GLOBAL EQUITY PERSPECTIVES 14 MAY 2018

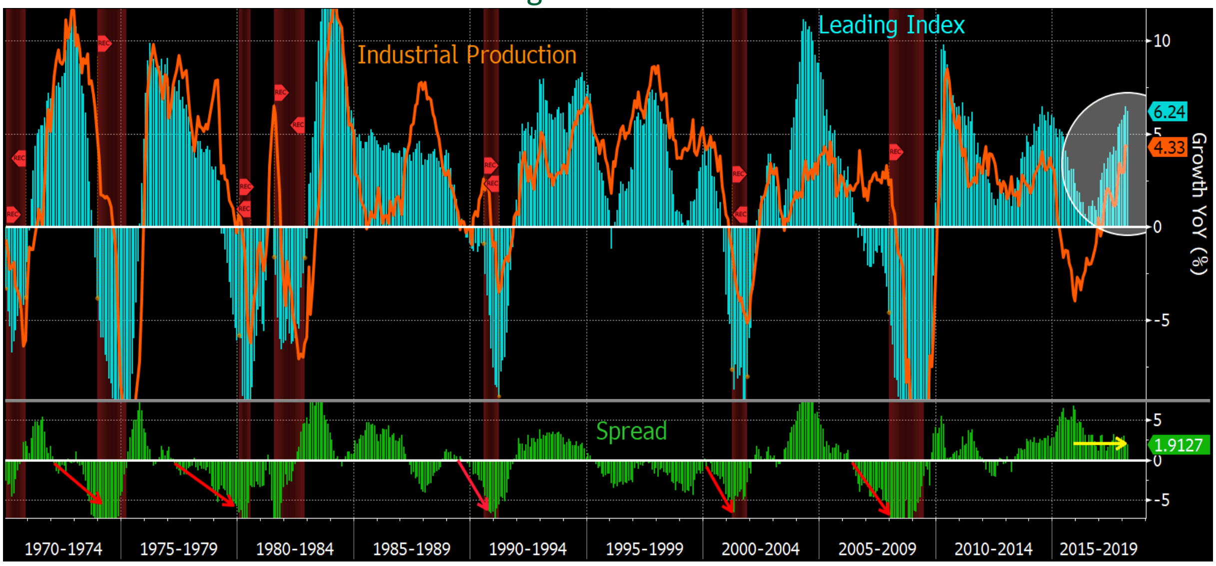
"There are more things that frighten us than injure us, and we suffer more in imagination than in reality."

Seneca the Younger

1. ECONOMIC SUPPORT

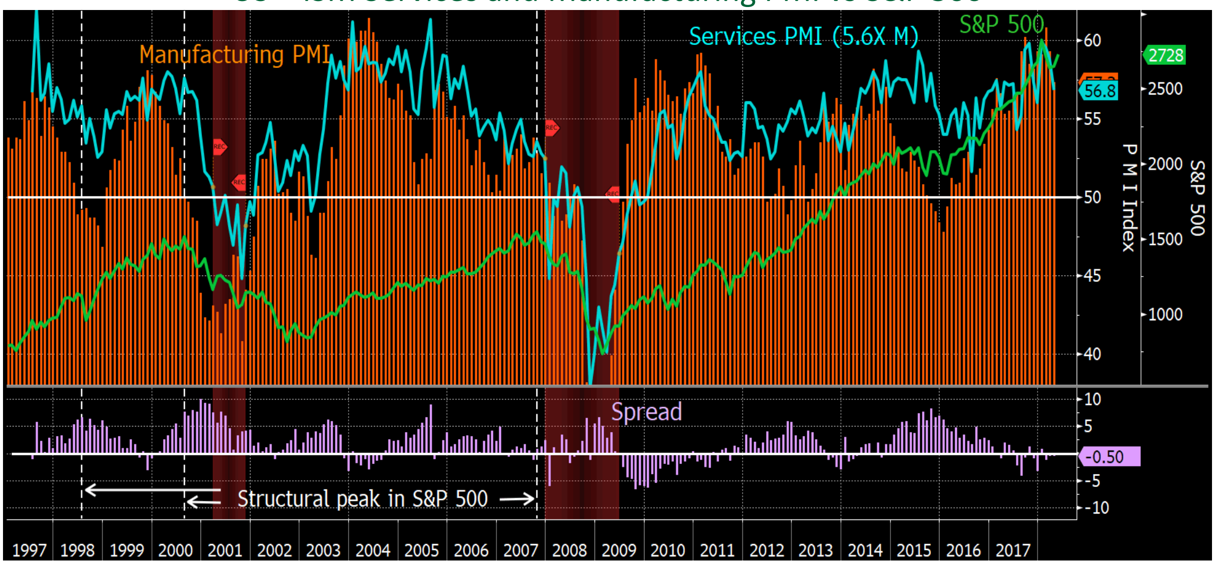
We monitor the risk of an upcoming US recession relentlessly because share prices have historically had their structural peaks a few months prior to a recession starting.

