GLOBAL EQUITY PERSPECTIVES 18 AUGUST 2019

"The noblest pleasure is the joy of understanding."

Leonardo da Vinci

1. YIELD CURVE

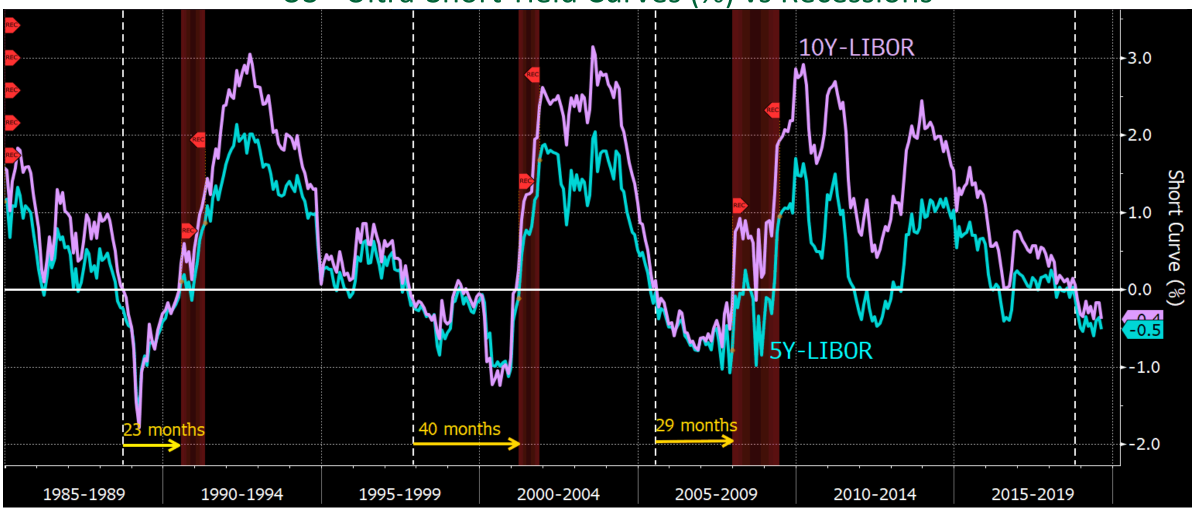
The US yield curve has made it to our front-page for the first time. Angst around trade tariffs and negative news on the German economy triggered the first inversion of the 2Y/10Y curve in the current economic cycle for a few short moments last Wednesday but featured in many headlines.

US - Yield Curves (%) vs Recessions (Short = 10Y-2Y. Long = 30Y-10Y)

The curve steepened through the day into constructive territory and continued this trend thereafter. Nevertheless, recognising this alarm, historically when this short curve (the blue line in the chart) inverted on a sustained basis, it acted as a warning of a US recession being, on average, 20 plus months away. On this basis it seems the current economic cycle can stay constructive well into the first half of 2021. Along with this, we should also make our clients aware that the long curve does not yet make its contribution towards such a warning, while historically it correlated better than it currently does with the short curve at such events.

We are more uncertain about the fundamental value of ultra-short curves because short rates are more susceptible to daily news items and short-term market positioning. Nevertheless, the following chart considers their messages in the above context:

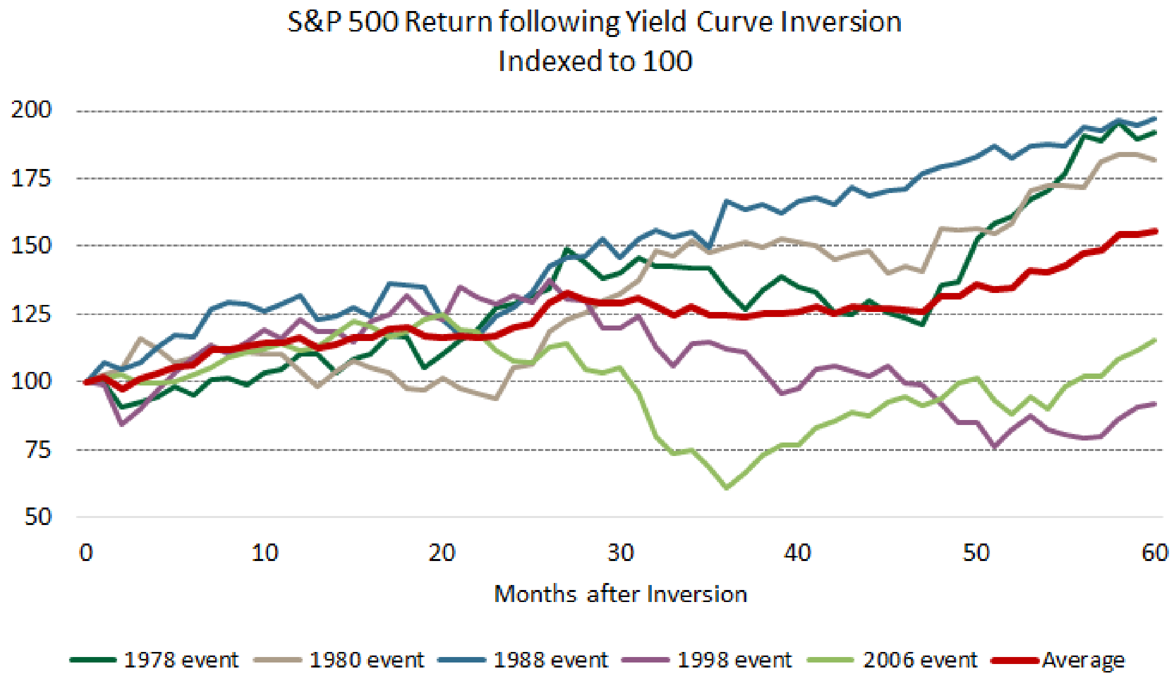
US - Ultra-Short Yield Curves (%) vs Recessions



Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

These ultra-short curves inverted towards the end of last year. They historically have longer lead-times than the longer curves, but interestingly, provide roughly the same message as the short curve in our first chart. We also note that their inversions currently remain quite shallow in contrast to their previous trends, providing a mild rather than strong recession warning.

We remind our clients about further relevant issues around recessions. Share prices traditionally peak within six months of the respective recession – if those recessions are deep enough to cause structural breaks in share prices. As a reminder, this aspect is also reflected in the following chart we have shown in a recent note:



The chart illustrates the S&P 500 behavior since the 2y/10y inversion events over earlier economic cycles (prices are indexed to 100 at the inversion event). Prices continued in most cases on a positive trajectory for quite some time, with the 1998 and 2006 inversions (the tech bubble and credit crisis respectively) leading to the most negative results. In the case of the average performance (the red line) it remained in positive territory, and only stagnated after more than two years, picking up again subsequently.

It is clear that the depth of the economic recession following the yield inversion event is key in determining the potential risk for the equity market at the time. We currently see continuing economic expansion in the US, but at a slow rate – the proverbial 'soft landing', but on a 'long landing strip'. We elaborate more on this theme in paragraph 3 of this note.

2. US CONSUMER

We noticed a headline in a research note last Friday reading 'US consumer the pillar of the world economy'. That sounded like quite a brave statement to us, but as our clients may recall, we have earlier expressed opinion that the US consumer behavior is key to its capital markets – consumption makes up 70% of GDP.

Growth in both the Chinese and US retail sales are stable, respectively at +7.6% and +3.4% in domestic currency terms. The weak Renminbi is currently hurting the Chinese number in Dollar terms, but their sales are within 8% of the total US retail sales (considering twelve-month numbers). The combination of these two forces remain a huge focus area for strategic investors.

