GLOBAL EQUITY PERSPECTIVES 10 SEPTEMBER 2018

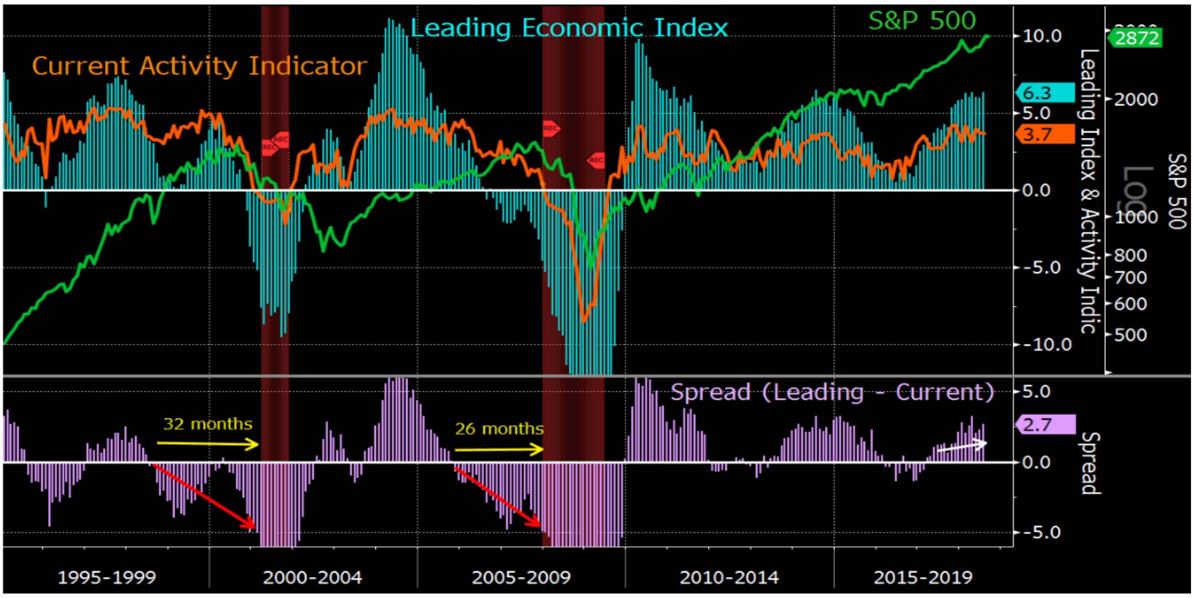
"I like constructive criticism from smart people."

Prince

1. US ECONOMY

The most important issue for the global capital markets remains the health of the US economy. The following chart provides good information in this context:

US – Conference Board Leading Economic Indicator & Goldman Sachs Current Economic Activity Indicator



Goldman Sachs's current economic indicator remains stable at relatively elevated levels. Further to this, the spread between this series and the Conference Board's leading economic index has historically provided valuable early warning signals of a potential slowdown, and a subsequent recession (see the yellow arrows in the above chart). This spread remains constructive.

US – ISM Manufacturing PMI vs Consensus S&P 500 Earnings Growth (%)

