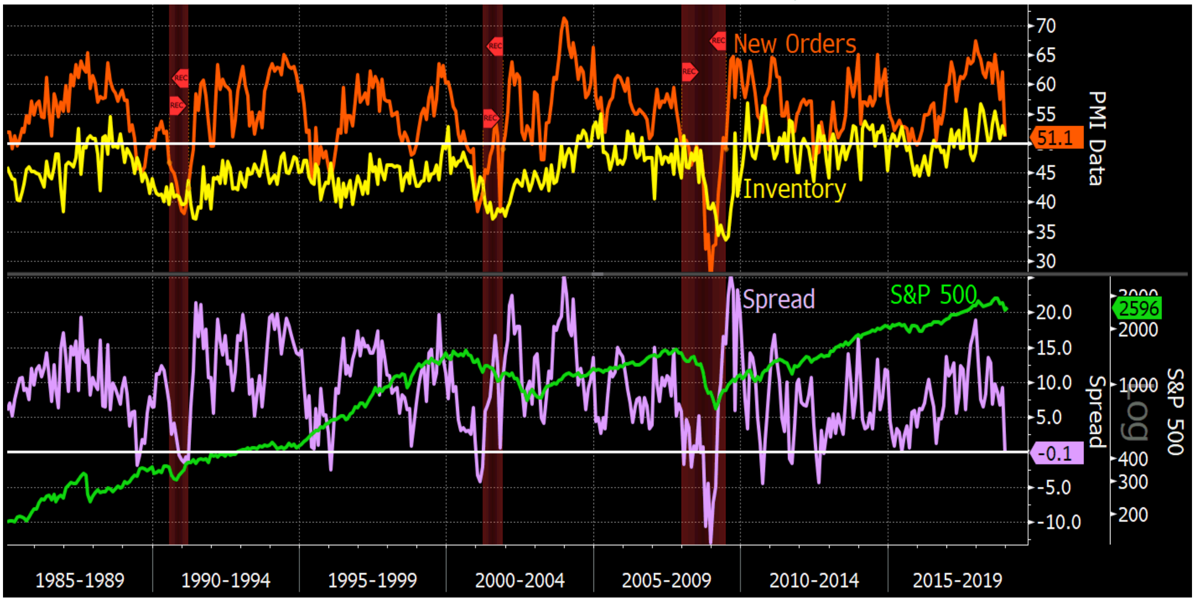
Many investors took fright from the sharp drop in the index of US manufacturers' activities:

US – ISM Manufacturing and Services PMI



The sharp drop occurred from an elevated level but is still well above average. This implies continuing economic expansion, though at a more moderate rate.

