GLOBAL EQUITY PERSPECTIVES 13 AUGUST 2018

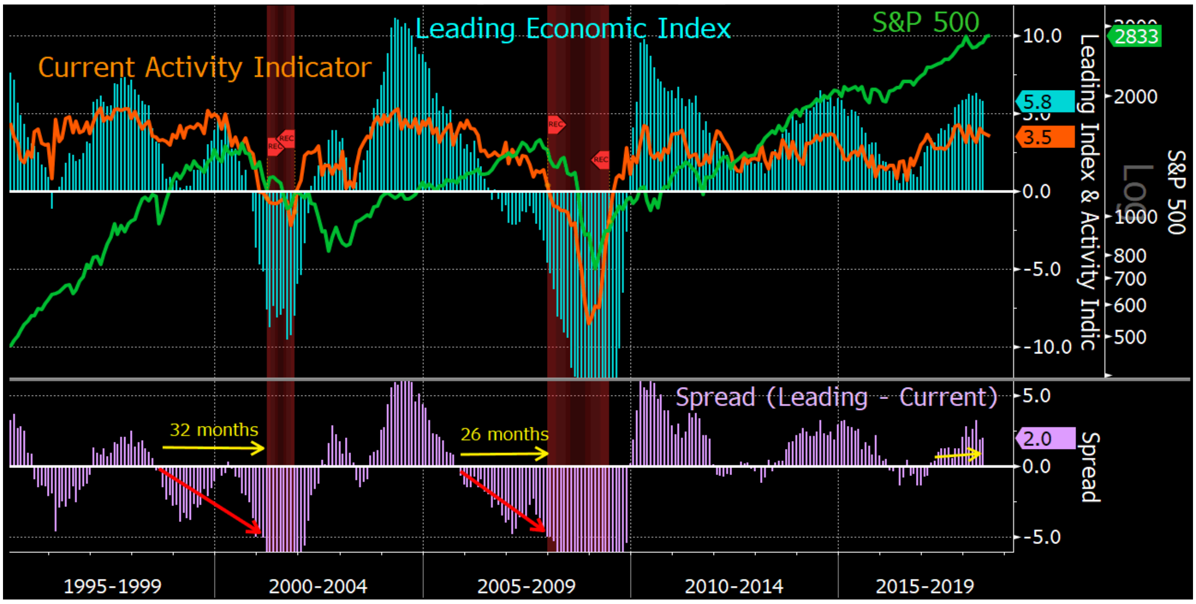
"Difficulties strengthen the mind, as labour does the body."

Seneca

1. US ECONOMY

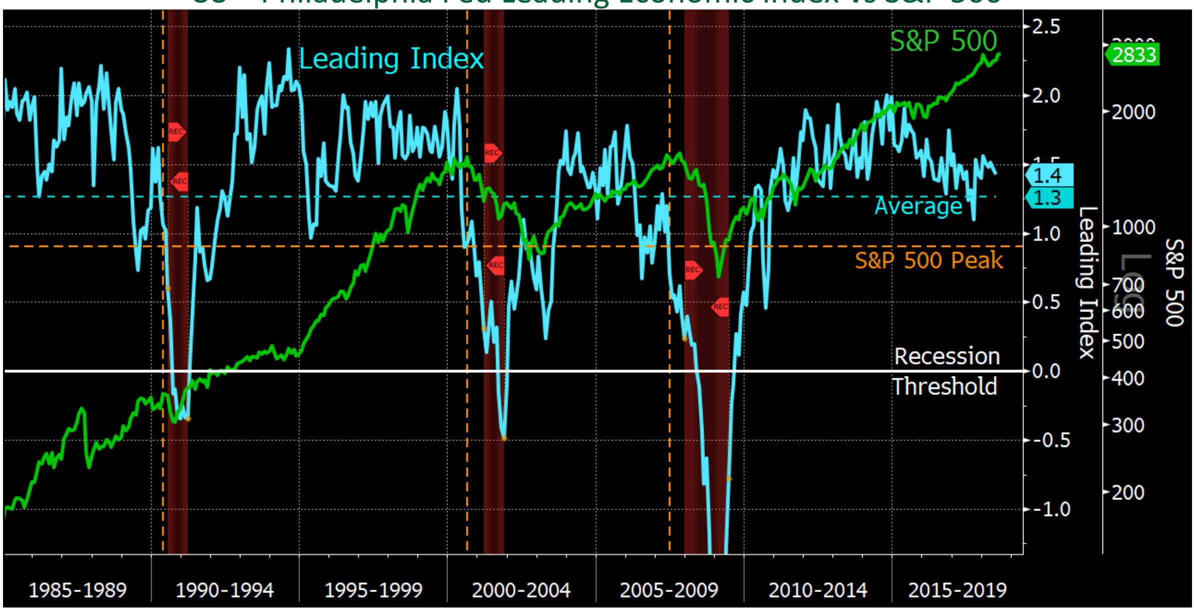
We keep monitoring US economic indicators to form an opinion of the level of risk for an upcoming recession, and therefore for a potential peak in share prices:

US – Conference Board Leading Economic Index & Goldman Sachs Current Economic Activity Indictor vs S&P 500



The above leading economic indicator seems to be rolling over but is still at an elevated level. This remains supportive of equities. The current economic indicator also remains at an elevated level. Along with this, the spread between the two series remains in positive territory. This spread has historically provided a very early warning of an upcoming recession.

US – Philadelphia Fed Leading Economic Index vs S&P 500



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

The Philadelphia Fed's leading economic index started rolling over a while ago, but remains at quite elevated levels. This index is also an effective tool to identify the structural peaks in share prices (at a 0.9 reading). The current reading is still above its long-term average and does not provide any alarm yet.

2. COMPANY RESULTS

The second quarter reporting season has almost completed. 91% of the S&P 500 companies have already reported, and 84% of the 380 European BE500 companies that report quarterly have done so. The results thus far are as follows:

	S&P 500 2Q2018 Results (11 Aug 2018)			BE 500 4Q2018 Results (11 Aug 2018)		
	Growth	Surprise Factor	# +ve Surprises	Growth	Surprise Factor	# +ve Surprises
Sales	11.1%	1.4%	70.7%	5.9%	0.6%	59.0%
Earnings per Share	25.6%	5.5%	83.6%	5.6%	1.1%	52.4%

US company results in general outperform even the high expectations the market had. Whilst bottom-line earnings benefit from lower tax rates, it is especially pleasing to see the double-digit growth in top-line revenue numbers, clearly reflecting the current supportive US economic backdrop. Against this, European results appear quite pedestrian, with a more muted surprise factor.

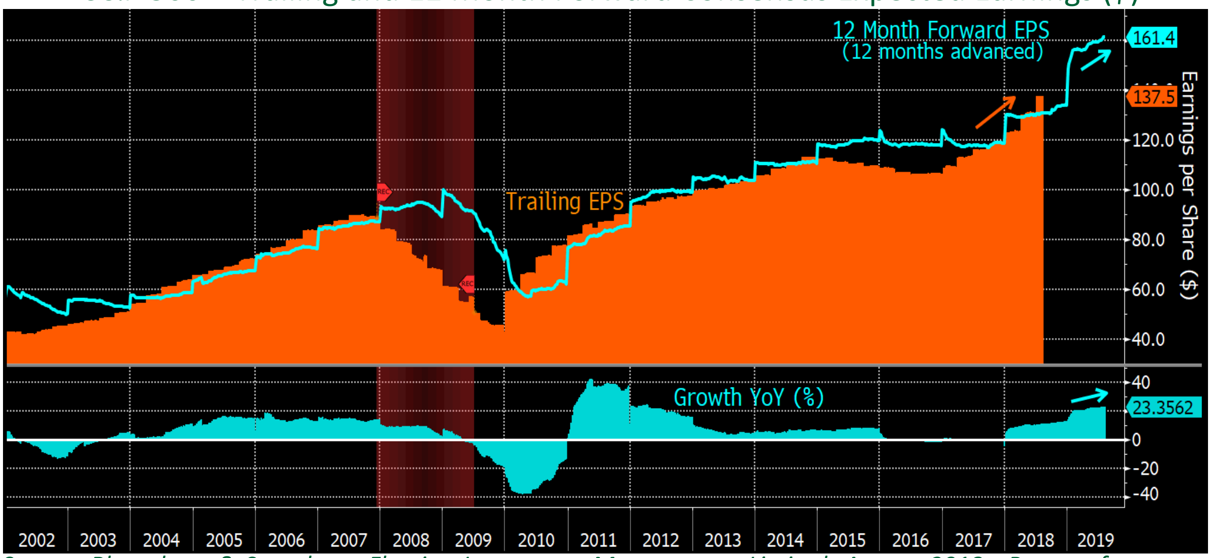
Some sceptics opine that this may bring us close to a peak in US earnings. We have illustrated in an earlier note that, in terms of economic growth, the US economy's level of recovery during this cycle may still have some way to go. We have also calculated the following comparison in terms of S&P 500 earnings by considering the level of growth from one peak in the earnings cycle to the next:

S&P 500 - Growth in EPS from Previous Peak to Current Peak				
	1989	2001	2007	2018 (?)
Nominal Terms	47%	116%	64%	53%
Real Terms	26%	55%	36%	26%

The current level of earnings growth since the previous earnings peak (+26% in real terms) has only reached the lowest level of previous cycles (the one ended in 1989) whilst the US leading economic indicators remain constructive. We would therefore not support the view of being close to a peak in earnings.

In this context, the following chart reflects analysts' expectations well:

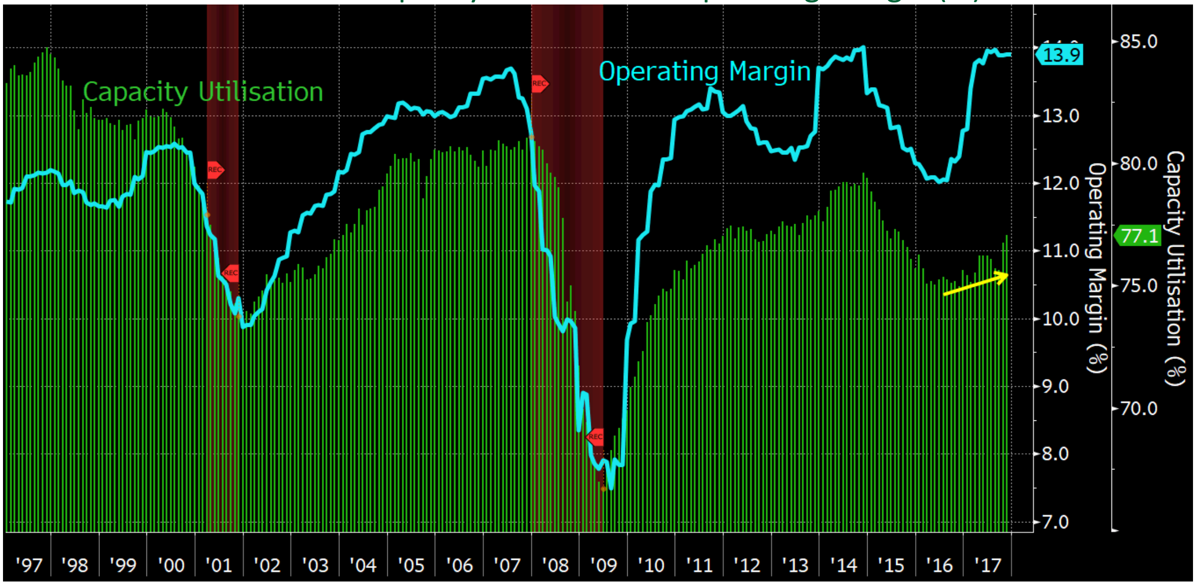
S&P 500 – Trailing and 12 Month Forward Consensus Expected Earnings ($)



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

Expectations for earnings growth continue to be revised upwards, now at +23.4% see the preceding chart). Barring a particularly negative economic event, this should continue to support share prices.

S&P 500 – Capacity Utilisation vs Operating Margin (%)