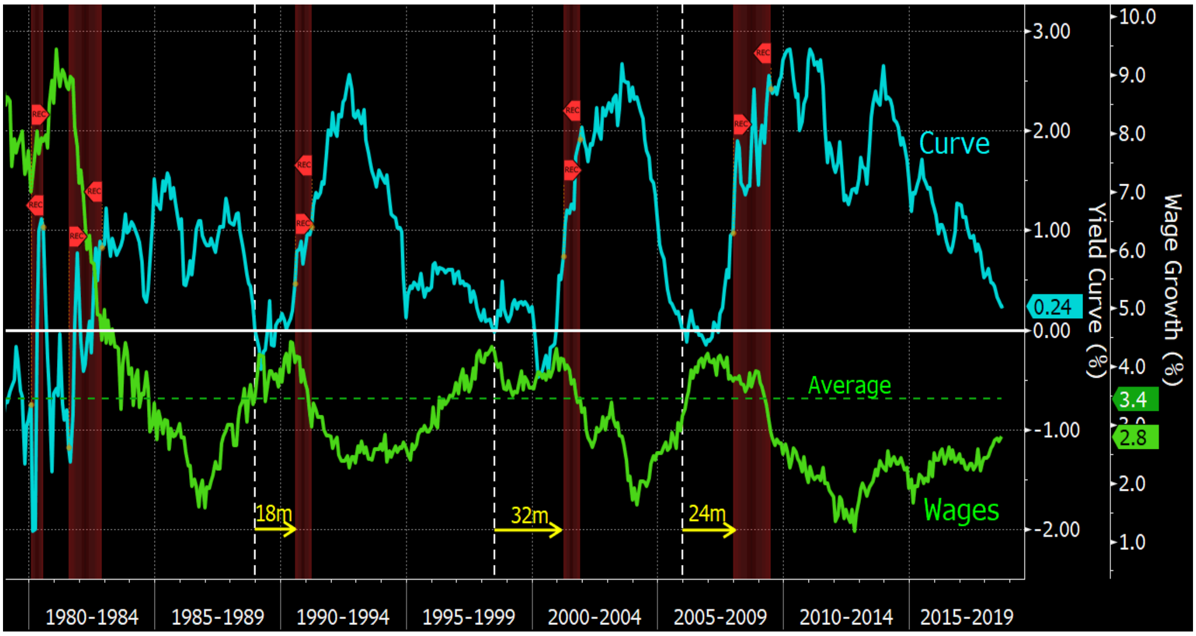
The Manufacturing PMI has increased to a 14-year record. Expectations for earnings growth remain elevated, in excess of a fifth. US economic fundamentals seem to remain strong.

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

2. US WAGES

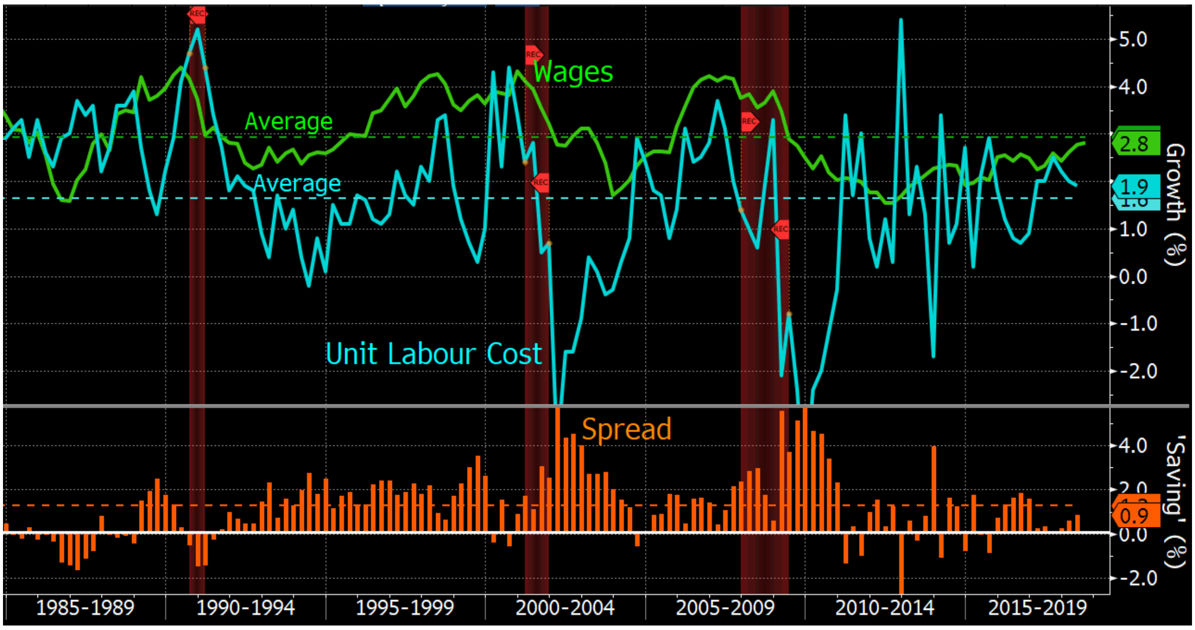
US employment data is strong, with new employment almost double the long-term average and record low unemployment. Wage increases continue in an upwards trend, currently at +2.8%. Investors continue questioning whether this, combined with the flattening yield curve, may pose risk for capital markets.

