GLOBAL EQUITY PERSPECTIVES 11 MAY 2020

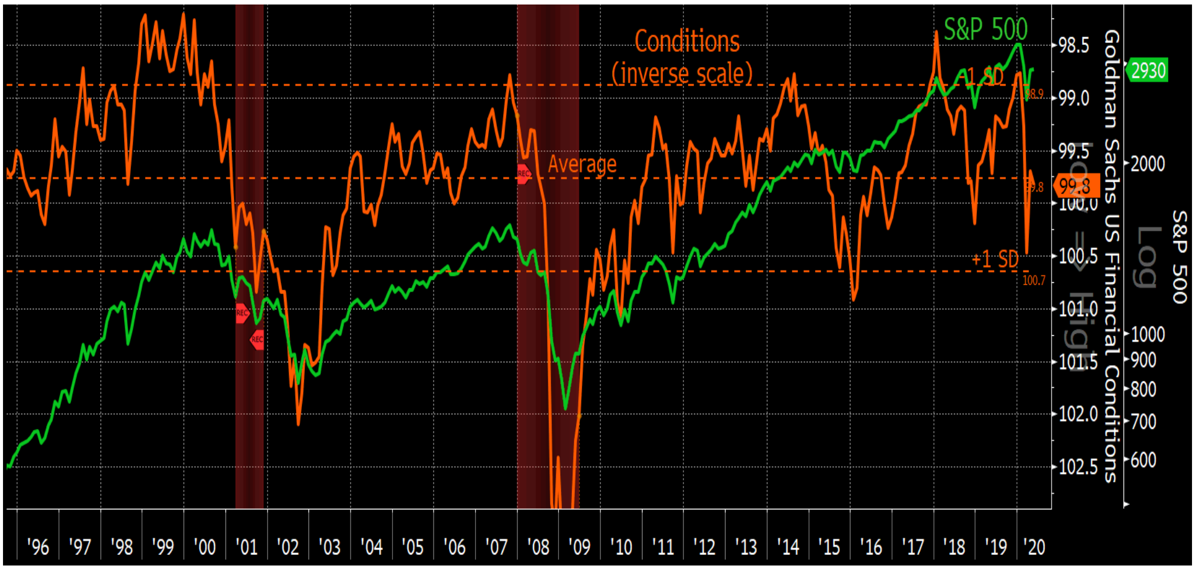
"One cannot develop an effective philosophy without having been exposed to life's lessons."

Howard Marks

1. FINANCIAL CONDITIONS

It is important for investors to consider the different forms of overall financial conditions.

Goldman Sachs Financial Conditions Index vs S&P 500



The Goldman Sachs Financial Conditions Index reflects different financial variables (e.g. interest rates, credit spreads, exchange rate, etc) that influence economic behaviour and therefore future economic activity. After the recent spike, the index has returned to its average level, currently reflecting a balanced position.

Bloomberg Financial Conditions+ Index vs S&P 500

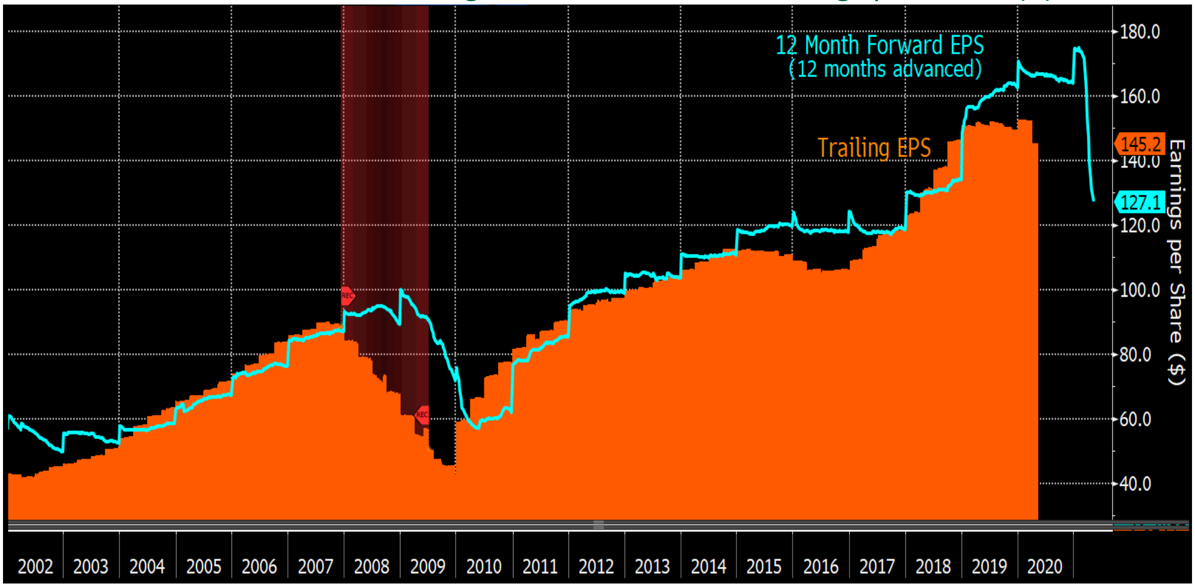
The Bloomberg Financial Conditions Index reflects the different financial stresses in the US capital markets. It recently experienced an exceptionally sharp drop from a +1 to a -2 standard deviation level. It has since recovered well and is now close to its long-term average level, also reflecting a balanced position.