US – ISM New Orders vs Inventory PMI



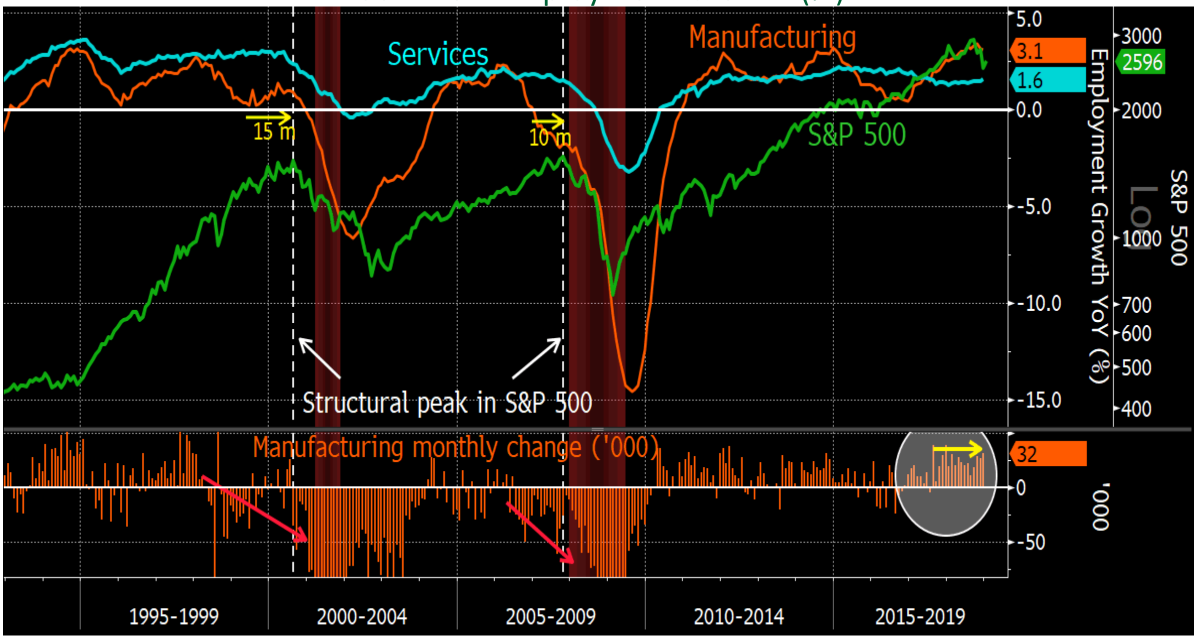
The new orders component of the index dropped the most. There is a perception that companies are currently holding back placing new orders awaiting more clarity on the Sino-US trade tariff negotiations. The spread with the inventory component has closed (bottom section of the above chart). This historically happened frequently during economic expansion phases and would become more of a threat should the negative trend persist.

New employment data paints quite a different picture. We show in the following chart the growth in new employment for both the services and manufacturing sections of the US economy.

Manufacturing employment is a better indicator of market peaks than services. The former is currently growing at +3.1% against +1.6% in services. It has historically provided an early warning when growth stagnates (see the vertical lines in the chart). The bottom section of the chart of monthly nominal new employment number also reflects a solid environment in manufacturing.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

US – New Employment Growth (%)



The 4Q2018 reporting season starts in two weeks. We expect good results, but also realise that company growth outlooks will moderate meaningfully off a high operational base and lower tax payments. The following chart considers this issue along with the manufacturing outlook:

US – ISM Manufacturing PMI vs 12 Month Forward S&P 500 Earnings Growth (%)

There is a strong correlation between the two series in the chart. Earning expectations have just moderated from double digits to (high) single digits. We are very happy with such an earnings outlook. Successful Sino-US negotiations regarding trade tariffs clearly are critical for US manufacturing. It is currently disconcertingly quiet on this front.

3. VALUATION LEVELS

Many investors made a case against equities last year on valuation considerations. With the moderating outlook and stock market volatility it is worth considering these issues at the beginning of the year.

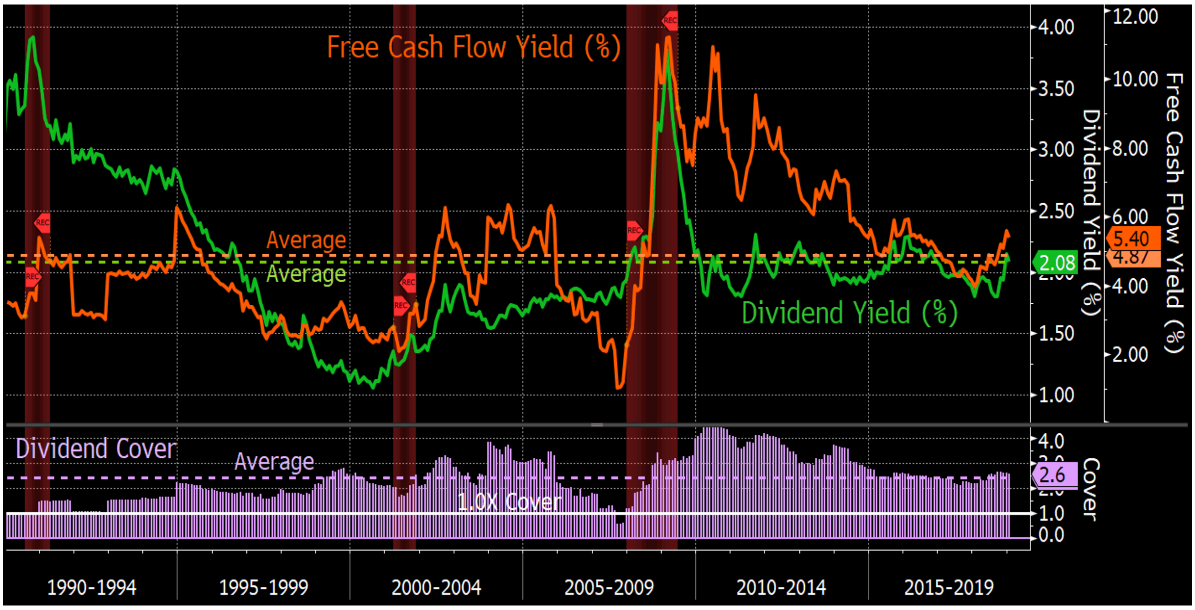
We are more cash flow driven in this context, but also respect the more popular earnings approach most investors have. We present the key metrics on the following page and try to consider both historic and forward multiples as data is available.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