US – Conference Board Leading Economic Index vs Industrial Production



Although industrial production makes up less than a fifth of the US economy it can act as an important swing factor. The leading economic index in the above chart is at an elevated level, with industrial production currently growing in excess of 4%. Whilst both series are currently supportive of equity investing, the spread between the two also has offered valuable guidance well in advance of previous recessions (see the red arrows in the bottom chart). This spread also provides a constructive conclusion currently.

US – ISM Services and Manufacturing PMI vs S&P 500



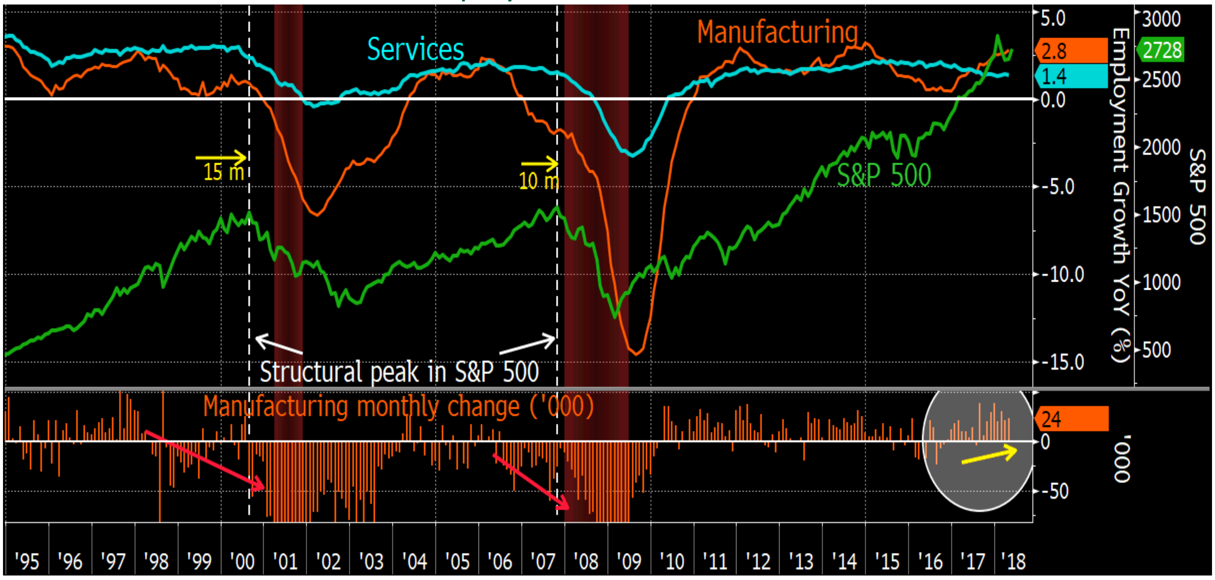
Source: Bloomberg & Stonehage Fleming Investment Management Limited May 2018. Past performance should not be used as a guide to future performance.

The Manufacturing PMI has a better record than the Services PMI in calling the structural peaks in share prices when the reading crosses the expansionary 50 reading level downwards (see the preceding chart). Both indices are currently at elevated levels. Whilst we may expect some deterioration in either or both going forward, their current levels leave ample room to remain constructive.