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

2. EARNINGS SEASON

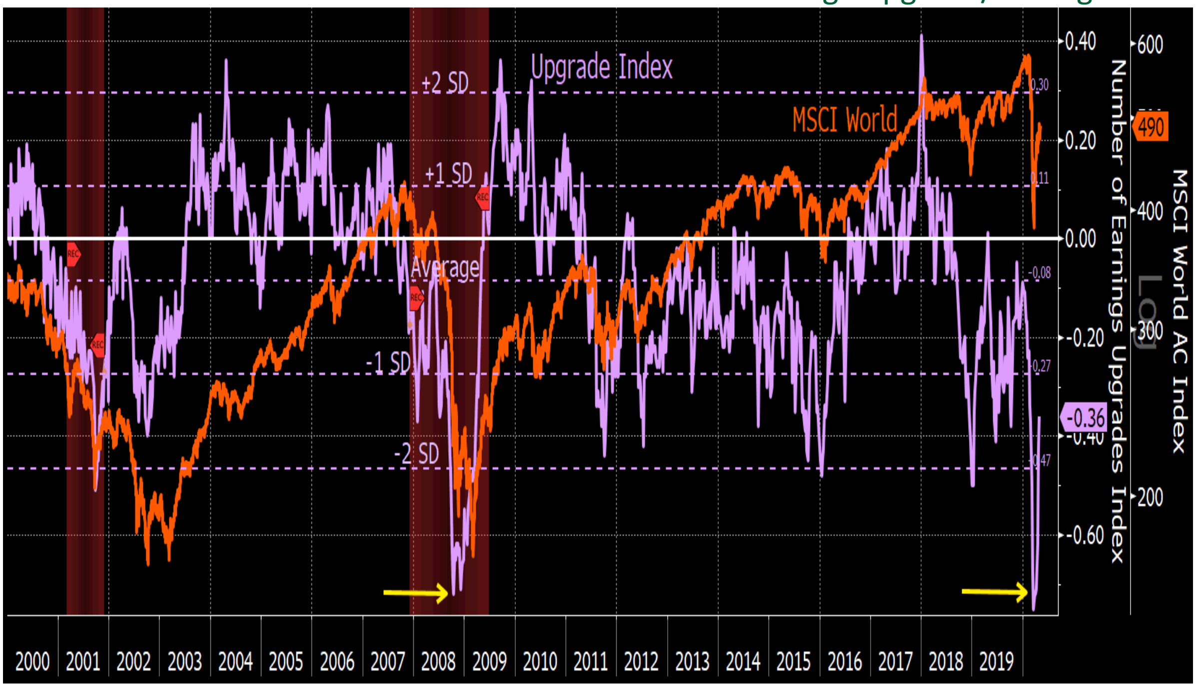
The earnings season is in full swing. 87% of the S&P 500 index constituents have already reported. The consolidated earnings per share thus far is -7.3%, with marginally over half of the companies reporting growing earnings. Just over two thirds of the companies reported better than expected earnings.

