STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 28 MAY 2018

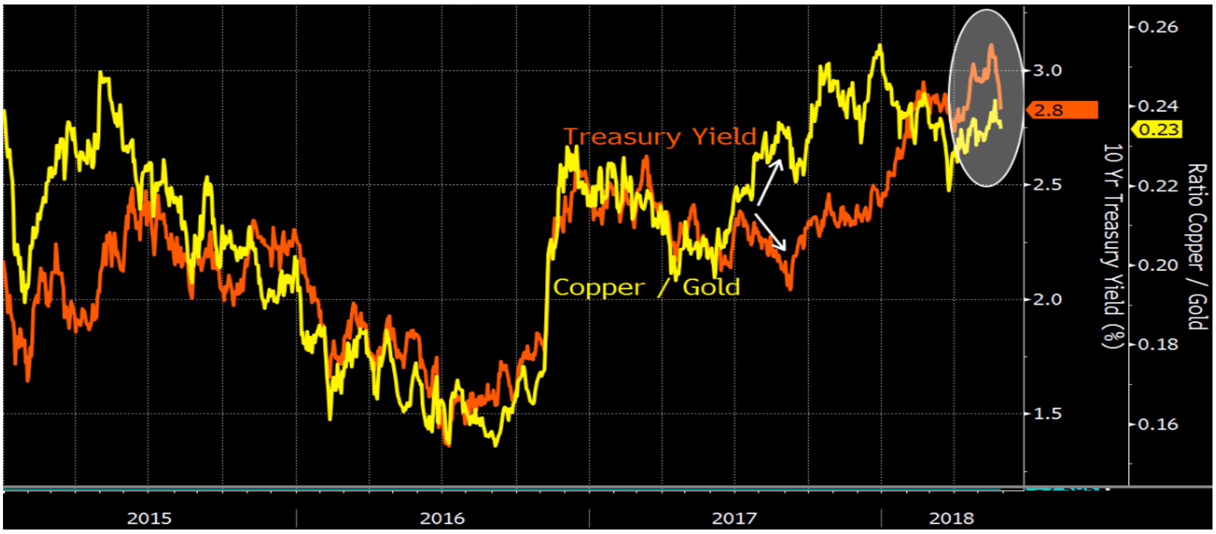
"Luck is what happens when preparation meets opportunity."

Seneca the Younger

1. STABLE BOND MARKET

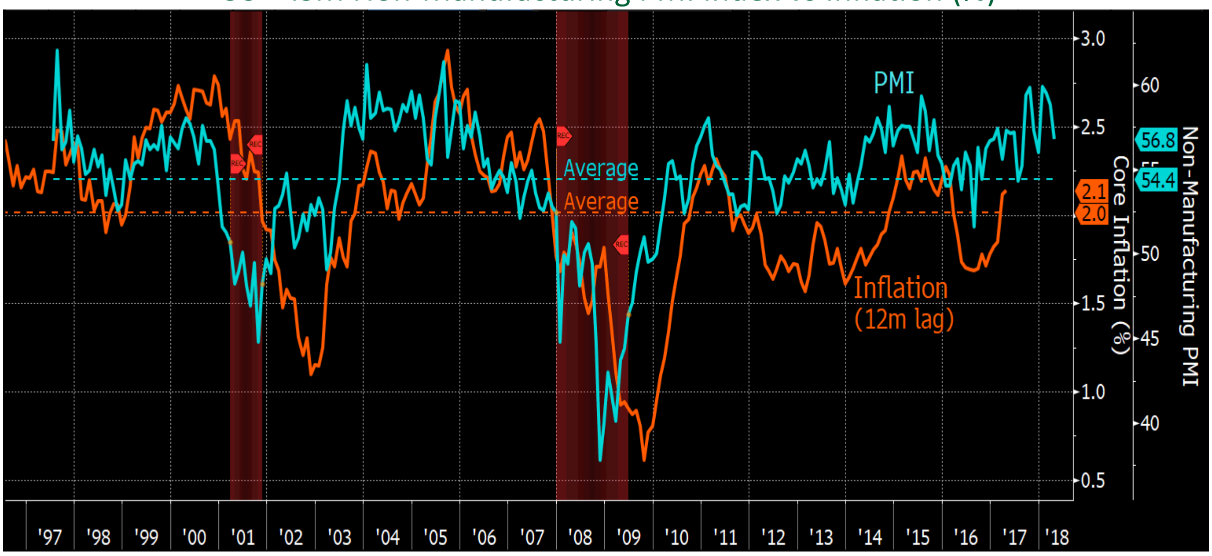
It is striking how stable the US bond market remains despite the anxiety in February following the strong US employment numbers. As the following chart illustrates, economic realities in the end are more determinant of the capital markets:

US – Ten Year Treasury Yield (%) vs Ratio of Copper Price / Gold Price



The copper/gold price ratio is indicative of both the strength and inflationary risks in the global economy and has a good correlation with US interest rates. Contrary to many earlier fears about runaway US inflation, this ratio seems well contained, and the ten-year treasury yield has dropped back below the psychological 3% level.

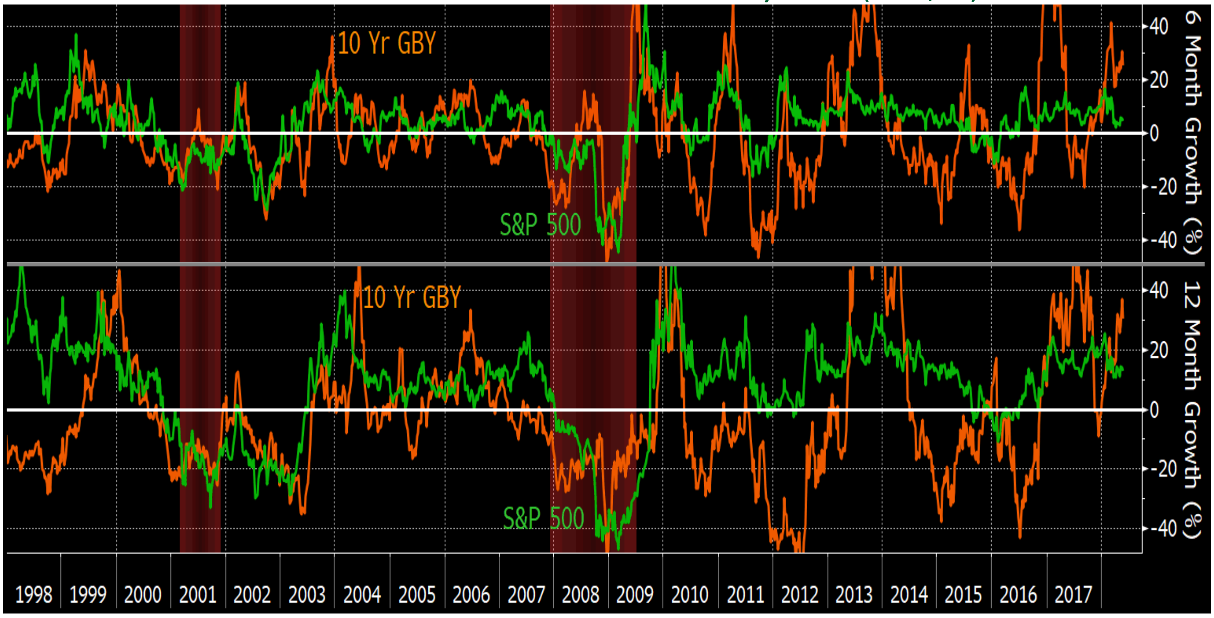
US – ISM Non-Manufacturing PMI Index vs Inflation (%)



It seems that the PMI data may have peaked, but we can still expect it to 'pull up' inflation levels somewhat (considering the historic correlation between the two series). This would, in our view, still be part of a standard normalization process and would not yet cause concern.