S&P 500 Historic and 12 Month Forward P/E Ratio

The S&P 500 P/E valuations have recently dropped sharply from one standard deviation above average to below average. This is the case for both historic and forward earnings. Investor considerations in this context have moved from a case against equities to one in favour of equities on this basis. This has not been the case for quite some time.

S&P 500 – Free Cash Flow and Dividend Yield Valuations (%)



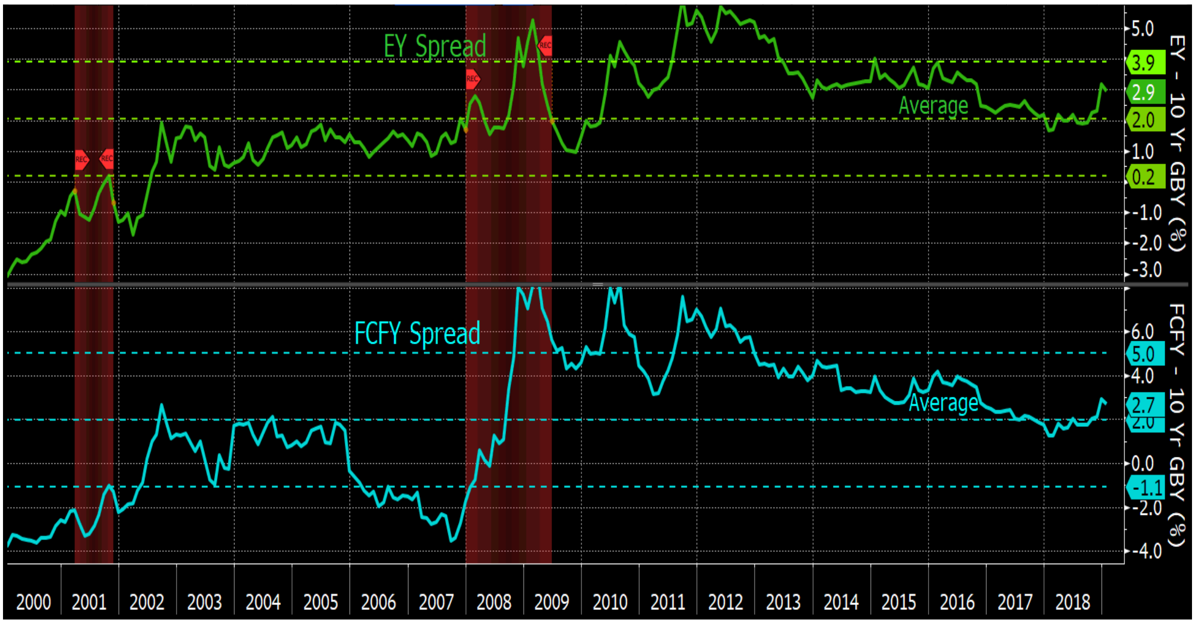
The free cash flow yield has grown to 5.4%, well above its average levels. The dividend yield at 2.1% is marginally above its own average. The free cash flow covers dividend payments 2.6 times, at its average level. All these reflect healthy valuation levels to consider investing rather than disinvesting.

