GLOBAL EQUITY PERSPECTIVES 2 MARCH 2020

"Successful investing is about managing risk, not avoiding it."

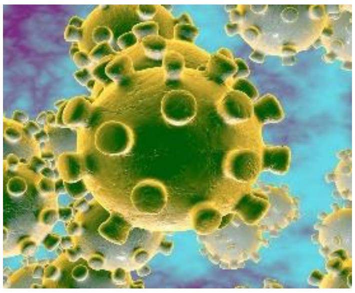
Benjamin Graham

1. THE VIRUS

Contrary to earlier hopes, coronavirus is spreading through the world with infections now on all continents. As the number of newly reported cases in China are fortunately dropping, the number in the rest of the world now exceeds China's. China has been effective at containing infections by quarantining whole cities. The rest of the world cannot follow suit and rely on good information and different forms of self-isolation. The heartening news of almost half of all Chinese small and medium size enterprises are back in operation and Israeli medical researchers already having achieved a 'significant breakthrough' possibly ready for effective treatment within two months holds good promise.

It is clearly difficult to have a high conviction view on how this crisis will play out. Our overall perceptions are as follows:

- Investors had earlier been more hopeful that the spreading of infections would be more limited. The wide spreading to so many parts of the world is therefore of concern.
- Many businesses throughout the world are now negatively affected, whether through employee isolation or through supply chain interruptions. This is going to have a more meaningful effect on many businesses' short-term results than what was previously expected. These effects are now expected to carry into at least the second quarter. Some of this business will be permanently lost.
- The question of a potential recession is back on the table. If this may materialise, we expect it to be short-lived with a typical V-shape recovery.
- The media will continue to bombard us with bad news (and exaggerate). This, along with many businesses reporting poor results, may unnerve investors even further.
- Some businesses (especially those with weak balance sheets) may develop cash flow and liquidity problems.
- Some investors are expected to capitulate and cause further market volatility.
- We expect some central banks and governments to provide monetary or fiscal support should it become necessary.
- The fundamental values of most businesses are not affected to any large extent – the value is predominantly determined by their long-term performance, not by short-term tactical issues. Investor sentiment, though, does not always reflect this.
- There already seems to be some capitulation with many shares dropping indiscriminately and trading volumes rising sharply.
- We are being offered good buying opportunities, but against the above backdrop we believe we can apply patience and be very selective.
- Investors have good opportunity to restructure and purify their portfolios. They should also caution against selling at distressed levels.

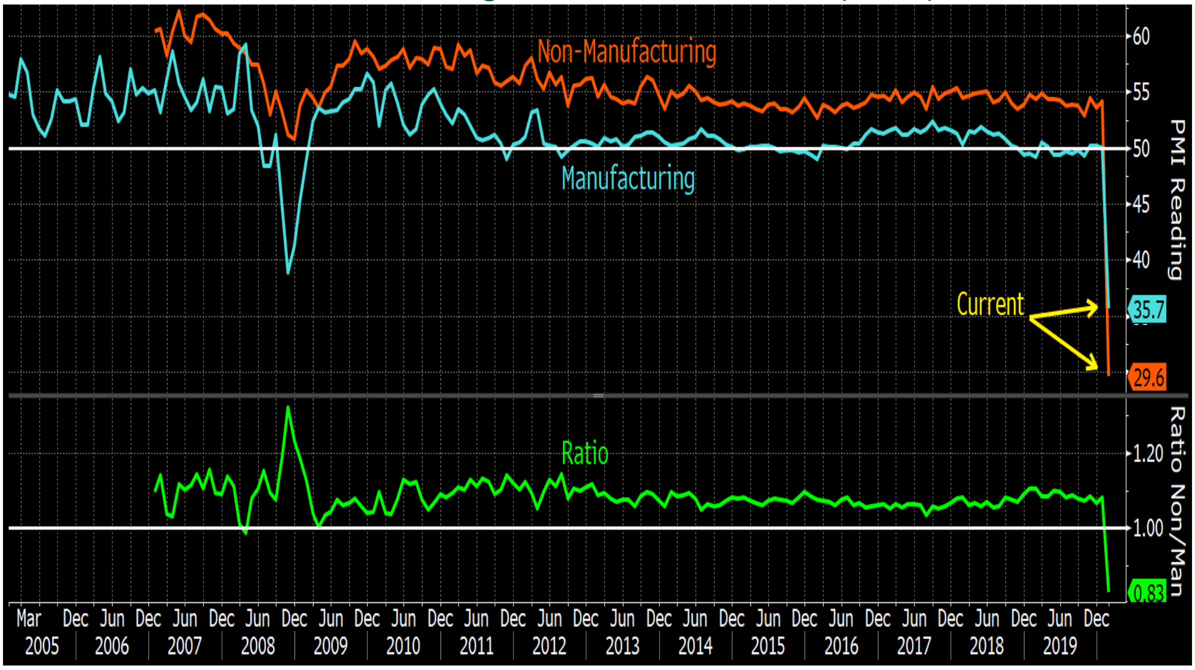


In short, we believe coronavirus creates the buying opportunity many have been longing for. They just wanted it without the accompanying bad news. Now that they have it, they are scared. They need some time to digest the new information.

