STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 11 FEBRUARY 2019

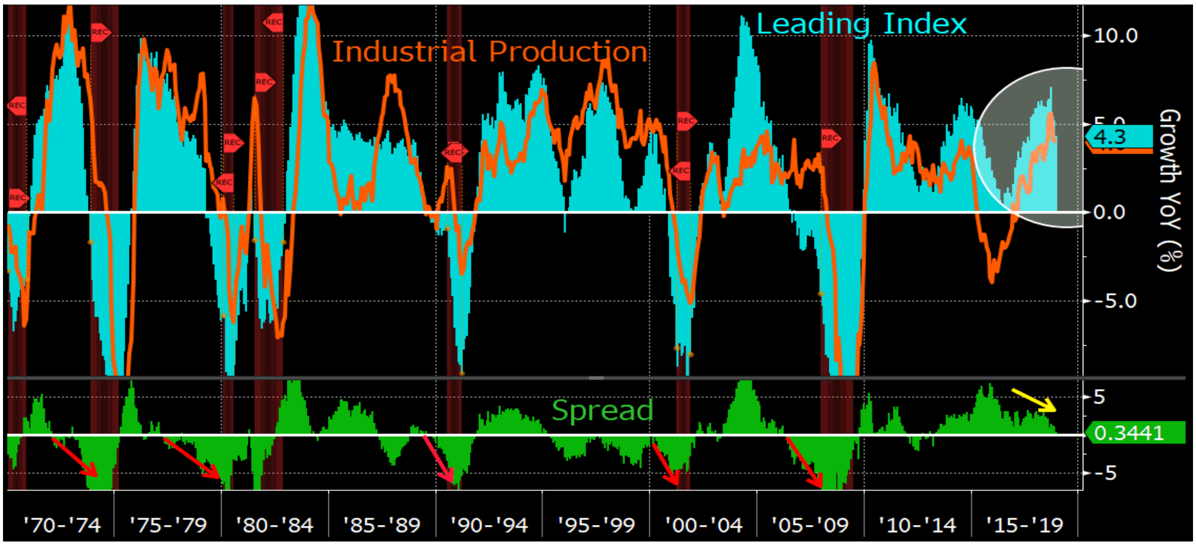
"The aim of the wise is not to secure pleasure, but to avoid pain."

Aristotle

1. STABLE ECONOMY

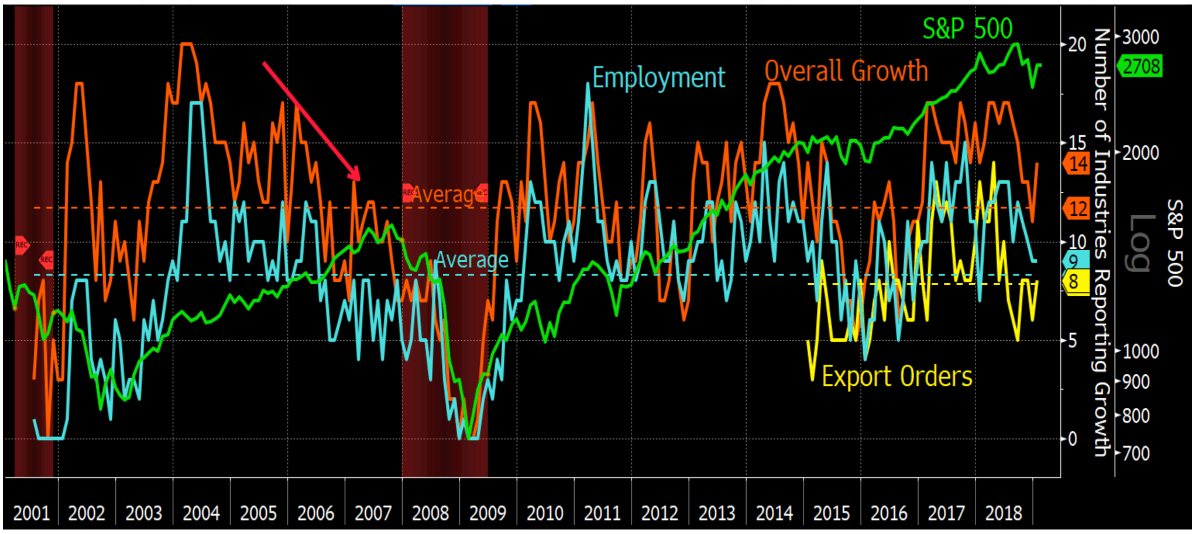
Even though industrial production makes up less than a fifth of the US economy, its higher volatility causes disproportional sensitivity in capital markets. The following chart is helpful in assessing risks in this context:

US – Conference Board Leading Economic Index vs Industrial Production



Industrial production remains strong. The growth in the leading economic index currently marginally exceeds the growth in industrial production. We expect both series to experience lower growth levels going forward, but the spread between the two series historically served as a good warning indicator of an approaching recession (see the red arrows in the chart). On this basis it seems that the next US recession is still some way off.