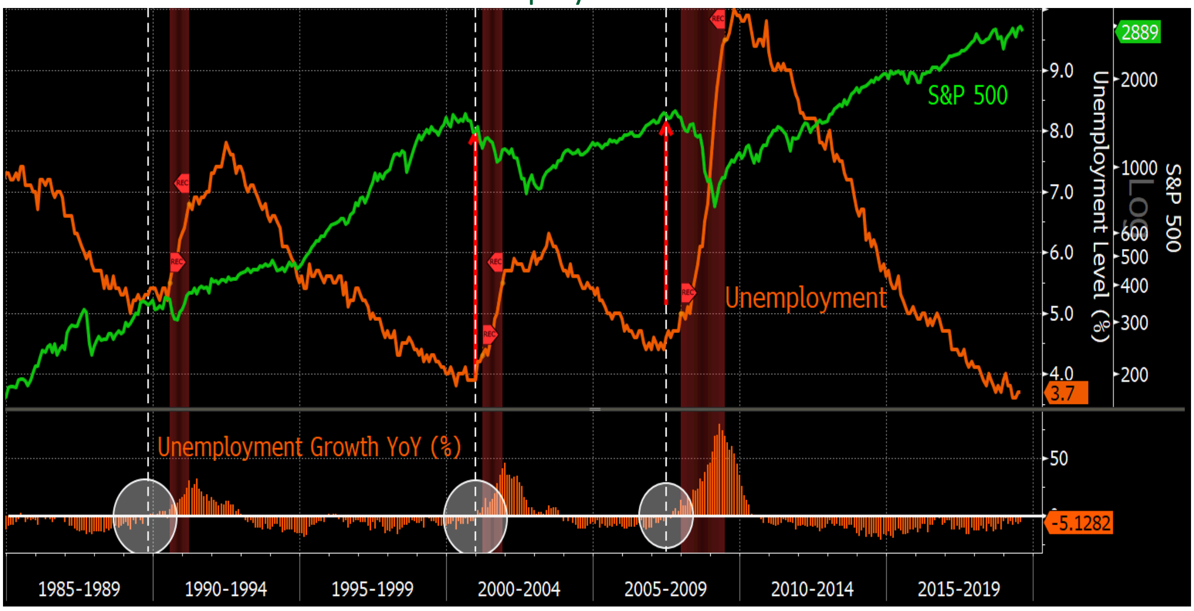
The following chart considers the two main measures of US consumer confidence:

US Consumer Confidence Indices – Conference Board vs University of Michigan

Both the Conference Board (CB) and Michigan confidence indices are well above their respective averages. The Michigan reading for this month has dropped marginally, causing some negative headlines. The CB update will be released this Friday, but the July reading was strong.

With more volatility in the CB data, the ratio between the two indices offers helpful information – the ratio historically formed a negative trend in the run-up to a recession (see the green bars in the chart above). This trend is currently still constructive.