US – Yield Curve vs Wage Growth (%)



We have made our stance on the flattening yield curve clear in our previous note and make the point again that it has not flattened yet, and that when this happened historically it provided (on average) a two-year early warning of the next recession. The inverse relationship with wage growth is clear in the above chart, and also that the current level of wage growth is still materially lower than the levels preceding recessions historically. The combination of these two considerations keep us on the side of equity investing.

US – Wage vs Unit Labor Cost Growth (%)



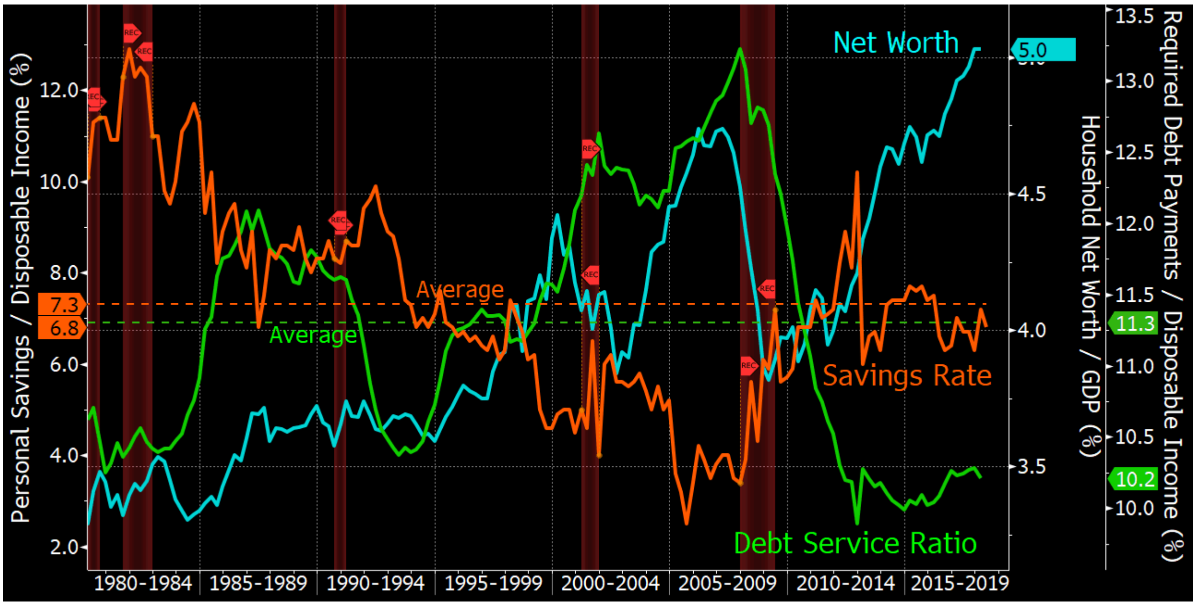
The above chart shows wage growth along with growth in unit labour cost, with the latter currently receding. This implies that higher productivity absorbs some of the wage increases (reflected in the spread chart at the bottom). This is clearly important fundamental information, and supports higher wages that can be released into consumption and further support for the economy.