US – Number of Industries Reporting Growth vs S&P 500



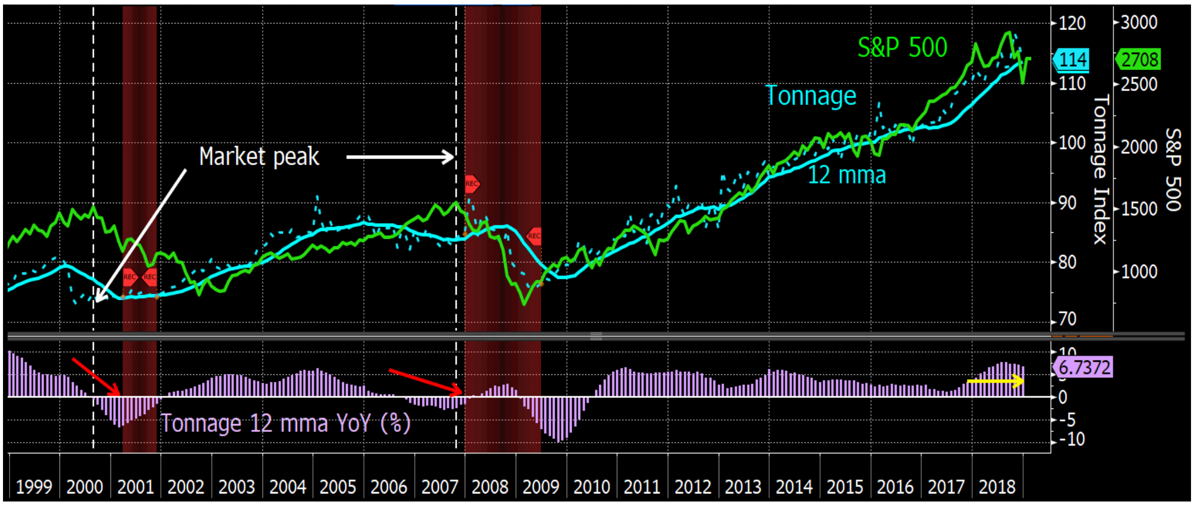
The above chart reflects the number of industries reporting experiencing growth. The readings have been trending lower from elevated levels over the past few months, but the most recent readings are up, with current readings above their respective average levels. This reflects a stable US economic environment.

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

2. ECONOMIC TESTS

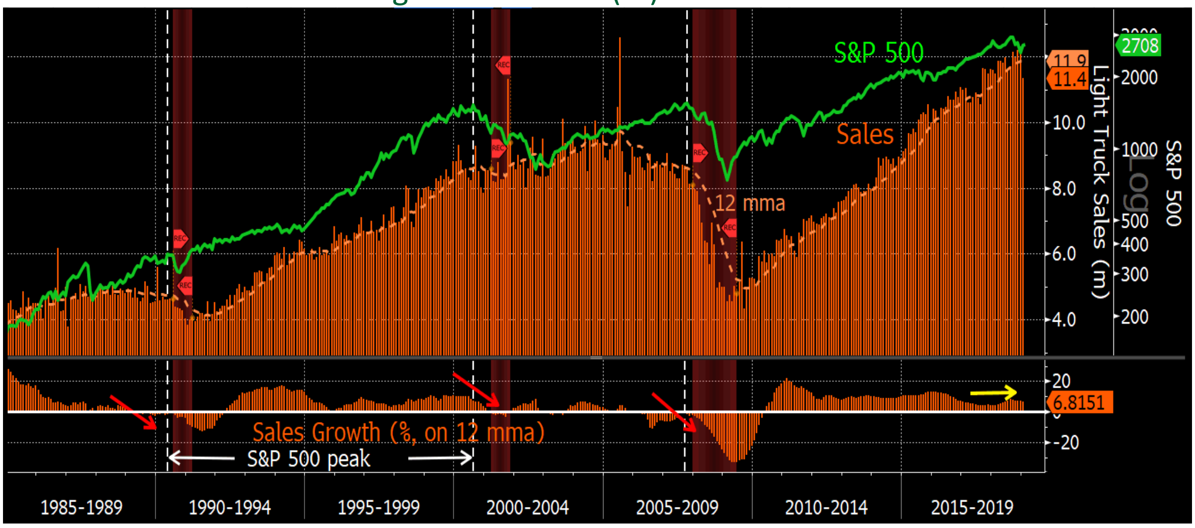
We have a number of ‘sanity tests’ on the US economy to ensure we have enough reason to keep our confidence:

US – Total Tonnage Transported vs S&P 500



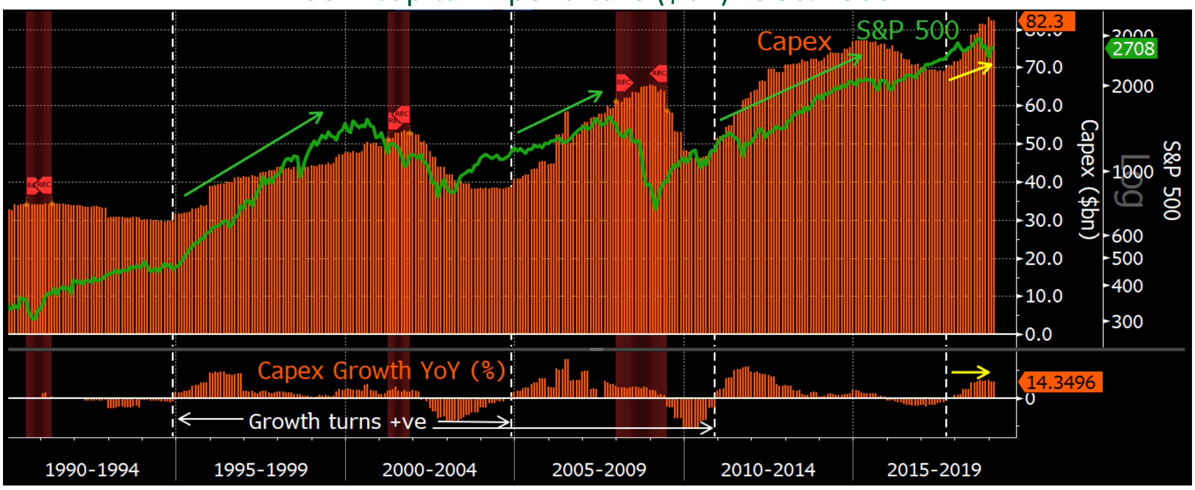
The total tonnage transported is currently growing in excess of 6%. This is high in historic context. Tonnage traditionally starts dropping more than a year before the subsequent recession.

Light Truck Sales (m) vs S&P 500



Light truck sales are currently growing in excess of 6%. These sales traditionally start dropping well in advance of the subsequent recession.

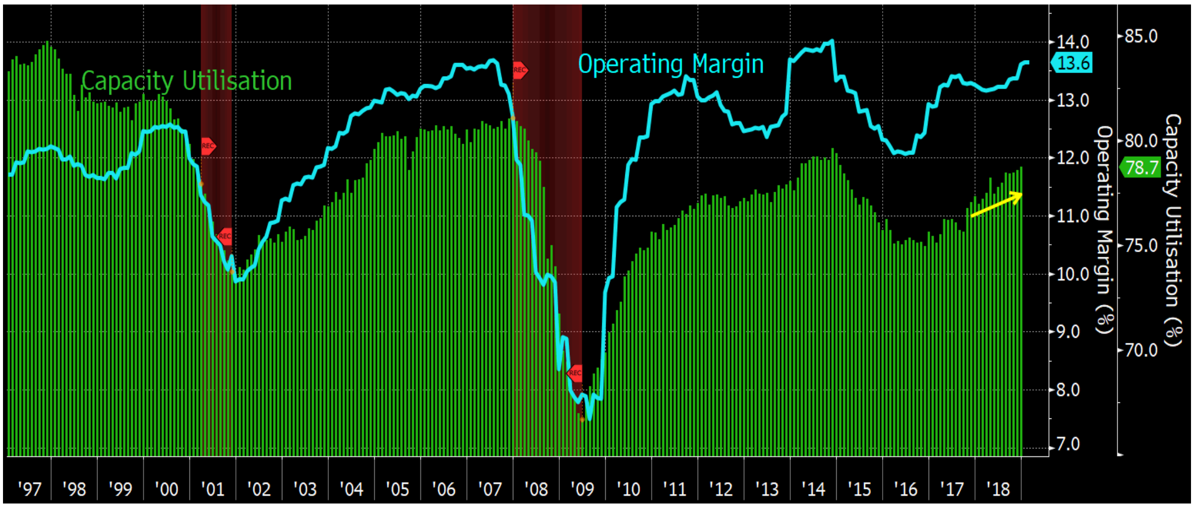
US – Capital Expenditure ($bn) vs S&P 500



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

Capital expenditure (capex) is essential at the current stage of the economic cycle to continue supporting economic expansion. It is currently growing well at 14%.