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

US – 6 and 12 Month Growth in Ten Year Treasury Yield (GBY, %) vs S&P 500

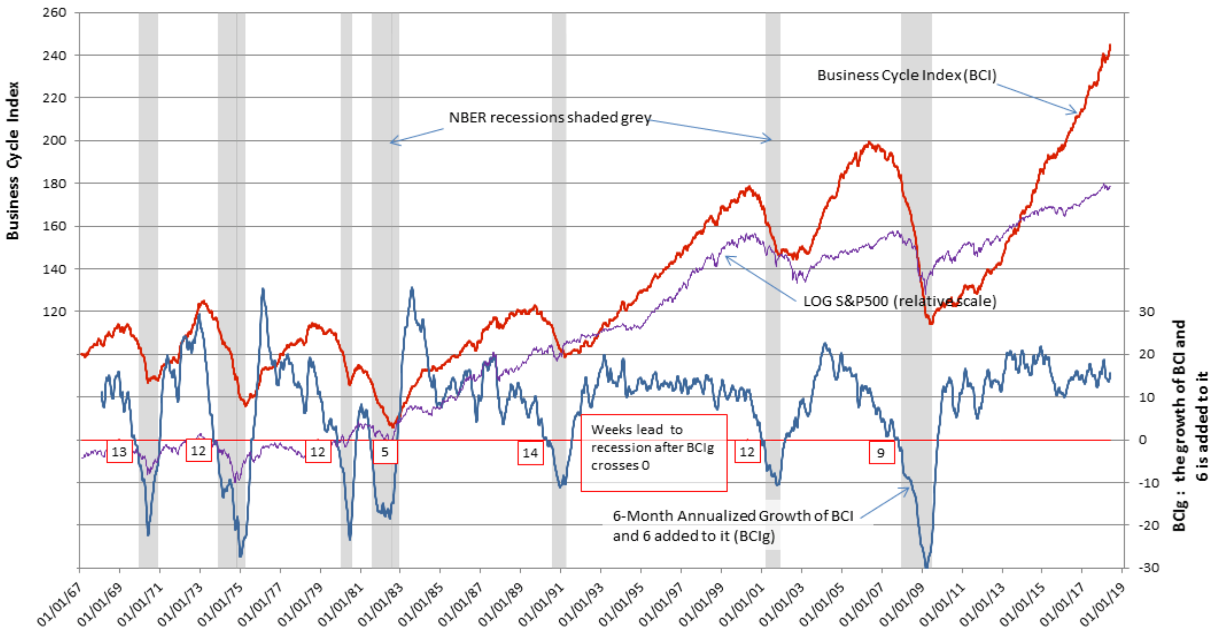


As reflected in the above chart, the structural relationship between US interest rates and share prices over six or twelve months seem to remains intact. We do not detect anything particularly out of the ordinary in the chart.

2. US BUSINESS CYCLE

The following chart shows a valuable US business cycle index. It is based on a combination of the longer-term treasury yield, the short-term treasury bill yield, unemployment claims, employment numbers, home sales and share prices.

US - iM Business Cycles Index vs S&P 500



Source: iMarketsignals. May 2018. Past performance should not be used as a guide to future performance.

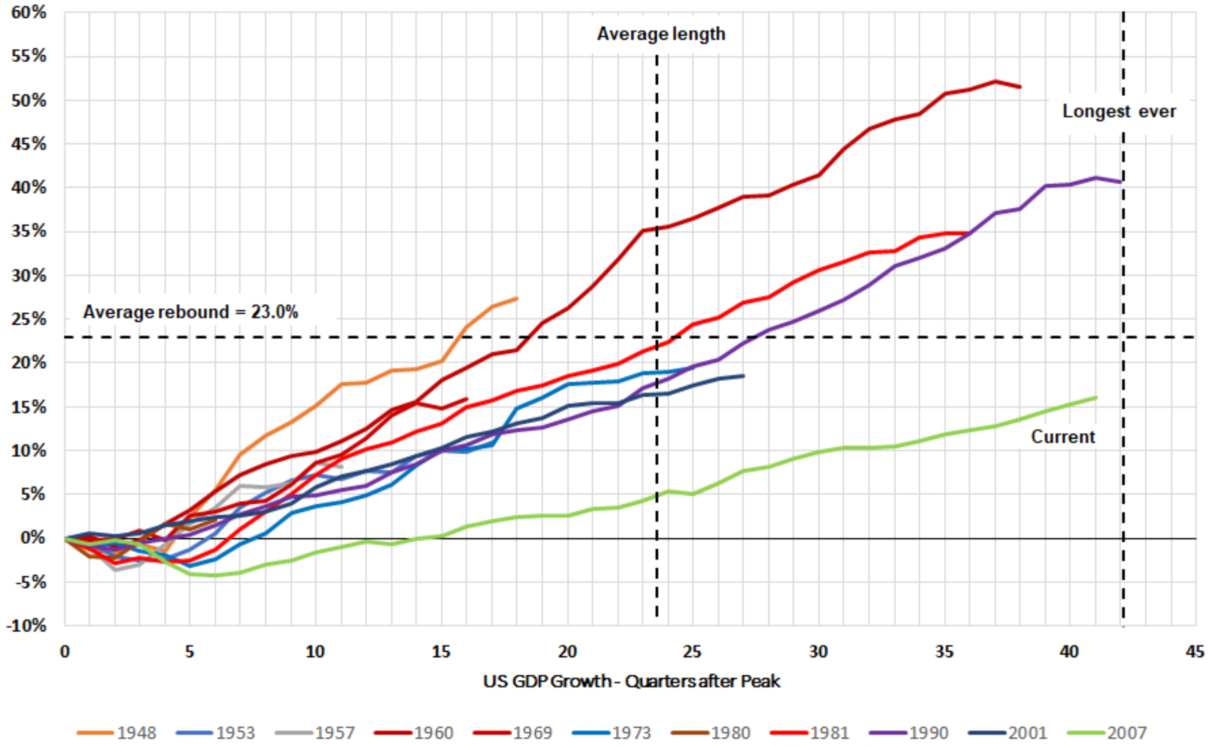
The index's most recent reading has spiked upwards (the red line). The 6-month growth in the index (the blue line at the bottom of the chart) has a good record in predicting a recession well in advance (about a year on average) when the growth stagnates and becomes negative.

