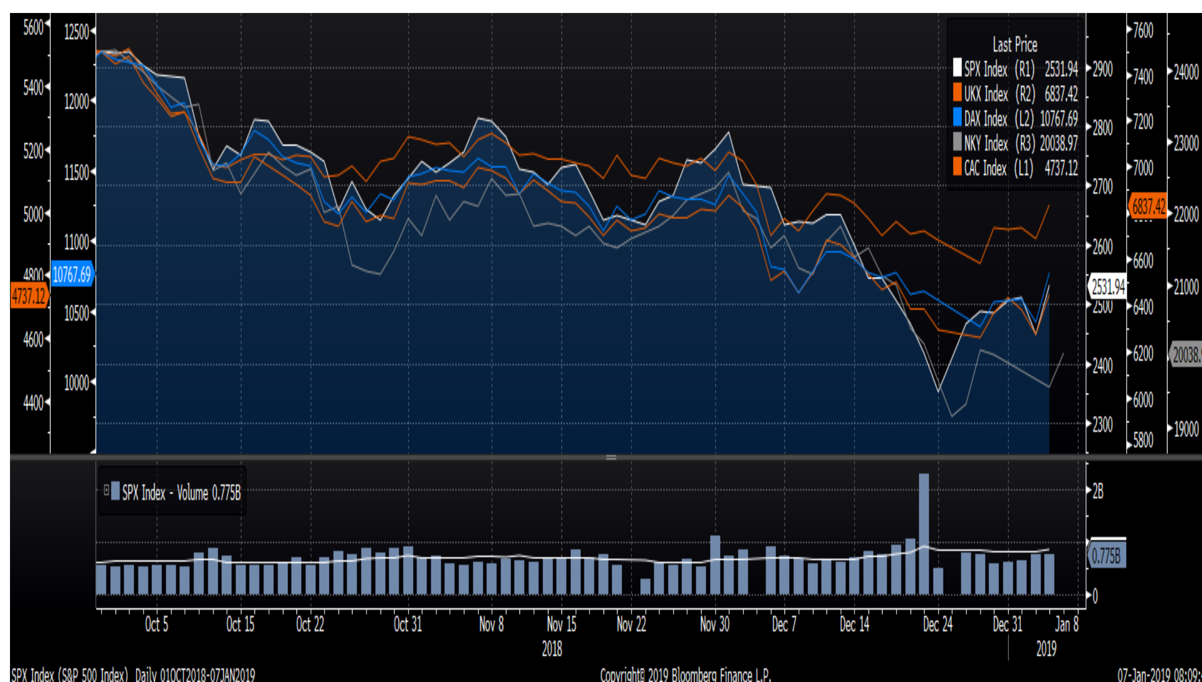
Market Review

The sell-off in global equity markets in the last quarter of 2018, primarily led by the Dow Jones and S&P 500 Indices in the United States, is largely at odds with current US business data and economic forward indicators which point to ongoing positive performance – these differences highlight the potential for misplaced fear to take precedence over the market fundamentals.

US S&P 500 Index vs. FTSE 100; the DAX 30 (Germany); Nikkei 225 (Japan); and CAC 40 (France) October 2018 to July 2018 to Present



Source: Bloomberg

The 4th Quarter – "Fear"

Concern that corporate profit growth had peaked initially sent U.S. equity valuations falling in October, as some analysts revised their optimistic US equity revenue growth forecasts for 2019, down to a rate of around 5% from previous estimates of 10%.

In November came the threat of further US tariffs being imposed in the trade war with China, along with the Digital Services Tax proposed by the U.K. government, targeting companies such as Alphabet and Facebook. These served to give markets a further jolt; falls were led by companies with the highest valuations, such as technology and consumer discretionary shares that have led the near decade-long bull market. Investors flocked to the perceived safety of utilities and household-product makers, that is those more defensive sectors with the least exposure to the economic cycle.

December brought the arrest of Huawei Technologies Co's Chief Financial Officer Wanzhou Meng in Canada on the basis of a US charge, with its attendant implications for the US - China relationship. The timing was unfortunate, coming at a moment of already heightened tensions in the trade arena – this placed additional strain on overall sentiment and therefore on equity market valuations as it was felt this issue would hamper progress on the trade talks.

