STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 29 APRIL 2019

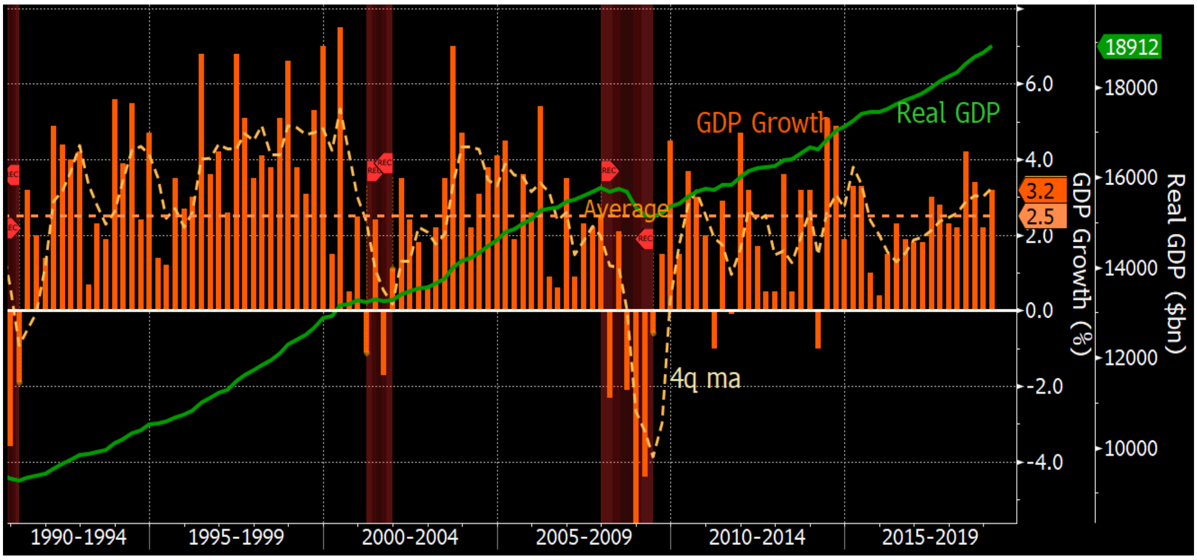
"Things are never clear until it's too late."

Peter Lynch

1. US SURPRISE

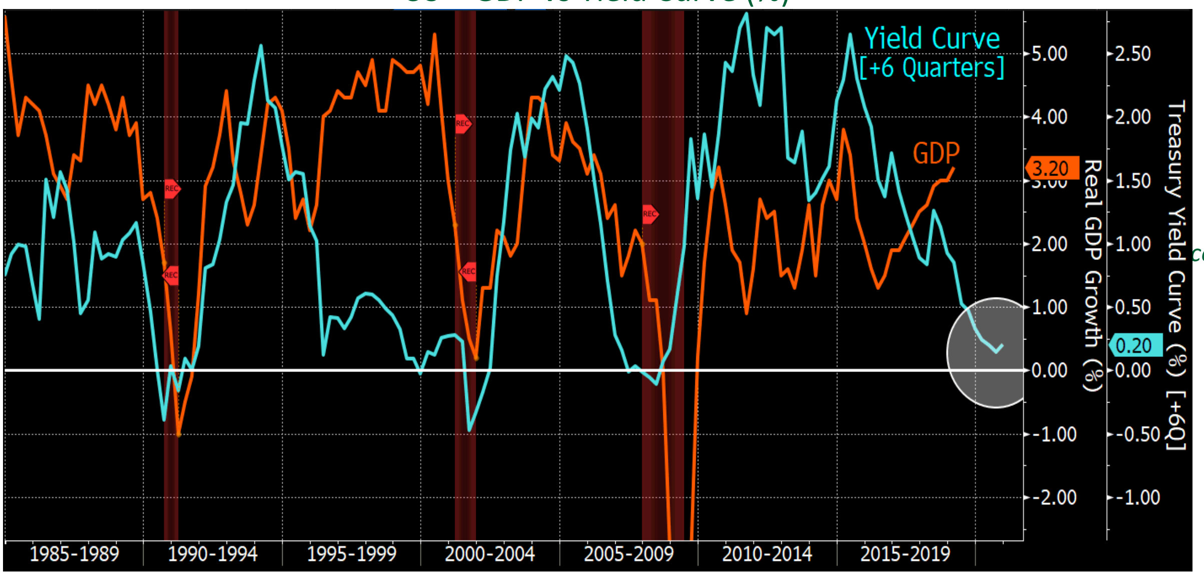
The first quarter US economic growth data has been a positive surprise to many:

US – Gross Domestic Product (GDP)



Average consensus expectations of +2.1% GDP growth were handsomely exceeded at +3.2%. This brought the annual growth to +3.2%, the highest level since 2015. Growth in international trade and building inventory accelerated, making up half of the overall growth. Consumption growth slowed to a still respectable +1.9%. Overall nominal GDP is now a fifth larger than its peak before the Great Recession (with compounded growth of +1.8% p.a.).

US – GDP vs Yield Curve (%)

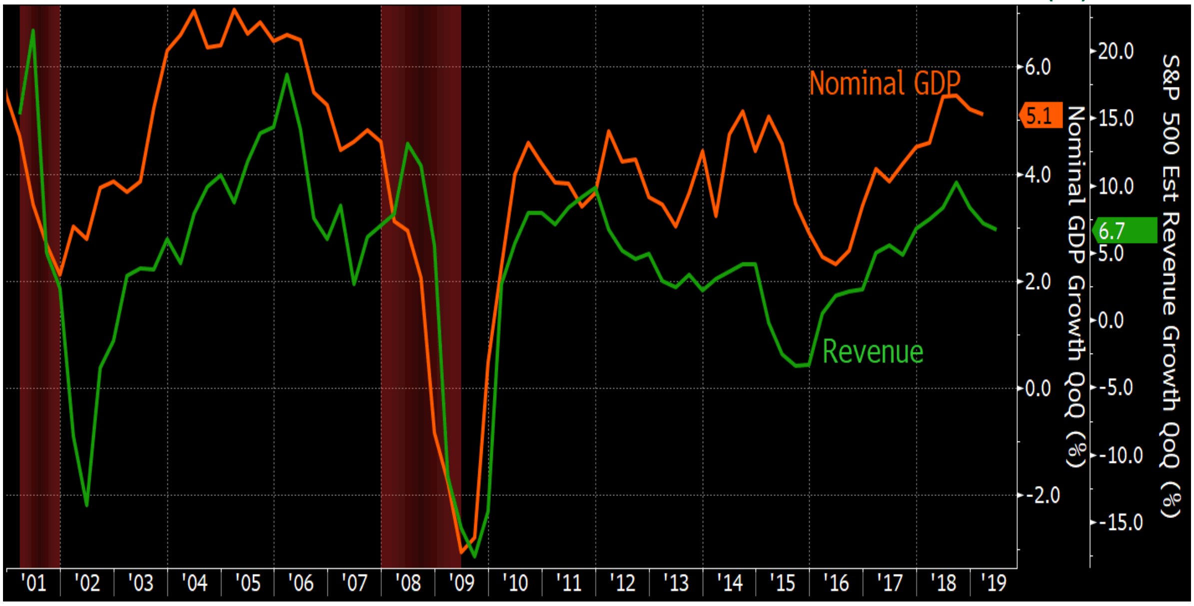


With the yield curve in the above chart leading the GDP data, we expect economic growth for the rest of the year to slow from current levels. It is, though, striking that the curve seems to have halted its flattening process for now – it has recently actually started to steepen again, staying in constructive territory for capital markets.

