STONEHAGE FLEMING

# GLOBAL EQUITY PERSPECTIVES 29 OCTOBER 2018

*"If you can't explain it simply, you don't understand it well enough."*

*Albert Einstein*

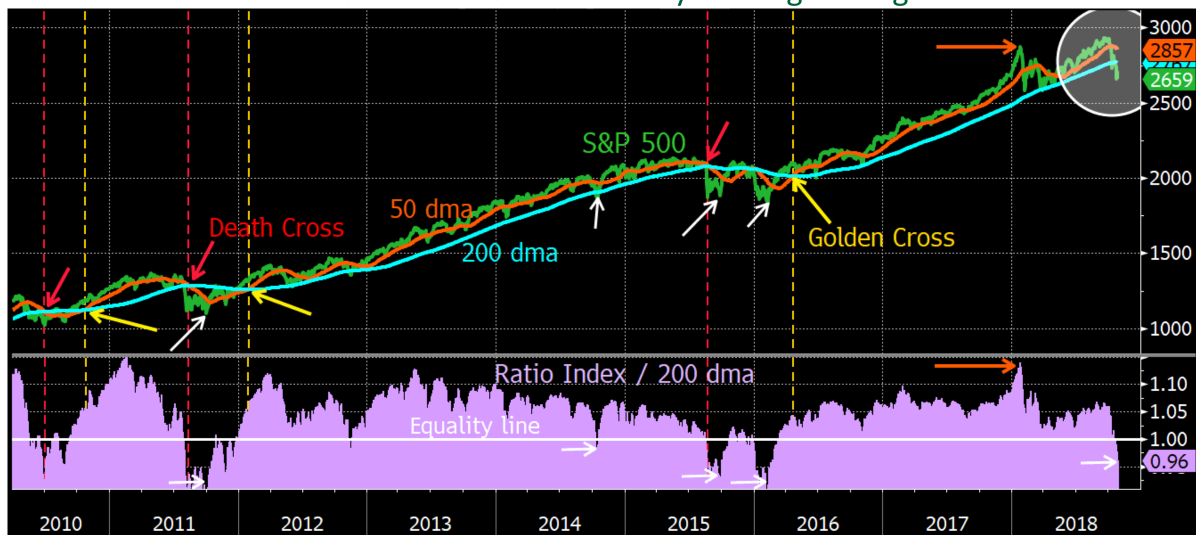
## 1. CORRECTION LEVEL

The weak stock market performance over the past few weeks has brought it close to an official correction level of -10%.

S&P 500 Drawdown from Recent Peak (%) and Relative Strength Indicator (RSI)

Although the current experience is anything but comfortable, we should also mention that the correction is not out of the ordinary in the context of other experiences during the current bull market. The current RSI overbought/oversold indicator is also at a very low historic level, reflecting some level of extreme reaction.