2. EARLY EFFECTS

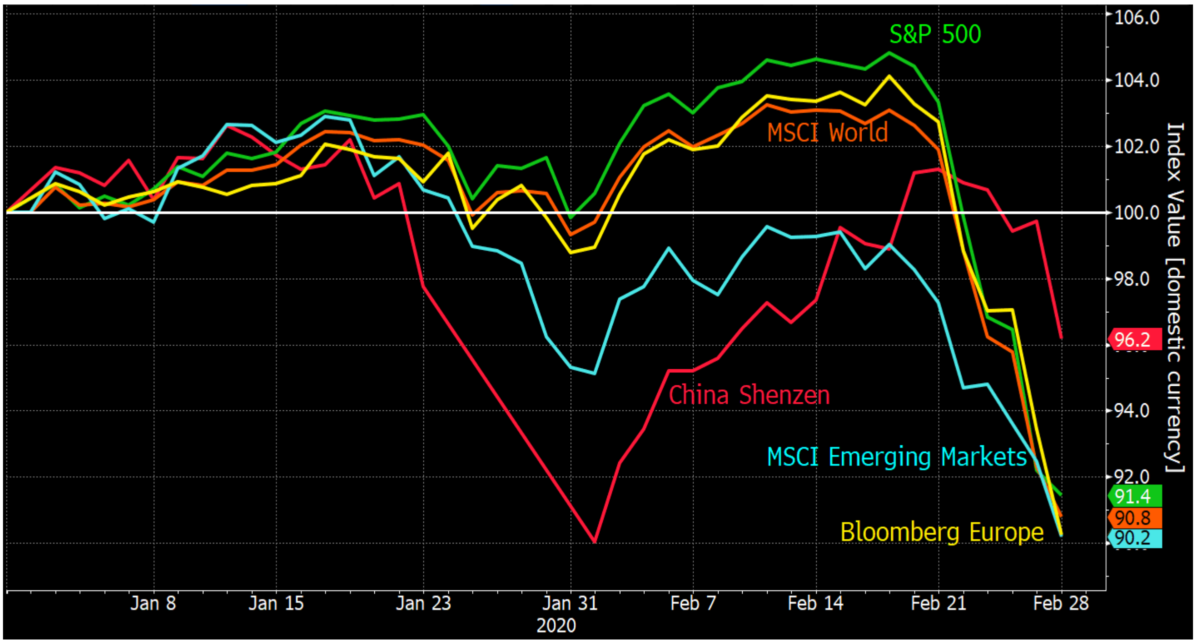
China's PMI data were released over the weekend:

China Purchasing Manufacturers' Indices (PMI's)



Both the Manufacturing and Non-Manufacturing data dropped sharply from constructive levels to record low levels, the former by -30% and the latter by over -45%. Strikingly, for the first time ever the Non-Manufacturing reading is lower than the Manufacturing reading (see the bottom section of the chart). This results from over half of the nation's population effectively being held in quarantine.