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

3. US HOUSEHOLD FINANCES

We have received an intersting question whether there is not risk of US households becoming urged to offload their equity profits and depress share prices. The following charts sheds some light in this context:

US Households Finances



Households' net worth has risen to a record 5.0% of the US GDP. Previous recessions were preceded with peaking net worth ratios. We currently have two major differences in this context against the two preceding recessions:

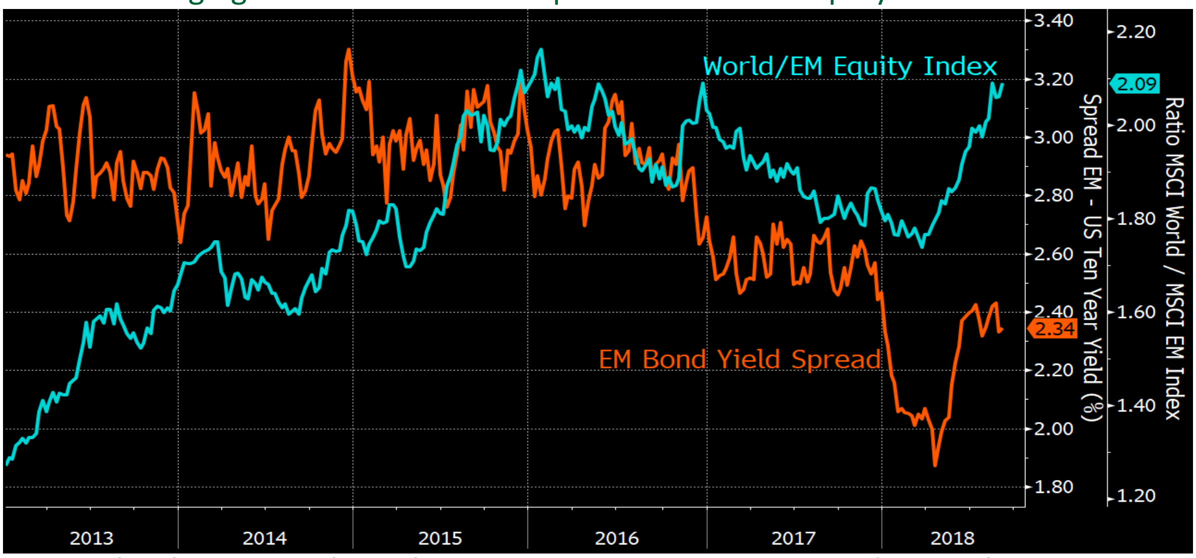
- Their debt service ratio used to peak close to the previous recessions. The ratio is currently close to record low levels.
- The current savings rate is close to the long-term average and materially higher than the levels preceding the previous two recessions.

It seems that households have less reason currently than before to 'cash-in' on their record-high net worth.

4. EMERGING MARKET VOLATILITY

The current volatility in many emerging markets (EM's) fits into the developments of the exuberance earlier this year in their bond markets, as reflected in the following chart:

Emerging Markets Bond Yield Spread vs Relative Equity Performance

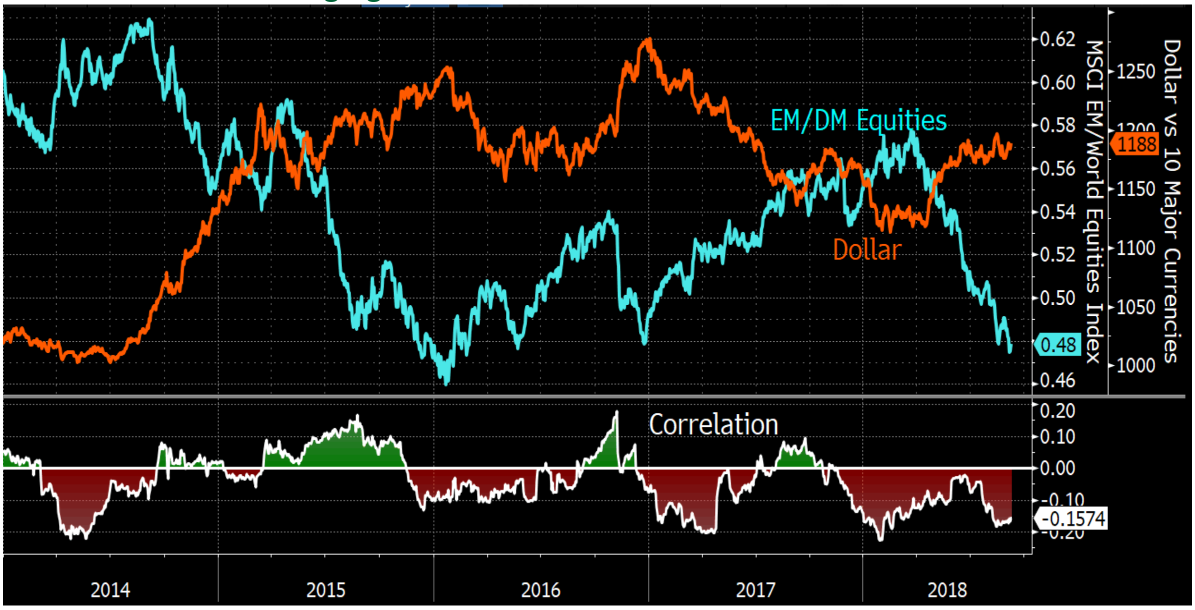


Source: Bloomberg & Stonehage Fleming Investment Management Limited. September 2018. Past performance should not be used as a guide to future performance.

Some of the EM bond market exuberance has corrected already and took equity performances along in this correction process. The bond market spreads are now closer to the levels of last year and we can hopefully conclude that the worst of the necessary correction may be close to being done.

Many blame the strong Dollar directly for the EM volatility. We are not sure the Dollar deserves all the blame, and rather reflect on the generally weaker EM economies. The following chart sheds some light in this context:

Emerging Markets Relative Performance vs Dollar



Although there has historically largely been a negative correlation between the Dollar and the relative performance of emerging market equities, the level of this correlation has been relatively low. Along with this, we conclude the following from the chart:

- The (negative) correlation has recently been close to its five-year record low.
- Emerging equities' underperformance is currently close to its five-year record low.

Although the recent emerging market experiences have been painful to many, it does not seem totally out of the ordinary, and as illustrated in our initial chart, in some way seems to result from earlier exuberances with the Dollar making less of a contribution.

The following chart illustrates an interesting anomaly currently in emerging equities:

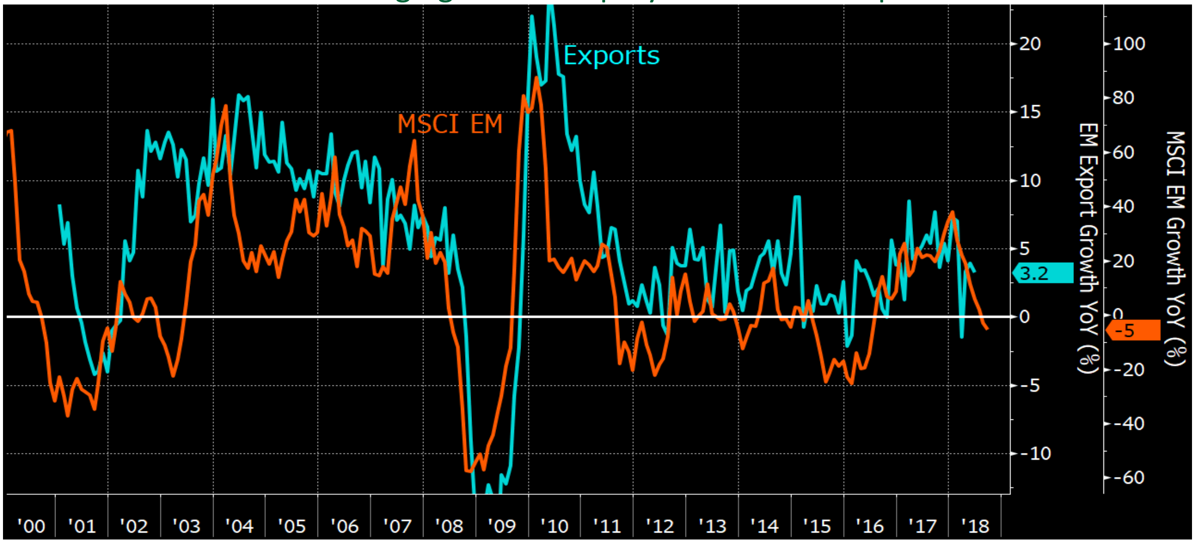
US ISM Manufacturing PMI vs Emerging Equities