S&P 500 with 50 and 200 Day Moving Average



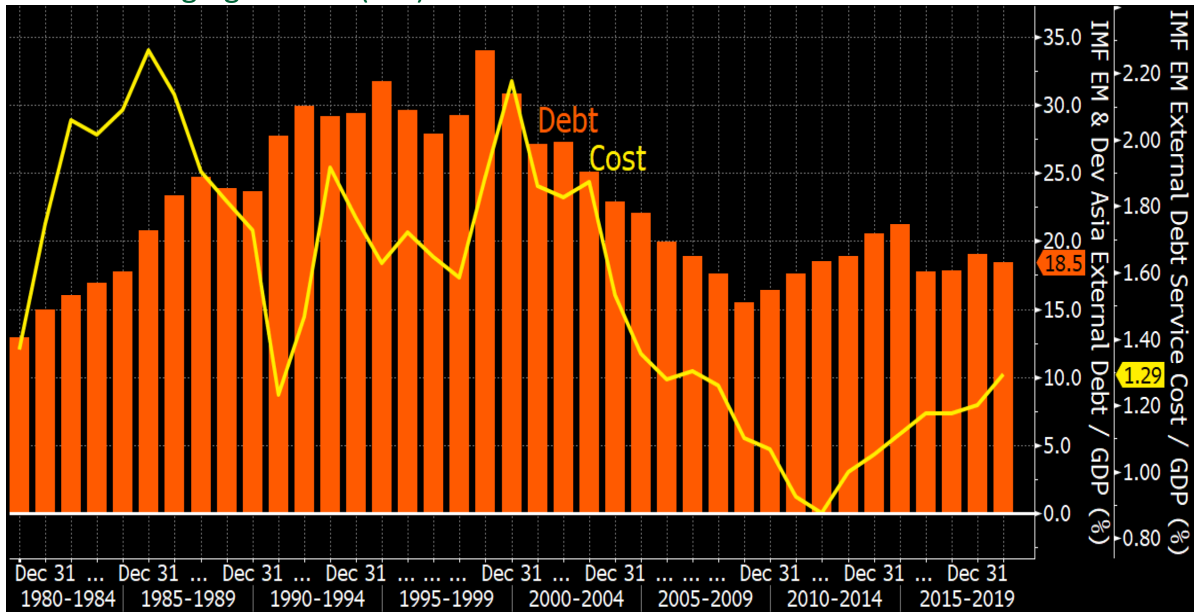

The S&P 500 has just dropped through its 200-day moving average. This is not yet a technical break (the 50-day reading must cross the 200-day moving average for that). We have clear fundamental explanations for the previous similar occasions in the above chart (the US credit rating downgrade in 2011 and the sharp US economic slowdown in 2015).

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

## 2. EMERGING MARKET DEBT

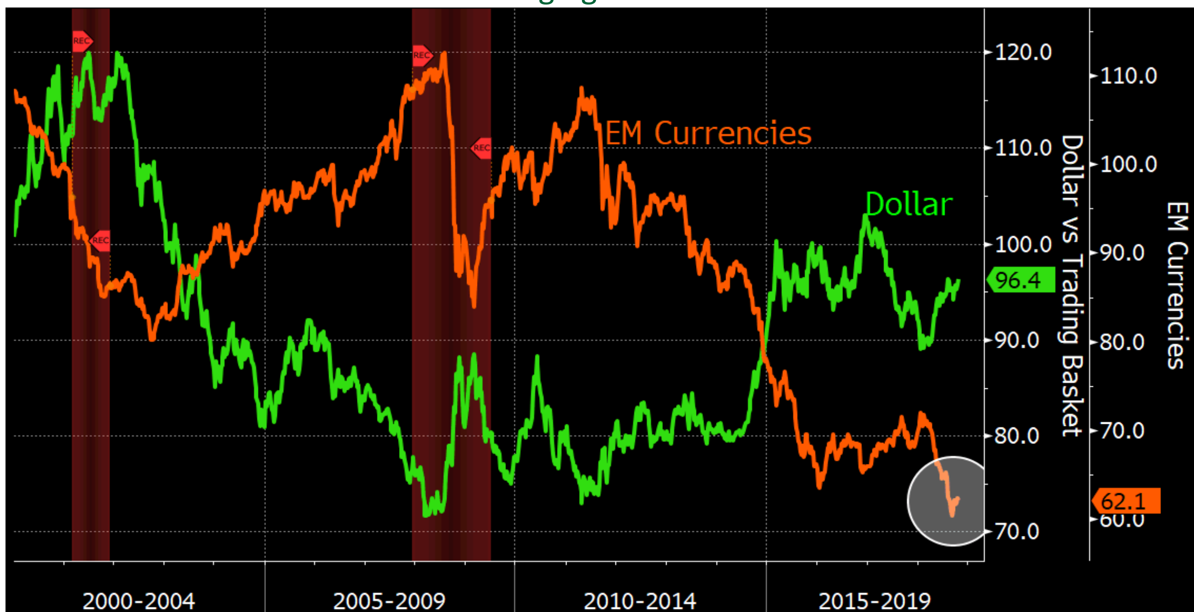
Emerging markets suffer currently from the combination of the strong Dollar and large indebtness in many of their member countries. We find the following charts of value in this context.