2. US EMPLOYMENT

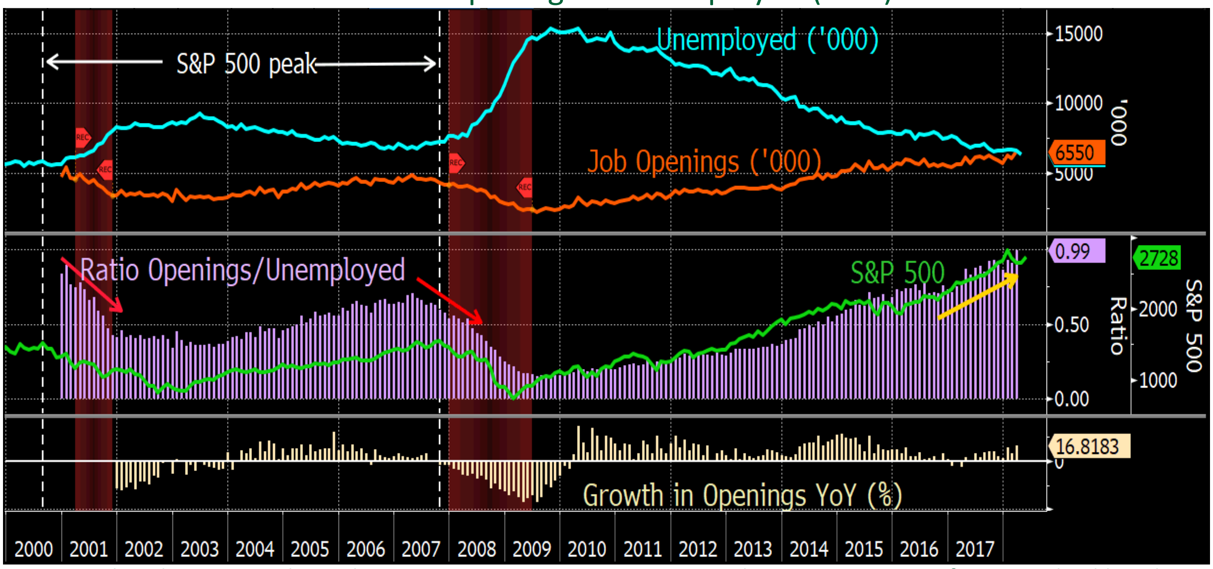
The US unemployment rate dropped to a very low level of only 3.9%. The most recent reading below 4.0% was at the end of 2000, shortly before that recession. Whilst this may sound alarming to some, we would remind our clients that it is rather the <u>growth</u> in the unemployment level that has historically provided a valued warning in this context (when the growth becomes positive). The growth number is currently -11%, which is more assuring.

US – Employment Growth vs S&P 500



The employment growth in the critical industrial sector is currently accelerating at +2.8%. This provides a constructive view for continuing economic expansion whilst the growth in the services sector is stable at half that level. The monthly change in manufacturing employment numbers (bottom part of the above chart) is also constructive considering experiences in this context historically.