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

The historically strong correlation between the US PMI data and the growth in EM equities' share prices broke down this year. The weak emerging currencies clearly have something to do with this, but the discrepancy seems to be wide at the moment.

The following charts provides an interesting perspective on EM trade:

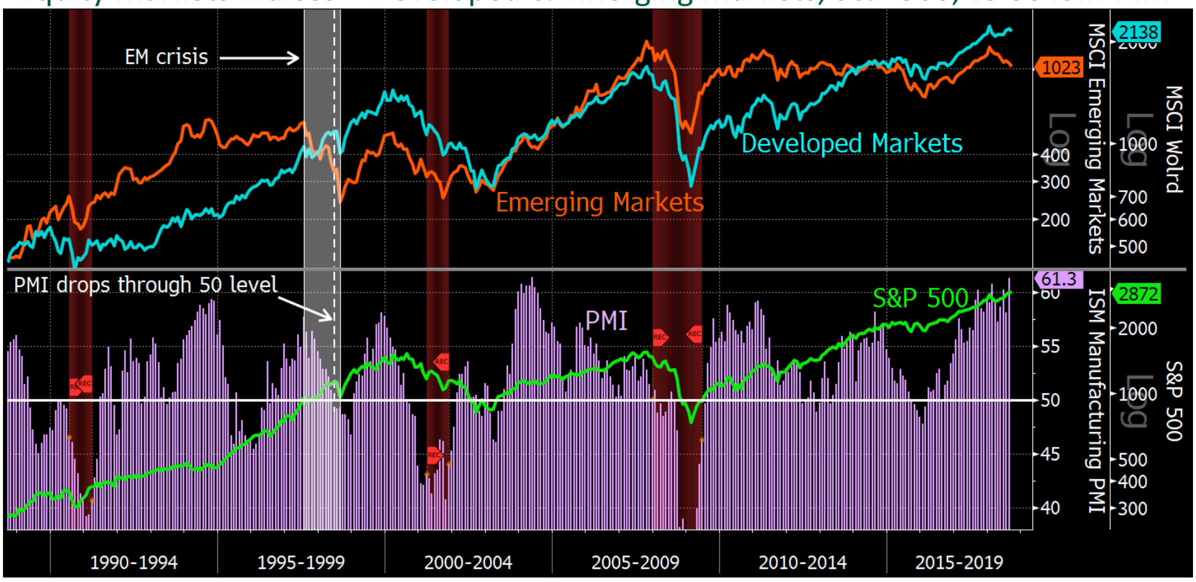
MSCI Emerging Market Equity Index vs EM Exports



EM shares have historically performed well in line with international trade data. It seems that experiences on the export front remains on course and should continue to support their economies.

