STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 23 JULY 2018

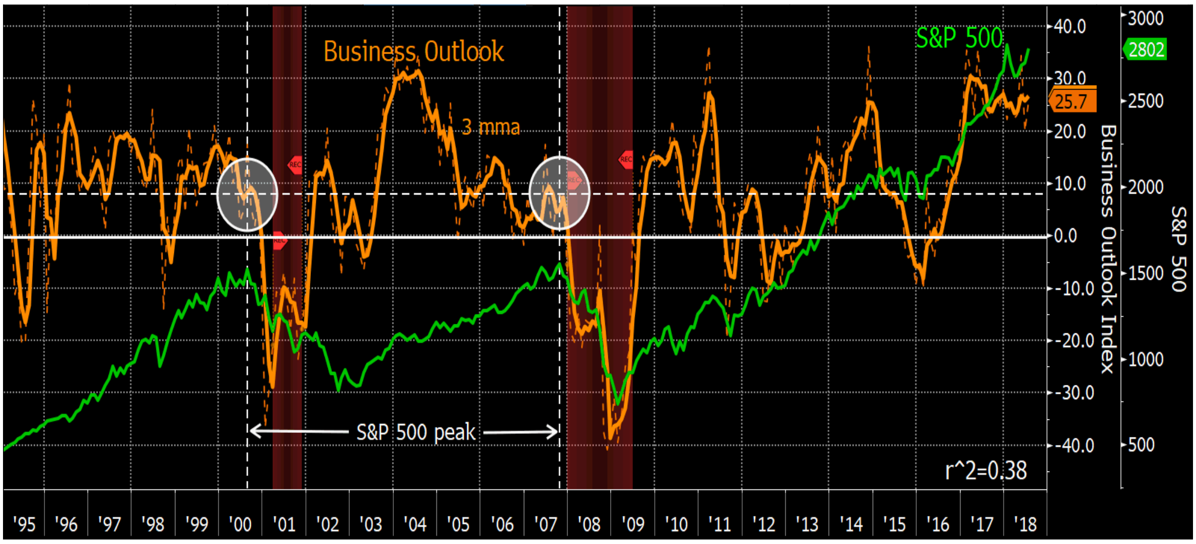
"He who is brave is free."

Seneca

1. US ECONOMIC BACKDROP

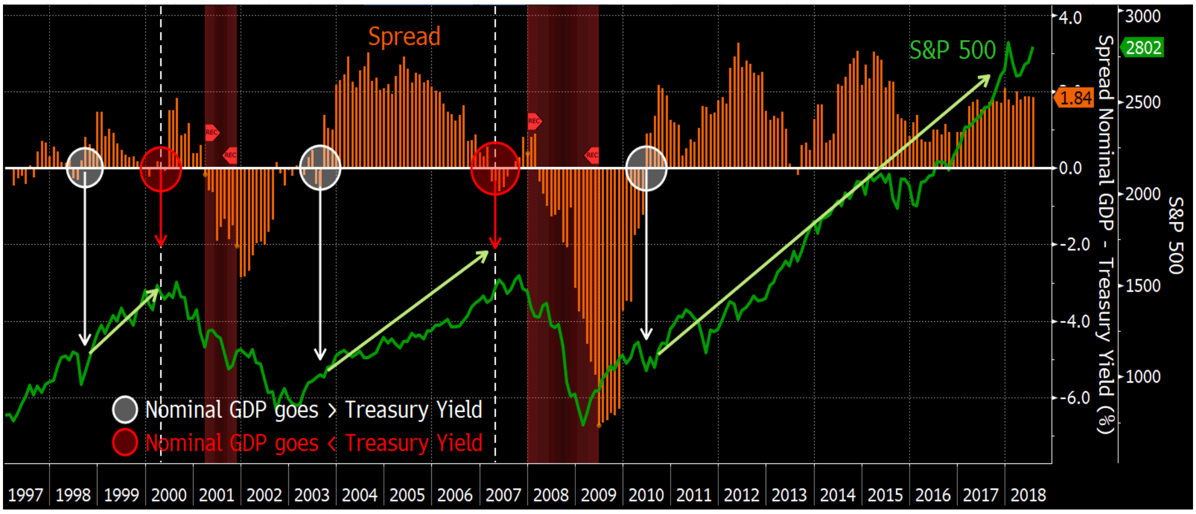
Most leading US economic indicators are currently at historically elevated levels, with some seemingly in a process of peaking and rolling over. Headlines of 'this is as good as it gets' may well be expected. The following chart is a representative illustration of, despite such a peaking process, how constructive the economic backdrop continues to be for equity investing:

US – Philadelphia Fed Business Outlook Index vs S&P 500



The business outlook index has been drifting for a while but is still at an elevated level. The index historically peaked at least 16 months before the subsequent recession and drifted to an index reading of 8 at the peak of the S&P 500 index. The outlook index reading currently has a reading of three times that level, and therefore reflects ample room for continued equity market performance.