US – Number of Job Openings vs Unemployed ('000) vs S&P 500



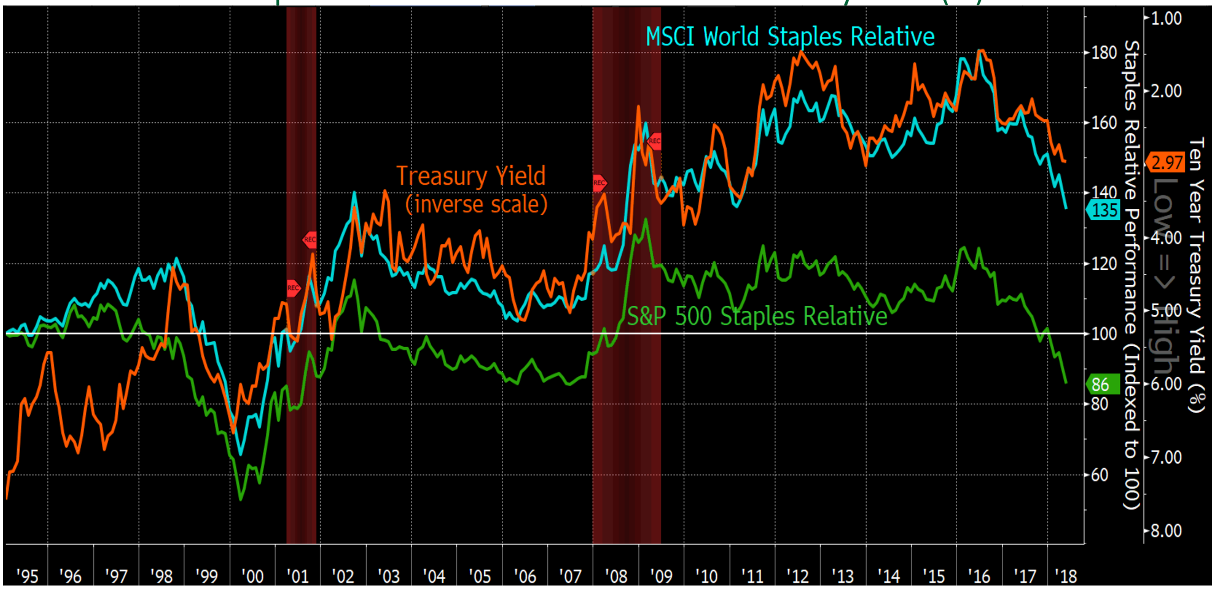
Source: Bloomberg & Stonehage Fleming Investment Management Limited May 2018. Past performance should not be used as a guide to future performance.

The number of new job openings keep rising, whilst the number of unemployed are dropping, to the extent that the openings are approaching the number of unemployed. The current ratio of 0.99 between these two numbers is at a record level this century, with the growth in openings at +16% (see the bottom section of the preceding chart). With the ratio historically receding in the run-up to structural peaks in share prices and recessions, all this information seems constructive for equity investing.

3. STAPLES BOMBED

The Staples sector has underperformed recently following the inception of the bear market in the fixed interest market:

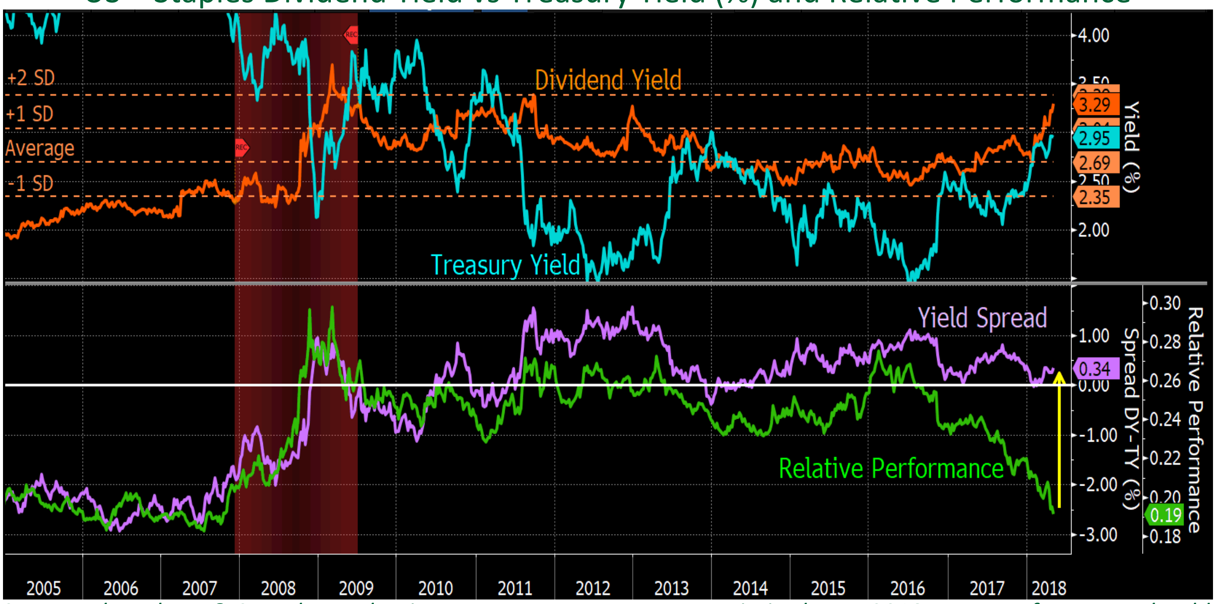
Staples Relative Performance vs US Treasury Yield (%)



The relationship between the sector's relative performance and US interest rates is strong for several fundamental reasons (the interest rate line is on an inverse scale in the above chart). With expectations of further interest rate rises the immediate outlook for this sector does not appear that attractive from a macro point of view.

