STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 17 MAY 2021

"It is not the answer that enlightens, but the question."

Eugene Ionesco

1. EARNINGS SEASON

Over 90% of the S&P 500 and BE 500 (US and Europe respectively) index members have reported their first quarter results. It deserves front-page coverage this time.

	S&P 500 1Q2021 Results (15 Jun 2021)			Bloomberg BE 500 1Q2021 Results (15 Jun 2021)		
	Growth	Surprise Factor	# +ve Surprises	Growth	Surprise Factor	# +ve Surprises
Sales	9.8%	3.7%	70.8%	6.5%	1.2%	62.3%
Earnings per Share	47.0%	23.3%	86.8%	111.9%	19.2%	70.2%

The growth numbers in the above table, of course, are off the very low base of last year. Nevertheless, US absolute Sales numbers have exceeded European peers by quite a margin. Furthermore, our focus is more on the performance relative to consensus expectations (the 'surprise' numbers).

US Sales growth has surprised by over a third and European growth by almost a fifth. The percentage of members that have delivered positive Sales surprises is also materially higher in the US. Earnings deliveries produced a similar picture.

All-in-all, shareholders on both continents have much to celebrate from their businesses' operational results.

MSCI World – Price Index vs Earnings Upgrade Index

In terms of further earnings expectations for the next twelve months, the earnings upgrade index of the above World Index members is currently at a record level, more than two standard deviations away from its average level. This supports share prices well.

The question can be posed whether this is 'as good as it gets' in terms of earnings expectations. Historically, share prices have often drifted for a while following such high revisions.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2021. ***Past performance is not a guide to future performance.***

2. RISING INTEREST RATES

We have previously shown our chart reflecting the point that, in the vast majority of instances, rising US interest rates have historically been followed by positive stock market performance. This is true irrespective of the level of interest rates. The main exception was in the early Eighties, a period saddled with high inflation levels.

The ten-year US Treasury yield has already increased by 1.1% from its bottom level in July last year. One may query whether further rises can become detrimental to Equity performance. The following table reflects an analysis of rates rising by more than 1.5%:

S&P 500 – Gain/Loss Following >1.5% rise in Treasury Yields (%)

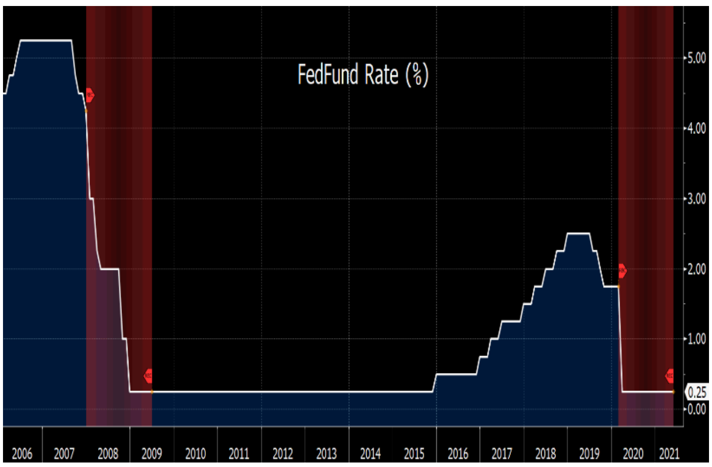
Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-year Treasury Yield	S&P 500 Gains/Loss	Gain/Loss Annualised
26/12/62	29/08/66	44.7	1.7%	18.3%	4.5%
16/03/67	29/12/69	34.0	3.6%	1.3%*	0.5%
23/03/71	16/09/75	54.6	3.2%	-18.1%*	-4.4%
30/12/76	30/09/81	57.8	9.0%	8.7%*	1.7%
05/04/83	30/05/84	13.1	3.9%	-7.9%*	-1.5%
29/08/86	16/10/87	13.8	3.3%	11.8%*	9.7%
15/10/93	07/11/94	12.9	2.9%	-1.4%	-1.3%
19/01/96	08/07/96	5.7	1.5%	6.7%	13.7%
05/10/98	21/01/00	15.8	2.6%	45.8%	29.0%
13/06/03	28/06/06	37.0	2.1%	26.0%	7.5%
30/12/08	05/04/10	15.4	1.9%	33.3%	22.6%
24/07/12	31/12/13	17.5	1.6%	38.1%	22.3%
08/07/16	05/10/18	27.3	1.9%	35.5%	13.4%
09/03/20	25/02/21	11.8	1.0%	39.4%	34.3%
	Average	**25.8**	**2.9%**	**17.0%**	**7.3%****
	Median	**16.6**	**2.4%**	**15.0%**	**10.2%****
	% Positive			**78.6%**	