US – Spread Between Nominal GDP and Treasury Yield (%) vs S&P 500



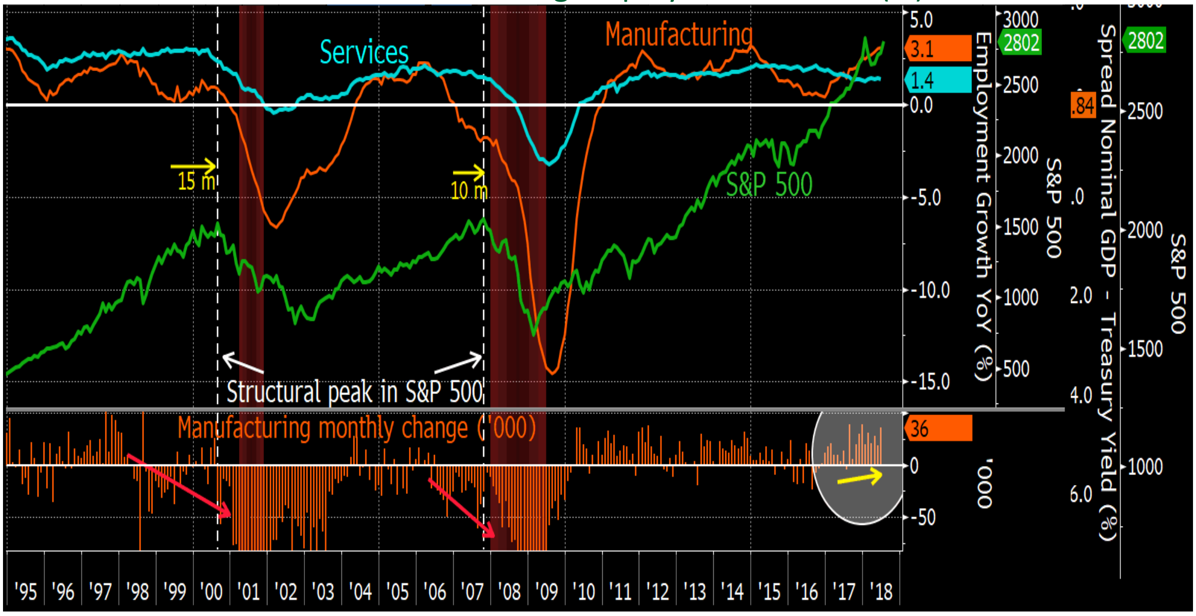
Despite the rise in interest rates, the spread between the economic growth levels and interest rates remain at elevated levels. This continues to be supportive of the equity market.

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

2. US EMPLOYMENT

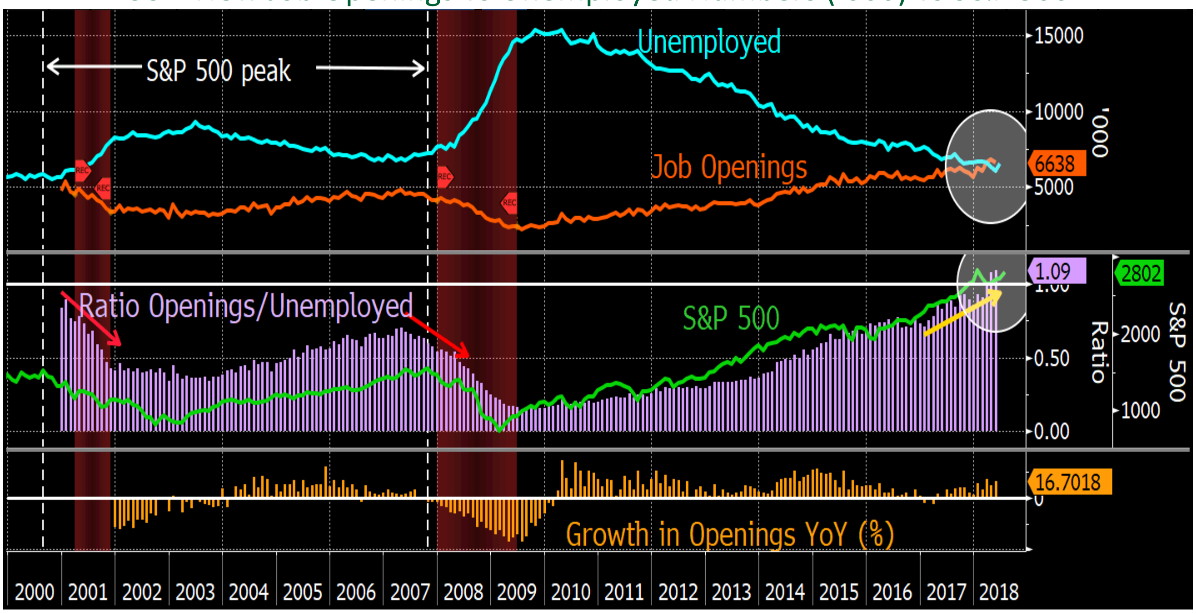
With domestic consumption making up 70% of the US economy and their stock market leading the world equity markets, their employment data is of critical importance to all investors.