These are all absolute valuation metrics. The chart on the next page considers valuation levels also on a relative basis considering interest rate levels. We show the spread between both earnings and free cash flow yields with ten-year treasury yields.

Our chart considers a relatively short history in the interest of conservatism. Interest rates were much higher before the inception date on the chart, with a result of much lower valuation spreads than spreads on the chart. We believe that we are in an environment of lower inflation and lower interest rates than before the turn of the century and rather err on the conservative side in establishing norms (the averages) in this context.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

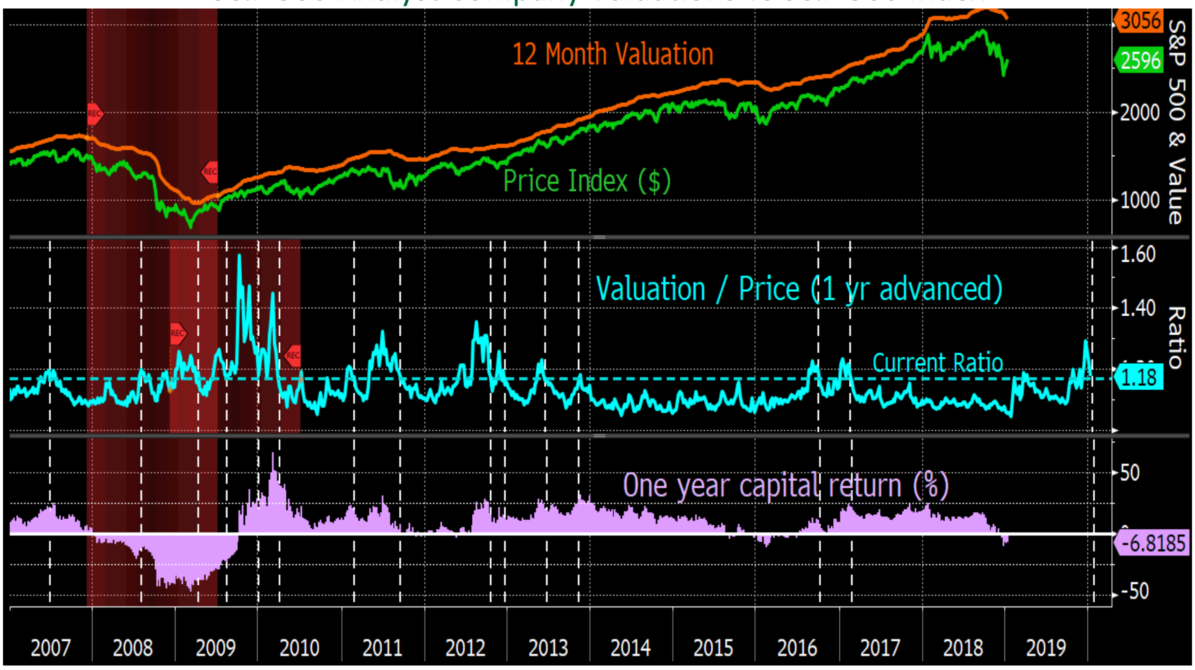
S&P 500 – Earnings and Free Cash Flow Yield Spreads with Ten Year Treasuries (%)



Both the earnings and free cash flow yields are well above their respective averages and reflect attractive equity valuations in this context. Taking the average current spread of 0.8% it implies that treasury yields can rise to 3.5% over a short period and still leave equities more attractive from a valuation standpoint. We have not seen that level of yield for six years and would rather look forward to that materialising.

