STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 17 JUNE 2019

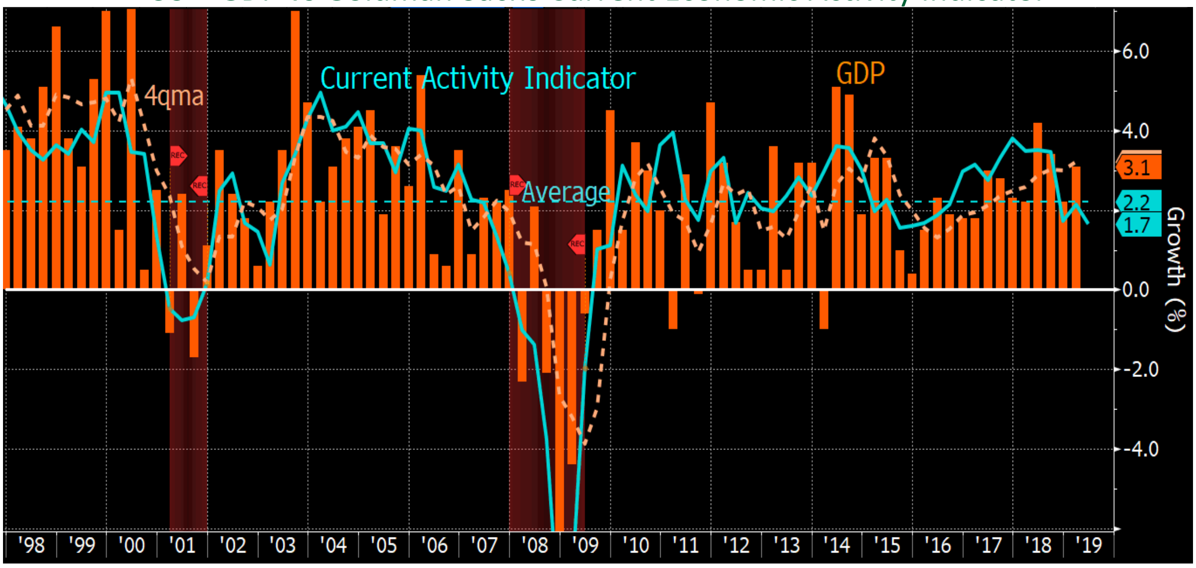
"You will be much more in control, if you realise how much you are not in control."

Benjamin Graham

1. US ECONOMY

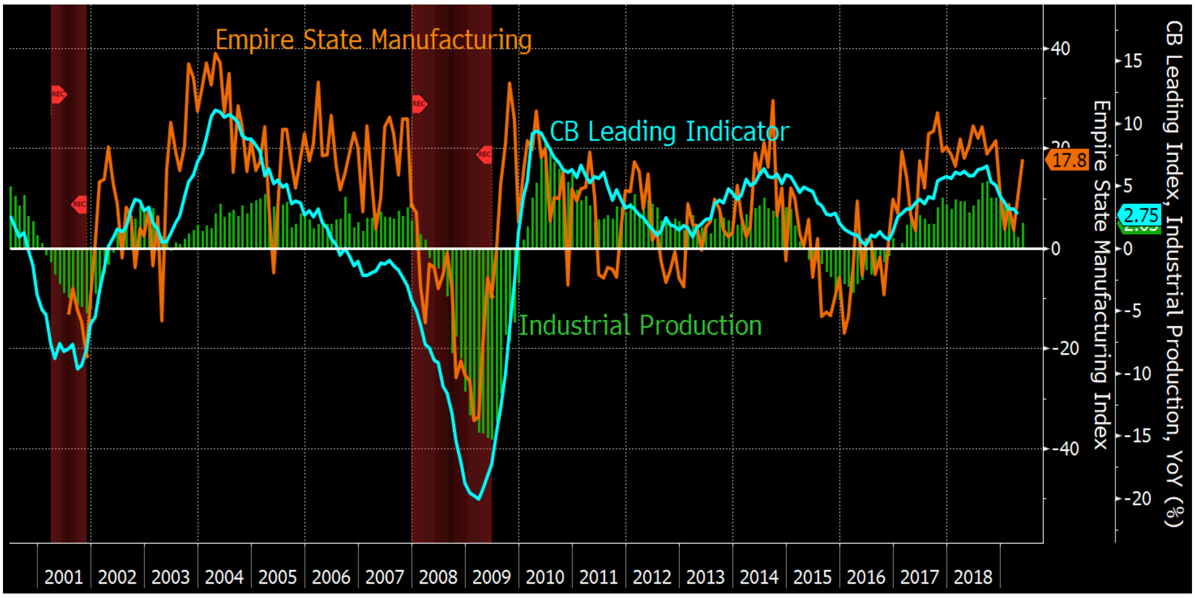
US GDP has been growing at +3.1% over the past four quarters. This is generally perceived as a ceiling due to current market uncertainties and the drop in the Current Economic Activity Indicator in the following chart:

US – GDP vs Goldman Sachs Current Economic Activity Indicator



The Activity Index is still growing at a healthy +1.7%, but we can clearly expect GDP growth to moderate going forward. The major question is obviously how vulnerable the economy may be. On this note, the main US leading economic indicators continue to moderate but remain constructive. Contrary to most expectations, all the main confidence index readings have strengthened in May. The following chart elaborates further on this theme:

US – Conference Board Leading Economic Index vs Empire State Manufacturing Index and Industrial Production



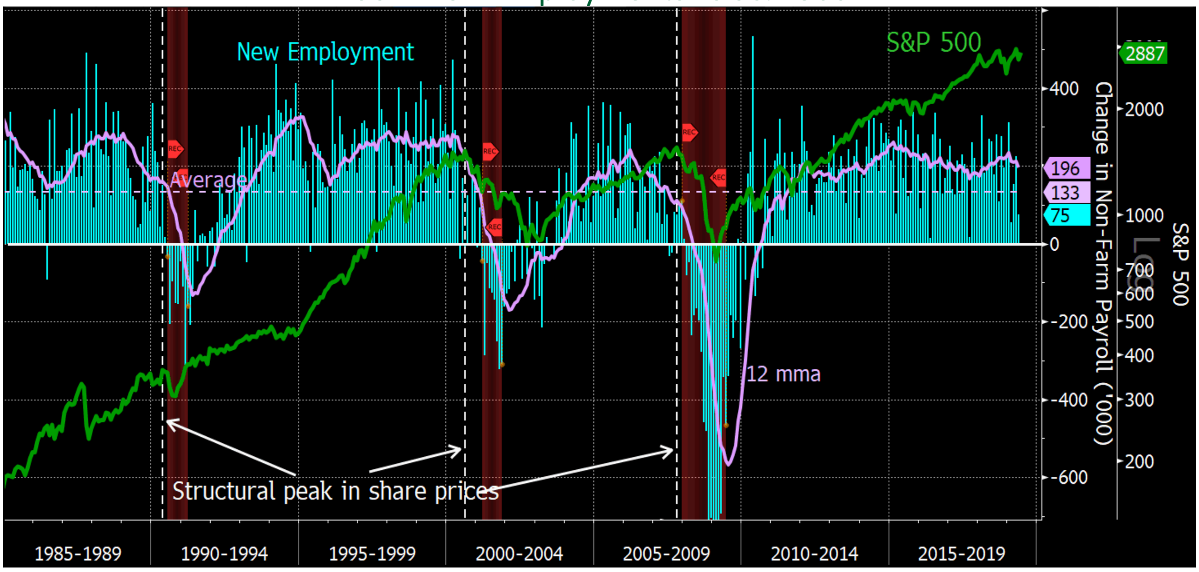
Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2019. ***Past performance should not be used as a guide to future performance.***

The growth in the Leading Economic Index continues a downwards trend, but against this, the growth in the Manufacturing index and physical industrial production have turned the corner upwards. This implies a continuing healthy economy.

2. US EMPLOYMENT

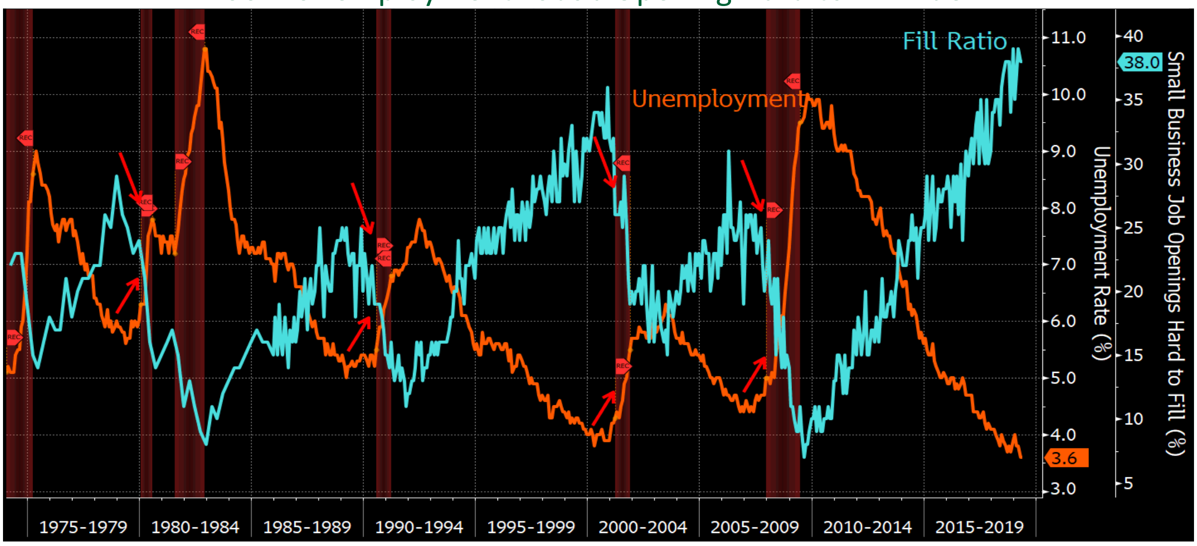
Some investors are concerned about the low new employment number of 75,000 in May. The following charts put this in broader context:

US – New Employments vs S&P 500



The twelve-month moving average of the new employment number is still a high 193,000, well above the long-term average of 133,000. Historically the moving average dropped to the average before the next recession took effect. On this basis we have little reason yet to have concerns in this context.

US – Unemployment vs Job Opening Hard to Fill Index

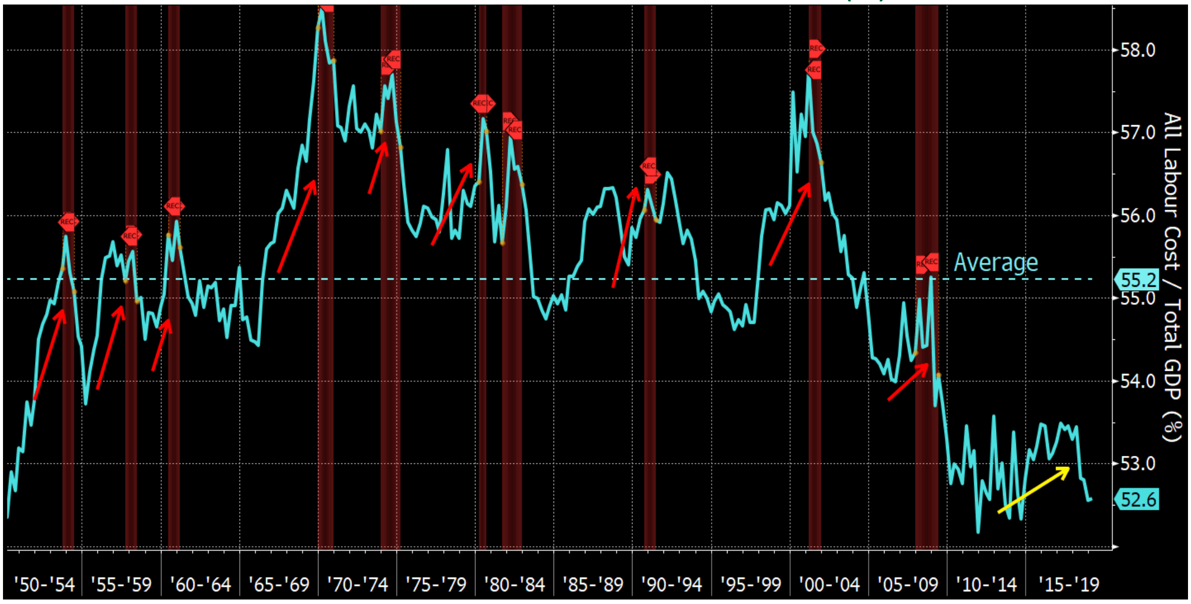


The unemployment rate of 3.6% is at an historic low. Historically this ratio turned for the worse well before the next recession started. Similarly, small businesses currently find it the hardest ever to fill new job openings. This ratio historically dropped from peak levels well before the upcoming recession. Both these series illustrate a strong US employment picture.

Many have concerns about the potential costs of the tight labour market. Wage growth is currently growing at +3.4%, well above the long-term average of +2.9%. Notably, wage growth historically became an economic threat at levels around 4%, and after lasting for more than two years. The following chart also puts perspective on overall labour costs:

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

US – Overall Labour Cost vs Total GDP (%)



Despite the higher wage growth, overall labour costs as a ratio of the total GDP have been at an historic moderate level since the credit crisis and despite a slowly rising trend, remain well contained.

The US labour market seems to be on a healthy footing in most aspects.