US – Services and Manufacturing Employment Growth (%) vs S&P 500



Overall employment is currently growing at +1.6%. Strikingly, manufacturing employment growth is currently accelerating, growing at almost double this rate. Whilst it is the smaller employment sector, it is more volatile and more effective in predicting the peaks in share prices (around a year early warning) and the subsequent economic recession (see the orange line in the top section of above chart). The current employment data in this context is therefore particularly supportive to equities. This comment is further supported by the data in the following chart:

US – New Job Openings vs Unemployed Numbers ('000) vs S&P 500



The trend in the number of registered unemployed people keeps receding, whilst the reverse is the case for new job openings. Strikingly, for the first time since the turn of the century, the latter now exceeds the former (see the top section of the above chart), with job openings growing at +16% and the ratio of openings to unemployed now at 1.09 times (see the lower section of the chart). The trend of this ratio is a good stock market leading indicator and has been effective in forecasting recessions. The current trend is particularly constructive.

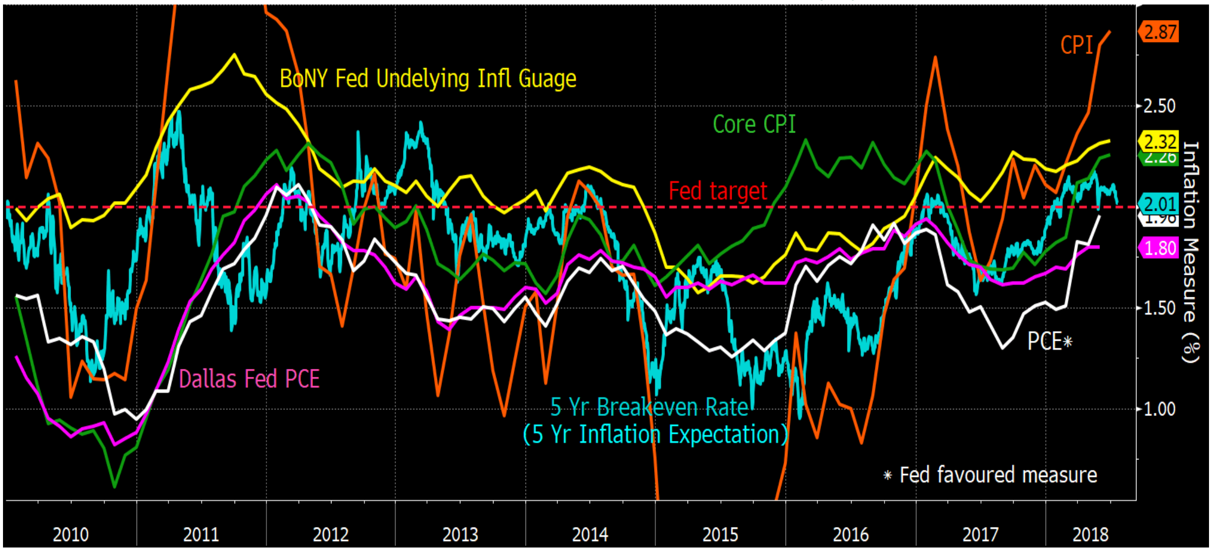
Source: Bloomberg & Stonehage Fleming Investment Management Limited. July 2018. Past performance should not be used as a guide to future performance.

3. US INFLATION

There are some concerns about the potential risk for runaway inflation and it is important for us to keep reconsidering the topic. We do not yet have enough reason to share those fears.

The following chart shows several different inflation measures. The Federal Reserve focuses predominantly on the price index for personal consumer expenditure (PCE). They judge that a level of +2% as the most consistent over the longer run with their mandate for price stability and maximum employment.