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

2. US NOMINAL ECONOMY

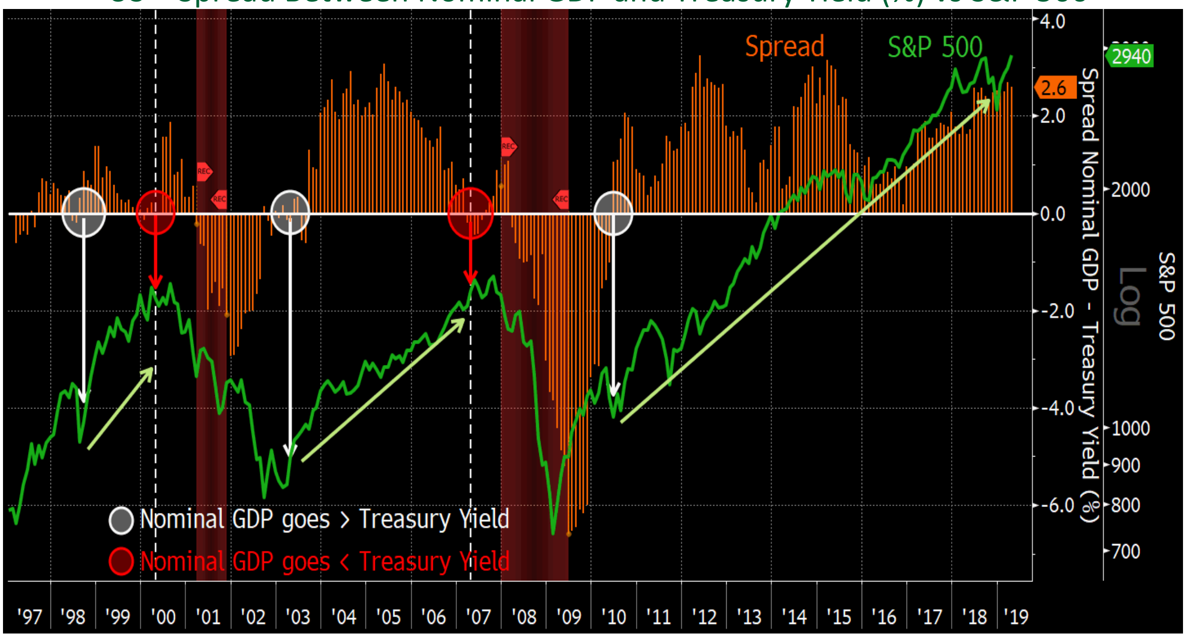
US – Nominal GDP Growth vs Estimated S&P 500 Revenue Growth (%)



The nominal GDP growth dropped marginally to a still elevated +5.1%. On this basis, it seems that the consensus twelve-month S&P 500 revenue expected growth of a healthy +6.7% is realistic and can lead to continuing earnings and dividend growth for quality businesses and that an imminent earnings recession is an overly bearish view.

The following chart pulls the nominal economy well through to the capital markets:

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



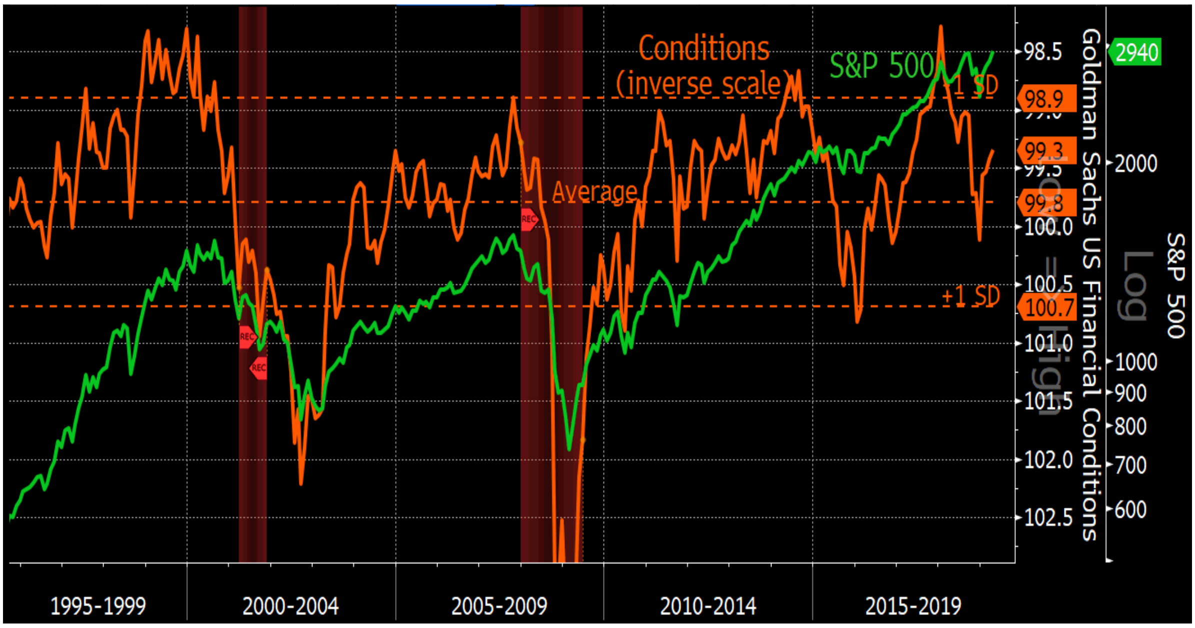
The spread between nominal economic growth and interest rates has a good record to warn against the risks of potential share market peaks and imminent recessions (when a positive spread shrinks to zero, see the red circles in the chart). This spread currently continues to be at elevated levels and does not provide any such alarms and remains to be constructive.