Emerging Market (EM) External Debt vs Debt Service Cost as % of GDP




The external debt is high at almost a fifth of GDP. It is, though, also clear that these levels are lower than with the 1997/98 emerging market crisis. Especially the US economy is currently much stronger than then and can buffer the EM weakness much better. These debt service costs are currently rising quite sharply, but again, are not at the high levels reached during the previous EM crisis. Their current economic weakness should therefore be of less global risk than with the previous crisis.

Dollar vs Emerging Market Currencies




EM currencies weakened materially this year along with the strengthening Dollar. Whilst the Dollar is maintaining its strength, it is interesting that EM currencies seem to have stabilised recently at this century's lowest levels.

The following chart shows the EM P/E valuation relative to the S&P 500's valuation. Apart from the distressed levels during the credit crisis the relative EM valuation is at a historic low level, even though continuing growth in earnings are expected for the coming year.

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

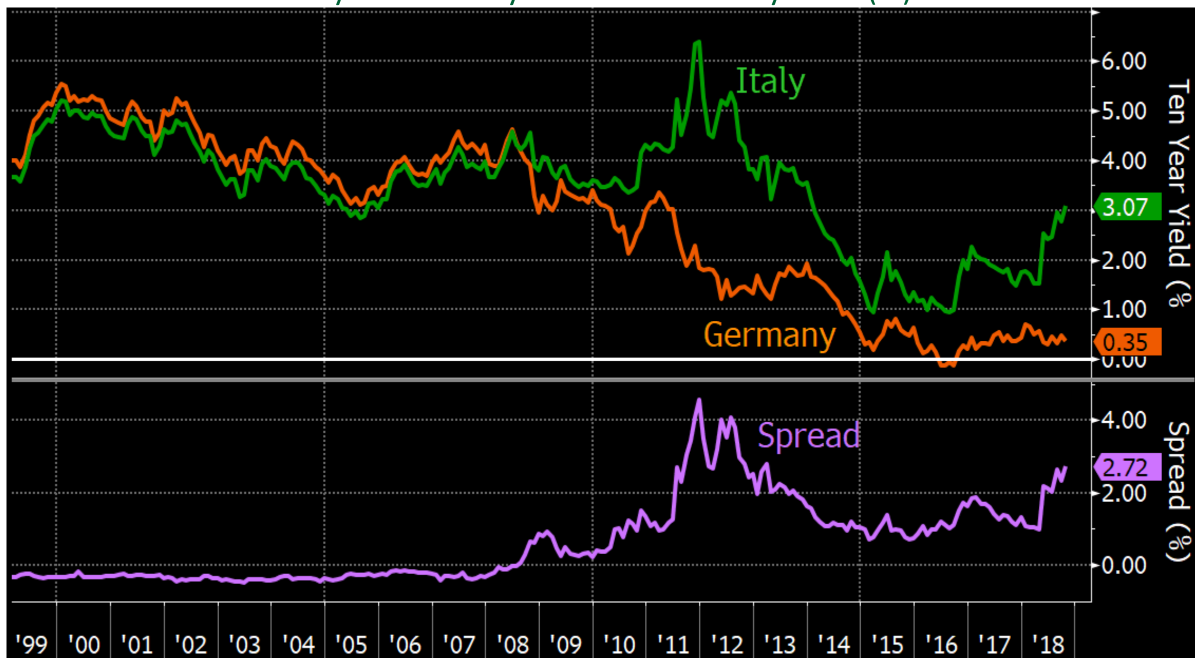
Emerging Market P/E Ratio Relative to S&P 500 P/E Ratio

On the above relative basis the EM stock markets seem rather attractive.