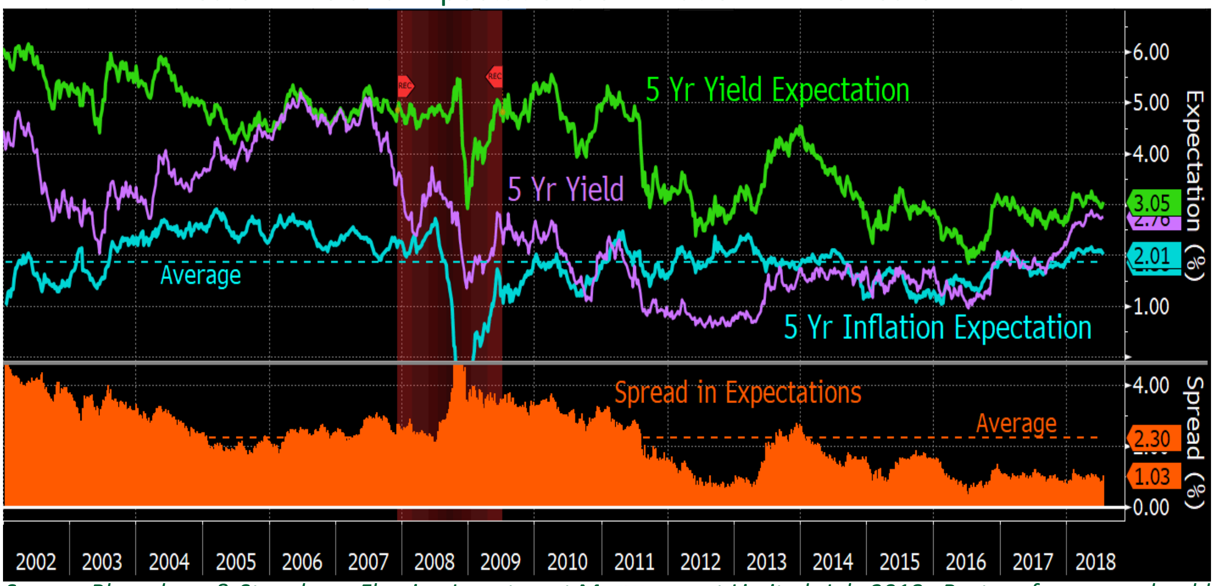
US – Different Inflation Measures (%)



All the different inflation measures are currently in a rising trend. The consumer price index (PCI) in particular has risen, mainly because of the higher oil price. Core CPI (excluding oil and food, because of their volatility) is much lower, with the PCE being close to the target rate. Strikingly, the market's expectations for inflation over five years is currently on the target rate (after expectations receded recently). These bring us to the conclusion that the Fed may be comfortable with the US inflation environment and does not need to be particularly aggressive in its tightening process.

We can see the market's expectations for future interest rates through the application of zero coupon yields, and similarly see the expectations for future inflation levels by considering the real yield of the inflation linked maturity curve. The following chart reflects these expectations:

US – Five Year Treasury Yield, Expectations of The Five-Year Treasury Yield in Five Years' Time and Expectations of Inflation in Five Years' Time



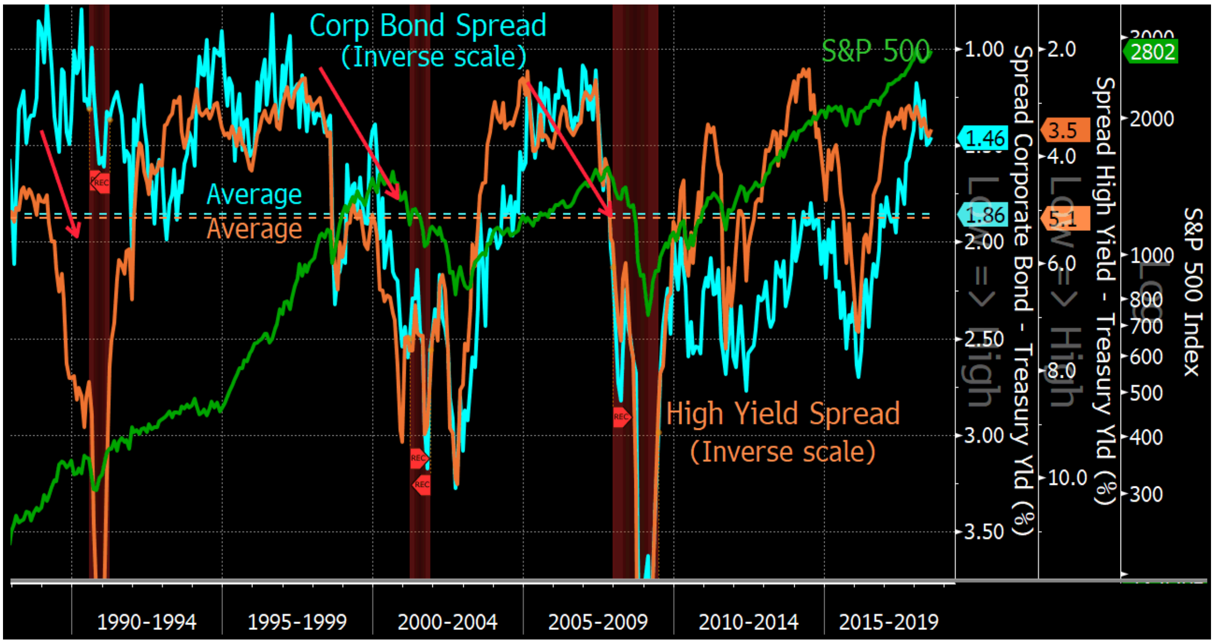
Source: Bloomberg & Stonehage Fleming Investment Management Limited. July 2018. Past performance should not be used as a guide to future performance.