3. FINANCIAL CONDITIONS & STRESSES

We follow a number of data series to understand overall capital market conditions and particular stresses. The following charts provide valuable information in this context:

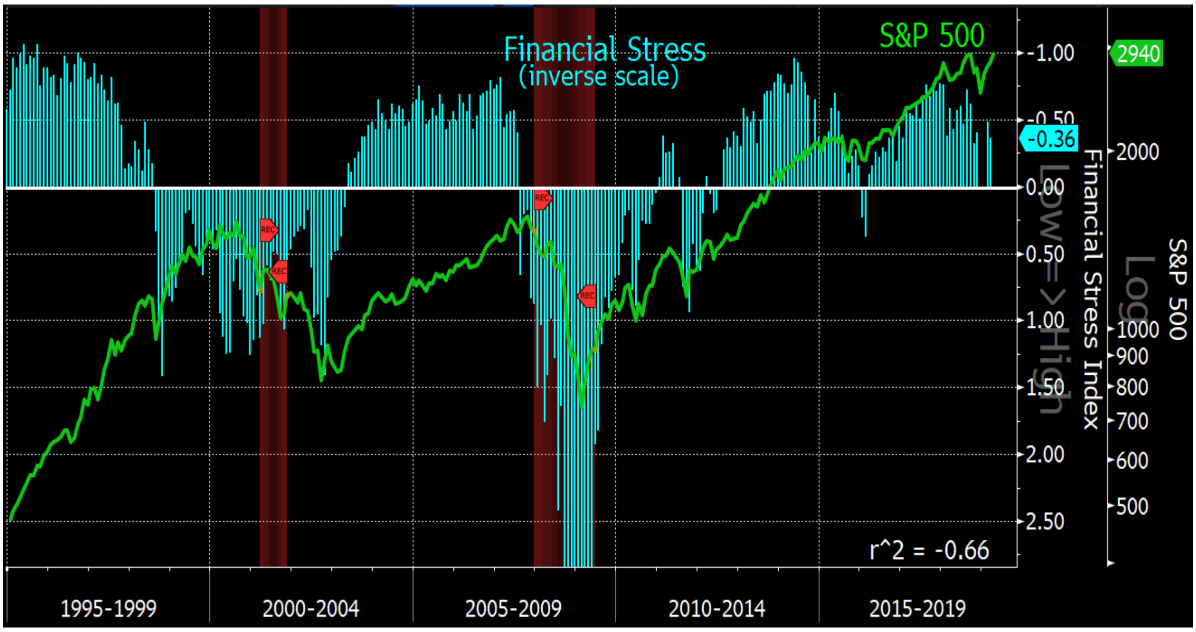
Source: Bloomberg & Stonehage Fleming Investment Management Limited. April 2019. Past performance should not be used as a guide to future performance.

US - Goldman Sachs Financial Conditions Index vs S&P 500



The above financial conditions index has a solid record in warning against extreme conditions (positive or negative) in the capital markets. It currently reflects a healthy environment, on a constructive path for further positive capital market performance.

Kansas Federal Reserve Financial Stress Index vs S&P 500



The Kansas Fed's Financial Stress index also has a good record in providing early warnings against structural changes in capital markets. It currently remains in constructive territory with little sign of particular concern.

We follow a similar series from Goldman Sachs considering financial stresses globally and have charted it against the MSCI World share index. The two series have high correlation with the stress index providing valuable early warnings. It is currently at more elevated levels than the above chart, indicating a healthy global financial market environment.