The next chart provides valuable information of analysts' company valuations and its merits in considering the current equity opportunity:

S&P 500 Analyst Company Valuations vs S&P 500 Index



The orange line reflects the twelve month forward consolidated target valuation of the companies in the index. The blue line reflects the ratio between the valuation and index lines. We have advanced the line twelve months forward to compare this ratio with the returns materialised.

The vertical lines are drawn to show the S&P 500 historic capital returns following those occasions when the valuation ratio was at its current level (1.18). Barring the Credit Crisis recession period, the returns have predominantly been at the higher end of historic returns.

We believe that S&P 500 valuations are attractive after the last year's market experiences.

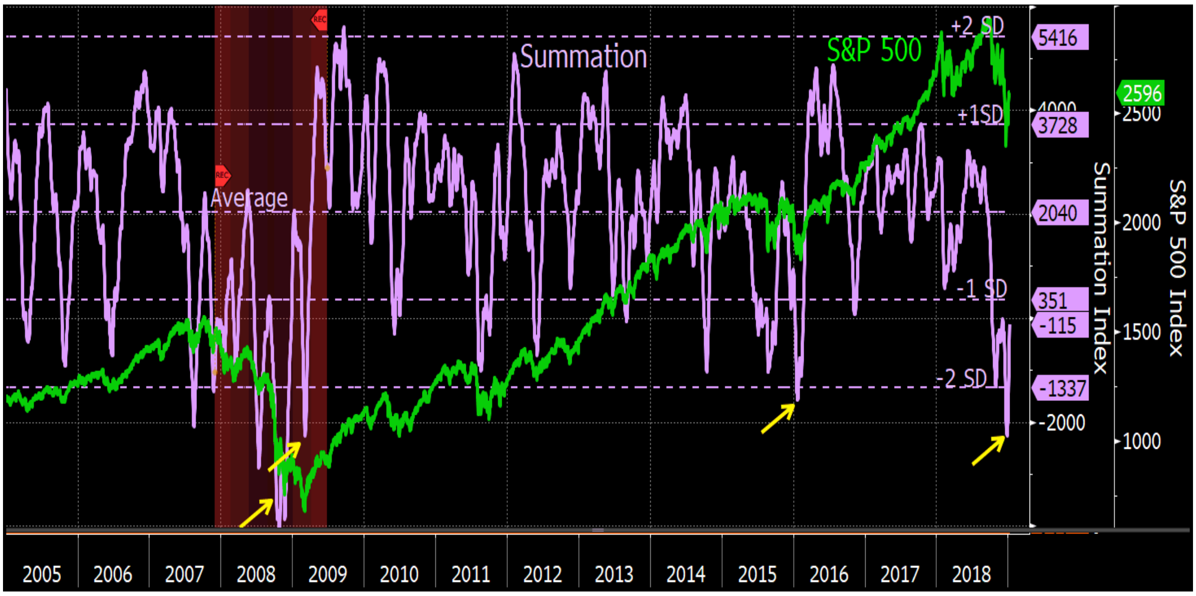
Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

4. TECHNICAL PICTURE

On Friday 21 December 2018 exceptional volumes of shares were dumped on the NYSE at very low prices. We drew all our technical charts on the following Monday and realised an exceptional opportunity – most technical indicators reflected conditions as dire as during the Credit Crisis. Whether fear overtook those investors, or they planned to pass tax losses to Uncle Sam, we perceived the fundamental outlook much better than reflected on our stock market screen.