Major Stock Exchange Indices – Indexed to 31 December 2019 = 100



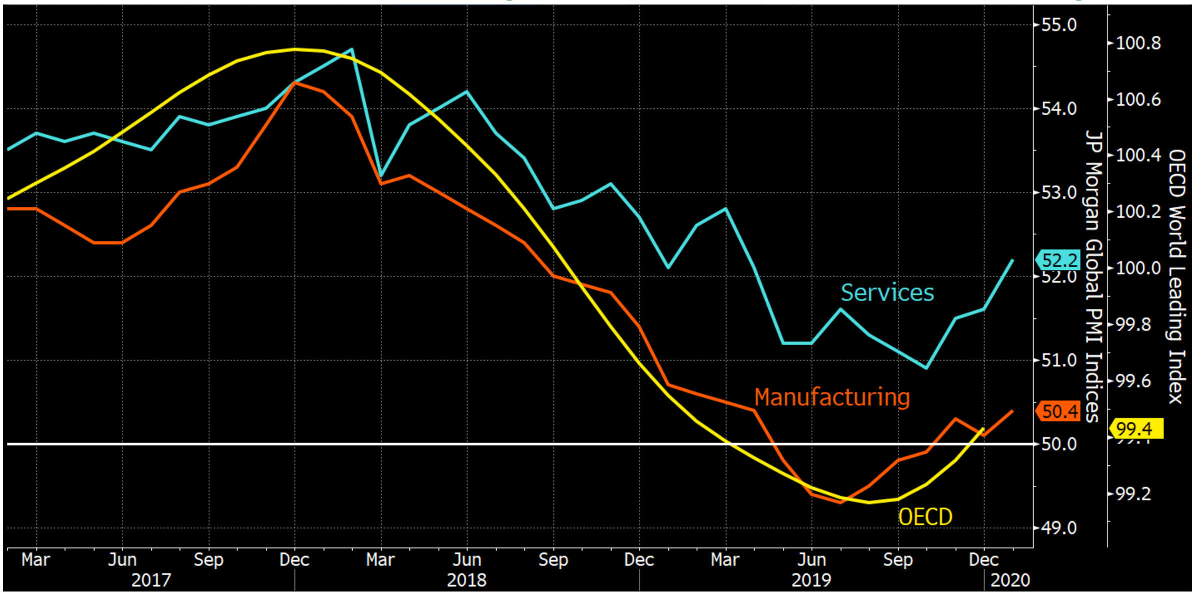
Most of the major world stock indices have already dropped by almost 10% from the beginning of this year (and about 13% from their respective peak levels). This is clearly into official correction territory. The standout exception is China – it initially also dropped to the same extent, but made a good recovery close to recent peak levels as the government stepped in with support. It has since slipped again, but is ironically doing much better than the rest of the world despite its own shut-down and severe woes.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

3. WHERE WE WERE

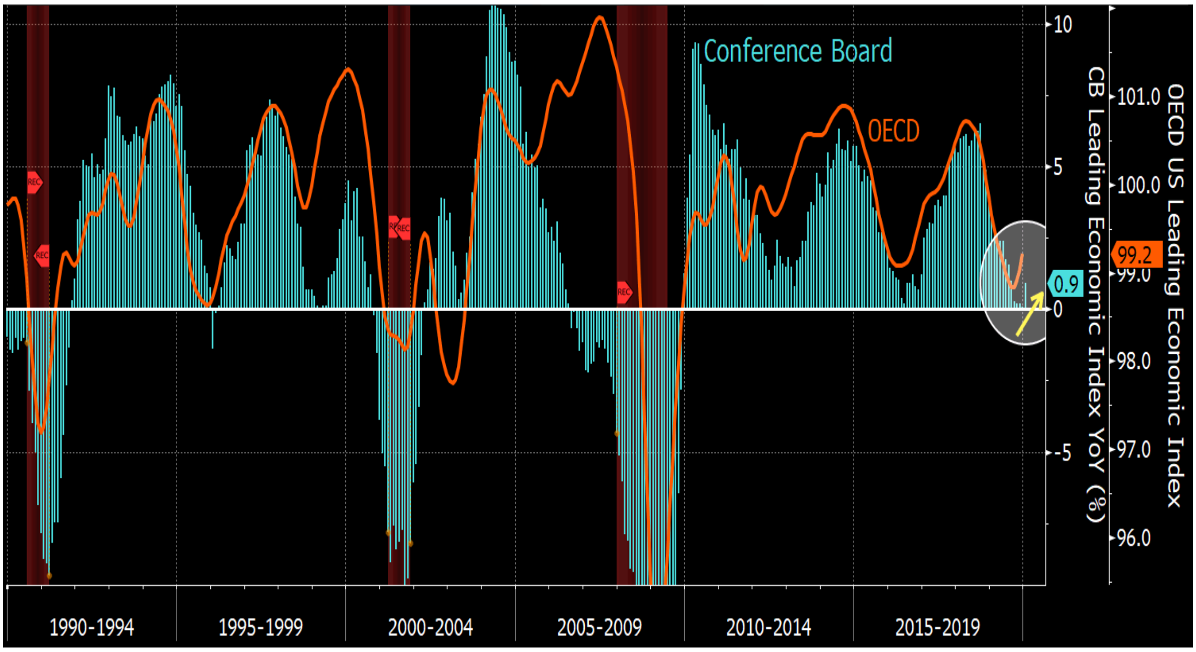
Coronavirus clouds the world's immediate economic outlook materially, but it is also important to consider the fundamental economic issues that were in place before it struck:

World Economic Outlook – JP Morgan Global PMI Indices and OECD Leading Index



Both the global Manufacturing and Services PMI indices last readings were in constructive territory in their respective positive trends. The same constructive comments can be made for the OECD's leading economic index.