## 3. ITALY BUDGET CONSTRAINTS

Italy's large budget deficit is affecting global market sentiment in different ways.

Italy vs Germany Ten Year Treasury Yield (%)




Investors recall the market jitters during Greece's budget crisis a few years ago. As a reminder, Italy's budget deficit in nominal terms is more than eight times the size of Greece's. They struggle currently to obtain EU approval for their budget, with the effect of sharply rising Italian interest rates. The spread with Germany's rates has increased sharply recently. Many Italians divest from their own market into Germany's, which in turn keeps their rates unnaturally low. This, in turn, keeps the Euro from appreciating against the Dollar, and therefore continuing Dollar strength.

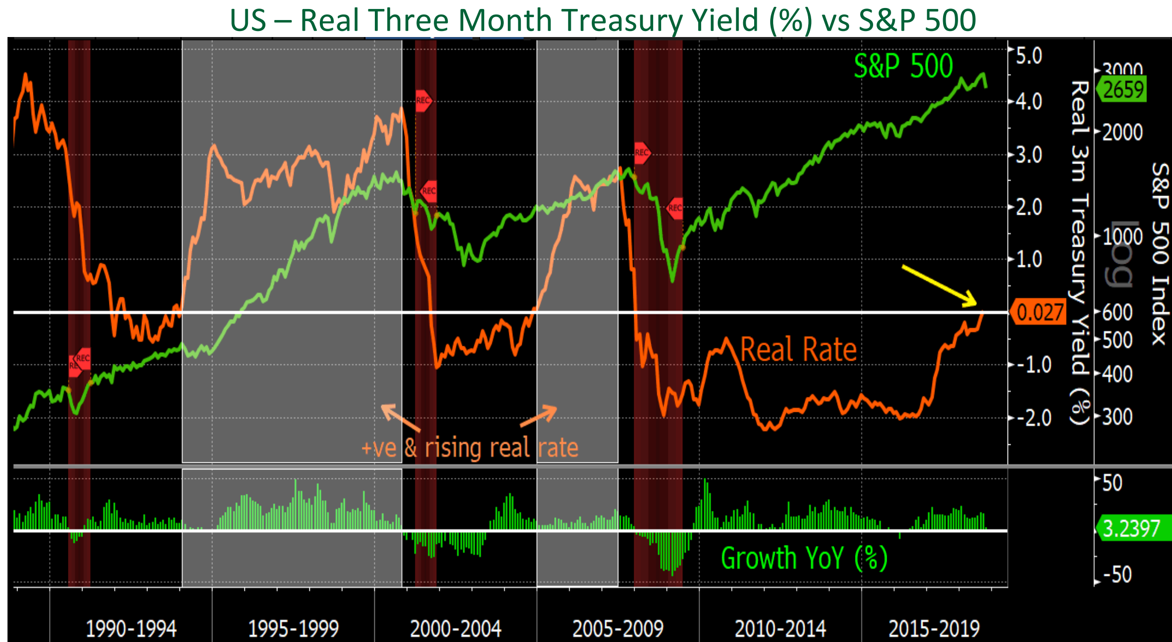
For reference, we can compare the 2011/12 spread in the above chart with the S&P weakness in the charts in paragraph 1. It is important for global capital markets that the Italian budget constraints with Brussels get resolved.

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

## 4. REAL U.S. INTEREST RATES

With rising US interest rates many investors start considering holding money on deposit rather than investing in the stock market. This can gain in popularity as interest rates become positive in real terms.

US – Real Three Month Treasury Yield (%) vs S&P 500




Three-month rates have just moved into positive territory in real terms. Deposit holders can now feel they can 'move forward' in real terms.