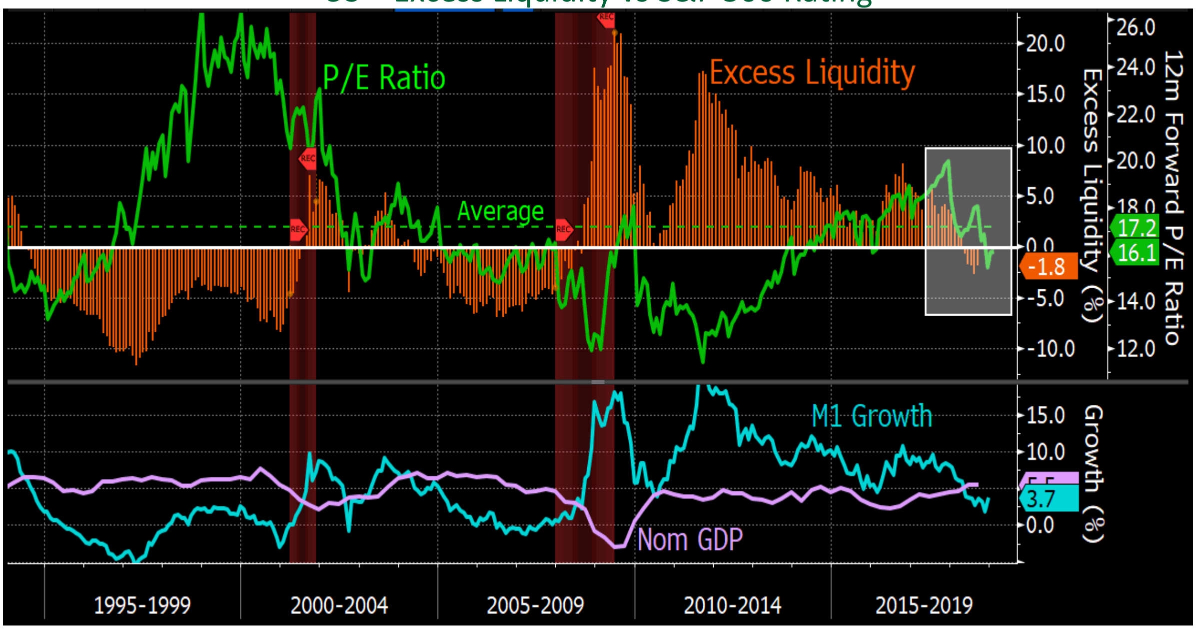
S&P 500 – Capacity Utilisation (%) vs Operating Margin (%)



Both capacity utilization and operating margins are rising, neither of them yet at their respective historic record levels. This should continue supporting US company results despite the current high base.

3. LIQUIDITY SHORTAGE

US – Excess Liquidity vs S&P 500 Rating



As reflected in the preceding chart, the US economy is currently suffering from a shortage of liquidity – the growth in the nominal GDP exceeds the growth in money supply. This has a detrimental effect on share ratings, also reflected in the chart.

Our impression is that nominal GDP growth has peaked for the moment while money supply may stay stable. The shortage of liquidity can then stabilise, which may prevent a further valuation derating of the equity markets.