Jay Powell – US Federal Reserve Chair

However possibly the biggest impact in befalling equity market valuations came from comments made by Jerome Powell – Chairman of the US Federal Reserve (the Fed) - in which he downplayed recent market turbulence and said "the Central Bank doesn't plan to alter efforts to reduce its balance sheet", that is, it was seen as a statement of intent that the Fed would continue on its current and intended path of increasing US interest rates to some pre-determined level.

What global financial markets had expected to hear at this point was that the Fed would pause this tightening path, given that rising borrowing costs threatened to curb economic growth. By pausing the Fed would in theory allow the economy to grow further, cause inflation expectations to pick up, stocks to continue higher in line with earnings, and for Treasury yields to rise.

With no plans to alter this current path, the message from Mr Powell was viewed by many market participants as a looming and major policy mistake, bringing a significant increase in the odds of an accelerated slowdown in the US economy.

However by late December and with the S&P 500 on the verge of a 20% correction (since October 2018), the S&P 500 advanced 5% in a single session and the Dow Jones added 1,086 points, the biggest one day rise in this index since March 23rd, 2009.

Retailers rallied, with a 6.3% rise for consumer-discretionary companies leading S&P 500 consumer sectors to the upside. Shoppers then delivered the strongest holiday sales increase for U.S. retailers in six years according to Mastercard Spending Pulse, which tracks online and in-store spending with all forms of payment. Shares of Amazon Inc. helped set the tone, rising more than 9% after the company said it logged yet another record holiday season. The energy sector meanwhile rose more than 6%, with oil companies lifted by a sharp rebound for crude.

Thin holiday period trading and stocks bouncing back from extremely oversold conditions will have helped this sharp rebound, but still leaves major indexes nursing losses for December in particular and 2018 in general.

On New Years' Eve, markets were further buoyed by US President Donald Trump tweeting that he and Chinese leader Xi Jinping had made "big progress" in a telephone discussion about trade and tariffs, and that progress towards a deal was "moving along very well." However, sources close to the talks said Trump may have been exaggerating progress in a bid to calm markets, this according to The Wall Street Journal.

January – "The Fundamentals Reassert"

As we entered the New Year, US stocks surged higher buoyed by a significantly better-than-expected jobs report for December and new and dovishly-interpreted remarks by the Chairman of the Federal Reserve.

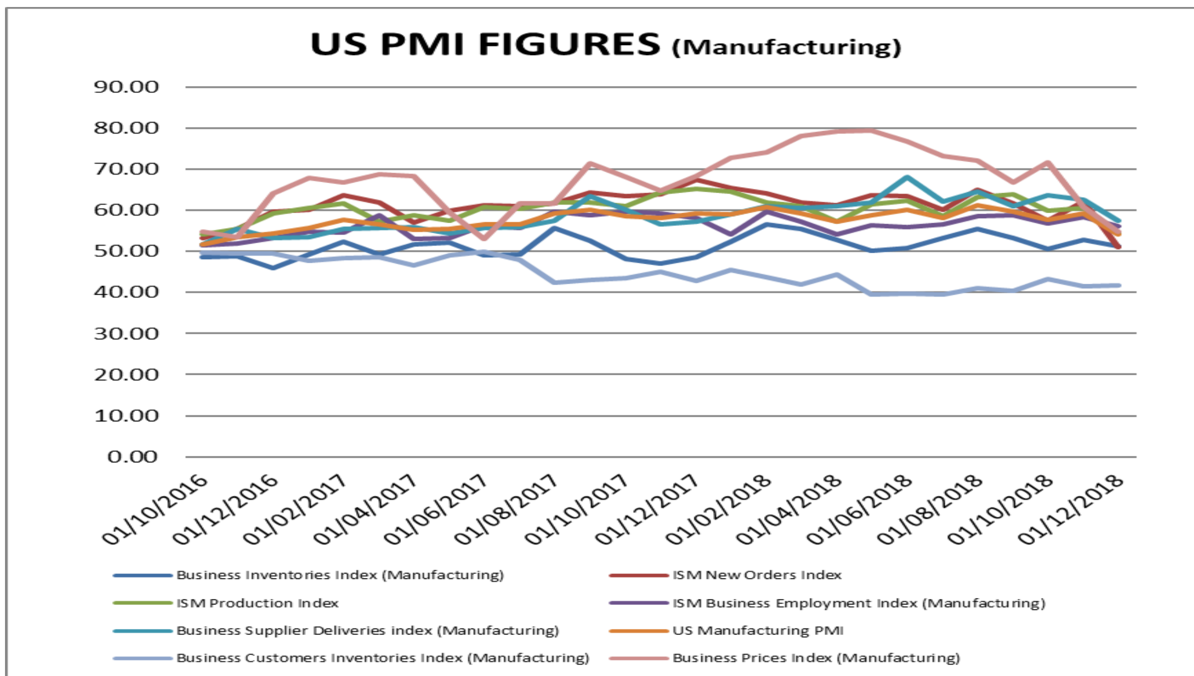
The Bureau of Labor Statistics said the U.S. economy added 312,000 jobs in December - economists polled by MarketWatch had been expecting an increase of 'only' 182,000. Encouragingly the unemployment rate actually increased, meaning more Americans are looking to re-enter the workforce, and keeping the supply of available workers at decent levels.