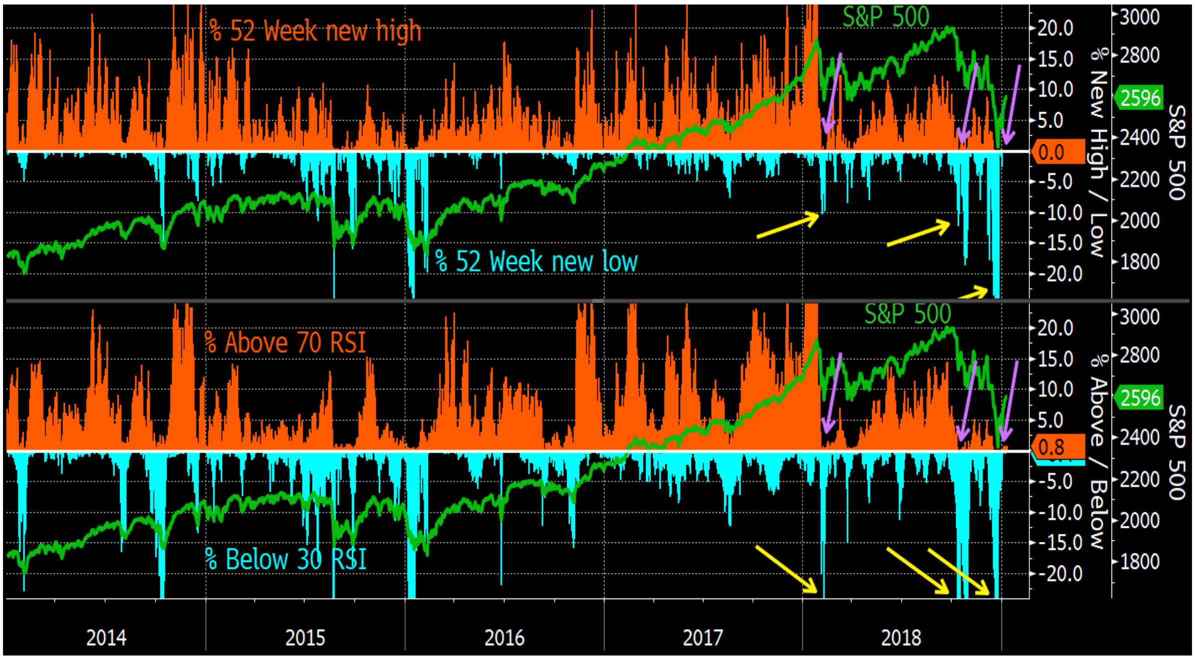
We have updated our charts and show two below to reflect the current picture.

S&P 500 Advance – Decline Summation Index vs S&P 500



The above advance-decline index succeeds reasonably well in calling technical buying opportunities. The December reading was more than 2 standard deviations away from average which has happened only once since the Credit Crisis. It has since recovered from the extreme level but is still more than a standard deviation away from the average.

Percentage of S&P 500 Companies Above/Below 52 Week High/Low and Above Below 70/30 RSI Level vs S&P 500.



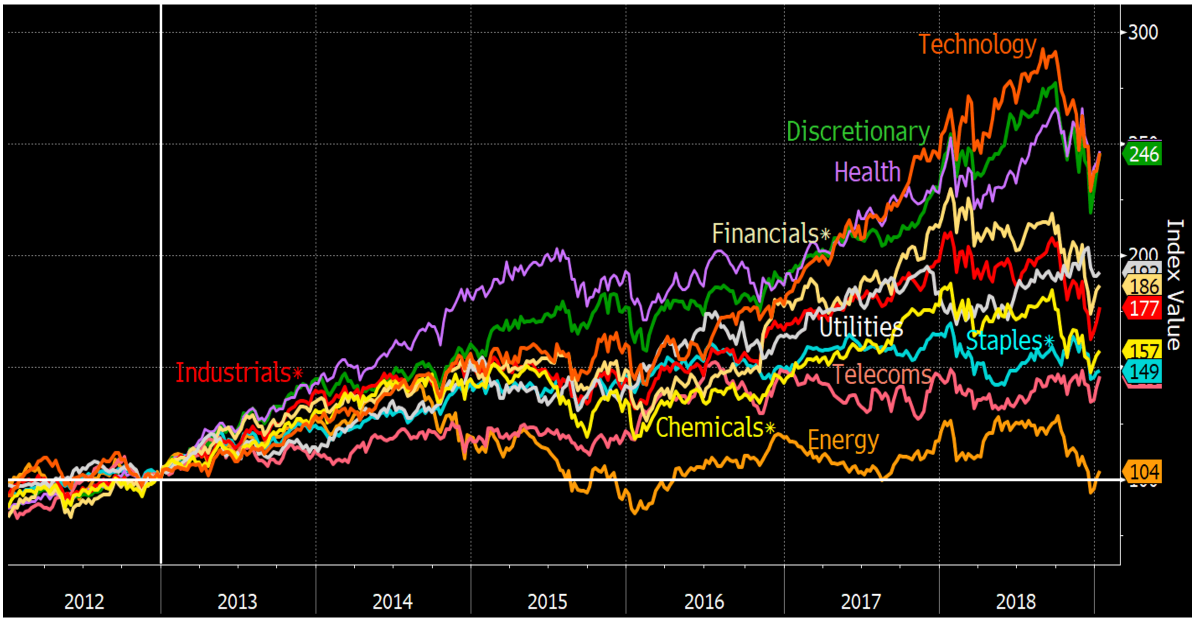
All the 52-week high/low and 70/30 RSI readings in the chart were at extremes in December. Some have already returned to neutral levels. Overall, our charts reflect the S&P 500 not yet 'out of the penalty box' but with an improving trend.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