US – OECD Leading Economic Index vs Conference Board Leading Economic Index



The OECD data for the US shows a similar positive trend. It usually leads the Conference Board's Leading Economic Index (see the above chart). This is currently again the case – the latter turned the corner in January rising off an almost neutral level. The strong combination of these two charts could have excited many investors.

We also follow world trade and export data, and specifically also Sweden and South Korea's data in this context. The former is a good indicator for European and the latter for overall world trade. Whilst Sweden's data remains weak, South Korea's data has made a positive turn. World trade has also turned for the better with its last reading.

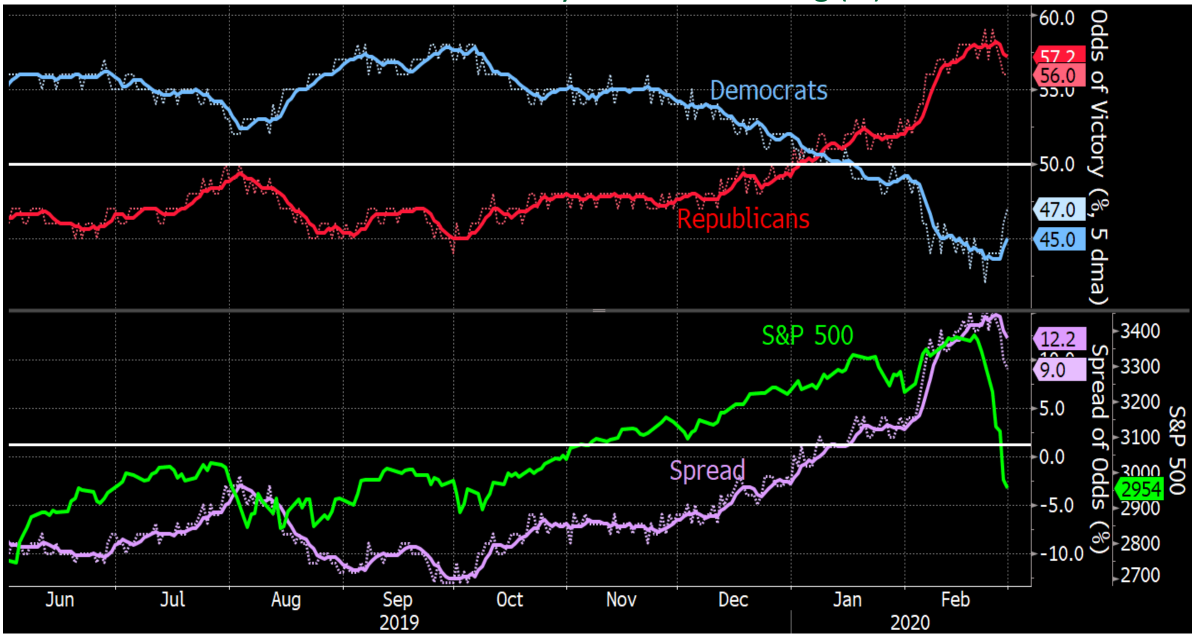
It is apparent that the world economic outlook was turning for the better before coronavirus struck.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. January 2020. ***Past performance should not be used as a guide to future performance.***