This index is currently growing at +15.8%. This level has historically indicated continued business cycle expansion with no indications of an imminent recession.

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

We often hear comments that the US economy has by now been in an expansionary phase for too long and proverbially that 'no tree can grow forever'. The following charts provides interesting perspectives in this context:

US – Length and Level of Economic Cycle (Peak-to-Peak)

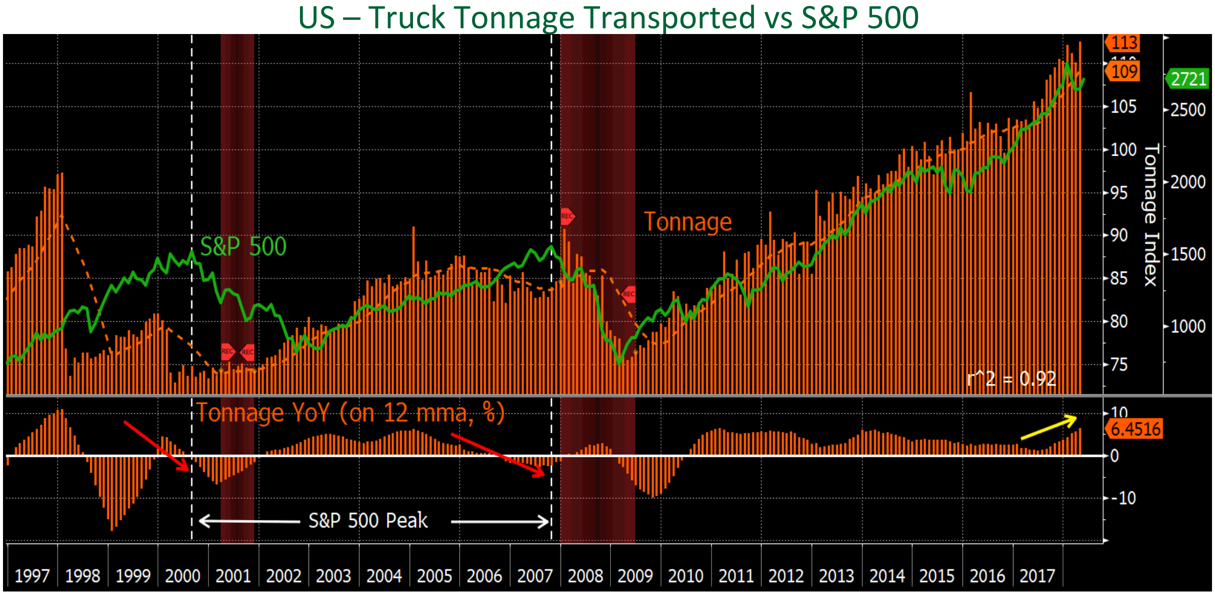


The current economic cycle may, towards the end of this year, become the longest in seventy years. It is, though, striking that the level of recovery is still quite moderate and not yet even at three quarters the level of historic levels of recovery. We therefore cannot simply, because of the long duration of the current recovery cycle, take a negative view of further potential in this context.