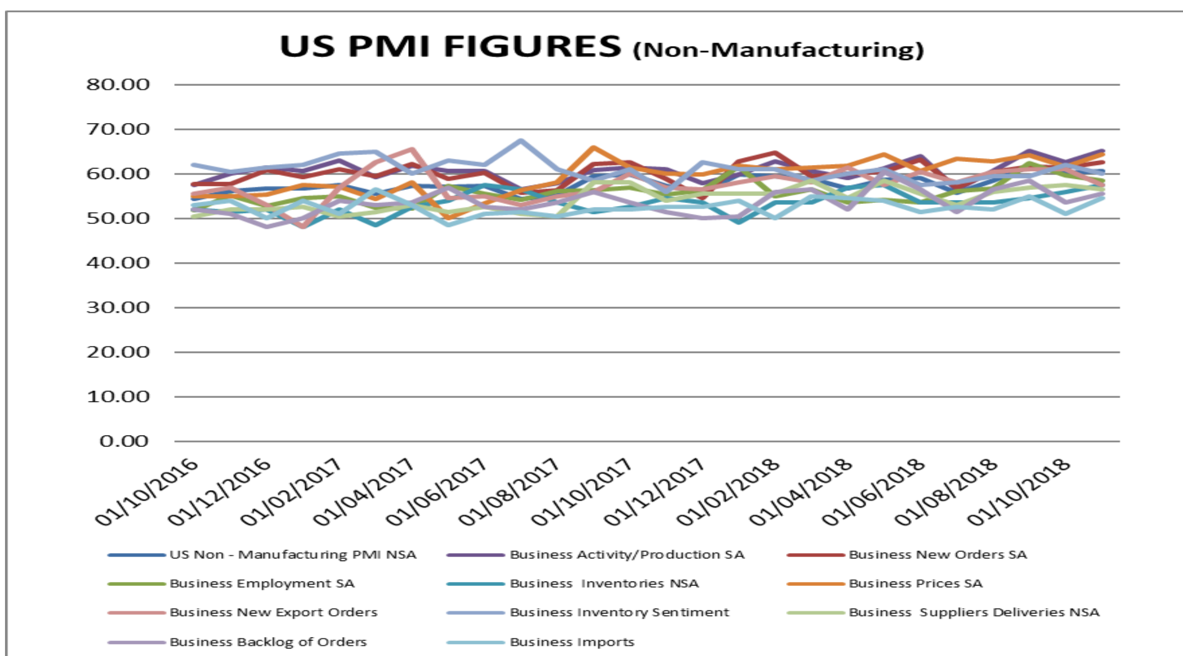
Stocks received a further boost when Federal Reserve Chairman Jerome Powell very carefully stated during a panel discussion that the Federal Reserve "will be patient as we watch to see how the economy evolves", this being immediately interpreted as the Fed taking into account market sentiment and the need to foster rather than impede the ongoing US economic expansion.

Investor optimism was further reinforced by Powell who said during this appearance that the positive jobs report didn't materially increase his concerns over rising inflation. And he further reiterated that the Central Bank would continue to keep an open mind about how far it would raise interest rates in 2019, and how aggressively it would shrink its balance sheet of government bonds accumulated during years of Quantitative Easing policy. He further stated that future Fed decisions would be principally 'data-dependent', that is based on incoming data about the U.S. and the global economy, including recent weakness in equity markets.

This was perceived as a significant U-turn from the Chairman of the Fed following his previous comments and was seen as supportive of market expectations that the Fed would – wisely - pause in its path of interest rate increases.