The expectations for five-year yields in five years' time have been stable this year and is still on the same level of eighteen months ago (see the green line in the preceding chart), despite the rise the current five-year yield (the purple line). The picture is very similar for the expectations of inflation in five years' time (the blue line). Further to this, the spread between the expectations for the five-year yield and inflation levels (the orange bars) remains in a downwards sliding trend. The combination of these points provides further comfort that risks for much higher inflation seem to remain muted.

4. CORPORATE BONDS

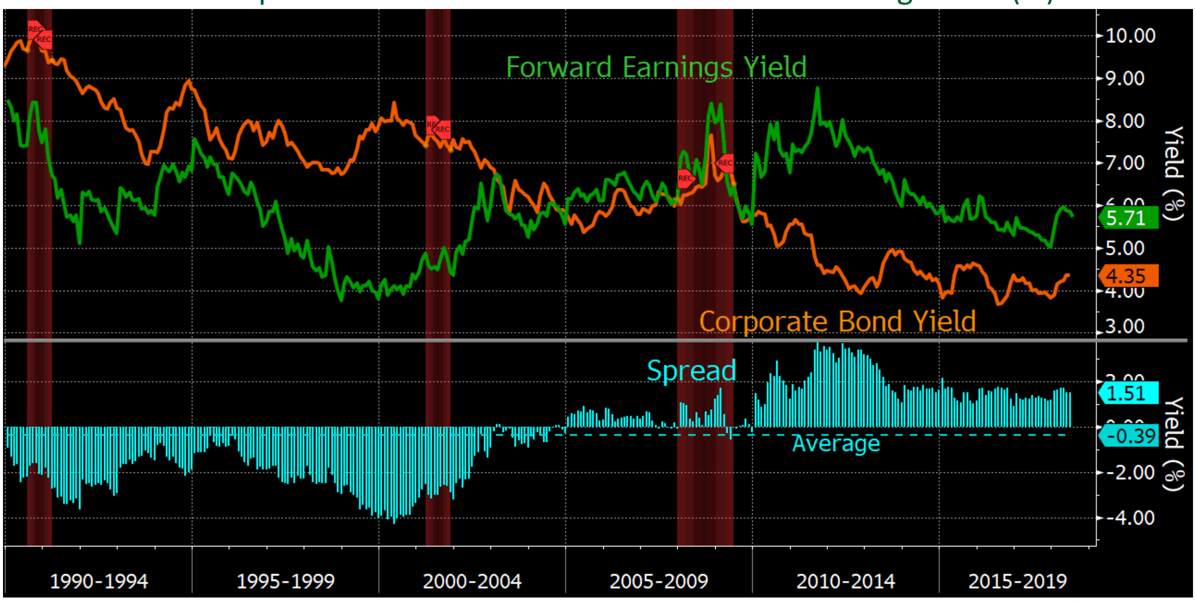
The prices for corporate, Emerging Market, high yield and junk bonds have recently dropped quite a bit and we should consider its implications for the main equity markets:

US - Corporate and High Yield Bond Spreads against Treasuries (%) vs S&P 500



Both the corporate and high yield spreads against ten-year treasuries seem to have peaked and be in process of rolling over (presented in an inverse scale in the chart above). This does not seem to imply imminent risk to the equity markets considering historic patterns in this context. Should these trends continue it may imply a very early (more than two year) warning of potential peaks in equity prices and subsequent economic recessions, but it seems to be way too early to raise alarms.