4. YIELD CURVE – YET AGAIN

Our clients may recall that we have high regard for the yield curve tool to understand capital markets and that we have stayed more constructive than many others on its recent messages. The following chart has a striking new message:

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

US – Yield Curve with Moving Averages (%)

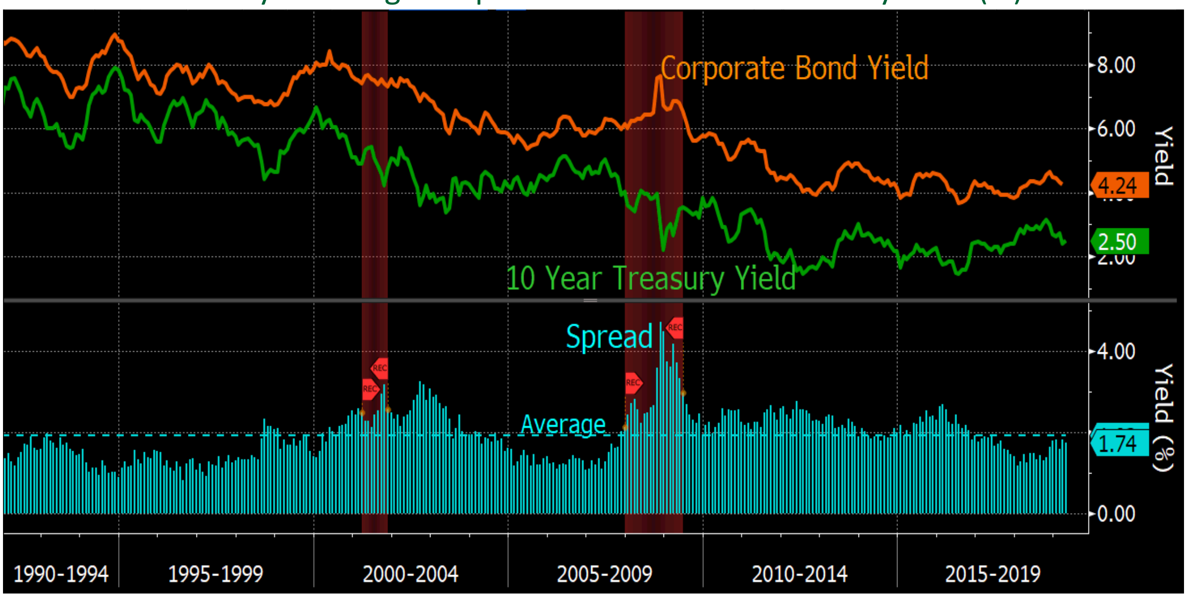
Contrary to our previous charts, this one is presented on daily data with moving averages for a more technical picture. Our first point is that the curve has never inverted during the current economic expansionary phase, and therefore has not yet foreseen the next US recession. The second point is that its 50-day moving average has now gone sideways for about three months, reflecting a stable economic environment. Our third point is that the curve has recently started steepening and is now on its 200-day moving average. This does not reflect a dire outlook as recently suggested in many headlines.

We won't be surprised if the first quarter GDP results may further boost the steepening of the yield curve and keep our glass half full for equity investing.

5. CORPORATES

The corporate bond market, in an indirect way, also serves as a good barometer of the health of the equity market. We consider its valuation metrics to form impressions of the implied risks for the equity market.