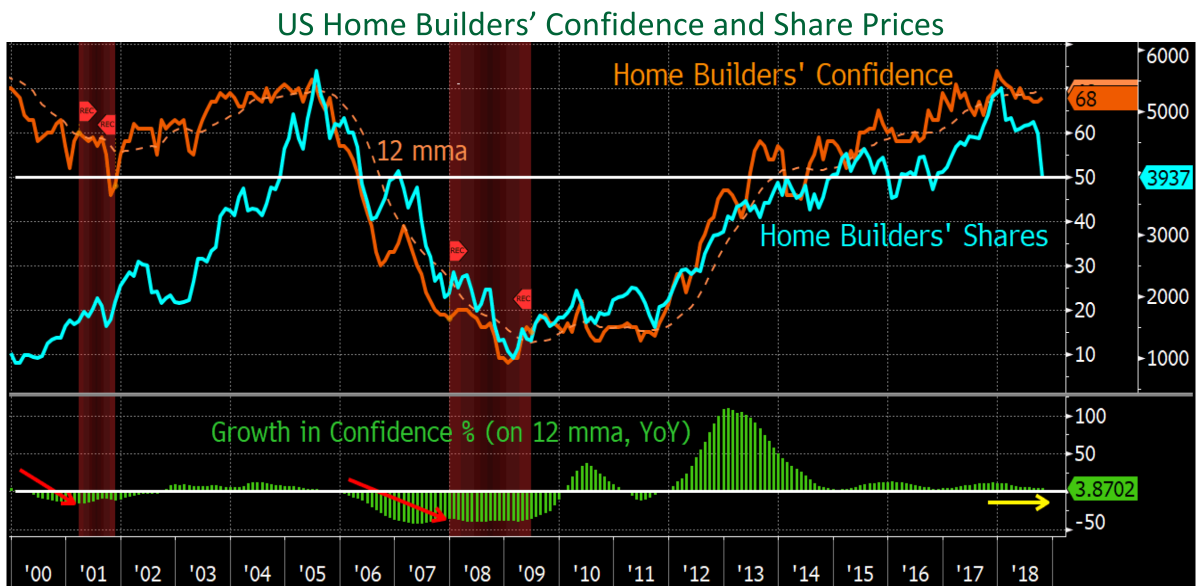
We shade the periods of historic positive and rising real rates in the above chart. The stock market did well during those periods. On this basis we should not fear the structural effects of positive real rates.

It is also striking that peaking real rates have historically closely coincided with the structural peaks in share prices (the end of the shaded areas) at levels in excess of 2.5%. Rates have just turned positive in real terms.

## 5. HOUSING SECTOR

Interest rate sensitive stocks are particularly weak currently. US homebuilders' shares have corrected by a quarter. It is important for us to consider the messages in this information.

