GLOBAL EQUITY PERSPECTIVES 1 OCTOBER 2018

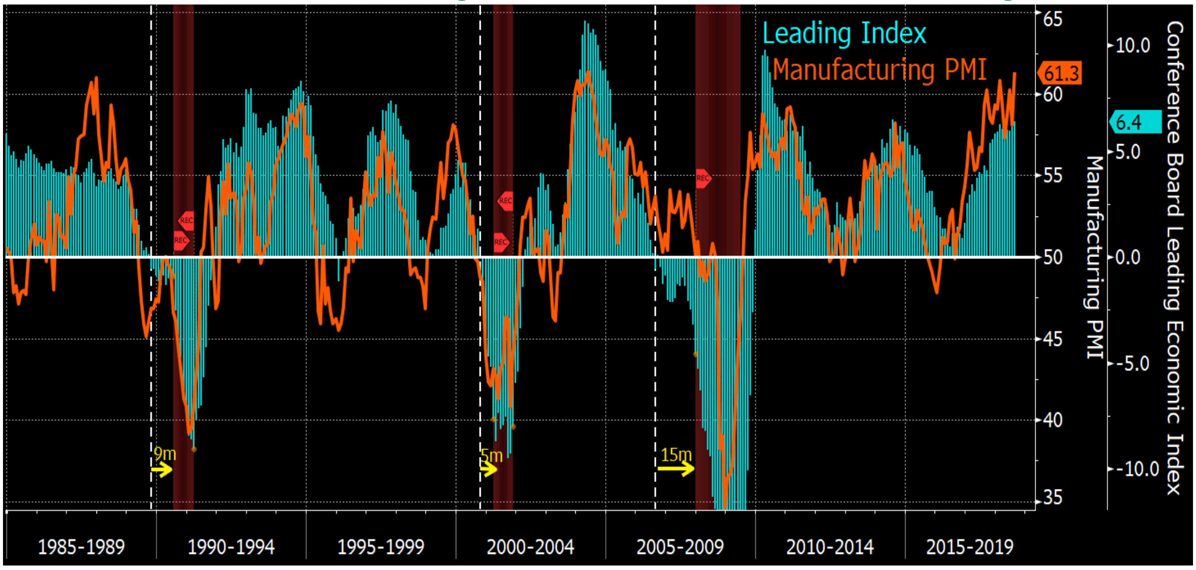
"What can be added to the happiness of a man who is in health, out of debt, and has a clear conscience."

Adam Smith

1. US OUTLOOK

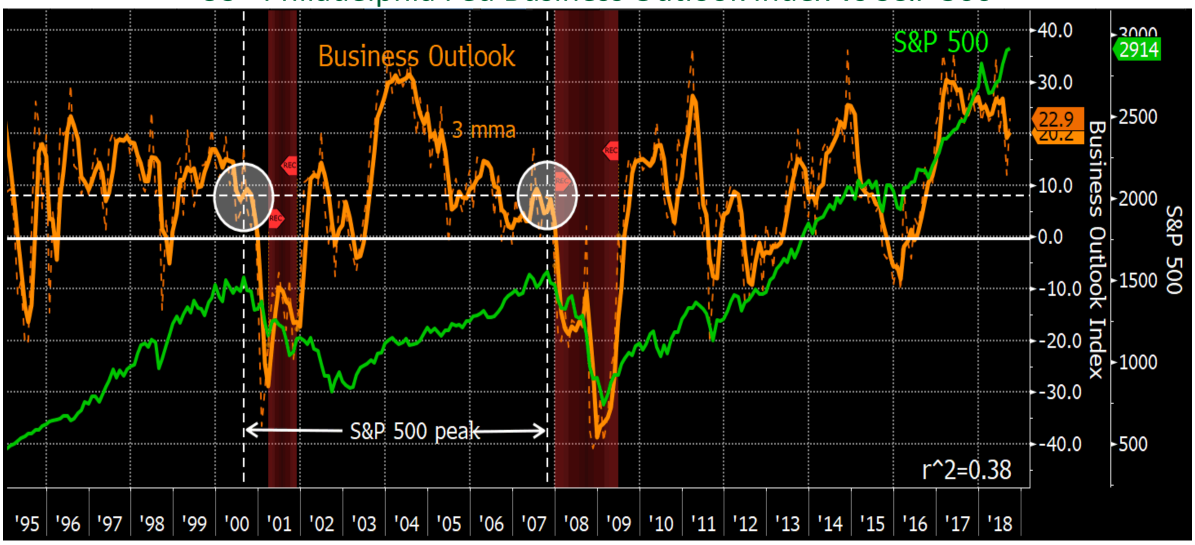
We continue to believe that the most important fundamental issue for the health of global financial markets is the outlook for the US economy. The following chart presents two of the most important leading US economic indicators:

US – Conference Board Leading Economic Index vs ISM Manufacturing PMI Index



Both the leading economic and manufacturing indices remain at elevated levels, with the latter now at a 38-year record high. This confirms that the US business outlook seems more than just constructive, and that company profits should continue to grow at a healthy rate despite their current high base. Sceptics have little reason for doubt about the business outlook for the next few quarters.

US - Philadelphia Fed Business Outlook Index vs S&P 500



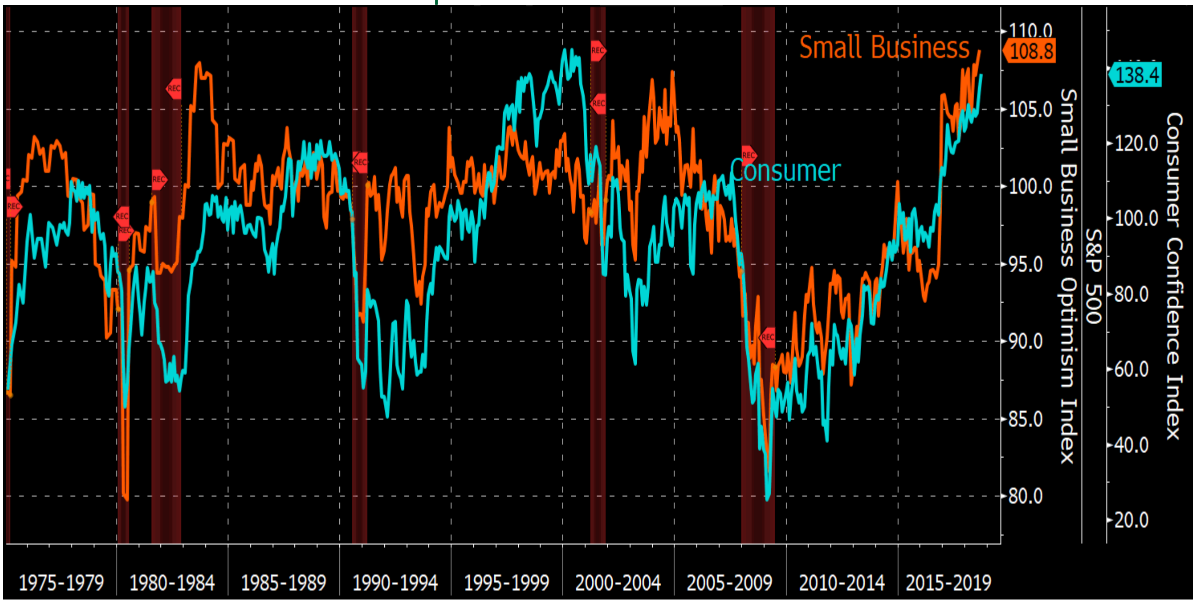
The above business outlook index remains at elevated levels and confirms our conclusion above. The index will have to more than halve to indicate risk of peaking share prices (the horizontal dotted line).

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

2. SMALL BUSINESS OUTLOOK

We have found the following chart particularly striking:

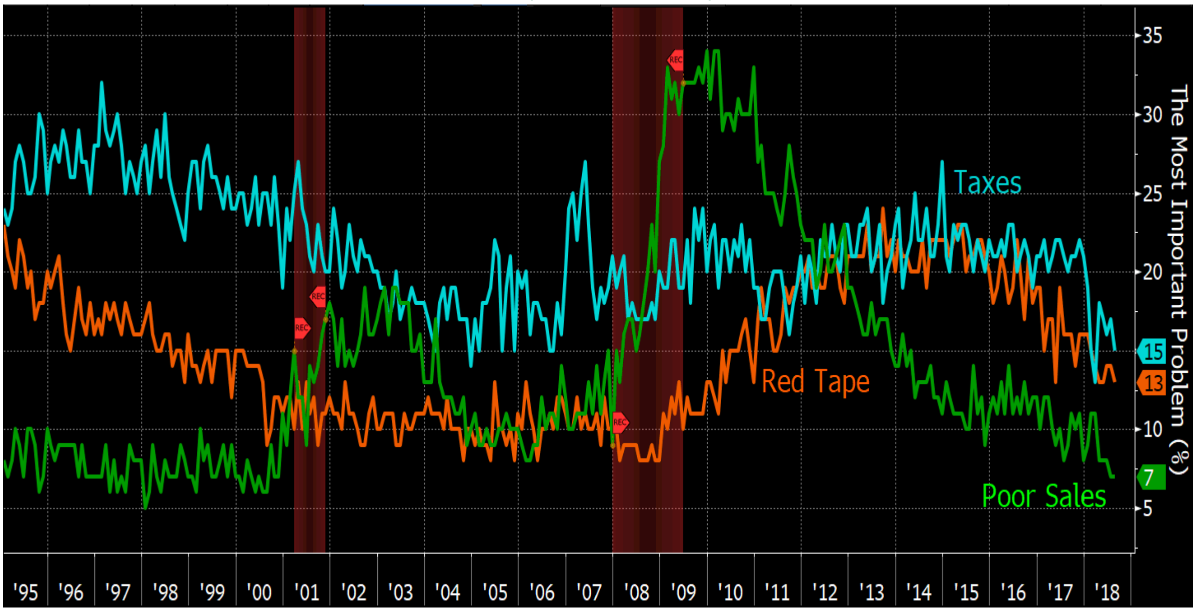
US – Small Business Optimism Index & Consumer Confidence Index



The Small Business Optimism Index has increased to an all-time record, and the Consumer Confidence Index is at an 18-year record high. This clearly bodes well for the US economy, seeing that consumption makes up 70% of the US GDP. Recessions have historically been distant when these indices have been around these levels.

US light truck sales are currently at record levels, growing at +8% on a 12-month volume basis. This reflects the confidence in this group to invest in their businesses.

US Small Business Surveys – Most Important Problems (%)

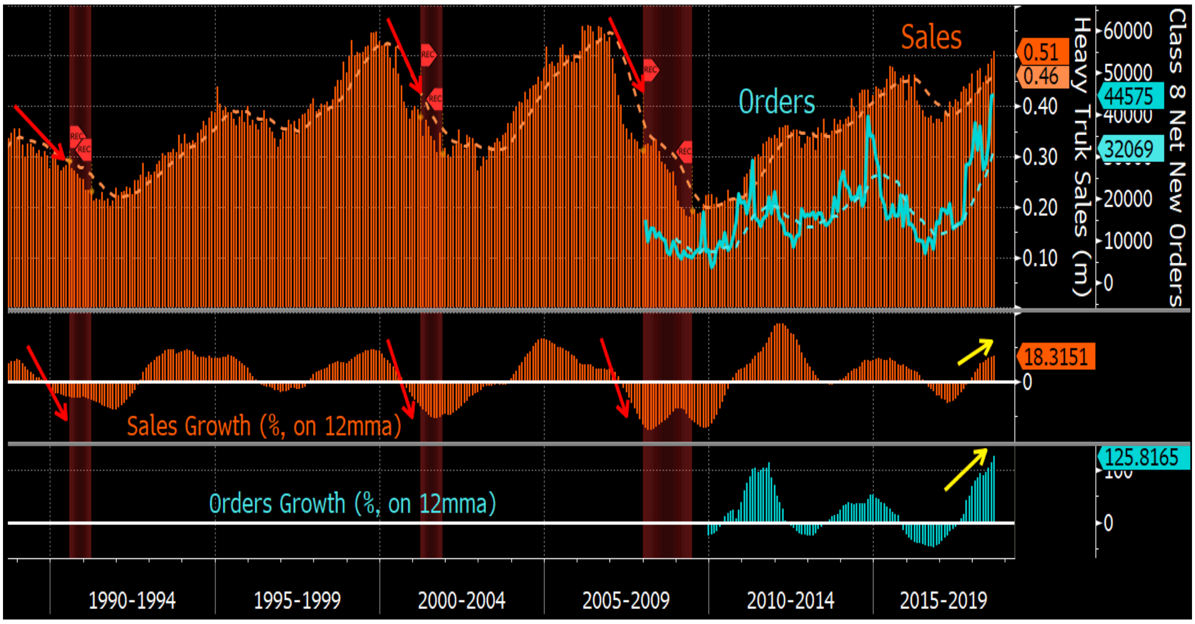


The above reflects important data on the problems small businesses encounter. Sales seem to be the least of the problems currently. Taxes and government red tape remained elevated until 2016, but both have dropped materially since then, the former to very low levels.