S&P 500 Index – Trailing and 12m Forward Earnings per Share ($)



It is clearly a negative reporting season in terms of absolute earnings, but importantly, investors are well prepared for the negative news. As reflected in the above chart, expectations for the twelve month forward earnings have already dropped from a peak level of $174.8 per share to the current $127.1 per share, a drop of -27.3%. All said, we are not overly concerned about the absolute index eanings level that may materilaise in the end – the focus should rather be on the specific businesses under consideration. This is an important point in active portfolio management.

MSCI World Index vs Index of Sell-Side Number of Earnings Upgrade/Downgrades



We show above our updated chart of sell-side earnings revisions of the world index constituents. The correlation with the world index is clear. It is striking how sharp and how deep the revisions index dropped with GVC (Great Virus Crisis), and importantly, how sharply it is currently recovering. It therefore seems that the current recovery in share prices has some fundamental reasoning behind it.

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

3. DIVIDEND CUTS

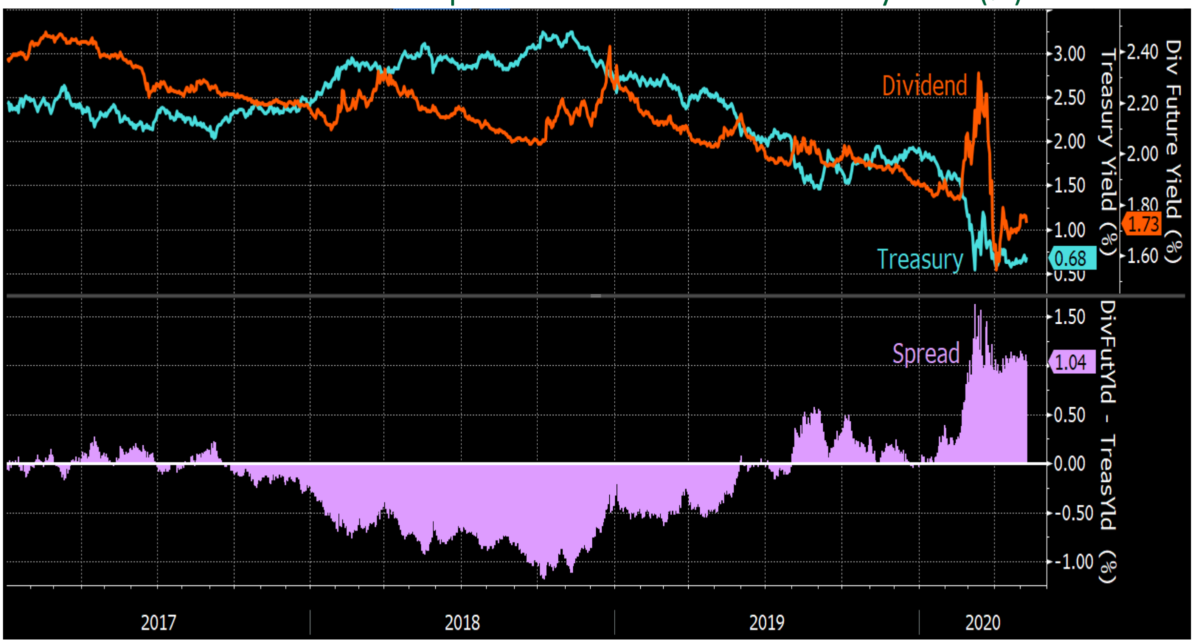
Dividend cuts have suddenly become nothing out of the ordinary because of GVC. We now experience boards rather taking conservative stances and preserving cash flows to provide for an uncertain immediate outlook.

As often happens with such unexpected changes, the market has risk of overreacting. The following chart of the Dividend Future index seems to confirm this point:

S&P 500 vs S&P 500 December 2020 Future Dividend per Share ($)

The dividend future suddenly dropped by an initial -37%, and subsequently recovered +30% to end down -18%. It is continuing its recovery trend. Strikingly, the S&P 500 price index is closely following this trend.