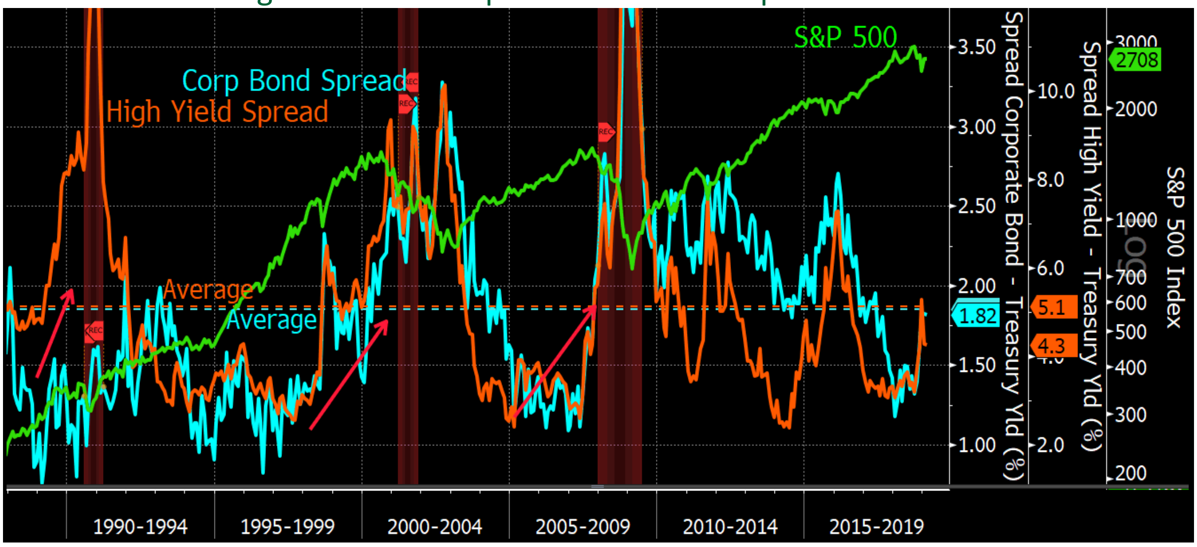
4. HIGH YIELD TESTS

We closely follow developments in the high yield market to identify changes in sentiment that can rub off on equity valuations. The following charts are useful in this context:

High Yield Bond Prices vs S&P 500

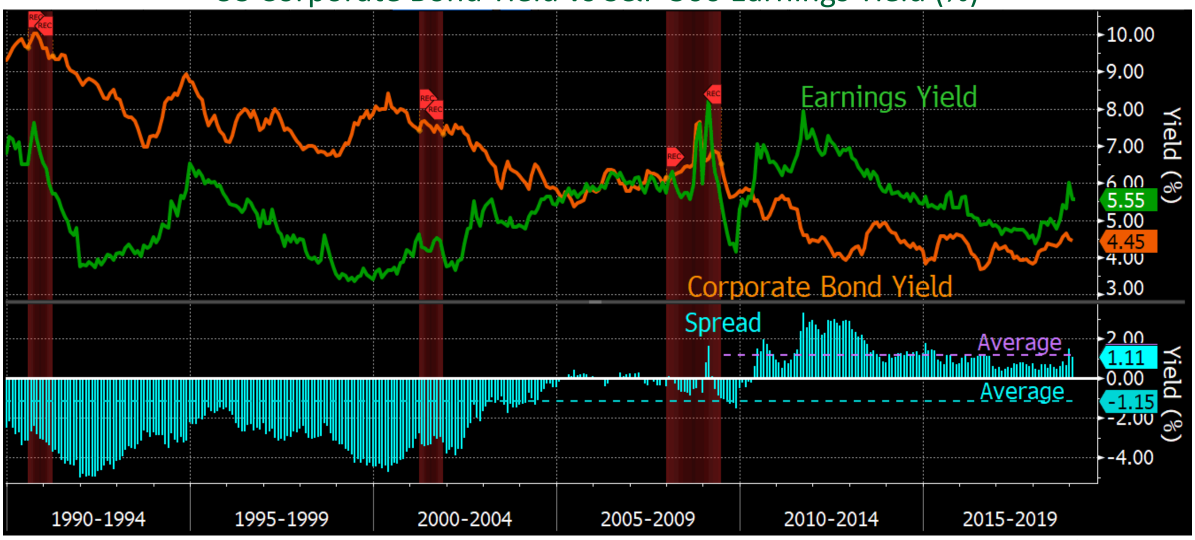
The prices of junks bonds, high yield corporate bonds and emerging market bonds delivered a poor performance last year. They have turned sharply for the better this year thus far, along with share prices. This turnaround is encouraging.

US High Yield and Corporate Bond Yield Spreads vs S&P 500



The yield spreads (with treasuries) spiked last year to long term average levels, raising some stock market alarms. They have since dropped back and currently reflect constructive stock market signals.

US Corporate Bond Yield vs S&P 500 Earnings Yield (%)