In previous letters, we have highlighted the prospect of a US recession potentially providing us with a significant headwind for the global outlook going forward.





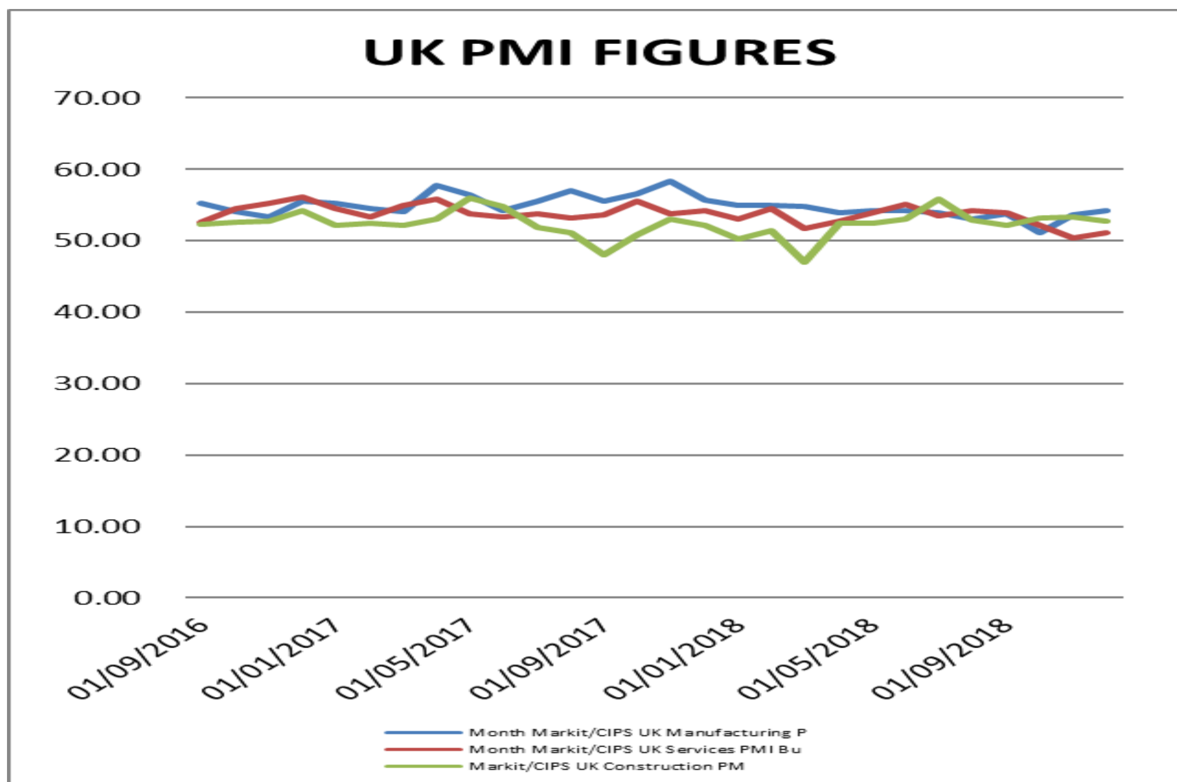
Source: MPL/Bloomberg

Purchasing Managers Indices (PMIs') are authoritative leading indicators for economic growth in various areas of production, such as for the Manufacturing and Non-Manufacturing, or Services, sectors. In the United States these PMIs (see charts) are still indicating ongoing evidence of economic growth, albeit at a slower rate than in the immediate past, and we note there is no evidence yet of any significant recessionary slowdown. Note that the Services or Non-Manufacturing Sector is the more important as it forms the lion's share of the overall economy. Readings over 50 indicate expansion and those under 50 indicate contraction.

An additional positive for manufacturing companies in the US, and indeed around the world, is that as a result of the fall in energy prices, the Business Prices Index (that is, input prices to companies) is falling.

The UK

Whilst we are currently retaining a relatively low exposure to the UK at present, largely due to consternation surrounding Brexit and recent equity market weakness, indicators for economic growth here are also signalling an ongoing expansion, albeit at a slower rate than in the US.



Source: MPL/Bloomberg

The weakness of Sterling vs. the basket of international currencies has played a major part here, by boosting the value of exports, revenue and any assets linked to this basket. In the recent past, pre-Brexit stockpiling by companies fearing a breakdown in supply chains and the movement of goods, has also played a part.