4. US ELECTION

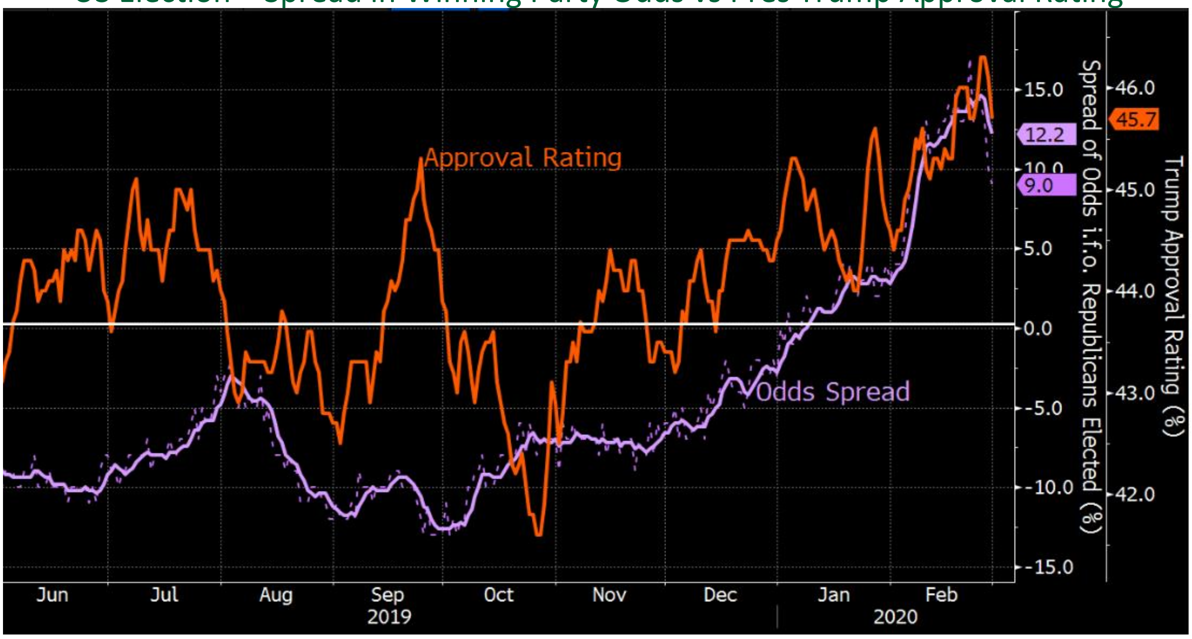
Bernie Sanders' progress in the Democratic Party's nomination progress is starting to be reflected in the winning odds data:

US Election – Party Odds for Winning (%)



Whilst the odds continue to favour the Republicans to win, it seems to have turned a negative corner in favour of the Democrats (see the top section of the above chart). The spread between the two series continues at elevated levels, but seems to have peaked (see the bottom section of the chart). The correlation with the S&P 500 index (the green line) may be coincidental, but is striking. It is often the change in trend and the level of change that cause alarm. The combination of these odds and coronavirus may unnerve some investors.

US Election – Spread in Winning Party Odds vs Pres Trump Approval Rating



Presidential approval ratings traditionally are relatively low (President Obama's readings fluctuated between 41% and 56%). President Trump's record low equals his predecessor's, but his best reading lags by 9 points. It has, though, a positive trend – which is perceived to be positive for capital markets. It remains to be seen whether Sanders's progress may affect this and potentially further unnerve markets until the election in early November. Biden seems to be making a comeback.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

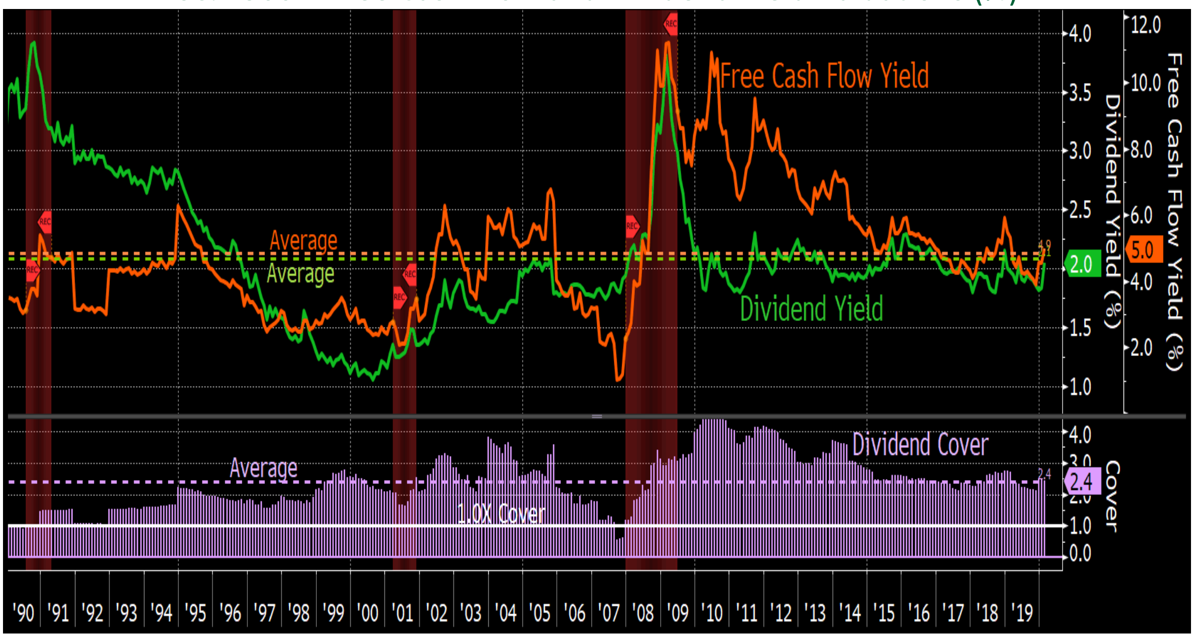
5. VALUATIONS

We face unchartered territory regarding many companies' results for the current and next quarter. The market is becoming aware of this outlook, but we need better news on coronavirus to be able to calm investor sentiments. While it is difficult to have high conviction earnings expectations we consider historic index results with the approach that this may be the appropriate levels even eighteen months forward in some cases (which is close to the market's usual forecast period).