Source: Stonehage Fleming Investment Management, LPL Research, FactSet, March 2021. **Past performance is not a guide to future returns**. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.
* Average Core Inflation = 6.3%
** Calculated from Average/Median Data

The far-right column reflects the annualised gains/losses during corresponding periods of rising rates. The earlier periods showed poor results, particularly those with high inflation levels (indicated with * symbols). The later periods generally delivered attractive returns, as were the overall average/median returns.

3. FED TIGHTENING

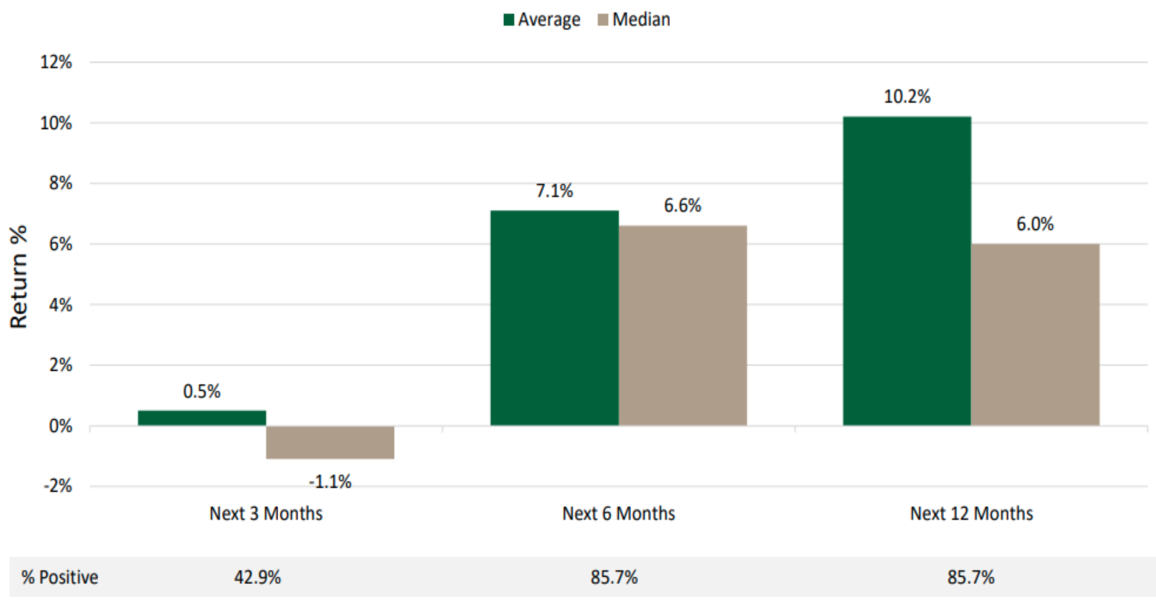
The Federal Reserve kept their target rate at 0-5% for seven years following the Financial Crisis despite similar fears initially for rising inflation expectations as we have currently. Many voices are currently arguing for them to temper inflation rather sooner than later, whilst they maintain a 'transitionary' view of inflation rising only tactically with a stance of 'not even thinking about thinking' to consider tightening anytime soon.



Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2021. ***Past performance is not a guide to future performance.***

Many investors fear the day the Fed capitulate on their current stance in this context. The following chart reflects the stock market reaction following the first tightening steps in earlier cycles:

S&P 500 – Index Returns Following Cycle First Fed Rate Hike



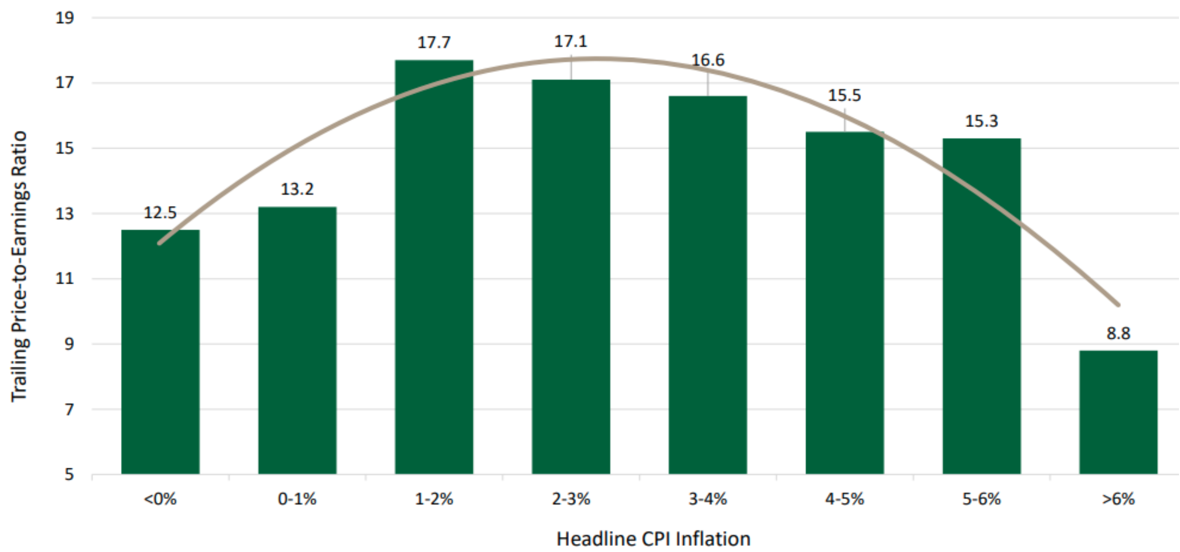
Source: LPL Research, Bloomberg, April 2021. **Past performance is not a guide to future returns**. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.
Data: Since 1987 (7 Occasions)

There have been seven such occasions since 1987. As reflected in the chart, the first three months following the announcements reflect investor uncertainty. The next six months and twelve months delivered attractive returns, with only one occasion of a negative return after twelve months. That happened in 1987 with the stock market collapse after three tightening steps by that time. On this historical basis investors, rather have reason to look forward to the first tightening than not.

4. INFLATION EFFECT ON RATINGS

Investors have been shaken by the 4.2% headline inflation number last week.

S&P 500 – Median P/E Ratio per CPI Inflation Tranche (%)



Source: Kohlberg Kravis Roberts & Co. L.P., April 2020.
Data: 1948 – 2020

The historical relationship between Inflation and P/E ratings is clear in the preceding chart. It forms a distinct curve, indicating that both very low and very high inflation numbers are detrimental to equity ratings. The proverbial 'sweet spot' is around 2%. This level 'oils the wheels of the economy' without causing detrimental cost pressures.

Very low inflation levels are associated with difficult economic circumstances and low earnings growth, resulting in lower valuation multiples. High inflation levels are associated with more unstable economic circumstances and lower quality of earnings growth, also resulting in lower valuation multiples.