S&P 500 Futures Implied Dividend Yield vs Treasury Yield (%)



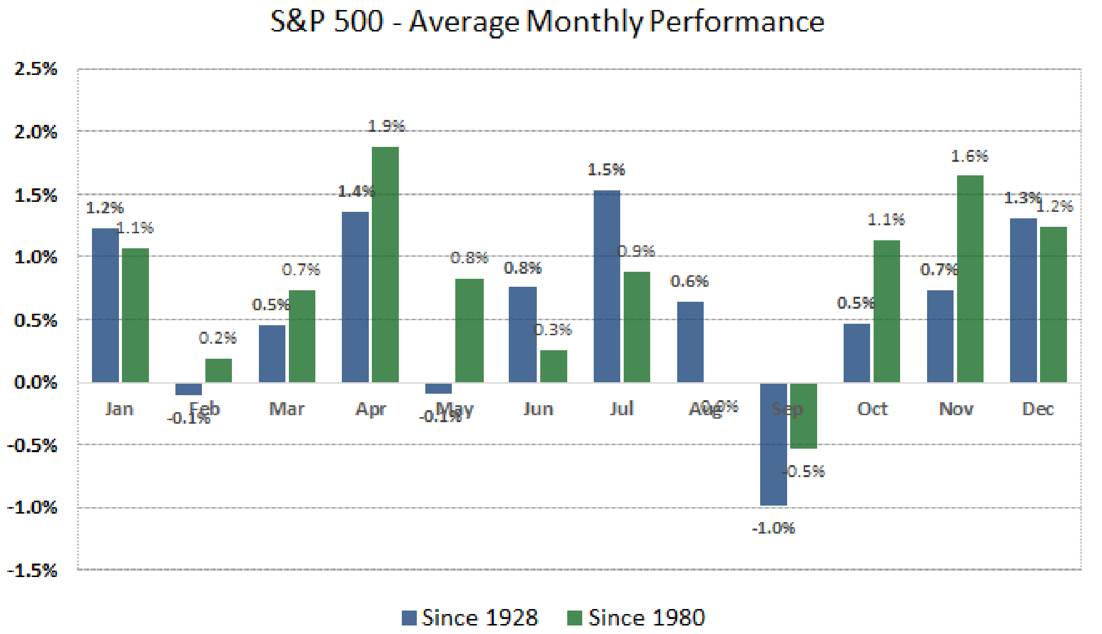
We show in the above chart the implied forward dividend yield compared with the Treasury yield. The bottom section reflects the yield spread, currently at 1.04%. Considering spreads since 2017, this argues in favour of equity investing at the cost of treasuries. To put it another way, the bottom chart implies that equities already provide for a scenario of Treasury yields rising by more than 1%. On this basis, equities cannot be labelled as being overvalued.

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

4. INVESTING ON AVERAGES

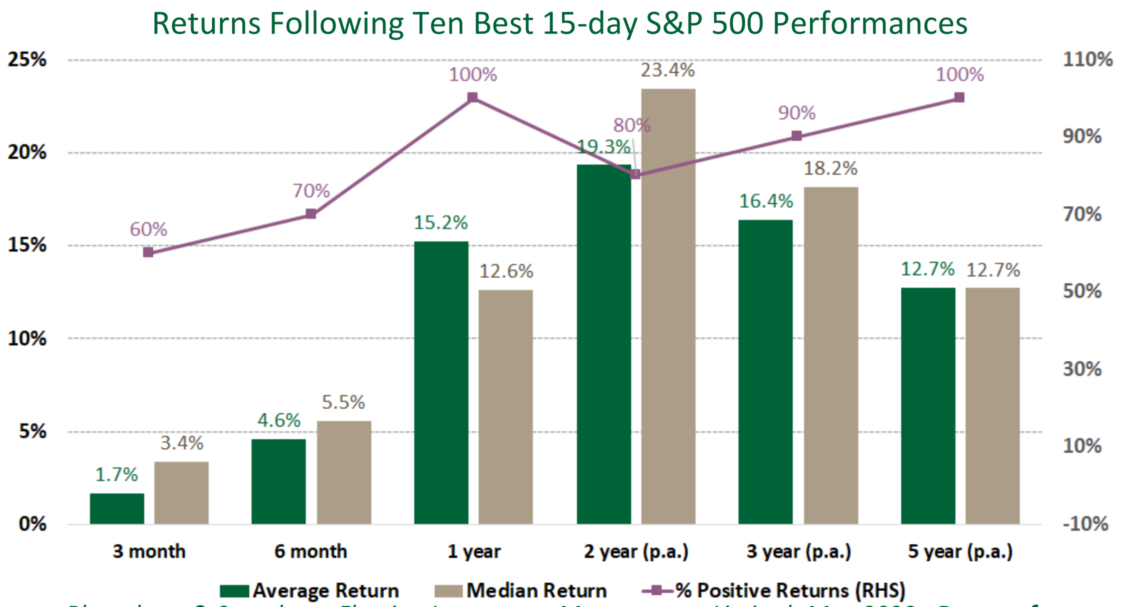
We fully realise investors cannot rely only on historical averages to make investment decisions about new investments, but 'history often rhymes' to quote Mark Twain. We have two interesting analyses in this context:

Some traders still consider a 'sell in May' strategy on the basis that returns from May through to October traditionally lag the other months. The following chart depicts the full picture on data since 1928 and 1980:



Whilst the above comment on seasonal performance is true (on average), returns over the weaker season remained positive (on average) and actually lower overall annual returns by about 3% (on average) should they be missed. Strikingly, April has this year again been a strong month (as it traditionally is), and May traditionally has also been relatively strong (on the data since 1980). It therefore becomes clear that one will need extreme astuteness to try timing the market over this weaker season to be able to add value to a portfolio by trying to actively trade it.

We have just witnessed a record 15-day return of +22% off the depressed base following the GVC collapse. Investors may be skeptical whether such a strong performance can still lead to further good performance. The following chart reflects performance data following the other ten best 15-day performances:



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

It appears from the chart that good 15-day S&P performances are traditionally followed by further attractive returns (on average). The probability of positive returns after one year exceed a 3:4 ratio (see the line on the chart).

Of course, the base and the fundamental circumstances under which the high 15-day return occurs are important. The current one occurred off a low base after a severe sell-off because of GVC.

5. EARNINGS CYCLE

As we explained in paragraph 2, analysts seem to become less negative on their earnings revisions. Capital markets often foresee such changes in perceptions. We are interested to understand the relationship between changes in share prices compared to changes in earnings cycles.

S&P 500 – Price Index vs Earnings

It is clear from the above chart that the peaks and troughs of share prices and earnings seldom coincide. We have done a full study of the historic timings of the troughs in the two series. The findings are reflected in the following table:

S&P 500 – Price Troughs vs Earnings Troughs

Earnings Cycle		Troughs		Trough Timing Difference	
Start	End	Date of S&P 500 Trough	Date of EPS Trough	in Weeks	in Months
08/1957	04/1960	10/1957	03/1959	75	17
04/1960	12/1969	10/1960	06/1961	35	8
12/1969	11/1973	05/1970	06/1970	5	1
11/1973	01/1980	10/1974	11/1973	-44	-10
01/1980	07/1981	03/1980	03/1980	1	0
07/1981	07/1990	08/1982	07/1983	50	12
07/1990	03/2001	10/1990	06/1992	90	21
03/2001	12/2007	09/2002	04/2002	-23	-5
12/2007	12/2019	09/2009	12/2009	16	4
			Average	23	5
			Median	16	4

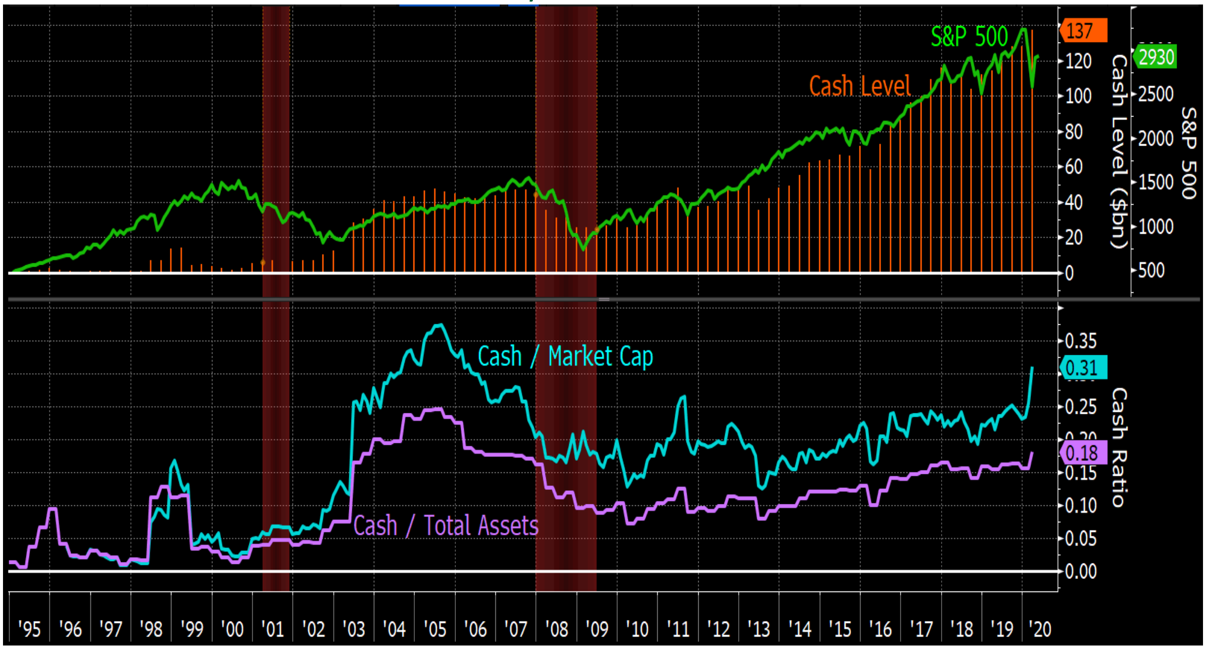
Historically share prices trough on average five months before earnings do, with the median number not far off. The reverse situation occurred with the Oil Crisis in the seventies and the overvalued technology bubble at the turn of the century, both having more enduring negative effects on share prices. Nevertheless, on this basis it seems that investors should caution against waiting too long for good earnings news before engaging with equities.