The 1997/98 emerging market crisis comes to mind under these circumstances. The following chart offers interesting perspectives in this context. We highlight the EM crisis period on the chart:

Equity Markets Indices – Developed & Emerging Markets, S&P 500, vs US ISM PMI



As currently, that crisis was triggered by currency volatility and was preceded by equity underperformance because of weak economic performance. We have calculated the following data pertaining to that era:

Performance around 1997/98 EM Crisis ($-terms)			
	Preceding Peak to Trough	Trough to Next Peak	Preceding Peak to Next Peak
Emerging Markets	-59%	124%	-7%
Developed Markets	-21%	59%	27%
S&P 500	-19%	60%	29%

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

The following comments are relevant in this context:

- The emerging markets suffered to quite an extreme extent over that period and did not recover to its preceding peak until the next global economic upswing. The level of recovery since its trough in this period, though, was very good.

- Developed markets and the S&P 500 performed in line with each other. The initial depreciation was sharp, but with a short duration.

- Both these markets delivered over a quarter growth to those investors who stayed put over the whole period.

- Importantly, the US PMI dropped through the critical 50 reading level in that period. It was, though, a false alarm and recovered soon into constructive territory again.

- The current US environment is very different, with the PMI at a 14-year record high.

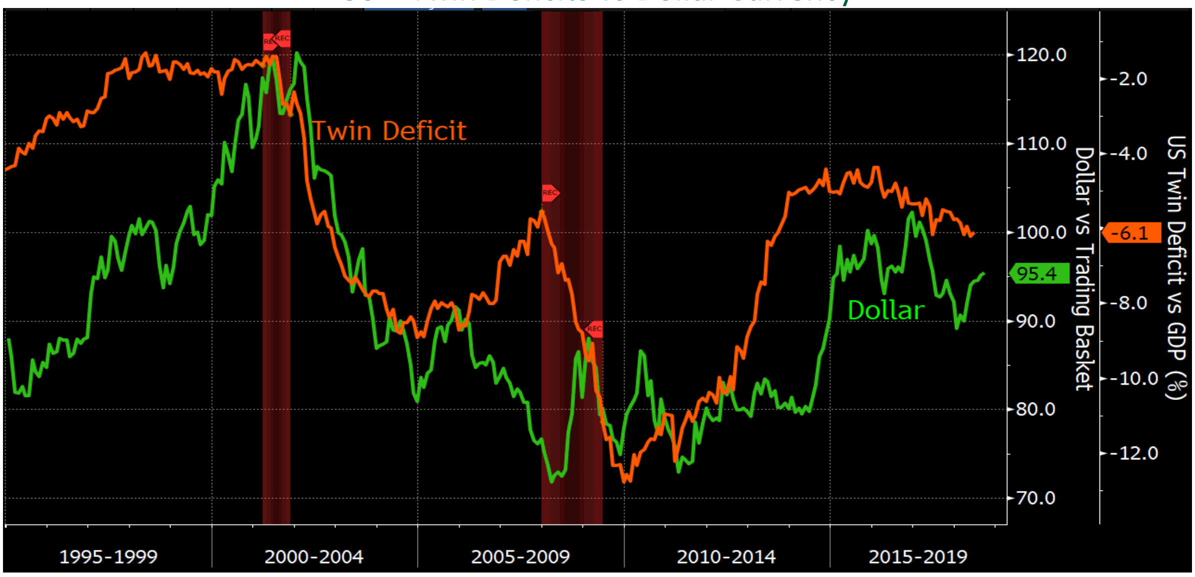
Investors seem to have more reason to stay put currently than with the 1997/98 credit crisis period.

5. DOLLAR STRENGTH

We can all make a strong case for further Dollar strength, and along with that fear of the detrimental effects it can have on the global economy and capital markets. The strong domestic economy and the Federal Reserve tightening process count as two of those arguments.