5. SECTOR PERFROMANCE

We are interested in sustainable compounding businesses. The following analysis of sector performance since the Credit Crisis sheds some interesting light on the subject:

S&P 500 Sector Performance – Total Return Index with 1 Jan 2013 = 100

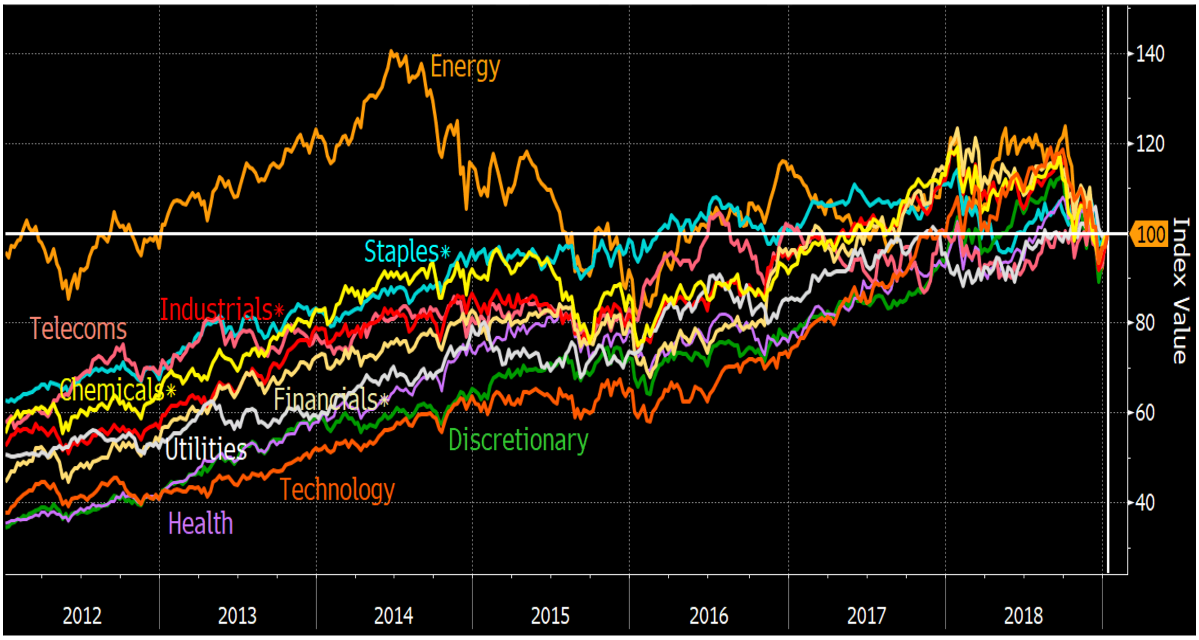


The S&P 500 reached its 2007 peak levels again in 2012 after the Credit Crisis. We consider 2013 therefore as a fair inception data to judge relative performances. The above chart reflects total return indexed performances (those sectors with an asterisk only have capital return data).