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

6. BERKSHIRE HATHAWAY

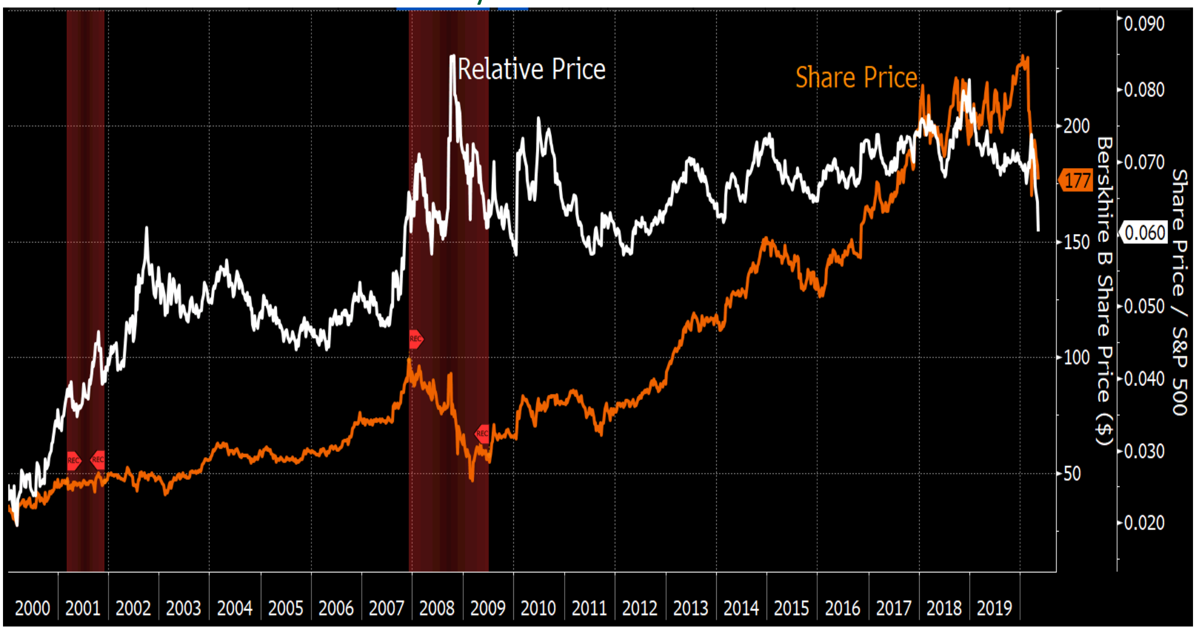
The news of Berkshire Hathaway's huge cash pile of $137bn draws a lot of attention. Many consider them as a safe haven under current dire economic conditions.