We are, though, also conscious of two main factors that may later on argue for limited further strengthening potential. The US maintains a huge twin deficit – both the fiscal and current (trade) accounts run large deficits. Their combined deficit is reflected in the following chart:

US – Twin Deficits vs Dollar Currency



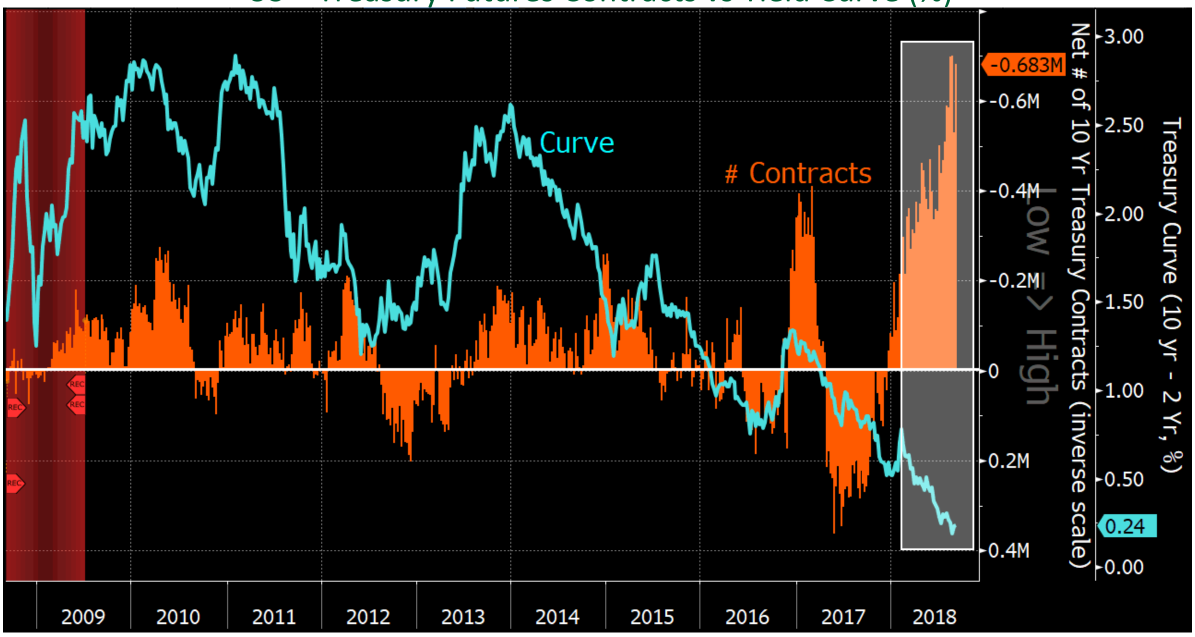
It is clear from the chart that the twin deficits have had a direct effect on the Dollar currency over time, and that the current direction of travel of the former is a continuing growing deficit.

Pres Trump is clearly very conscious of the trade deficit and is making his contribution to improve a more equal trade position for the US. It is, though, not clear yet whether he may cause more harm than good with his endeavors. This current account deficit makes up about 40% of the combined deficit, whilst his efforts to stimulate the domestic economy may well have a larger (negative) effect on the remainder 60% of the twin deficit. We would therefore see somewhat limited further strengthening potential for the Dollar from current levels, and not fear such effects for further investing.

6. INTEREST RATE OUTLOOK

We have shown in recent equity notes that conditions are favourable for the Federal Reserve to tighten further. Many investors fear the potential upwards effect on short rates, and that it can hasten the flattening and reversion of the yield curve. The following chart, though, argues against this theory:

US – Treasury Futures Contracts vs Yield Curve (%)



The orange bars in the chart reflect the net number of ten-year treasury futures contracts. They have historically showed quite a correlation with the yield curve. This relationship has broken down over the past few months (the shaded area), and there is now a high record number of net short contracts in place.

The implied view the owners of these contractors are taking is that ten-year yields will increase. The question then becomes whether that may happen at a faster rate than short rates, and as such stabilise (or reverse) the flattening curve. Should all this pan out this way, it may imply that the next US recession is still some way off.

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