US – Unemployment vs S&P 500

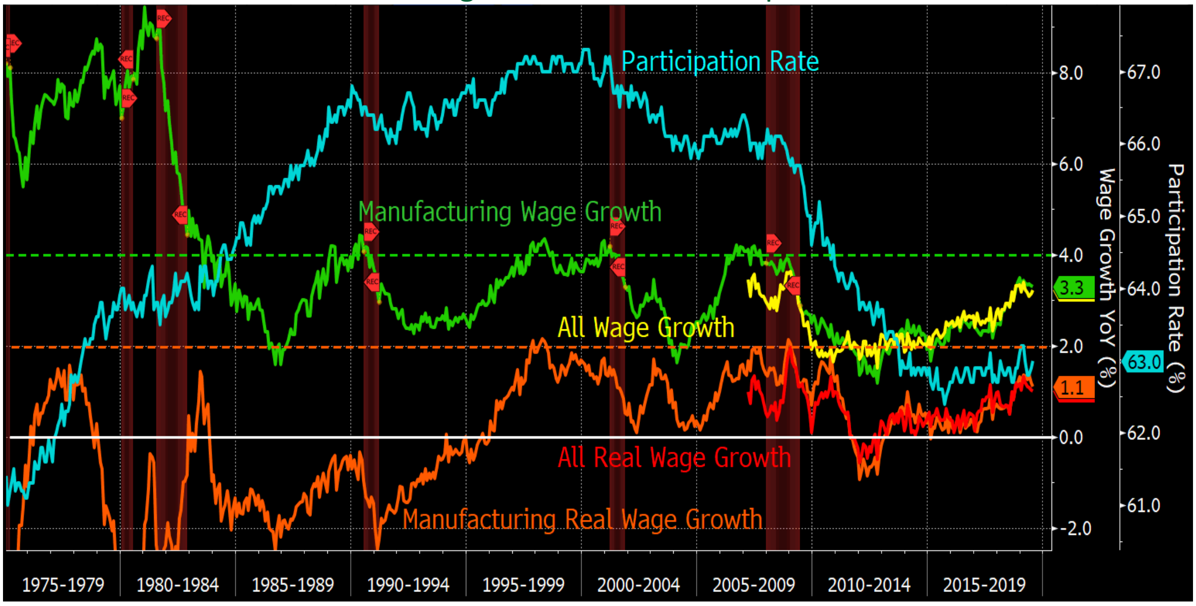


US unemployment is currently at historic low levels and implies a solid foundation for consumer confidence. It has not yet formed a clear bottoming-out pattern as it traditionally did before the respective upcoming recessions. The growth in the unemployment numbers (the bottom section of the above chart) also offers valuable insights – it has been effective in calling the structural peaks in the S&P 500 index when the negative growth number reached the zero level (the white circles in the chart). The current level of -5% does not yet provide such an indication.

Wages have also been supportive of the US consumer market. The following chart provides perspectives in this context:

Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

US – Wage Growth and Participation



Wage growth has been in a rising trend for some time already, currently at a cycle peak of +3.3% in nominal terms and +1.1% in real terms. Whilst these levels are some way off danger levels regarding recessionary risks (+4% and +2% respectively for around two years), they are supportive of consumer confidence. Importantly also, the current participation rate of 63% (the blue line) is well below levels perceived to hold recessionary risks.

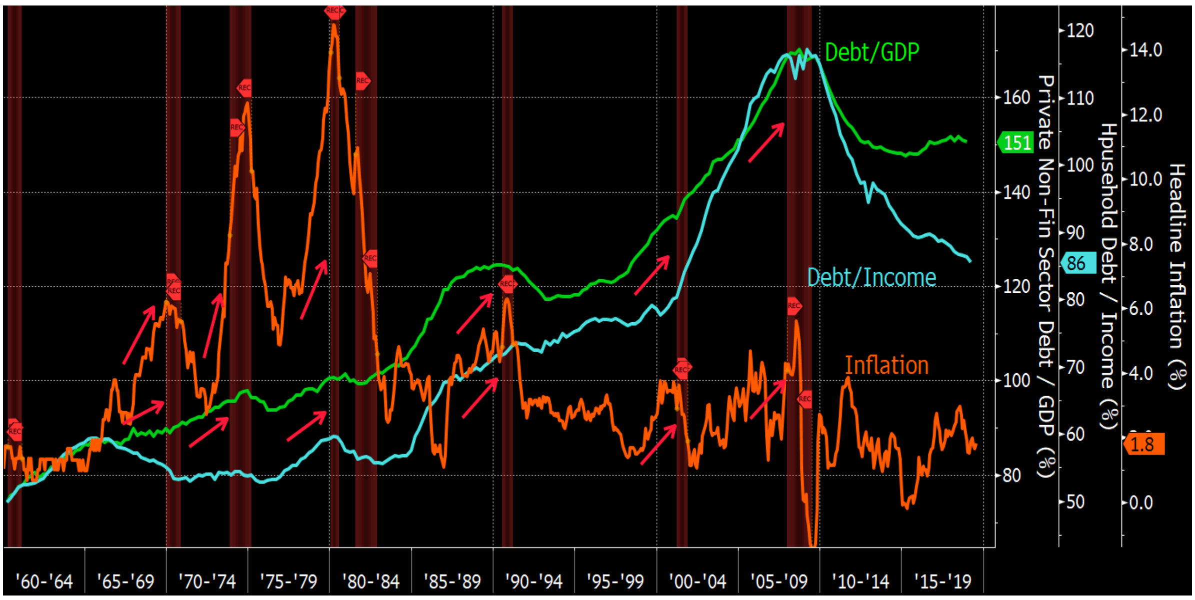
All-in-all, we continue see the US consumer continuing to be on the side of Equity investors.