Berkshire Hathaway – Cash Level vs Share Prices



Their cash holdings now equals 31% of their market capitalization, a level last seen in 2005. Whilst this may be perceived positively, shareholders are also conscious of the cash pile predominantly having a positive correlation with rising share prices (see the top section of the above chart). Shareholders have clearly been missing out hugely on many opportunities since the Credit Crisis. They have good reason to now focus on the utilisation of the investment opportunities GVC brought their company.

Berkshire Hathaway –Share Price & Relative Share Price



Whilst the share did well on an absolute basis following the GFC, on a relative basis the performance has been quite lacklustre (the white line in the chart). In fact, it has materially underperformed since 2018, and particularly with GVC. The relative performance has effectively stood still since 2008.

It is interesting that Berkshire recently bought Delta Airline shares, and afterwards reversed their decision and sold all their four airline companies' shares. It is also striking that they suspended their buy-back program in March despite their low share price (which is not recovering with the market).

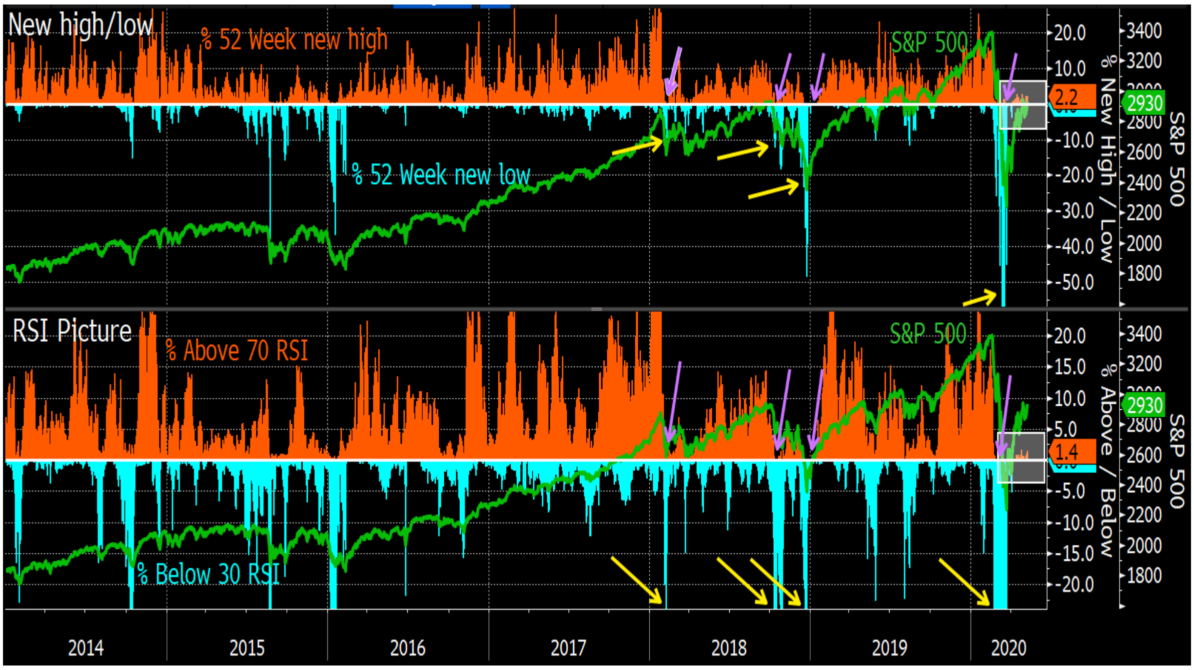
Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2020. ***Past performance should not be used as a guide to future performance.***

Berkshire Hathaway shareholders may face two dilemmas – their cash pile has not been put to proper work and about two thirds of their portfolio is invested in more cyclical type of businesses whilst the 'new normal' that GVC has caused, is prescribing very different types of holdings that are more focused towards sustainable quality. At least Berkshire has the dry powder to start addressing this structural issue.

7. TECHNICAL PICTURE

The following chart offers a good summary of the current technical picture:

S&P 500 vs % of Shares at 52 Week High/Low and Above/Below 70/30 RSI Volatility Levels



As reflected in the two highlighted boxes to the right of the charts, the current relevant percentages for both charts are at very low levels. This reflects a neutral technical picture with little excessive risk in this context.

Our thoughts are with everyone affected by COVID-19, be it directly or indirectly.

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.stonehagefleminginvestments.com/gbi

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

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Stonehage Fleming Investment Management Limited
15 Suffolk Street
London
SW1Y 4HG

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