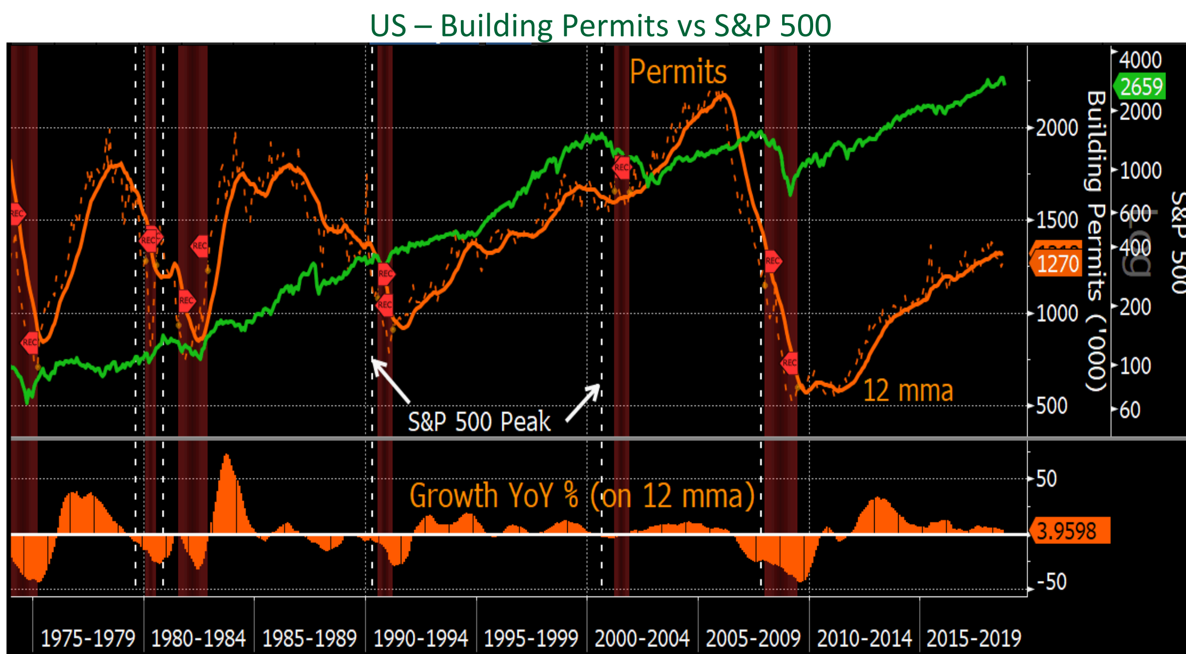
US Home Builders' Confidence and Share Prices




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

Historically home builders' confidence data has lead US recessions by about two years. It is currently still relatively stable.

US – Building Permits vs S&P 500

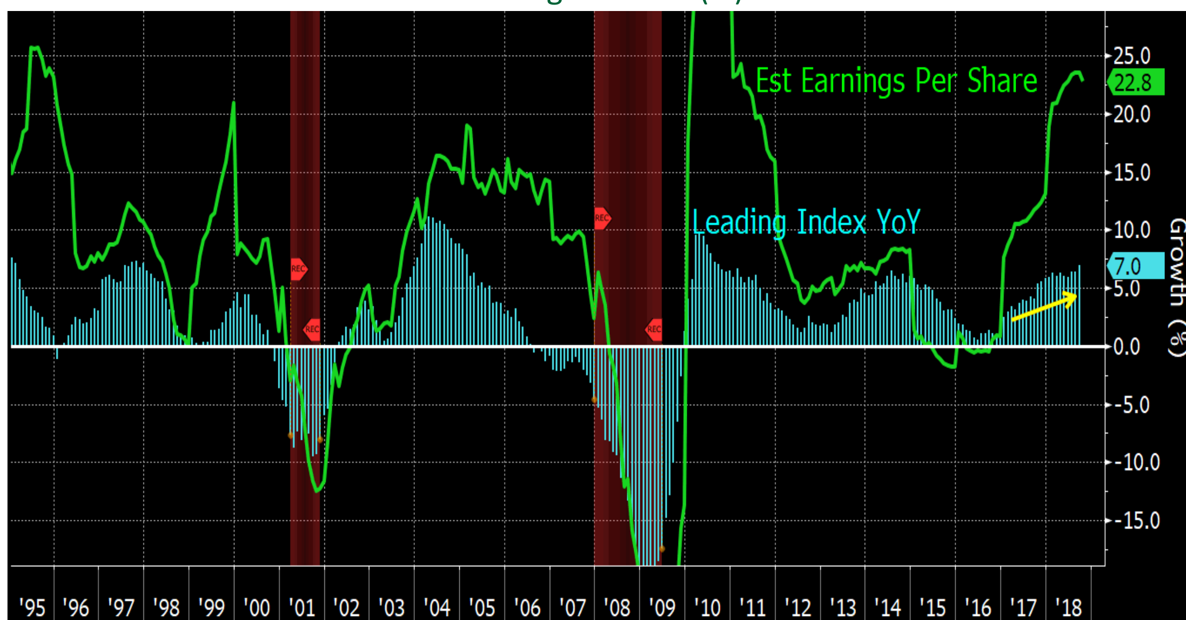



Building permits historically served as relatively good early warning stock market indicators. We indicate the respective structural stock market peaks in the above chart. They have most of the time been preceded by weak building permit data for quite some time. The current permit data is still positive and in itself does not yet raise particular alarm despite its interest rate sensitivity.