3. CORPORATE DEBT MARKET

Some have concerns about the levels of corporate debt. Many businesses run at record absolute debt levels. We note, however, that low interest rates make a difference in this context, and that the overall S&P 500 Total Debt / EBITDA ratio is currently below its long-term average (4.2 vs 4.6 times). Importantly, though, we value the signals the corporate debt market provides around capital market pricing.

US – High Yield Spread with Treasury Yield (%) vs S&P 500

The high yield spread is currently close to its long-term average. This indicates a healthy corporate debt market, with little indication of concern. This spread has a good negative correlation with share prices and therefore currently reflects a constructive backdrop for equity investing.

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

US – Corporate Yield Curve (vs Prime) vs S&P 500

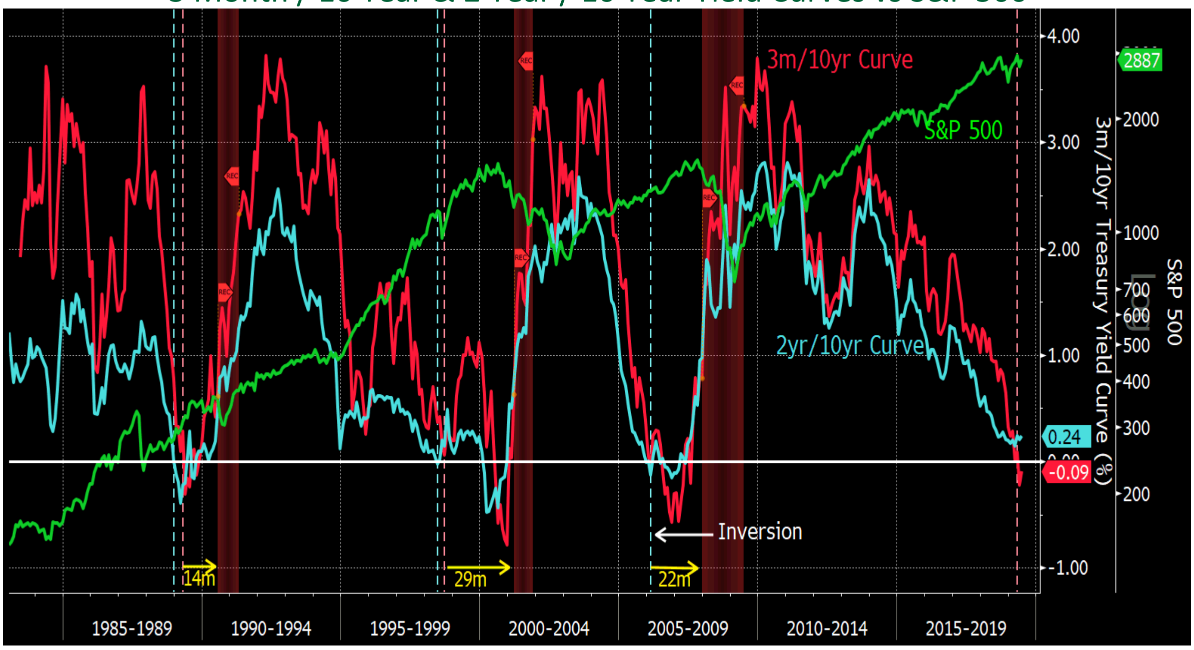
The corporate yield curve inverted at the end of 2017 and remains in negative territory. This implies less financial engineering opportunities and more need for management caution regarding debt issues. Such inversion events historically were followed by continued positive stock markets and preceded share market peaks by 2½ years on average (see the arrows in the chart). On this (relatively unscientific) basis the next peak can be expected towards the middle of 2020.

4. SHORT CURVE

Investors currently focus more on the shorter term 3 month / 10 year yield curve whilst the traditional orientation was more towards the 2 year / 10 year curve. We put more value to the latter for a more strategic orientation, but also take cognizance of evolving market preferences.

The following chart reflects on both these series:

3 Month / 10 Year & 2 Year / 10 Year Yield Curves vs S&P 500



Whilst the shorter curve is more volatile, their respective warnings of upcoming recessions have historically been quite close, with the longer one warning slightly earlier. The shorter curve has on average provided a warning 21 months ahead of the respective recessions.

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

This curve has this time provided its warning first about two months ago. The alternative curve has not yet provided any such warning and is in fact steepening currently. The most recent reading for the former is also a constructive (steepening) one. We are therefore conscious to not being overly cautious and prefer to wait for a clearer indication before taking negative action in this context. Even so, should the short curve be right, this would imply the next recession may start in early 2021 on this basis.