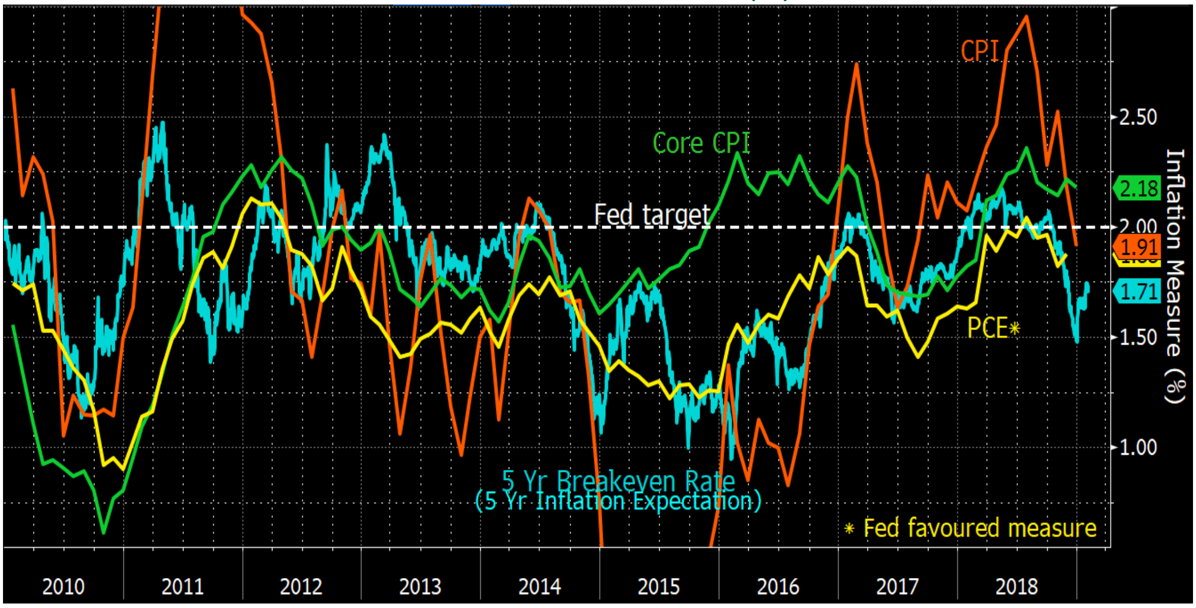
Source: Bloomberg & Stonehage Fleming Investment Management Limited. February 2019. Past performance should not be used as a guide to future performance.

The preceding charts reflects the S&P 500 earnings yield and corporate bond yields. The spread between these yields (the bottom section of the chart) is currently 1.1%. This is on its average level since the credit crisis (the purple line) but is 2.3% wider than its long-term average. This provides us with comfort that equities are, on a relative basis, rather attractively valued against corporate bonds.

5. INTEREST RATES

The fears for sharply rising interest rates have abated to some extent. We consider a few charts to assess our comfort in this context:

US – Inflation Measures (%)



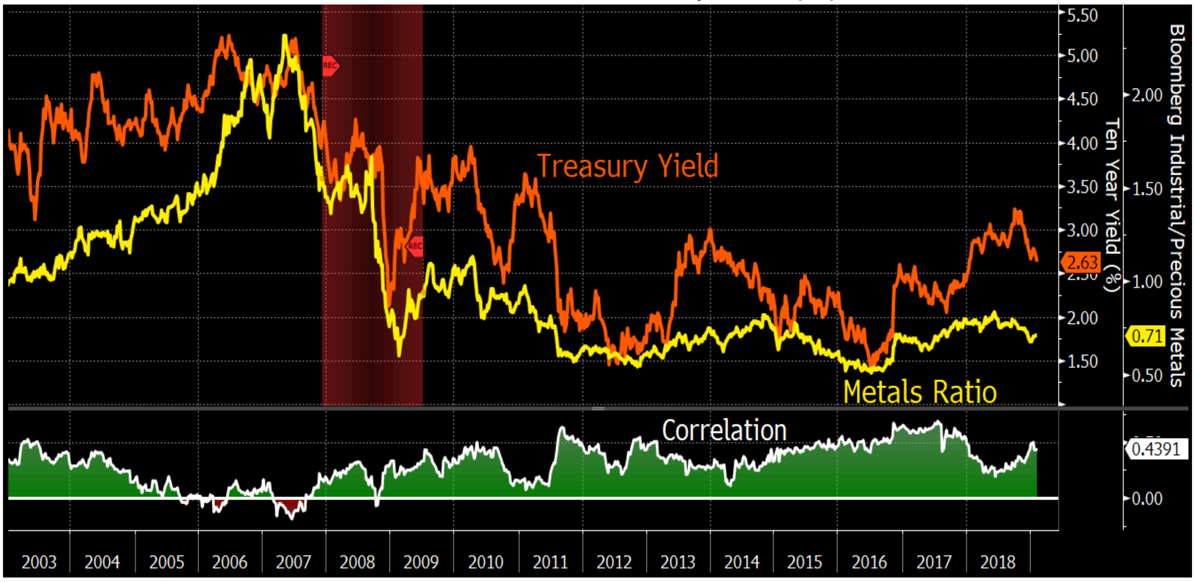
Inflation fears have abated, despite wages now growing at +3.2%. Most of the measures are currently below the Federal Reserve's 2% target. Five-year inflation expectations have receded sharply towards the end of last year, recovering since to 1.7%. We do not yet see data indicating inflation becoming a major threat.