That having been said, it strikes us that the S&P 500 Staples sector's relative performance is already approaching the preceding low levels and that the sector outperforms in the anticipation of a recession and then during a recession.

US – Staples Dividend Yield vs Treasury Yield (%) and Relative Performance



Source: Bloomberg & Stonehage Fleming Investment Management Limited May 2018. Past performance should not be used as a guide to future performance.

The sector's relative performance opened up (lowered) against interest rates materially over the past year (see the yellow arrow in the preceding chart). This has brought its dividend yield to a +1.5 standard deviation level against its history since 2005. This seems to be quite an attractive level from an income point of view.

Our impression is that the rising interest rate tide can remain a headwind against the sector for a while still, probably until the economic outlook starts deteriorating. From a valuation perspective it may well be approaching attractive levels already and income orientated investors fearing capital destruction in the fixed interest rate market may be sharpening their pencils slowly.

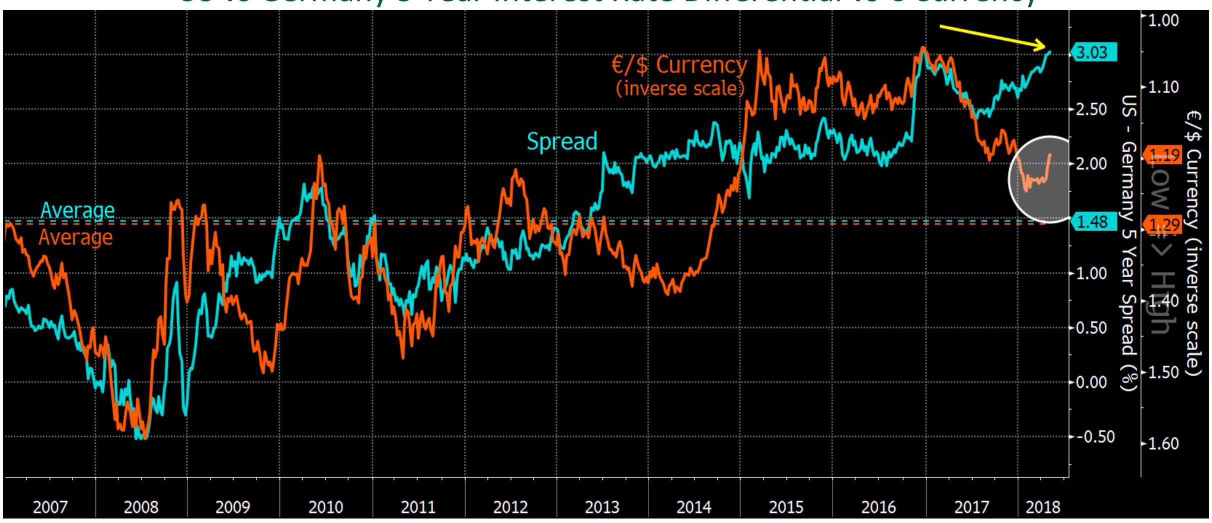
Against this backdrop, many investors wonder what level of interest rates the equity market is already discounting. Our crystal ball comes up with the following simplistic attempt:

S&P 500 – Forward Earnings Yield vs Treasury Yield (%)

The spread between the earnings and treasury yields show three distinct phases – the pre dot-com bubble phase, the post dot-com bubble phase and the quantitive easing phase. We are most probably now entering the post credit-crisis normalised phase. We have little argument against targeting the average over all these phases (1.5%). On this basis, the earnings yield is currently +1.3% above this average. Adding this 1.3% spread to the current 3.0% treasury yield, we conclude that the market effectively implies that it expects the treasury yield to advance to 4.3% in the foreseeable future (should the economic recovery stays its course). Interestingly enough, that takes us to pre-credit-crisis levels.