Portfolio Allocation

Mindful of the current environment and our comments above, the severity of the recent equity market sell-off may have already priced in much of any expectation regarding a slower revenue growth outlook for companies in the United States and globally. In such a slower global growth environment, we would favour large-cap stocks over more cyclically focused small-cap companies, hence:

USA

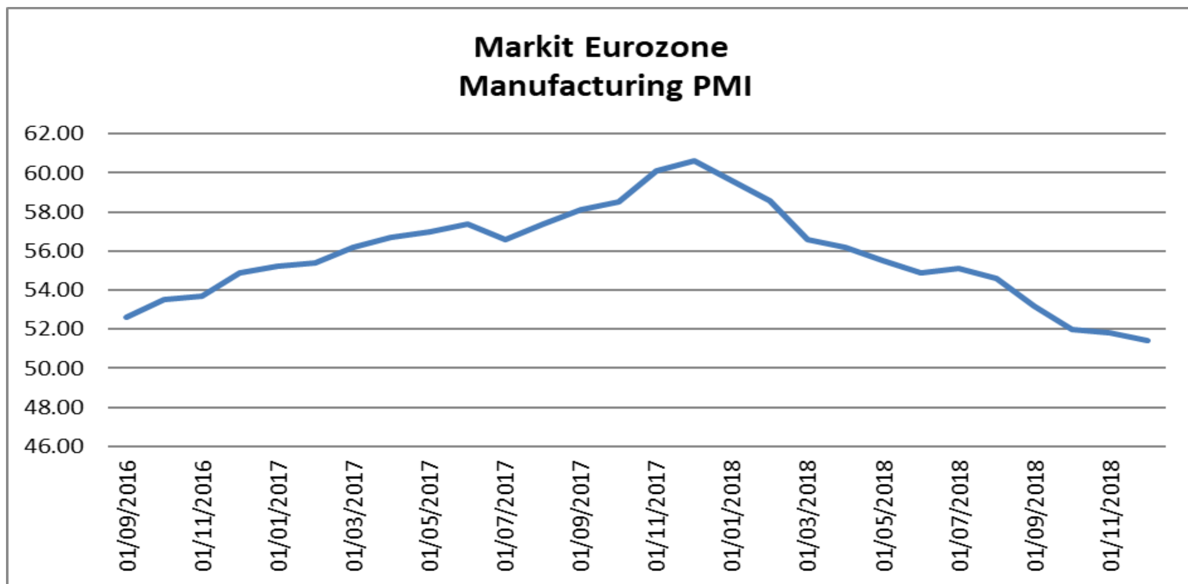
In the United States we intend to reduce our exposure to the small to mid-cap companies area of the market.

UK

In the UK, pre-Brexit stock piling by companies will benefit the small-to-mid cap companies sector, in the near term at least. However, the impact of any form of hard Brexit which is viewed to be a negative in the short term for UK Plc, will be felt most in this area, hence exposure to the sector will also be reduced here.