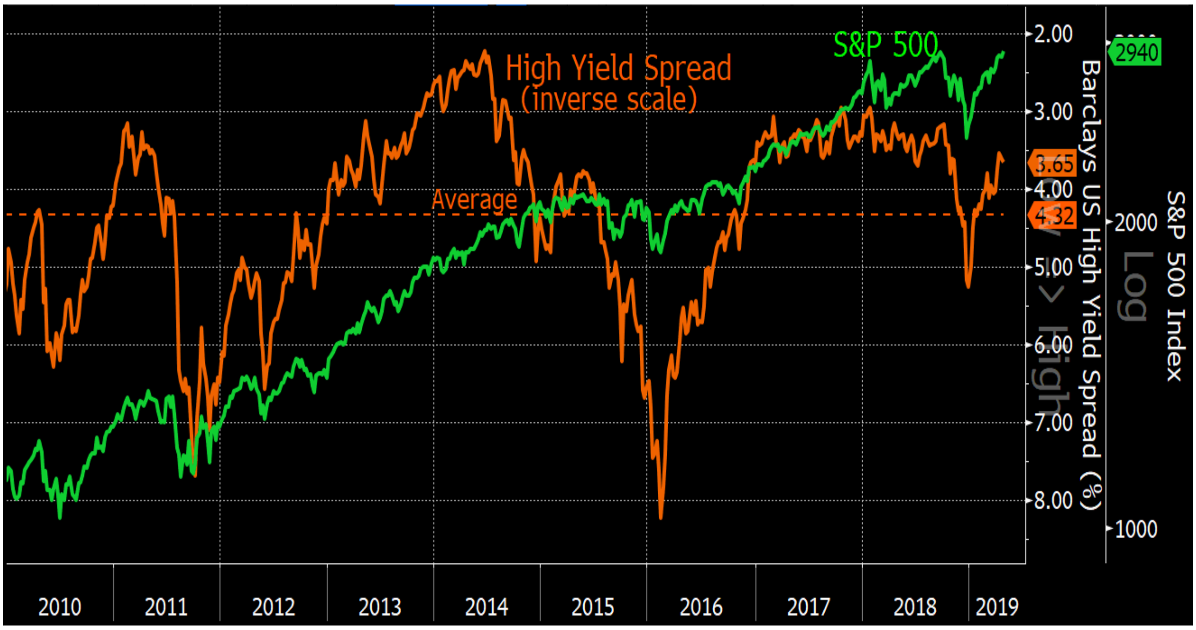
Moody's Average Corporate Bond Yield vs Treasury Yield (%)



Despite the fact that the corporate bond yield may seem low at 4.2% and therefore seem to be expensive, its spread of 1.7% with the treasury yield is close to its long-term average. This leaves us with the impression that the corporate market is potentially more tightly valued than the equity market and may be more vulnerable should interest rates rise materially.

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

High Yield Corporates Spread (%) vs S&P 500



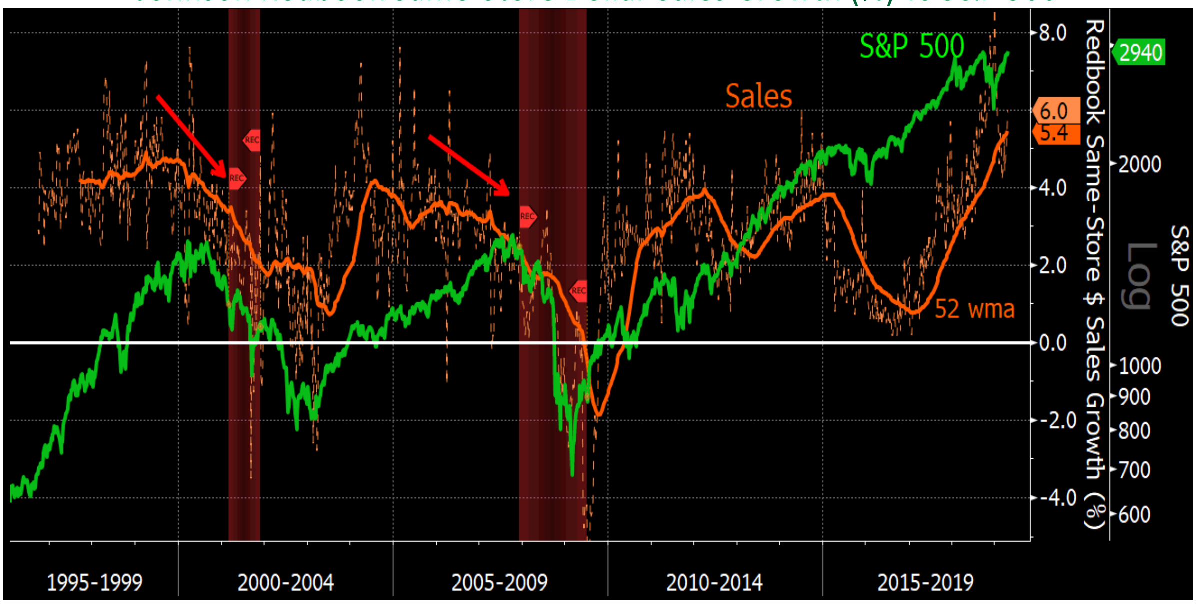
The high yield corporate market spread (with Treasuries) currently shows good support to the equity market. It implies further room for rerating considering its own historic norms. On the pre-condition of relatively stable interest rates, equities show further rerating potential on this basis.