3. STRUCTURAL IMBALANCES

As effectively illustrated with our chart on page 2, the level of risk for capital losses around US recessions varies widely according to the depth of the particular recession, and along with this obviously the structural imbalances there may be in the economy at the time. The most concerning balances are usually around debt and inflation levels.

The following chart puts these issues in perspective. There is currently widespread concern particularly around high corporate debt levels.

US – Private Sector Debt and Inflation vs Recessions

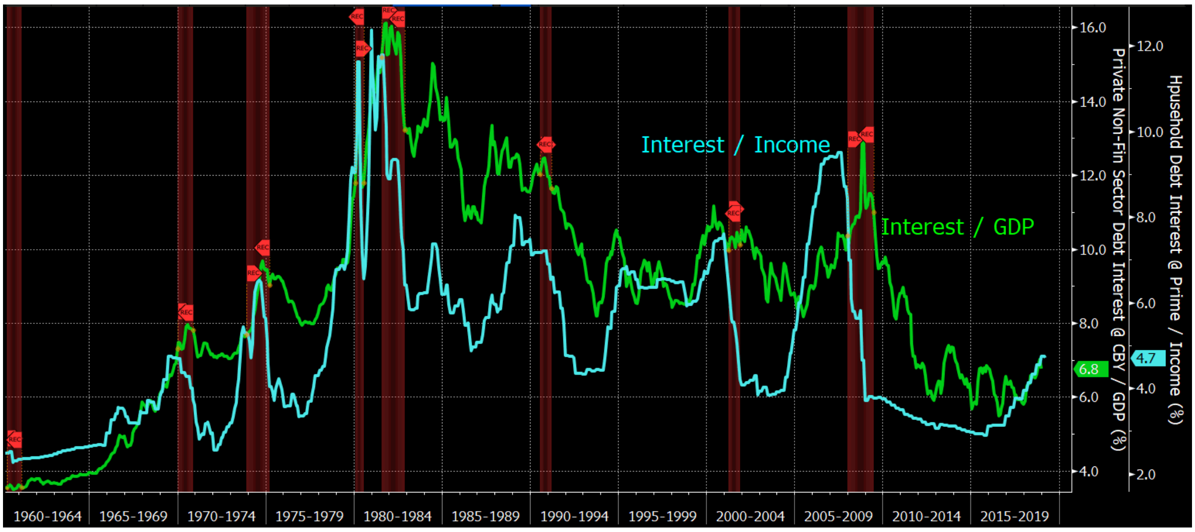


Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

The private sector Debt/GDP seems high (the green line in the preceding chart) but is lower than levels leading to the credit crisis. Importantly also, this ratio increased in the run-up to all previous recessions, whilst not being the case currently. Along with this, the Household Debt/Income ratio is currently in a steep decline against opposite trends during earlier economic upswings. Importantly, inflation remains at moderate levels, contrary to historic trends preceding recessions. Inflation expectations have been receding since the beginning of this year, currently at 1.4% after five years. It therefore seems that there are less structural imbalances to trigger a deep recession.