As reflected in the following chart, sales of heavy trucks have not recovered as well as the sales of light trucks after the Credit Crisis and have not yet reached the 2008 record levels. They are, though, recovering well now, growing at +18%. Along with this, importantly, orders of such trucks are currently growing at +125% on a 12-month rolling basis, with the volumes at over two-thirds those of the sales volumes.

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

US – Heavy Truck Sales & New Orders (Units)

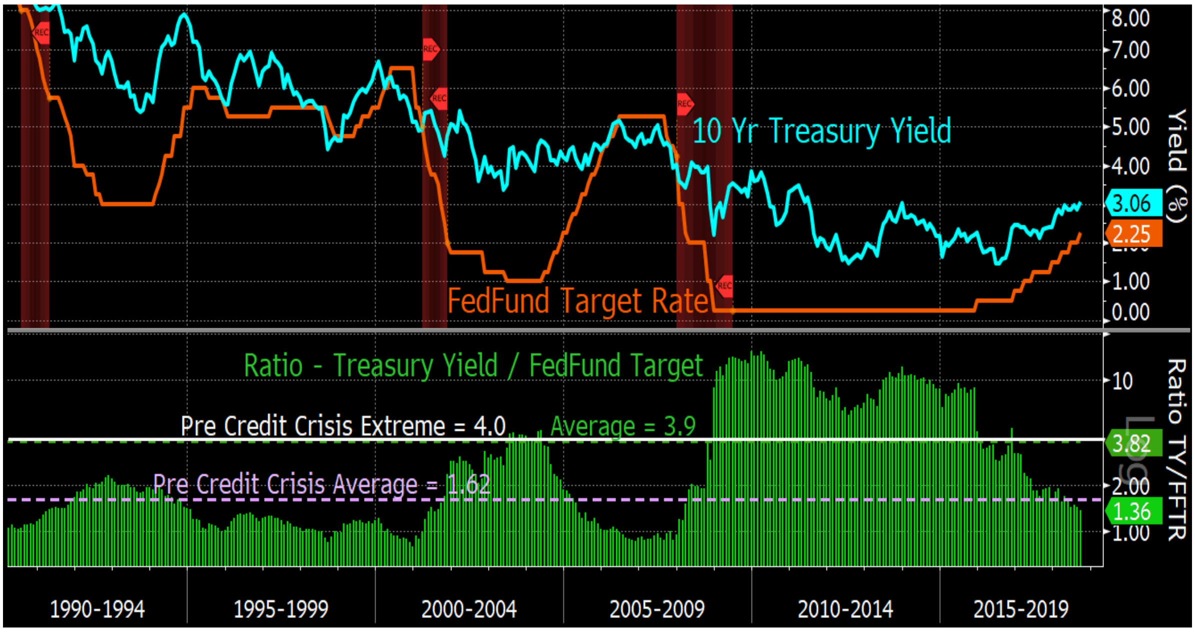


It is clear that it is going well with the US economy and that we can look forward to continuing good company results.

3. FED FUND RAISE

We view the increase of the Fed Fund target rate of last week as further confirmation that the US economy is healthy and can afford the building of 'reserves' for the future. Future inflation expectations are just marginally above the Fed's target of 2.0% and therefore does not in itself require the tightening announced.

US – FedFund Target Rate vs Ten Year Treasury Yield (%)



The above chart reflects the relationship between the target rate and the ten-year treasury yield. The following are the main points to make in this context:

- The current level of the target rate is far from levels associated with an over-heated economy and subsequent recessions. It has ample room to rise further.

- The treasury yield has risen marginally above 3%, but at a slower pace than the target rate.