3. US ECONOMIC ACTIVITY

We follow many data series to form an impression of the risks for an imminent US recession. Apart from auto sales numbers, these data series are currently predominantly constructive. The following two charts are of particular value in this context:

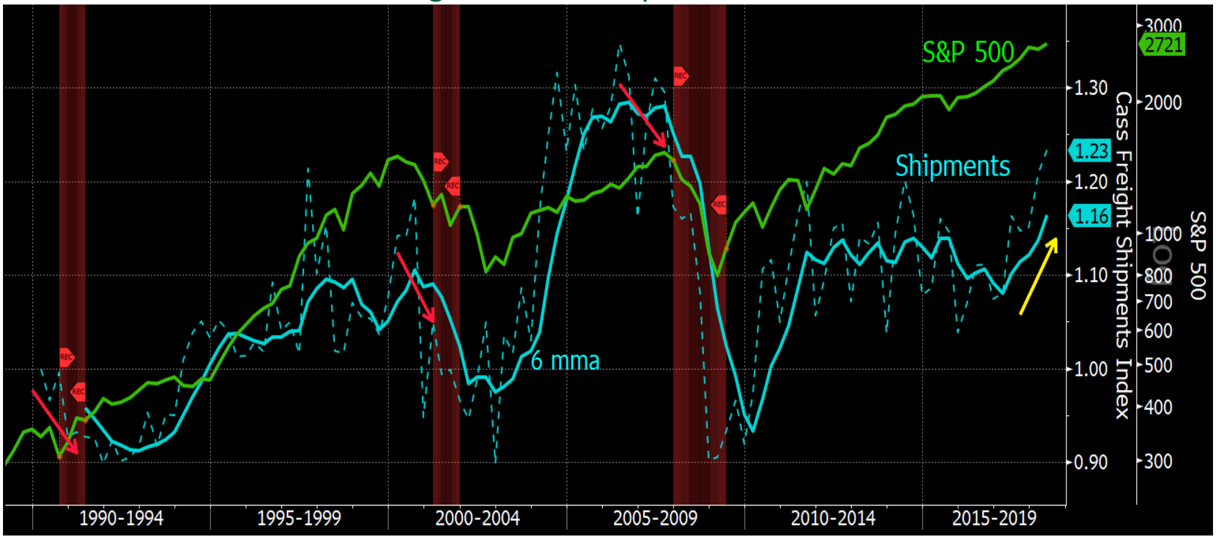
US – Truck Tonnage Transported vs S&P 500



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

The tonnage of goods transported in the US is currently still in a rising trend, growing at +6.5% annually. This is clearly constructive. Also, this series has historically been an early indicator of rising risks for an upcoming recession and the peaks in share prices (see the red arrows in the bottom section of the preceding chart). The current growth trend argues against such risks.