US – Corporate Bond Yield vs S&P 500 Forward Earnings Yield (%)



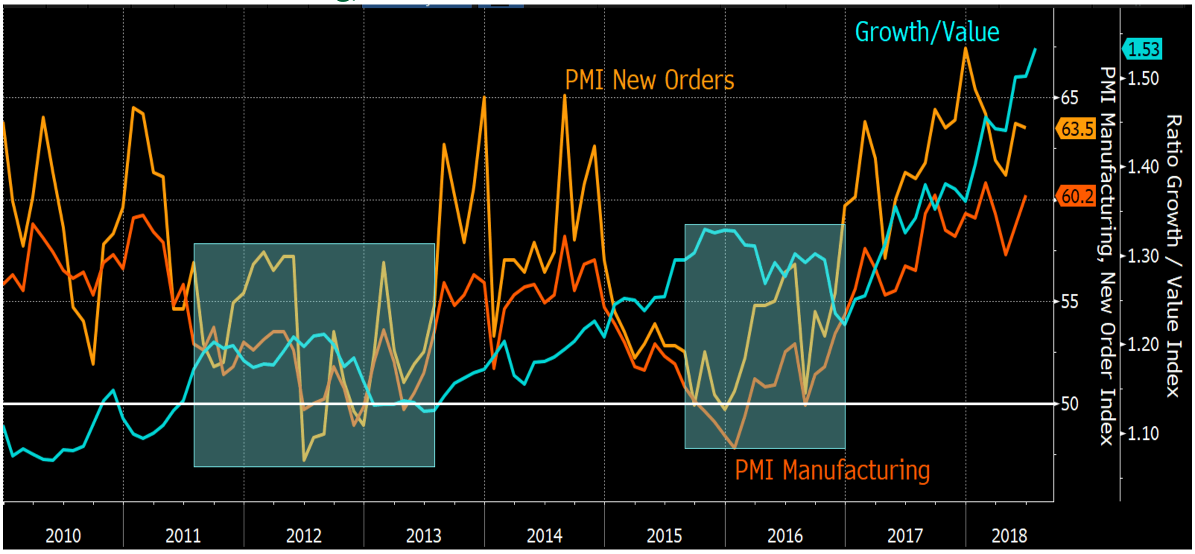
Source: Bloomberg & Stonehage Fleming Investment Management Limited. July 2018. Past performance should not be used as a guide to future performance.

From a yield valuation perspective, the S&P 500 earnings valuation seems attractive against corporate bond yields (see the bottom section of the preceding chart). The spread between the two yields are 1.8% in favour of equities considering a long-term average yardstick. Along with the conclusions from the first chart in this paragraph we therefore think that the corporate bond market still makes a case for investing in equities.

5. GROWTH VS VALUE

Many investors currently make a case in favour of the value investment style to the cost of the growth investment style. The arguments are predominantly based on rising interest rates and valuation grounds. These are solid arguments, but the timing for making that switch is more challenging:

US – PMI Manufacturing, New Orders Index vs S&P 500 Growth vs Value Price Index

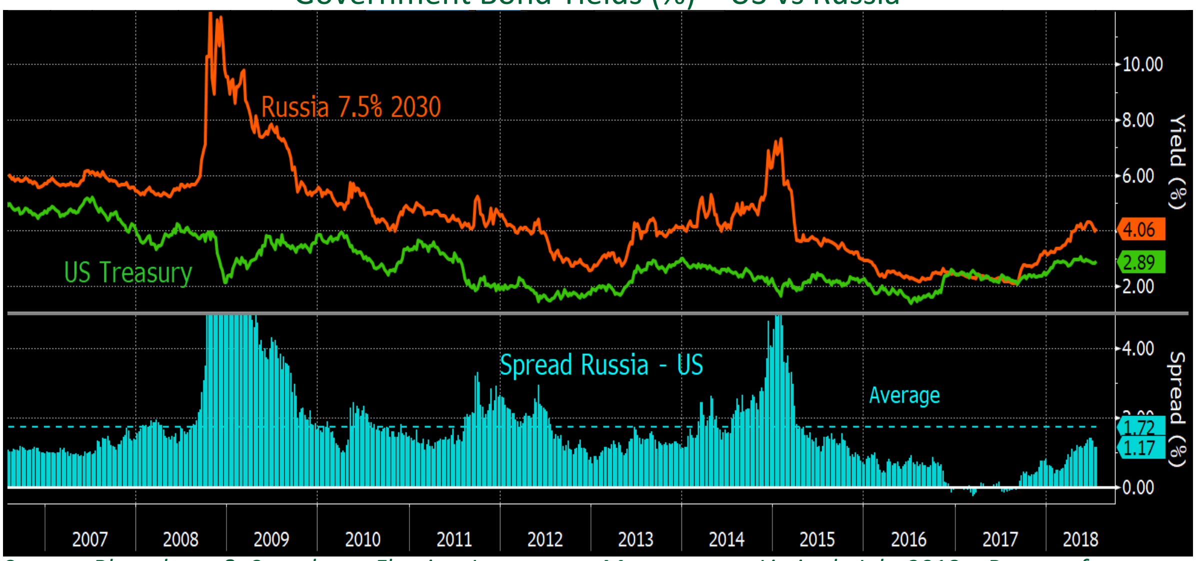


We have shaded the recent periods of underperformance of the growth style in the above chart. Those periods experienced much lower PMI data than what is currently the case.