Copper/Gold Price Ratio vs Treasury Yield (%)

The copper/gold ratio has an interestingly high positive correlation with the ten-year treasury yield (see the above chart). This ratio has been drifting lower since the beginning of last year. On this basis we cannot yet see signals of interest rates rising sharply soon.

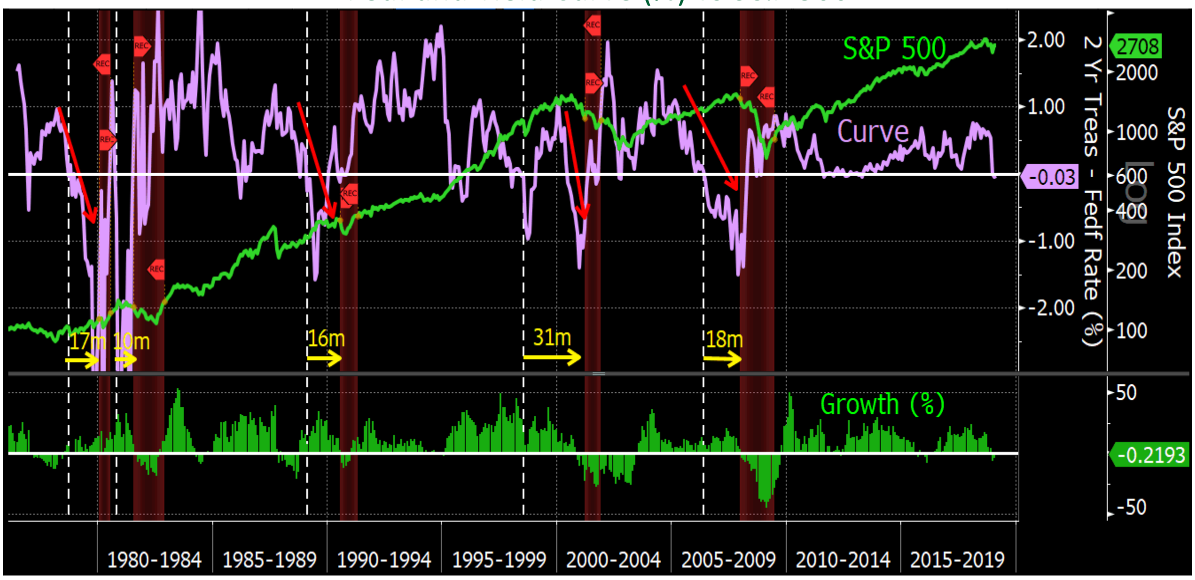
Source: Bloomberg & Stonehage Fleming Investment Management Limited. February 2019. Past performance should not be used as a guide to future performance.

Metals Prices vs Treasury Yield (%)



The ratio of industrial metal prices against precious metal prices also has an interestingly high correlation with interest rates. Likewise, with the preceding comments, this ratio has also trended lower since early last year. This also reflects relatively low immediate risk from the bond market to materially upset the equity market.

FedFund Yield Curve (%) vs S&P 500



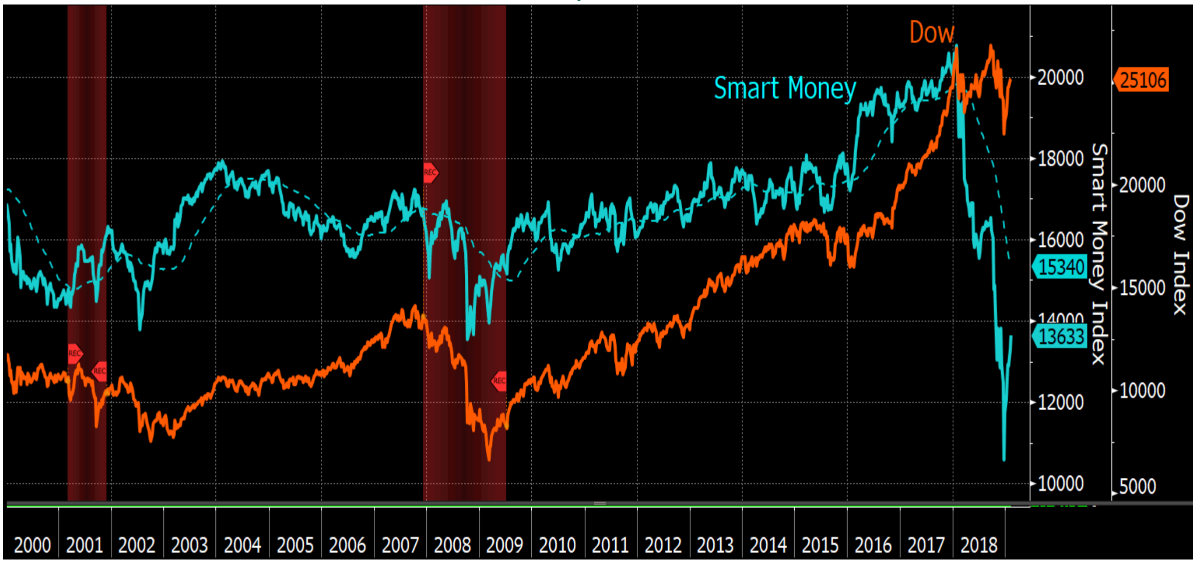
The FudFund yield curve has flattened with the recent tightening of their target rate. Should it invert going forward, historic trends in this context provide an average 18-month early warning of an upcoming US recession. With the Fed's recent language of 'patience' and being 'data dependent' and the current level of this yield curve we do not think they will tighten further anytime soon and rather see the Fed being in investors' corner.