S&P 500 – P/E Valuation

Both the historic and forward P/E ratios are back at long-term average levels. Some investors may still need lower multiples to rebuild their confidence in this context.

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

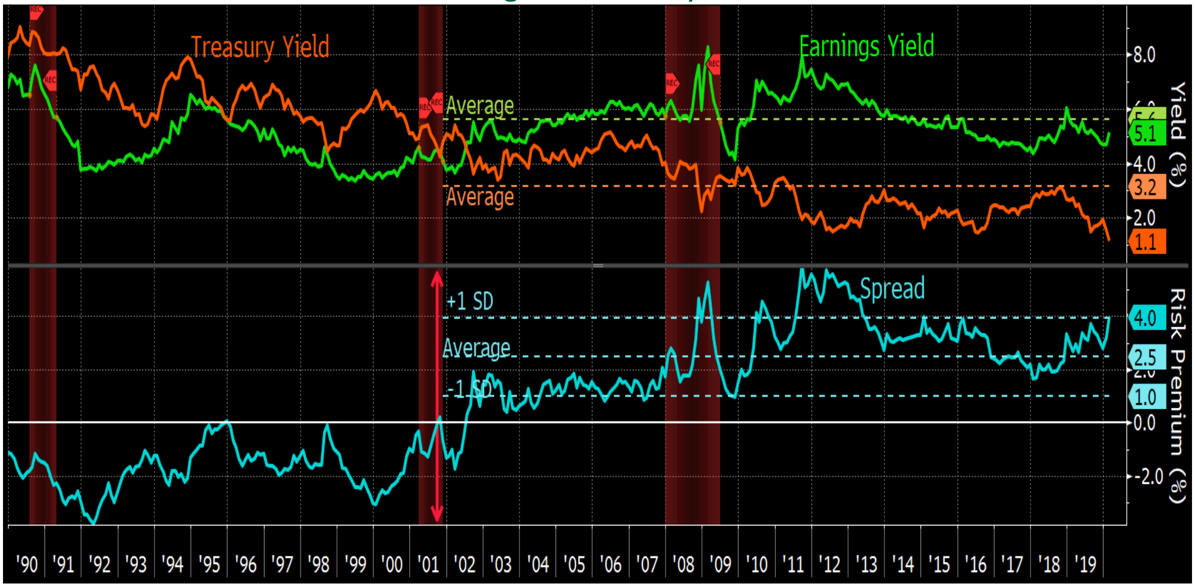


Similarly to the above, both the Free Cash Flow and Dividend Yield Valuations are back at their respective long-term levels, as is the Dividend Cover ratio. We believe odds are high for dividends to continue to be raised in most cases, making the S&P 500 index attractive from an income perspective.

These valuation considerations are all in an absolute context. We should also consider valuations from an income perspective:

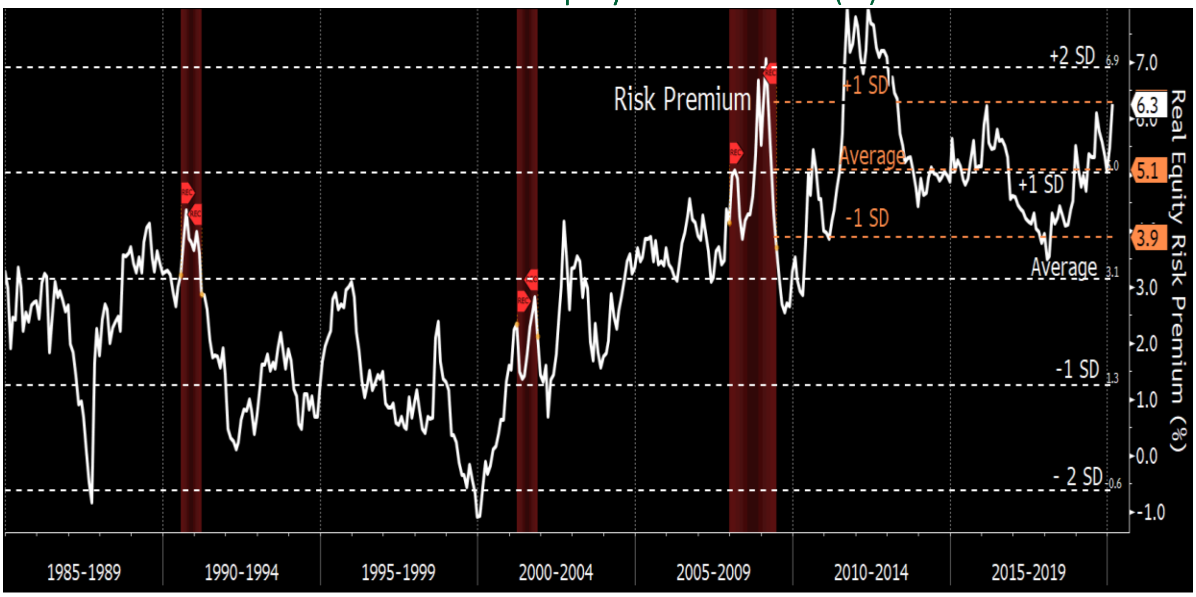
Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

S&P 500 – Earnings vs Treasury Yield Valuations



We compare Earnings Yields to Treasury Yields in the above chart and deliberately draw average levels only from 2001 as investors orientated themselves toward lower yields. The earnings Yield is only 0.5% from its average, while the Treasury Yield is 2.1% from its own average. The 4.0% spread between the two series (the bottom section of the above chart) is at +1 standard deviation (SD), leaving ample room for interest rates to rise and earnings to contract. On this basis bond holders have an excellent switching opportunity.

S&P 500 – Real Equity Risk Premium (%)



On a similar note, the Equity Risk Premium is currently on a +1.5 long-term SD and +1 SD since the credit crisis. Conservative investors would value the latter metric more. We make the same conclusion as with the Earnings Yield.

Bottom-up consensus valuations of S&P 500 companies are 22% above the current index value. This level of excess valuation has historically led to attractive returns a year later (apart from valuations during the Credit Crisis recession). There is room in these valuations to be trimmed.

We qualify the earnings outlook at the beginning of this paragraph – these charts reflect perceptions under a normalized environment. Investors should (as always) think at least a year forward while also preparing for a volatile immediate short-term outlook. We reckon these charts can be helpful in considering what we may wish in a year's time we actually did in the coming weeks and months.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

6. TECHNICAL PICTURE

We have many charts illustrating that the market is approaching oversold levels. In the interest of refraining from getting to a too long note we show three striking ones. Our clients are welcome to ask should they have interest in more charts in this context.

S&P 500 – Drawdown from Preceding Peak Level vs RSI (daily data)

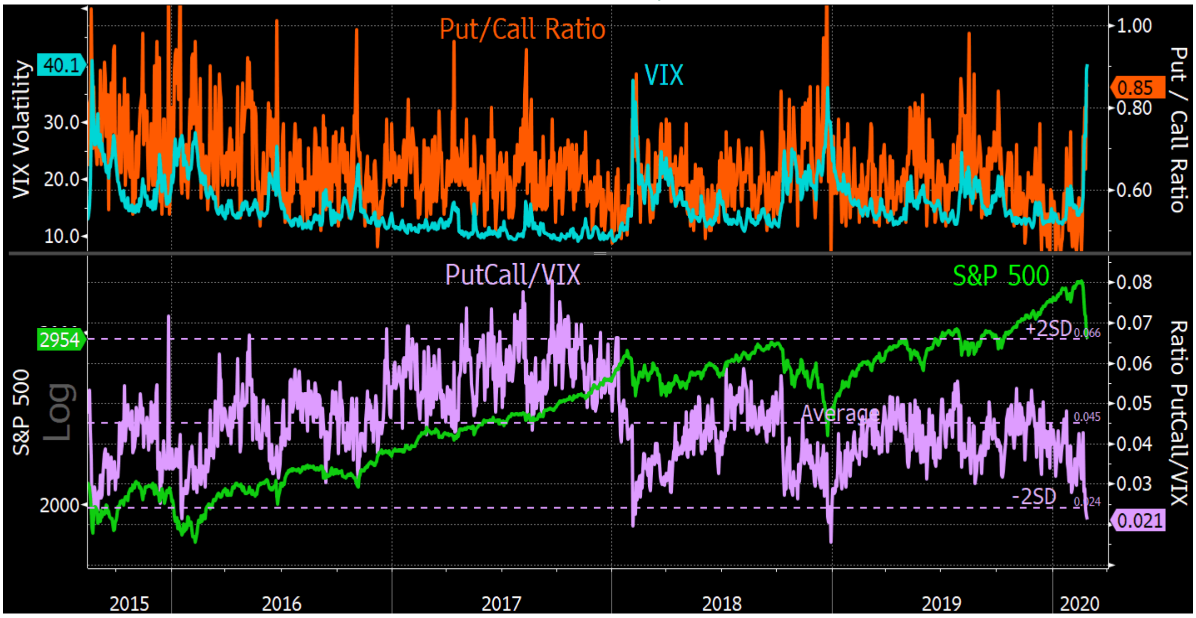
The S&P 500 is already in a correction mode being -12.8% from its peak level. Along with this its Relative Strength Indicator (RSI) is at an extreme low of 19.