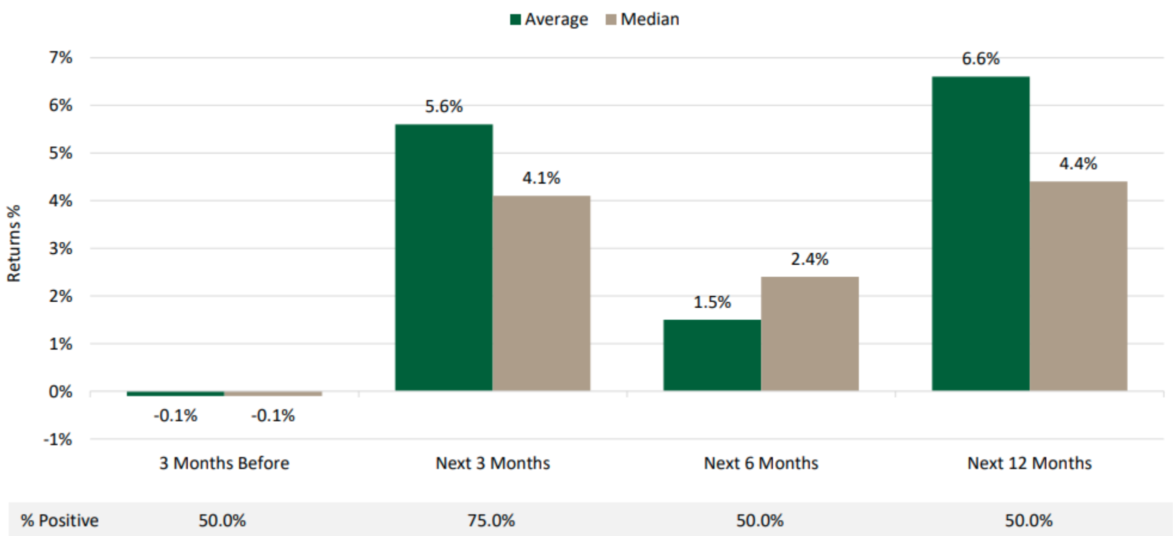
Investors have over the past few years been spoilt with almost ideal inflation levels from a valuation perspective. Fears for higher inflation levels and subsequent lower valuation levels are rampant currently.

It seems clear that we will have higher inflation levels for a while, at least while base effects become water under the proverbial bridge. It is therefore even more important to invest for solid sustainable growth to compensate for the risk of some valuation derating.

5. RISK OF HIGHER TAXES

Higher taxes are generally expected to finance some of the COVID-19 costs. Investors are anxious what affect that may have on their equity returns. We consider lessons from the past in this context:

S&P 500 – Total Return Around Increases in Capital Gains Tax Rates

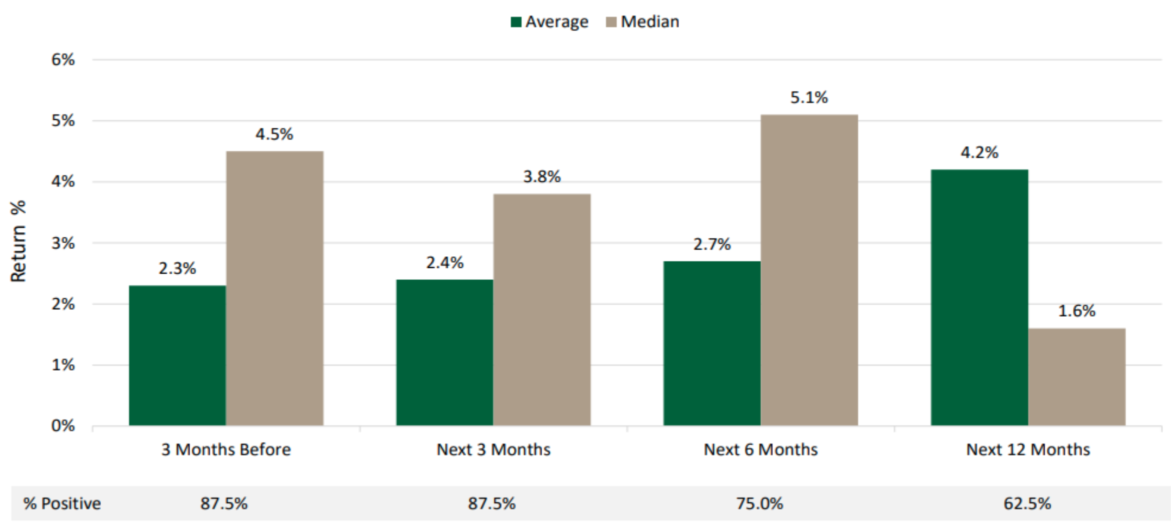


Source: LPL Research, Ned Davis Research, FactSet, April 2021. **Past performance is not a guide to future returns**. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.
Data: Since 1969 (4 Occasions, including 1969)
*S&P 500 Total Return