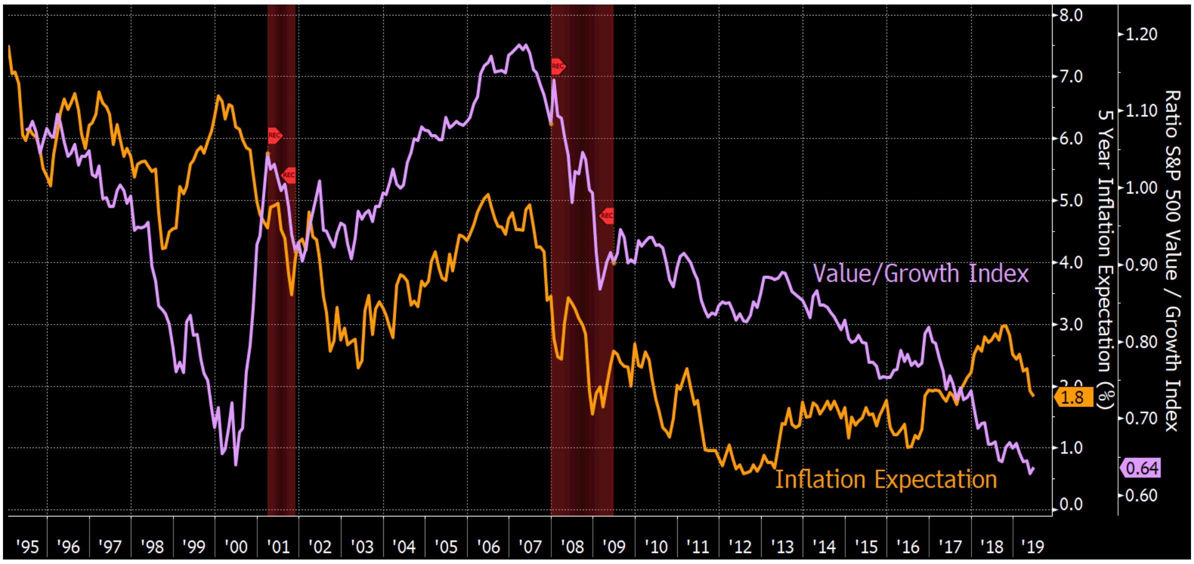
US – 2 Year / 10 Year Yield Curve vs Moving Averages (%)

Technically speaking we are at an interesting juncture currently – we are soon to know whether our preferred curve has made a 'golden cross' in its current steepening process (the 50- and 200-day moving averages are at the same level currently). The new direction may make a renewed impact on investor perceptions.

5. VALUE VS GROWTH

We occasionally revisit the fundamentals behind the relative performance of value versus growth strategies. The following charts assist in this process:

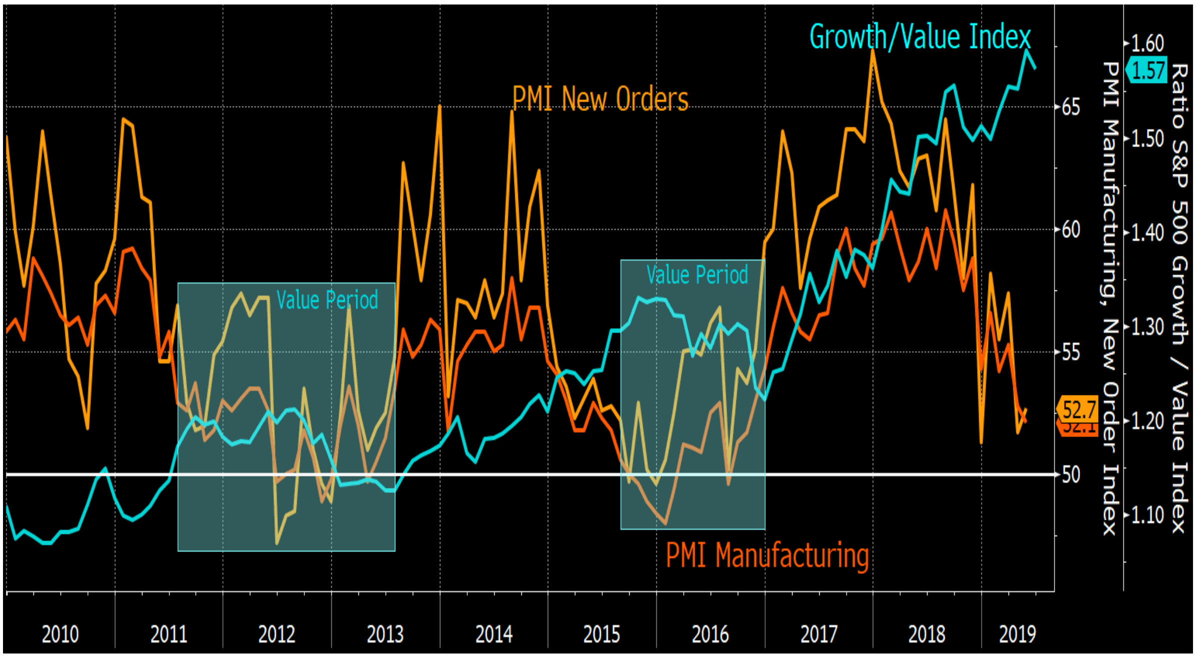
S&P 500 Value/Growth Capital Value Relative Performance vs Inflation Expectations