These comments clearly cover only a portion of fundamental issues in the context of considering risks in the bond market, but as equity investors we are comfortable with the above data. Also, as a wider point, equity investors should rather look forward to an economic environment supporting interest rates than one needing falling rates.

6. TECHNICAL INDICATORS

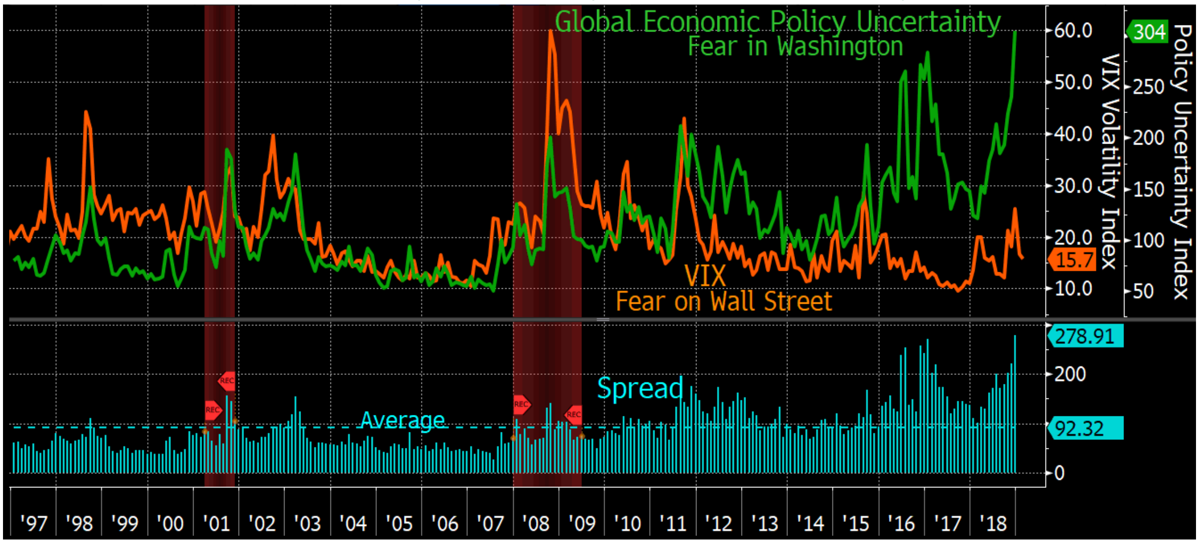
We are pure fundamental investors, but also follow several very informative technical indicators that reflect the overriding current investor sentiment. This often assists in the implementation of decisions taken on a fundamental basis. The following two charts have quite clear technical messages:

Dow Smart Money Index vs Dow Index



The smart money index reflects the extreme level of pessimism at the end of last year. It has since bounced back sharply but is still at a relatively low level. The direction of travel seems to be in our favour.

Economic Policy Uncertainty Index vs VIX Volatility Index



The economic policy uncertainty index in the above chart is currently at a record level, while the VIX volatility index recently dropped from an elevated level. The spread between the two series is currently at a record level. This clearly shows the potential for investor sentiment to change for the better should world political leaders be able to address the major economic policy uncertainties.

Gerrit Smit

Partner - Head of Equity Management
Stonehage Fleming Investment Management Limited

15 Suffolk Street
London
SW1Y 4HG
T +44 20 7087 0000
Email gerrit.smit@stonehagefleming.com
www.stonehageflemininginvestments.com/gbi

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

RISK DISCLOSURE