There have been four occasions of increases in Capital Gains tax rates since 1969. The above chart reflects S&P 500 returns around such events. Markets have, in general, been flat in the three months before implementation, but delivered fair returns afterwards. The data is suppressed by the 1969 tax hike in a bear market that started the previous year.

Investors are particularly anxious about the potential increase in the corporate tax rate. We have had 8 similar occasions since 1940 to consider in the chart following on the next page. Tax rates have increase by between 2% and 9%, with an average of over 5% increase.

S&P 500 – Total Return Around Increases in Corporate Tax Rates

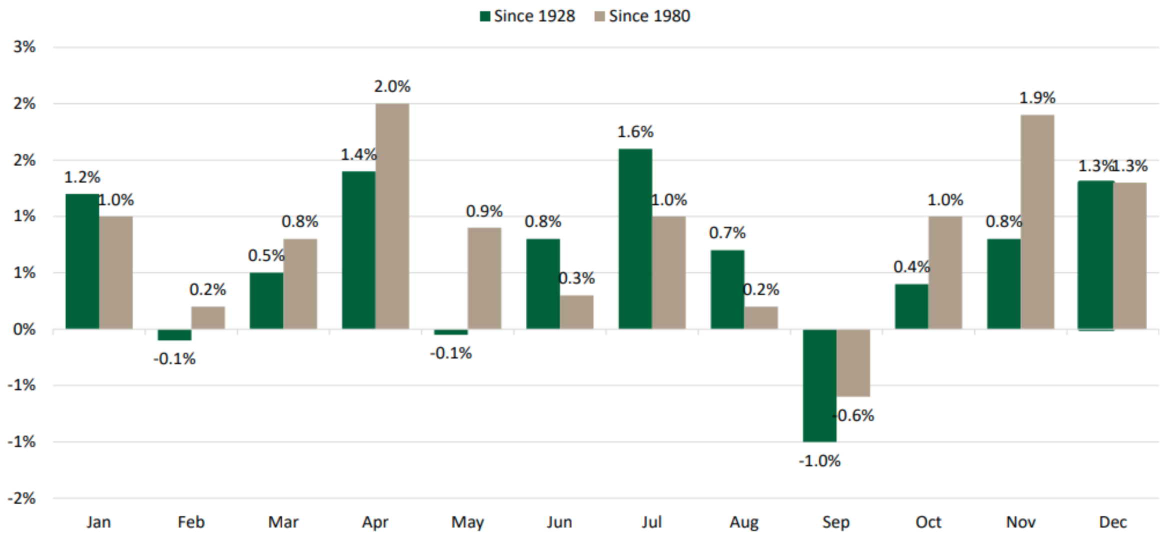


Source: LPL Research, FactSet, May 2021. **Past performance is not a guide to future returns**. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.
Data: Since 1940 (8 Occasions)

Strikingly, the average returns around the corporate tax rate hikes were positive in all periods in the chart. Only two occasions (successive hikes in 1940 and 1941) delivered negative results and affected the data in the chart detrimentally. On this basis, it seems that we do not need to fear a tax hike too much.

6. SELL IN MAY?

S&P 500 – Average Monthly Performance (%)



Source: Stonehage Fleming Investment Management, Bloomberg, May 2021. **Past performance is not a guide to future returns**. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

The above chart serves as a good reminder that investors do, on average, better to hold their investments through the May to August period – it more than compensates for the traditional September lull.

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