The technology, discretionary and health care sectors delivered handsome compounded returns of +16% p.a. or more over the period. It may be a surprise to some that health care could keep up in that category (Amazon is a large weight in the discretionary sector). Despite its dividend payments, energy delivered almost no return, with telecoms also lagging.

An analysis done on a specific inception date can be skewed towards particular issues during that time. We prefer to consider performance rather from an exit index value based to 100 and then to consider the cheapest entry at any moment during the analysis period. The above analysis is presented in this form in the following chart:

S&P 500 Sector Performance – Total Return Index with 11 January 2019 = 100



Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2019. Past performance should not be used as a guide to future performance.

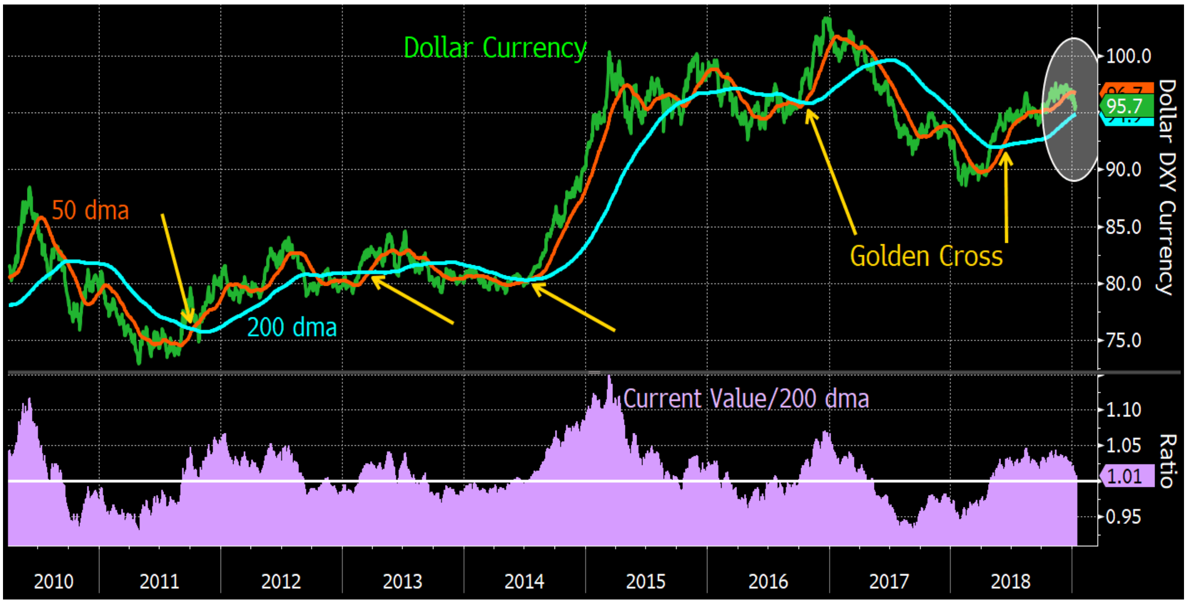
Technology deserves the crown for offering the most frequent best entry points on this basis. Discretionary is a close second, with health care not far behind. It is also interesting how competitive utilities have been at many times, taking the crown for most of last year. Energy gets the 'wooden spoon' for most of the period under consideration.

This analysis argues to some extent against the general perception that some favourite sectors often get overvalued and should be exited. It rather illustrates that continued operational performance keeps it in the stock market performance tables.

6. DOLLAR THOUGHT

The strong Dollar took blame for some stock market woes last year. Its current technical picture deserves some attention:

Dollar Currency with Moving Averages



It seems the softer economic outlook and lower than expected interest rates are starting to take some toll on the currency. It has rolled over and is close to its 200-day moving average (see the highlighted section in the chart). These are early signs of weakness, though not yet confirmed. Should weakness become a clearer feature it may rather be positive for many global fundamental economic issues.

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