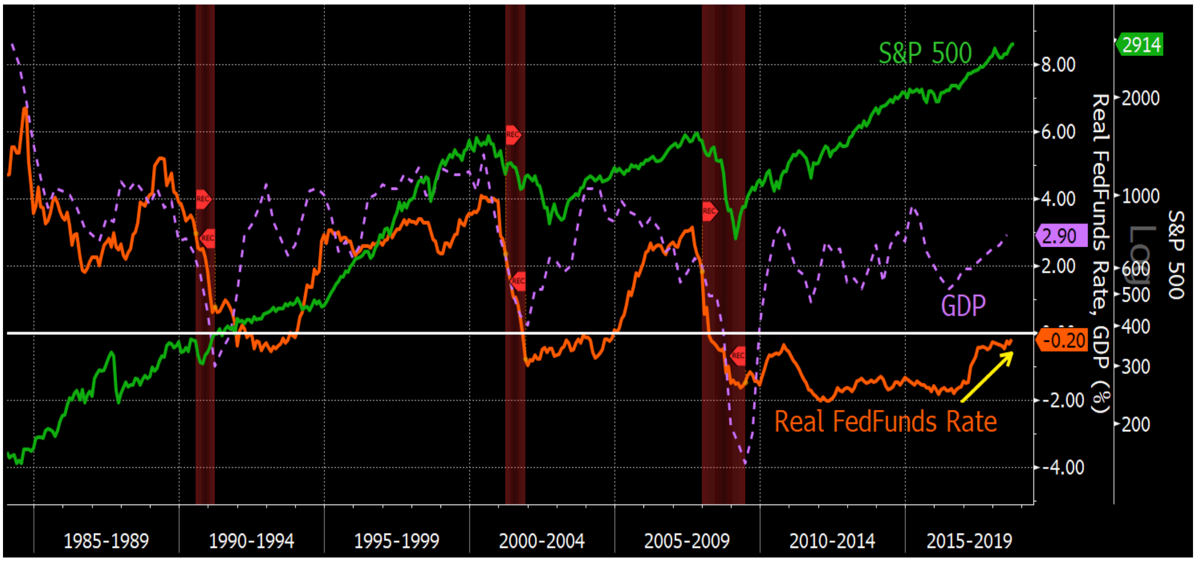
Source: Bloomberg & Stonehage Fleming Investment Management Limited. September 2018. Past performance should not be used as a guide to future performance.

- The current premium (0.36) over the target rate is marginally below the pre-credit-crisis level and implies that the long end of the market may rise further.

- A rising long end may stabalise the flattening yield curve against inverting in the immediate future.

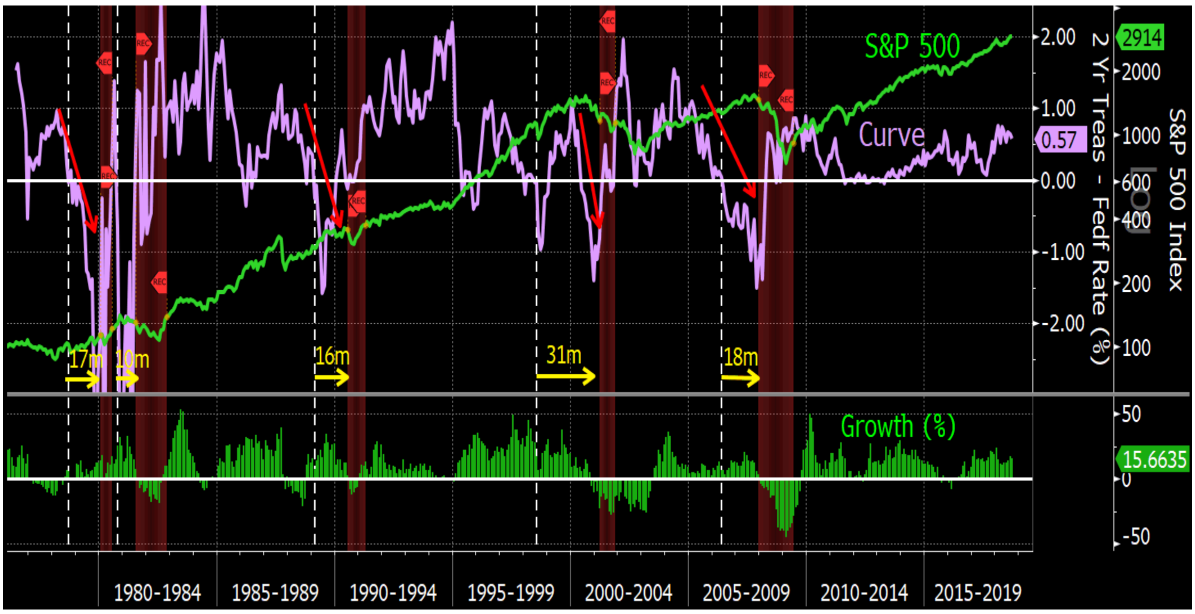
A real target rate usually reflects overall sound economic circumstances. The following chart reflects data in this context:

US – Real FedFund Rate vs S&P 500



The target rate is currently close to being at a real level and has ample room to rise further before it may get to those levels that have historically lead to dampening the US economy (those levels that immediately preceded the previous recessions). On this basis we should rather look forward to further Fed tightening. The following chart provides more context on this comment:

US – FedFund Target Yield Curve vs S&P 500



The target yield curve (against the 2-year yield) of 0.57% is not flattening currently. It would need short rates to stagnate and two further tightening events (of 0.25% each) to flatten the curve, and then an inverting trend to start effecting the economy negatively. Taking historic timings in this context as guide (the yellow arrows), it seems that the next US recession may be around 18 months away from when that may happen.

We showed in a recent note that S&P 500 companies' debt ratios are at below average levels.

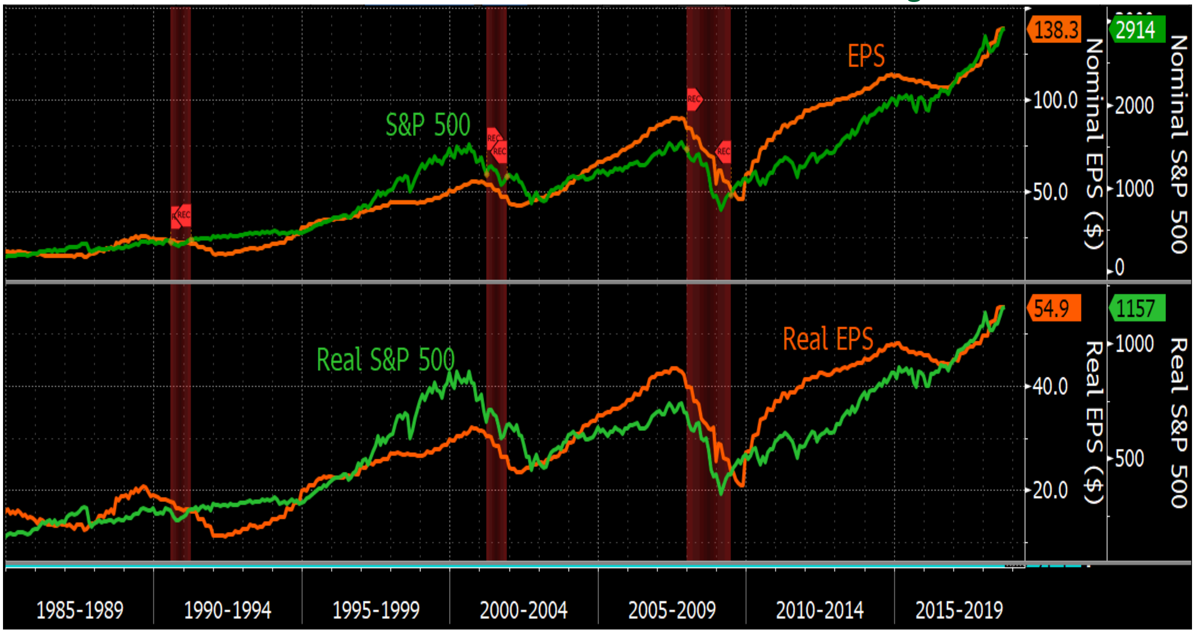
Source: Bloomberg & Stonehage Fleming Investment Management Limited. September 2018. Past performance should not be used as a guide to future performance.

4. PEAK PRICES

We come across many concerned about the length of the current bull market and the level of share price recoveries. Our first comment on this would be that the fundamental outlook and valuation levels are the primary issues to consider in this context. We have hopefully already been clear on the former issue, and in terms of the latter our stance is that forward absolute valuations are just marginally above long-term average levels whilst the outlook for inflation and interest rates are more muted than historic levels.