A main issue around debt is clearly the interest burden on the corporate or individual. We have done a rough calculation for some indication of interest burdens in this context, applying an average corporate bond yield and prime interest rate level to the respective debt levels in the chart on the previous page. Whilst this approach does not provide completely correct numbers, it does reflect broad indications in this context:

US – Private Sector and Household Interest Burdens

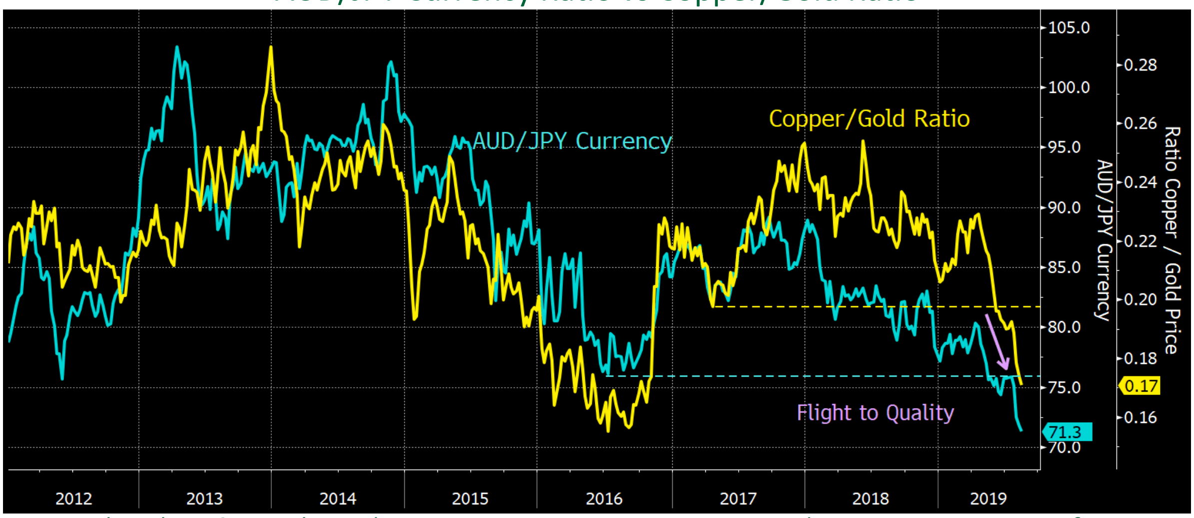


On the above basis, Corporate interest payments (as a ratio to GDP) have been in a rising trend recently, but are still at relatively low levels. The current level is actually still lower than most of the historic cycle low levels than to the respective cycle high levels. A similar relatively comfortable case can also be made for the Household interest/income ratio. On this interest cost basis, it therefore seems that there may not be less concerns about overall debt levels currently.

These conclusions support our perception of a 'soft landing on a long landing strip' for the US economy.