The relative performance is quite closely related to the direction of inflation expectations. The recent drop in inflation expectations seem to favour the Growth orientation. Going forward investors clearly must form a judgement in this inflation context.

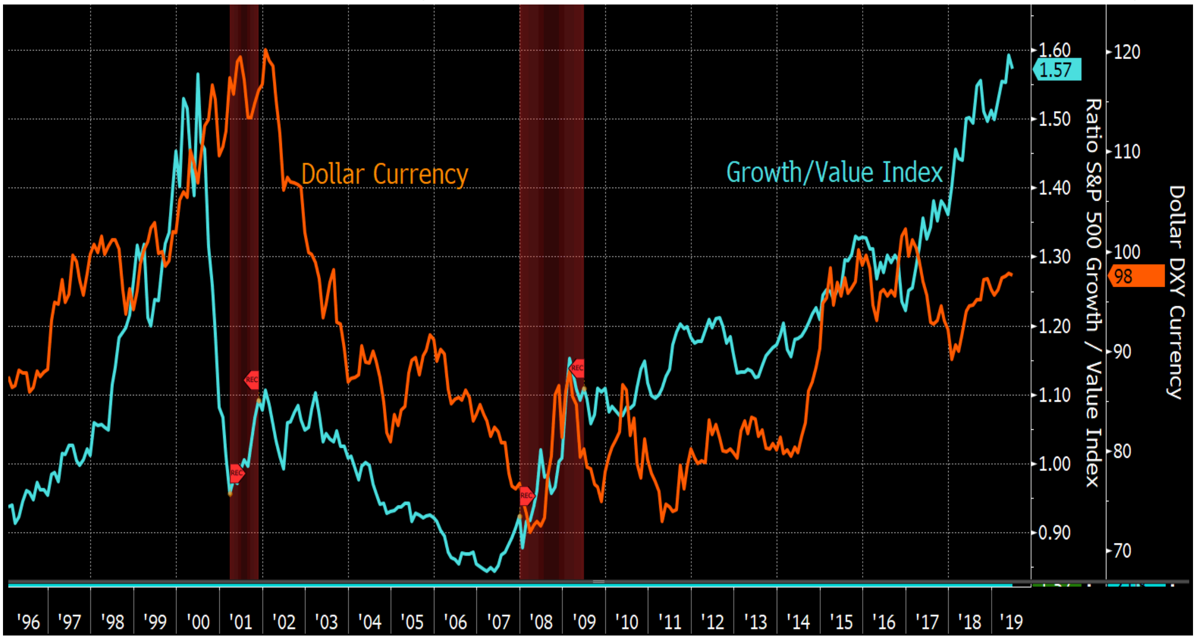
Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2019. ***Past performance should not be used as a guide to future performance.***

S&P 500 Growth/Value Capital Value Relative Performance vs New Orders & Manufacturing PMI Data



The Value approach historically performed better under conditions of low Manufacturing and New Orders (the shaded areas in the above chart). The current low readings in this context have not yet had such an effect. This is probably due to lower inflation expectations. Other things being equal, the coming direction of the Growth/Value relative performance may therefore be quite dependent on the new Manufacturing and Orders data, i.e. whether the economy stabilises or deteriorates further.