S&P 500 vs VIX Volatility Index and RSI (weekly data)

The VIX volatility index at a reading of 40.1 points is already at a +2.4 SD level away from its long-term average. These levels have historically been associated with getting closer to buying opportunities. The RSI is not yet in buying territory, implying room for some patience.

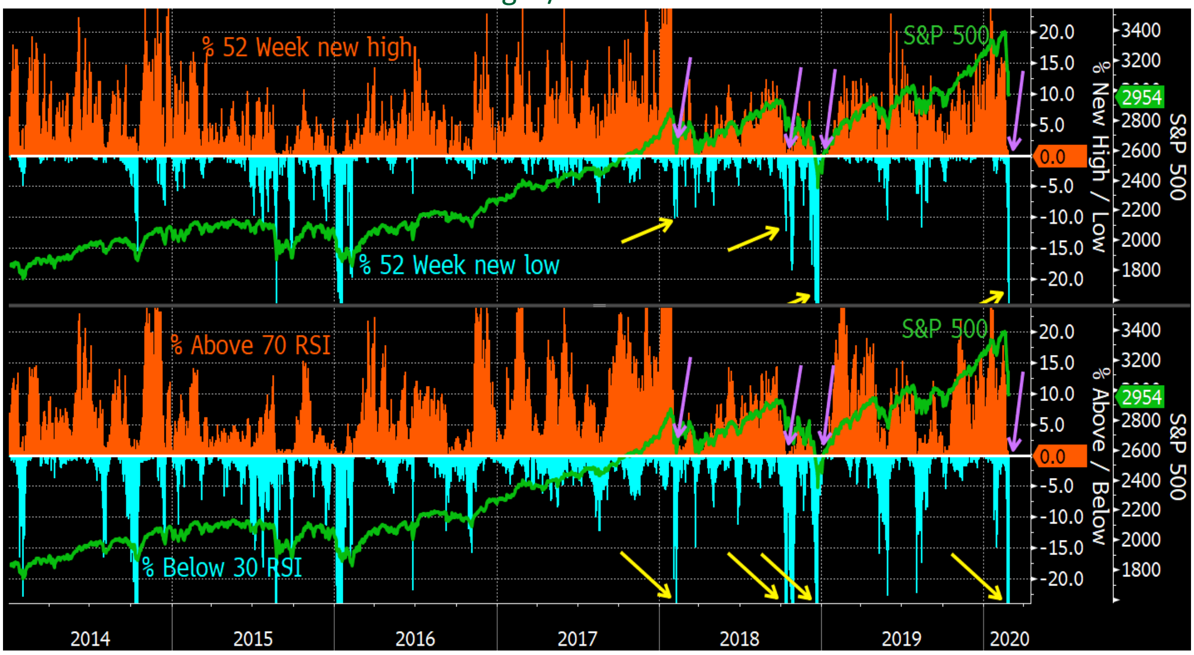
We combine the VIX index with the Put/Call ratio in the following chart. The ratio between the two series is drawn along with the S&P 500 index in the bottom section of the chart. This ratio in already over a -2 SD level. Such levels have historically indicated good buying opportunities.

S&P 500 vs PutCall/VIX Ratio



The following chart reflects oversold S&P 500 levels on the basis that the percentage of stocks at 52-week highs/lows or above/below 70/30 RSI levels are all at historic extremes. Such levels have historically been associated with good buying opportunities.

S&P 500 vs % of Stocks at 52-week Highs/Lows and Above 70 RSI or Below 30 RSI Levels



We are currently in particularly uncertain times and should stay very diligent in decision making. The outcome is hugely dependent on containing the aggressive spreading of the virus and finding successful treatment. It is too early to take a firm stance in this context, but there are some silver linings one shouldn't ignore.

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