Another perspective on this issue is to consider real prices and real earnings. The following chart shows both nominal and real data:

S&P 500 – Nominal and Real Prices and Earnings



Whilst valuation multiples, of course, are similar in nominal and real terms, we make a distinction in nominal and in real growth levels over the respective economic cycles. We specifically consider the peak-to-peak growth levels in this context:

Peak - To - Peak Annualised Growth (% p.a.)					
Cycle		Nominal		Real	
		S&P 500	EPS	S&P 500	EPS
1	1989 - 2000	14.9%	7.2%	11.0%	4.0%
2	2000 - 2007	0.3%	7.0%	-2.4%	4.5%
3	2007- Now	6.0%	4.0%	4.2%	2.2%

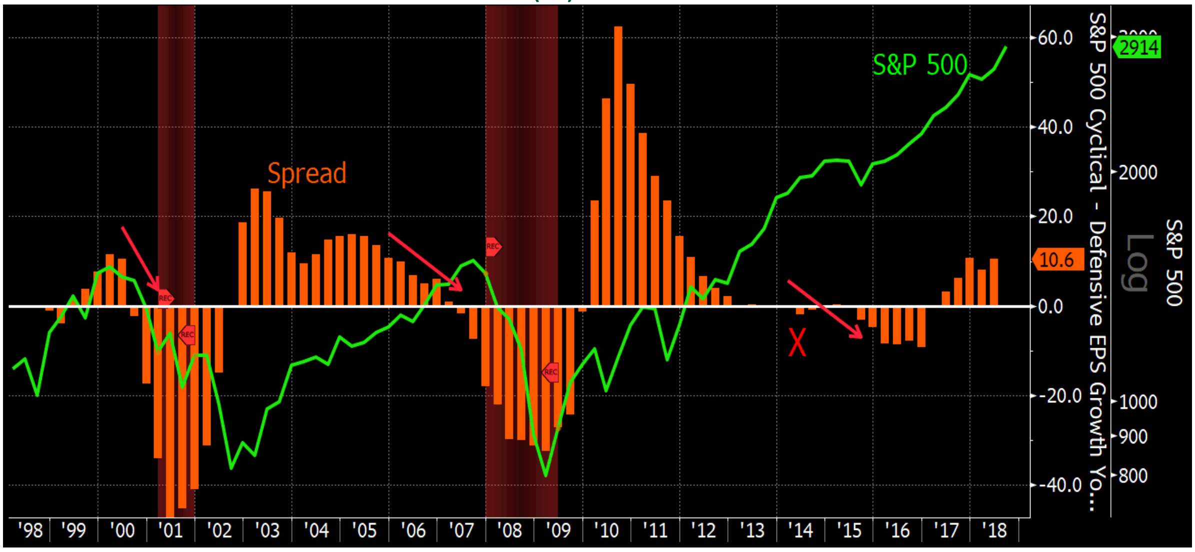
The technology bubble caused havoc with share prices and valuations, with respectively very high and very low returns for the first and second cycles, whilst the earnings growth is very similar over the cycles. If we average the share price (S&P 500) growth numbers over these cycles, they come to +7.6% (nominal) and +4.3% (real) respectively, not far from the current cycle's levels of +6.0% and +4.2% respectively.

These returns, of course, include dividends, which is important in context of the following point. The earnings (EPS) growth in the current cycle is much lower (almost half) than over the two previous cycles. On this basis, other things being equal, the current economic cycle lags its predecessors and may have further to go. On the premise that earnings drive prices, and we have already made the point that valuations are not overly expensive, we believe share prices have not yet reached peak levels for the current cycle.

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

The preceding point is confirmed by the following chart:

S&P 500 – Spread Between Cyclical and Defensive Companies' Earnings Growth (%) vs S&P 500



The results of S&P 500 cyclical companies' results currently outstrip the results of defensive companies. The spread between these results have historically provided a guide towards potential changes in trends of share price. Its guide remains constructive currently.

6. CHINA HOPE

The recent volatility in many Emerging Market shares are of concern to many. We expressed opinion in our previous note that Developed Market investors do not have ample information to expect similar experiences.

It seems that many Emerging Market currency and bond markets have stabalised. It is still too early to form firm opinion that the worst is over for those markets, but we do have reason for some hope.