4. FLIGHT TO QUALITY

AUD/JPY Currency Ratio vs Copper/Gold Ratio

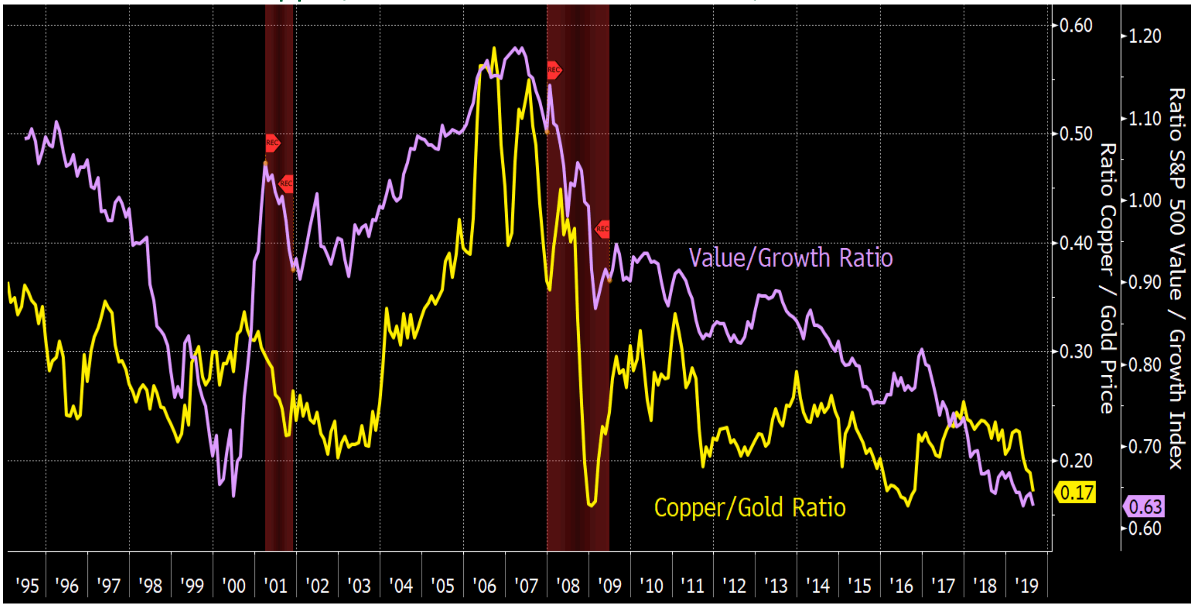


Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

We apply two technical indicators of support to quality investing in the preceding chart – the Australia Dollar / Japanese Yen currency ratio and the Copper /Gold commodity ratio. Both ratios have recently dropped through cycle lows (in 2016 and 2017 respectively) indicating a continuing flight to quality investing.

In this quality context, we apply the above commodity ratio in the following chart considering the Value/Growth investment theme:

Copper/Gold Ratio vs S&P 500 Value/Growth Ratio

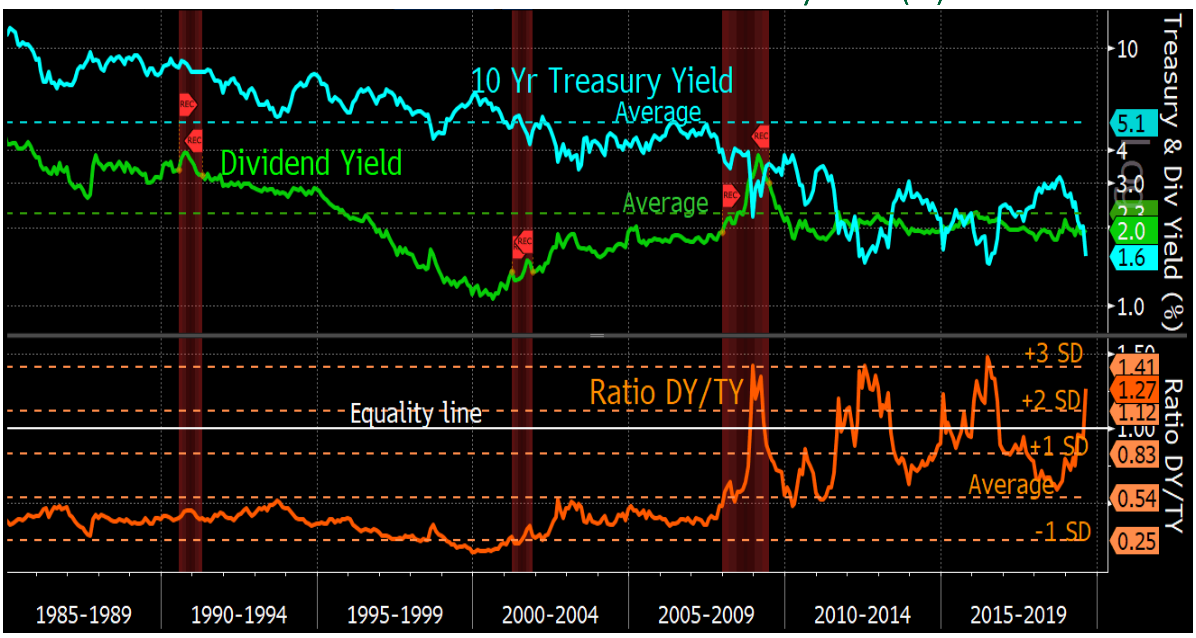


There seems to be a good correlation between the two series in the chart with the Growth theme continuing its outperformance against Value. Along with low economic growth and low interest rates, there are no clear technical indications of a turnaround in this context.