S&P 500 Growth/Value Capital Value Relative Performance vs Dollar Currency

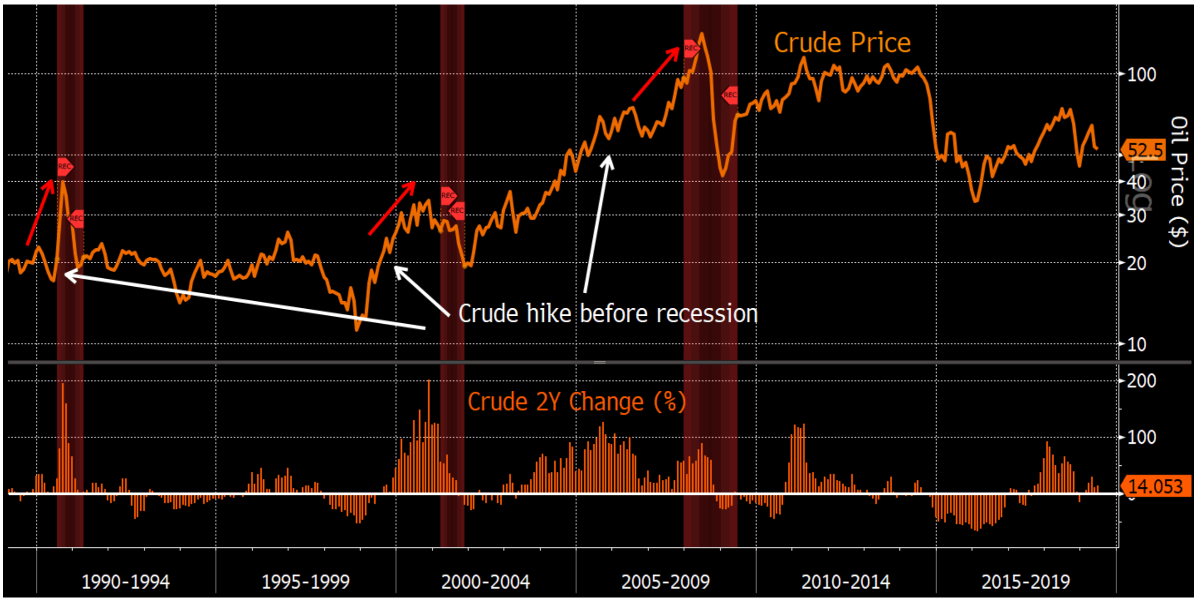


There also seems to be quite some correlation between the Growth/Value relative performance and the Dollar currency. This necessitates also a currency view to form firm opinion on future investment style performance.

6. OILING THE WHEELS

Whilst the current lower crude price oils the wheels of the world economy, we can remind ourselves of its effect in earlier economic cycles:

Oil Price vs US Recessions

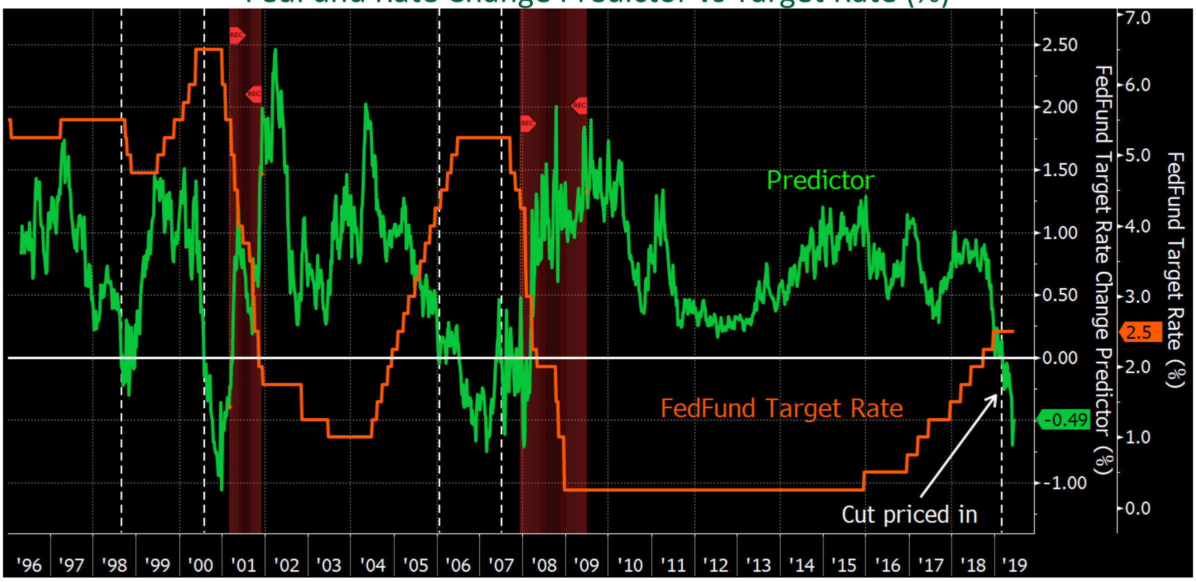


Crude historically doubled in the run-up to respective US recessions, having its costs effecting the economy – 'double spells trouble'. This is not remotely the case currently and it rather makes a positive contribution in this context.