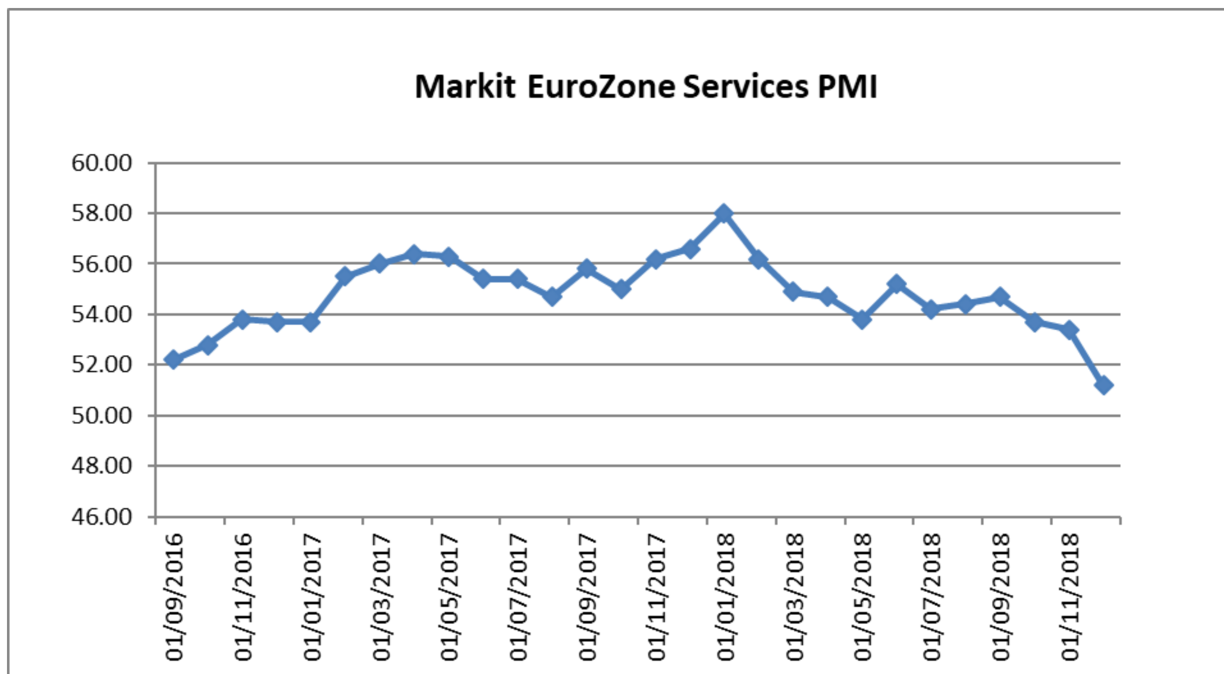
Europe

From an economic point of view, the outlook for European growth has of late become a cause for concern.



Source: MPL/Bloomberg

Leading indicators for productivity in European Manufacturing and Non-Manufacturing paint a similar picture for both sectors.



Source: MPL/Bloomberg

Information from the IHS Markit survey confirms a continuing trend of slowing growth during December, a significant part of this due to a notably poor economic performance from France where the activities of the 'Gilets Jaunes' movement reportedly led to the first fall in economic output for two-and-a-half years. The rest of the region lacks any such mitigating factors, although the recent weakness of the highly important automotive sector (on the back of emissions-testing issues) will hopefully prove only a temporary set-back.

The Eurozone generally saw a decline in growth rate, with Germany participating in the decline and registering its weakest outturn for five-and-a-half years, again based in part on weakness in the autos sector. Italy bucked the broader downward trend, though output merely stabilised following two months of contraction.

With expectations of European area output dropping to the lowest for over four years, companies are not anticipating any imminent revival in demand. Worries reflect multiple headwinds from trade wars and an associated slowdown in Chinese growth, Brexit, heightened political uncertainties in the likes of Italy and elsewhere, financial market volatility and slowing global economic growth.

As a result, we will be reducing our European exposure until prospects in the region improve.

Asia and Emerging Markets – (EM)

Purchasing manager indices are still in expansion phase in the Asia, LATAM, and Developing markets, although recent currency weakness experienced by some of the 'Fragile 5' economies of Brazil, India, South Africa, Turkey and Argentina have reflected internal problems within these economies.

Both EM exports and corporate earnings growth are still holding up, but the jury is out at this point as to whether these will come under further pressure, given the negatives outlined above.

EM equity valuations are back to reasonable levels, displaying an average Case-Shiller Price Earnings Ratio of 11 times earnings against a 10-year median of 14 times. Return on Capital on EM stocks is currently running at 13% and is on a 12-month forward EV/EBITDA (a key measure of corporate value versus earnings) of 9 times, which is seen as offering good value.

External financing concerns regarding a majority of EM economies are overblown. USD$ liabilities in economies such as China, Brazil, South Korea, and India are a fraction of the GDPs of those economies. Indeed, the percentage change in USD liabilities since Q2 2014 is negative in China, and negligible in Brazil and South Korea as they try to reduce USD exposure, and external financing in EM is mainly geared toward cyclical industries such as Utilities and Telecom Services.

Looking ahead

Long term trends within Emerging Markets, such as increasing needs for large-scale infrastructure and banking, together with innovation in areas such as digital consumption across the EM, financial services in India, hardware and artificial intelligence development, will continue unabated as large populations rapidly adopt key modern technologies.

Surprisingly, the levels of Emerging Market consumer penetration into various areas of the economy, such as ecommerce, mortgages, savings and the automotive sectors, remain at less than 5% across these areas, implying huge organic growth opportunities for companies operating within these EM industries.

With a long-term view in mind, the strategy going forward will be to slowly feed incremental funds into this area.