China – Shanghai Price Index

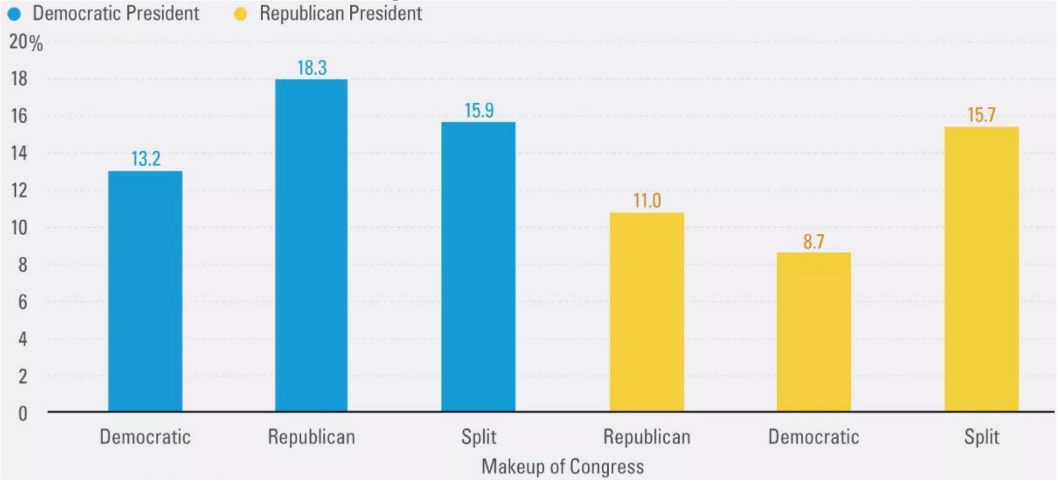
The Shanghai market showed a clear technical negative break in the first quarter (the 'death cross') with a material adjustment since. The index dropped materially below its 200-day average but has recently turned upwards through its 50-day average (see the highlighted section on the chart). This can be a first sign of hope.

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

7. US ELECTION

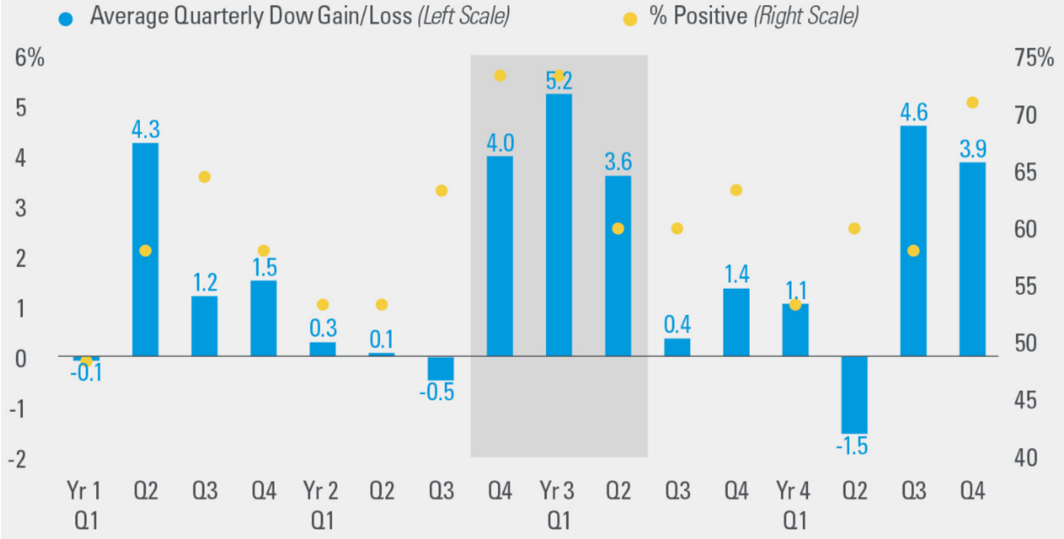
The party in the White House lost House seats in 35 out of the past 38 mid-term elections and investors may have uncertainties should the Republicans lose control of Congress in the upcoming election. It may not necessarily be reason for extreme concern:

S&P 500 – Average Annual Performance (1950 – 2017)



Historically the market fared the best with a Democratic president but with the Republicans in charge of Congress. This performance was followed by a split Congress (very closely whether a Republican or with a Democratic president).

Dow Jones Performance Over US Presidential Cycles (1896 - 2017)



As reflected in the above chart, the upcoming three quarters in the presidential cycles historically offered successive strong returns, with a high probability (73%) of good returns especially in the upcoming two quarters.

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Source: LPL Research. September 2018. Past performance should not be used as a guide to future performance.

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