7. FED CUT

A potential first cycle cut in the FedFund target rate has become quite topical. We show in the chart below our FedFund Predictor index along with the target rate:

FedFund Rate Change Predictor vs Target Rate (%)



According to this index a cut is expected imminently. Historically it has made good calls, though being somewhat prematurely. With the more constructive view we have of the US economy we would be careful to have too high expectations for an imminent cut.

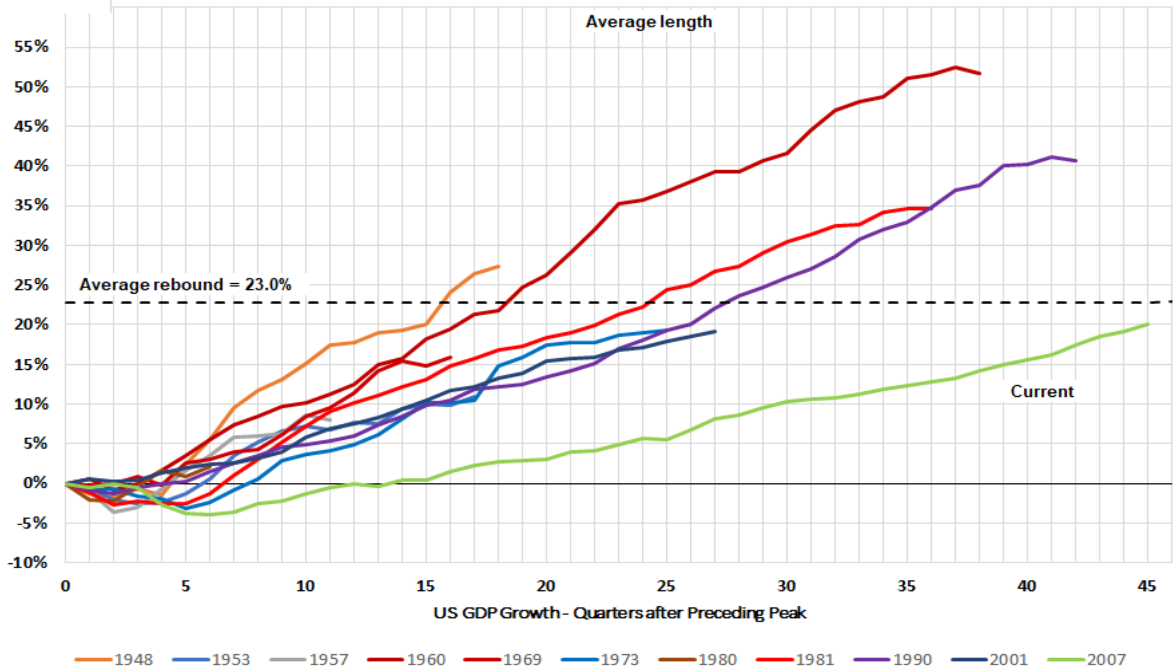
Should an imminent cut not materialise, there may be risk that the market forms views of a stubborn Federal Reserve and takes negative actions as a result. We would rather find confirmation of our constructive view in a no cutting conclusion.

It is relevant to mention that since 1984, barring the two most recent recessions, the S&P 500 delivered positive returns over the subsequent twelve-month period following a cycle's first rate cut.

8. LENGTH OF THE CYCLE

We have updated our chart of the length of the current economic cycle:

Length vs Height of US Economic Cycle Recoveries



Despite the extended length of the current cycle, the level of the recovery (+20%) remains below the average (+23%) of preceding recovery levels. We believe there is no information of particular value in the absolute length of the cycle. It is more about the nature of the current economic environment, and with the absence of material financial or real balances we may be heading for a 'slow soft landing on a long landing strip'.

We calculate the compounded capital returns over the respective economic cycles:

S&P 500 Peak-to-Peak Price Performance												
Recession	1948	1953	1957	1960	1969	1973	1980	1981	1990	2001	2007	All
Performance p.a.	10.4%	19.1%	6.8%	6.4%	2.7%	-0.2%	24.3%	10.5%	15.8%	0.3%	5.4%	7.5%

Whilst the returns differ materially amongst the different cycles, the current cycle's return (+5.4% p.a.) is still meaningfully below the long-term average of +7.5% p.a.

We have also calculated the compounded total returns (including dividends) over the most recent economic cycles reflected in this table:

Again, the current cycle's total return is still well below the compounded return over all of the relevant periods.

S&P 500 Peak-to-Peak Total Performance				
Recession	1990	2001	2007	All
Performance p.a.	18.4%	2.2%	7.9%	9.8%

All-in-all, we do not detect excesses in the current economic cycle and do not have ample reason to call an end to the structurally constructive investment environment.

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

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