## 6. PEAK EARNINGS

The financial press is currently littered with comments about peaking corporate earnings.

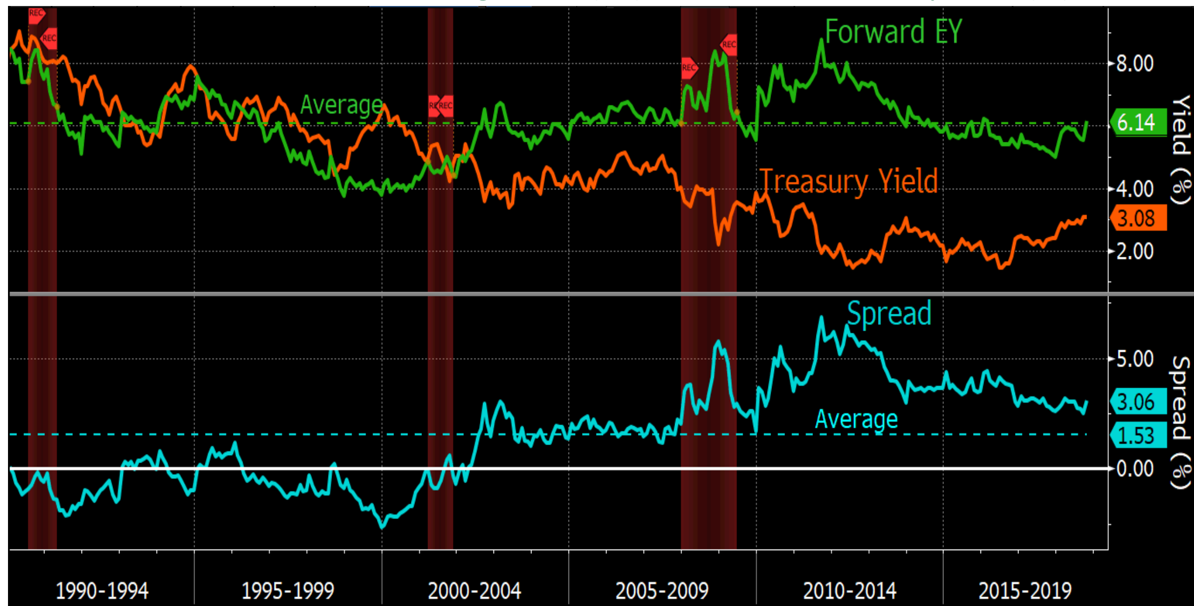
US – Conference Board Leading Economic Index vs S&P 500 12 Month Forward Earnings Growth (%)




The well-trusted leading economic index is currently at an elevated level and we can expect it to start receding. Its message remains positive until it drops to zero. We can simpathise with comments of peaking earnings <u>growth</u>, but not yet with those of peaking <u>absolute</u> earnings. As a reminder, we are yet to experience a bear market accompanied with growing earnings.

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

S&P 500 Forward Earnings Yield (EY) vs Ten Year Treasury Yield (%)




The forward S&P 500 EY is currently over 3% higher than the treasury yield, compared to a long-term average of 1.5%. On the basis of reverting to average, this implies that the stock market currently is already prepared for the treasury yield to rise to ~4.5% over the coming year.

Against this, if only this century's average spread (1.5%) may become the long-term norm, the market is not yet prepared for further rate rises. We reckon such an approach is too conservative seeing the excessive spreads immediately following the credit crisis era.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