6. BRICKS 'N MORTAR

It is general knowledge that the footfall is disappearing from US malls with corresponding results on those properties and businesses that have not evolved their business models. Investor sentiment on many bricks and mortar retailers has evaporated.

Strong entrepreneurs find opportunity in this structurally negative environment. For example, total US retail sales are currently growing at +3.6% nominally. Against this, same-store non-online sales are reported to be growing at +5.4%.

Johnson Redbook Same-Store Dollar Sales Growth (%) vs S&P 500



This sales trend is at historic elevated levels and remains positive. We can only conclude that a lot of rationalisations have already occurred and that the remaining bricks and mortar stores are run more productively than before and may offer some investment opportunities to astute value investors.

7. DIVIDEND INVESTING

Most investors identify wholeheartedly with the benefits of compounding dividend growth and its positive effects on capital values. Over the past 30 years over half of the returns on the S&P 500 index has been earned through the reinvestment of dividends received.

The real value of dividends lies in the sustainable growth in those income receipts, at a compounding rate well ahead of inflation, and then in re-investing those dividends at attractive valuations for participation in the capital growth over time. This principle is the foundation of our philosophy of investing in best-of-breed global businesses for their quality, competitive edge and attractive valuations. We believe all serious investors, and especially pension funds, should adopt such an investment philosophy.

The following chart compares the historically necessary investment amounts to generate a current value of $100:

Total Return Indices – S&P 500 vs Dividend Aristocrats (Current Values = 100)

The Dividend Aristocrats (members that have increased their dividends consecutively for at least 25 years) needed by far the lowest historic investments to grow to $100 currently. Since 2003 the High Yield Aristocrat members did not fare much better than the standard S&P 500 index members.

We have studied the 20 largest dividend payers in the Dow Jones index and compared their dividend growth and total return data over the past five years. The table follows on the next page with the study producing some important conclusions:

- There is high correlation between dividend growth and equity returns.
- Oil, Pharma and Retail are still large dividend contributors, but their relevance is deteriorating because of their low dividend growth. This may be of particular risk to large pension funds needing the growing income.
- Staples are still ‘hanging in’ to some extent but have risk of following Retail if they do not reinvent themselves further for better sustainable growth.
- Technology provides high dividend growth, which leads to excellent capital growth rates (apart from the likes of IBM).
- We expect a Technology business to soon be the largest dividend contributor in the US (either Microsoft or Apple).
- Technology has already become a substantial dividend payer (more than 30% of all the Dow Jones dividends) and can be perceived as the single most important dividend generator (not many foresaw such a comment at the turn of the century). This sector’s importance for future dividend income needs to be highlighted.

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

- The market is skeptical about the sustainability of Banks' growth potential (the dividend growth was off a low base after the Credit Crisis).
- Well-managed businesses design their own destiny and cannot necessarily be boxed into the above themes (e.g. Home Depot, United Health).

Total Returns for Largest Dividend Paying Companies in Dow Jones Index			
Company	Dividend Payment (m)	5 Year Div Growth (Comp p.a.)	5 Year Return (Comp p.a.)
Exxon Mobil Corp	$13,885	5.4%	-0.8%
Apple Inc	$13,769	10.9%	22.2%
Microsoft Corp	$13,487	10.4%	29.6%
Verizon Communications Inc	$9,916	2.6%	9.1%
JPMorgan Chase & Co	$9,615	16.1%	18.5%
Johnson & Johnson	$9,586	6.3%	10.0%
Chevron Corp	$8,668	2.2%	2.9%
Pfizer Inc	$7,663	6.7%	9.2%
Procter & Gamble Co/The	$7,268	3.0%	8.8%
Coca-Cola Co/The	$6,698	5.6%	6.7%
Walmart Inc	$5,993	2.0%	8.0%
Cisco Systems Inc	$5,899	13.0%	23.3%
IBM	$5,588	10.6%	-2.5%
Intel Corp	$5,440	7.0%	18.1%
Bank of America Corp	$5,420	24.6%	15.4%
Merck & Co Inc	$5,323	4.6%	9.3%
PepsiCo Inc	$5,201	10.3%	11.4%
Home Depot Inc/The	$4,907	23.7%	23.4%
Boeing Co/The	$4,042	23.0%	27.4%
UnitedHealth Group Inc	$3,429	26.3%	27.6%

The study further boosts our confidence in our approach of investing only for sustainable growth.

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

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