US – Cass Freight Volume Shipment Index vs S&P 500

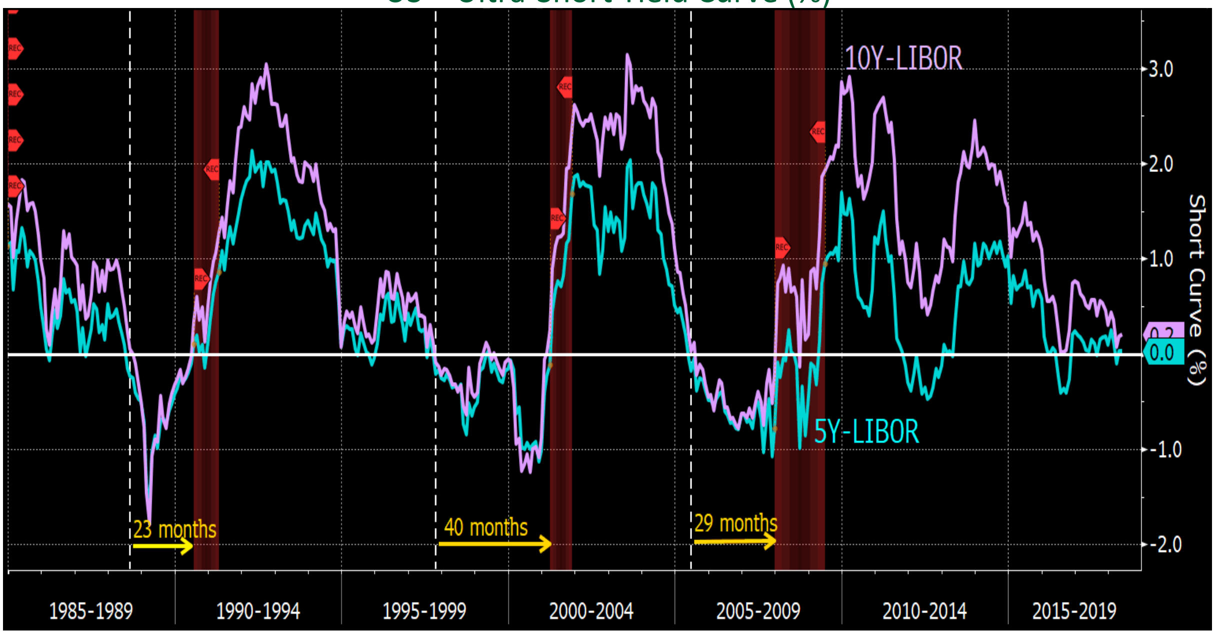


The shipment data in the above chart also show a rising trend currently. This also argues in favour of continued economic expansion in the US.

4. RISING SHORT RATES

Many fear the negative effects on the US economy resulting from short rates rising more rapidly than long rates (the flattening of the yield curve). It is too early, in our perception, to factor in economic effects in this context. We motivate our conclusion through the next two charts focusing on the shorter rather than the longer yield curves:

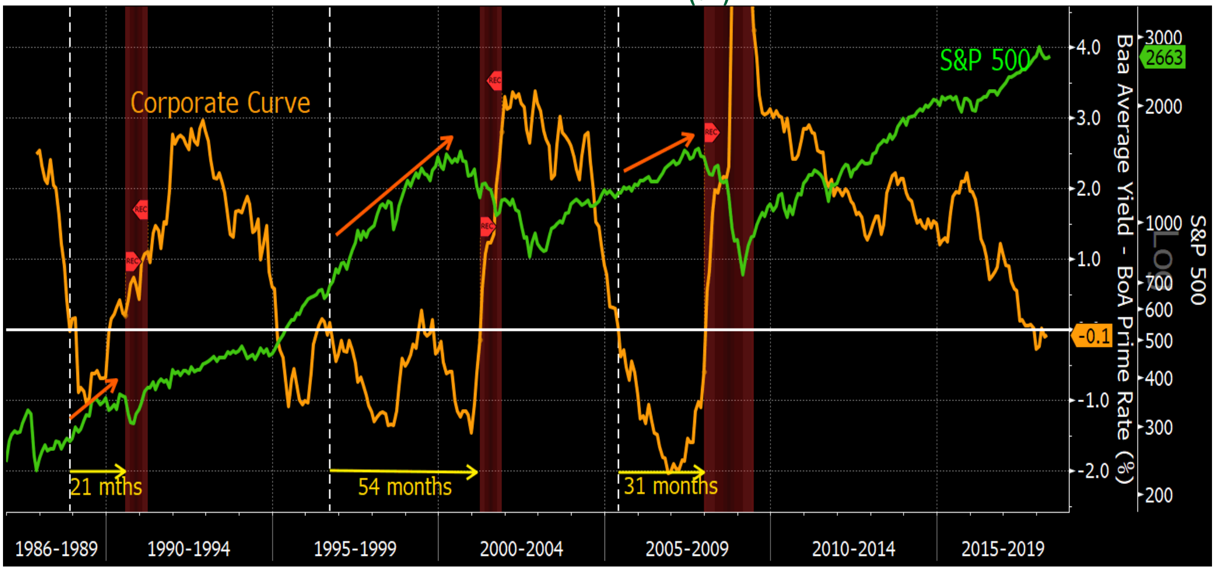
US – Ultra-Short Yield Curve (%)



The ultra-short yield curve has flattened, but not yet inverted. It is not clear whether it will shortly invert, but if so, an inverted curve has historically provided a two-and-a half year (on average) early warning of an upcoming recession. On this basis the peaks in share prices in this cycle still seem to lie quite some time in the future.

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

US – Business Yield Curve (%) vs S&P 500



We calculate the yield curve for corporates by subtracting the prime overdraft rate from the BAA Moody's corporate rate. On this basis the business yield curve seems to be in the process of inverting. Whilst most businesses in this cycle have fixed their debt towards the longer end and may not necessarily experience this effect, it may be that the capital markets rather simply consider this macro data (rather than company specific data) and we would therefore be more cautious for higher geared businesses.

Despite the preceding comment, this curve has historically provided a three-year early warning of a recession (on average) and as reflected in the chart, share prices continued to rise for extended periods after the reversions of the curve (see the orange arrows).

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