Against the further backdrop of a lacklustre interest rate outlook we would not rush ourselves out of a growth orientation. A potential world trade war can of course affect these issues, but a decision based predominantly on this is currently based on fear rather than on fact.

6. EMERGING MARKETS

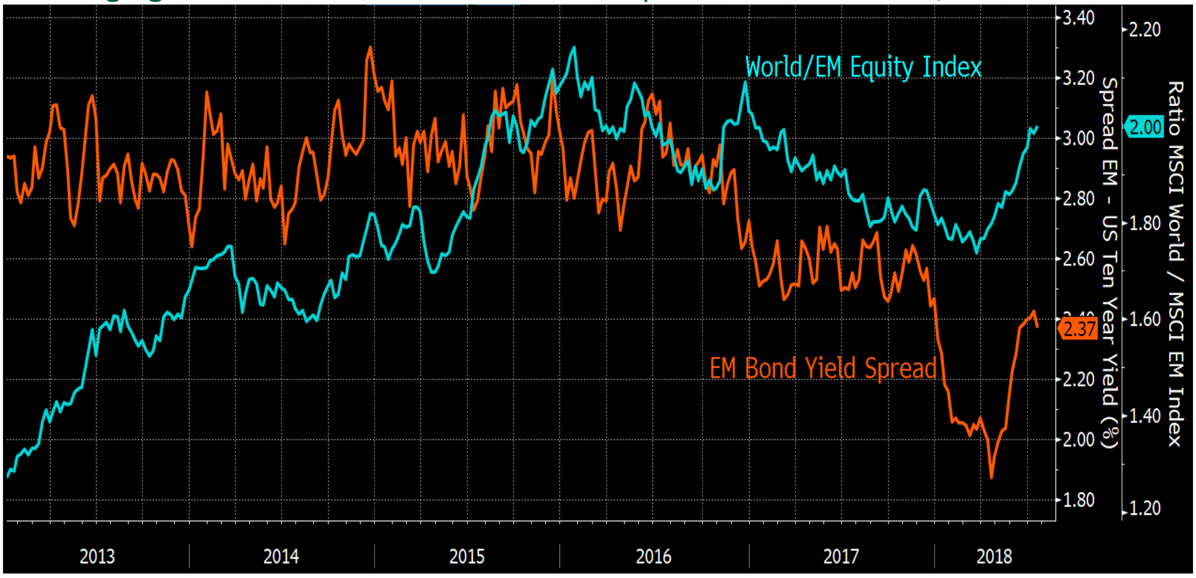
Government Bond Yields (%) – US vs Russia



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

The stronger Dollar has hurt Emerging Market (EM) currencies and their capital markets this year. We are of the opinion that there may have been some emerging market exuberance earlier this year and that the Dollar alone is not to be blamed. The preceding chart of Russia's yield spread being close to zero last year confirms this point – we struggle to understand the fundamental logic in that. Against this, this spread has now widened and is getting closer to its long-term average. It seems that most of the steam has been let out of this emerging market bond market.

Emerging Market Government Bond Yield Spread vs MSCI World/MSCI EM Index



Overall EM bond yield spreads have recovered after their excesses a few months ago. This change in sentiment also reflects clearly in the relative outperformance of the world equity index over the EM equity index.