5. DIVIDEND YIELD

With the combination of good S&P 500 dividend growth and lower interest rates, we are at an interesting conjunction in this context:

US – S&P 500 Dividend Yield vs Treasury Yield (%)

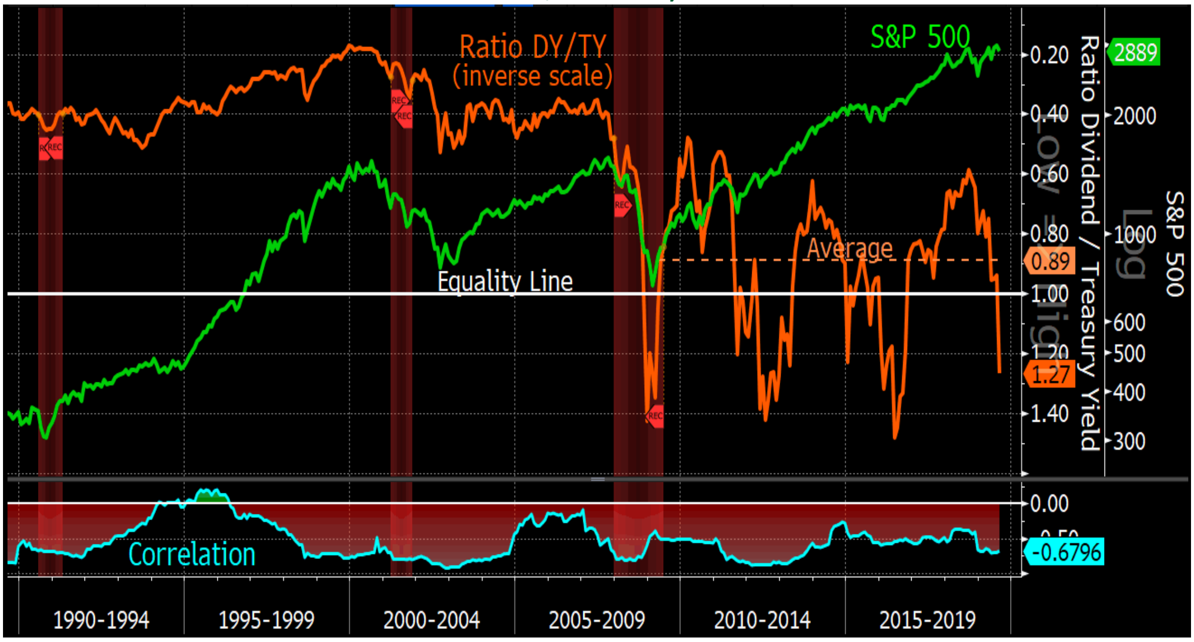


Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

With the Dividend Yield (DY) at 2.0% and the Treasury Yield (TY) at 1.6% (top section of the chart), the income ratio between the two is currently 1.27 in favour of equities (bottom section of the chart). This ratio is +2.5 standard deviations away from the long-term average. We see little risk for dividend cuts to lower the ratio (we actually see continuing good potential for healthy dividend growth), and rather see this ratio supportive of Equities.

We present the DY/TY ratio along with the S&P 500 index in the following chart. For ease of reference, the Y-axis for the ratio is presented on an inverse scale to compare with the S&P 500.

US - Ratio Dividend/Treasury Yield vs S&P 500



Logically, there is a (negative) correlation between the two series (confirmed in the bottom section of the chart). Other issues being equal, the ratio currently argues well in favour of Equities.

Considering the possibility of rising interest rates, we have the following comments. If we take a conservative approach and assume the ratio has structurally resettled in a new range after the credit crisis and consider only that average (not a long-term average), this implies the Treasury Yield can increase by 43% from the current 1.6% to 2.3% and still leave Equities fairly valued on this relative basis. This may well be possible, but we can also make the point that economic reasons for that to happen may well also be supportive of Equities.

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Source: Bloomberg & Stonehage Fleming Investment Management Limited. August 2019. ***Past performance should not be used as a guide to future performance.***

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