4. CURRENCY RISKS

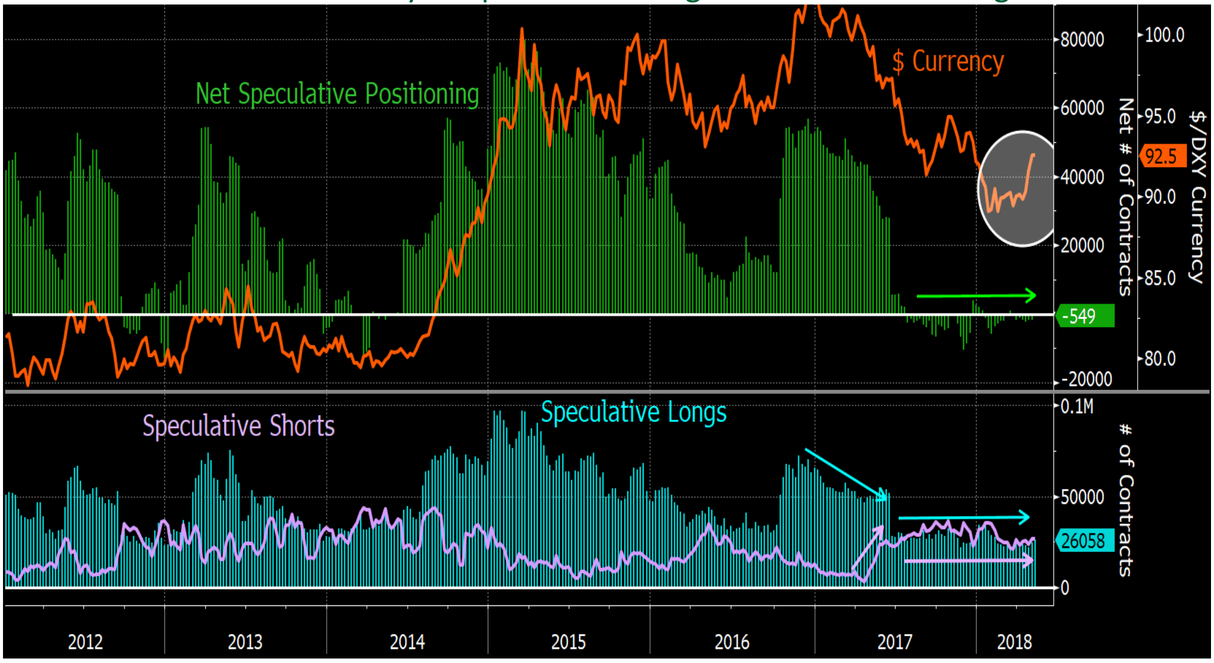
US vs Germany 5 Year Interest Rate Differential vs € Currency



Source: Bloomberg & Stonehage Fleming Investment Management Limited May 2018. Past performance should not be used as a guide to future performance.

It strikes us that the interest rate differential of over 3% between the US and Germany five-year rates are at a ten-year record. As reflected in the preceding chart, this seems to start attracting € currency money into the US and the € seems to not be that strong anymore.

Dollar Currency vs Speculative Long and Short Positioning



The preceding comment can also be considered in the context of speculators' positioning in the Dollar. There has historically been a reasonable correlation between the currency's direction of travel and the net speculators' positioning (see the top section of the above chart). The net positioning has now been flat for a year, implying that currency experts are reluctant to take a strong view on the currency. This implies that a change in this context may have a more profound effect on the currency.

There is a valid fundamental view that the growing US budget deficit may keep the Dollar from appreciating. For that to take full effect, we suspect US interest rates should therefore hold their horses, or European interest rates should start appreciating more aggressively. A combination of all these may be the end outcome, but in the interim we must take cognizance of the Dollar not continuing its downwards trend of the past year. European companies suffering from their strong currency may feel more hopeful for some mercy on this front.

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.stonehagefleming.com/gbi

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

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