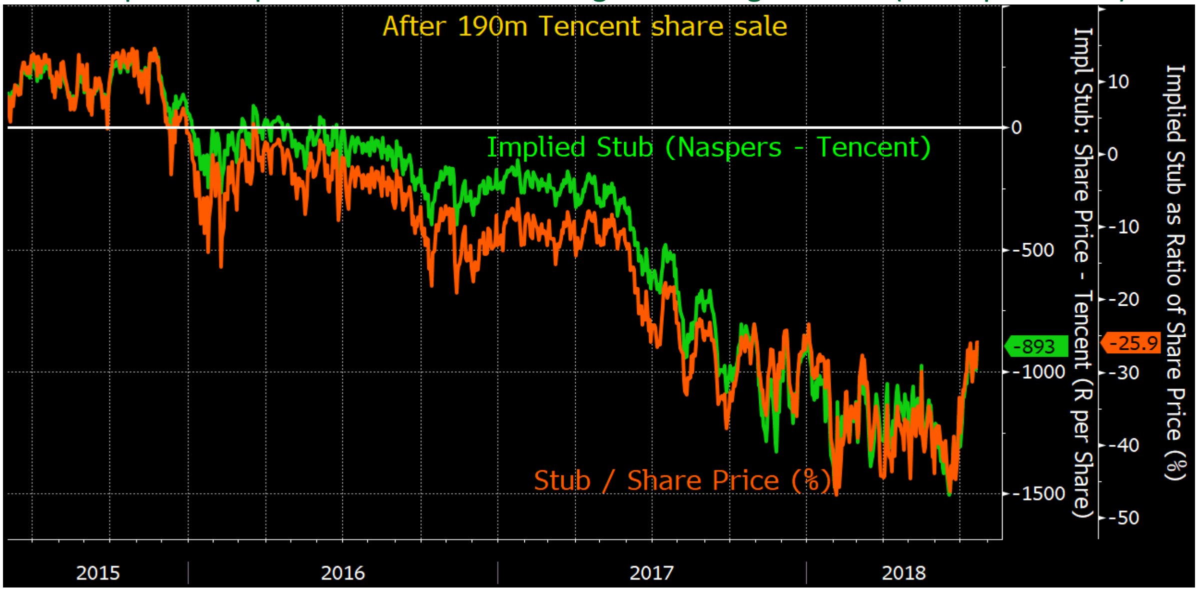
China – Shanghai Index vs Moving Averages

Technically the Shanghai market had its death cross at the end of the first quarter of this year. The gap between its 200-day moving average is now at an extreme level (the purple bars at the bottom of the chart). In the absence of negative economic events, we perceive the market to be close to being oversold.

7. NASPERS

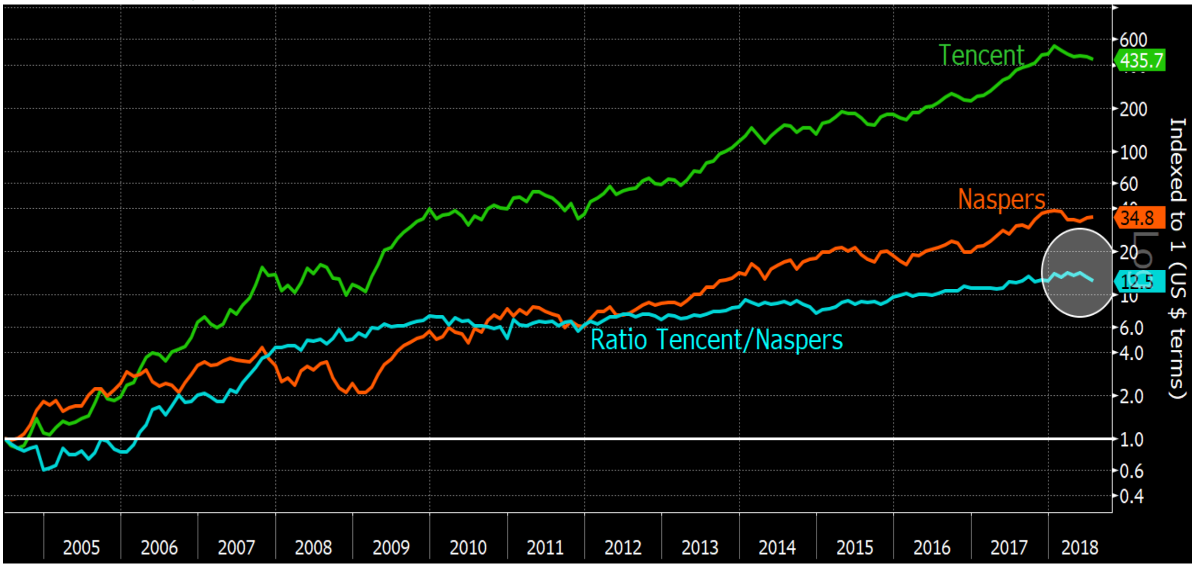
We have for long held the view that Naspers's share would find it difficult to outperform Tencent unless there is a material improvement in the performance of its core business units. Something seems to be in the process of changing in this context:

Naspers – Implied Value of All Holdings Excluding Tencent (Rand per Share)



Even after the shock disposal of 190m Tencent shares, the implied valuation of all other holdings (including the proceeds of that sale) touched a value of -R1,500 per Naspers share (or a discount of -45% of Naspers's share price). This discount has now narrowed to -26%, the lowest in over 18 months.

Naspers and Tencent Share Price ($) – Indexed to June 2004 = 1.0



The phenomenon of the Tencent performance reflects well in the above chart – apart from the share being up +436 times since its IPO in 2004, it is also up 12.5 times more than Naspers - by far its largest shareholder. The million-dollar question is whether Naspers can now alter the course of the relative performance (the blue line in the above chart).

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