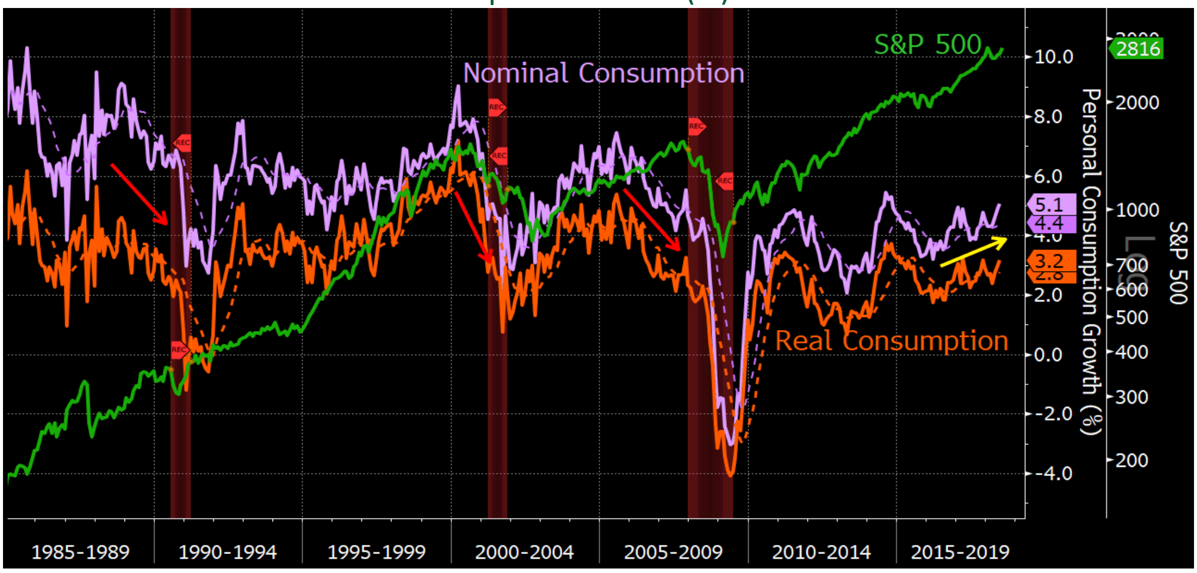


As we could have expected with the strong organic top-line growth, capacity utilisation is slowly recovering off a relatively low base. This has caused operating margins to recover well to record levels. With capacity utilization still relatively muted, we can make a case for margins to reach new record levels in the coming year and continue to support earnings.

3. GROWTH ENGINE

Because of its critical importance to the US economy, we keep updating our data on consumer consumption. Recent observations in this context remain constructive:

US – Consumption Growth (%) vs S&P 500



Consumption growth historically peaks well before the peak in share prices (see the red arrows in the above chart). The levels of consumption growth have been more muted since the credit crisis but is currently in a rising trend. This remains supportive of the US economy and share prices.

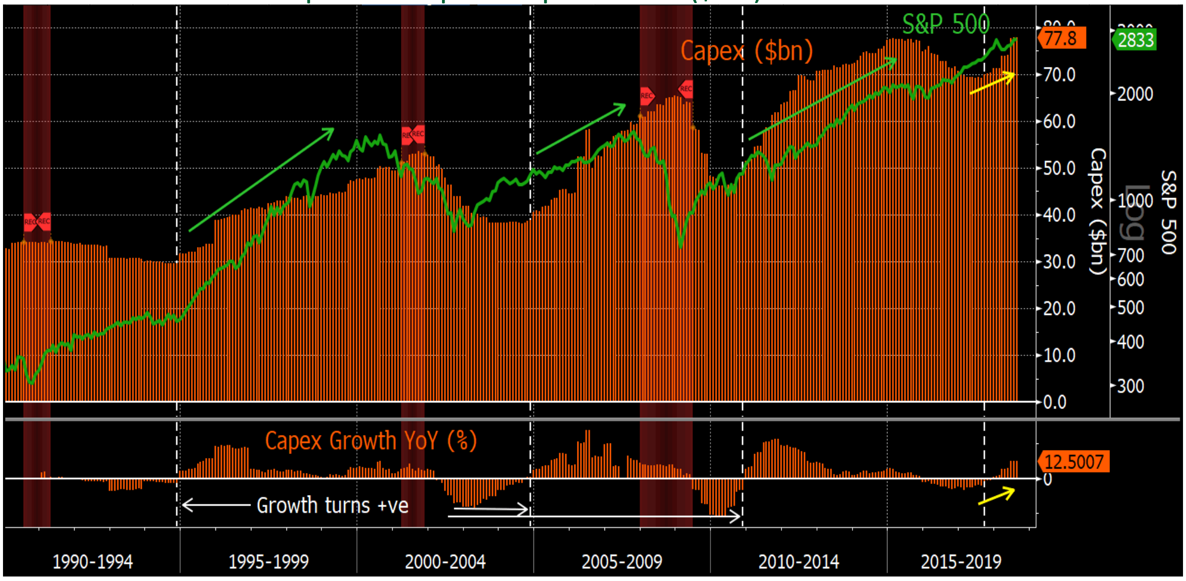
It is worth mentioning that US and (equally importantly) Chinese retail sales are currently growing at +5.1% and +13.2% respectively (both in US$ terms, on twelve-month data).

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

4. BUSINESS EXPANSION

It is good to see that US companies are starting to invest and expand their capacity:

S&P 500 Companies Capital Expenditure ($bn) vs S&P 500 Price Index

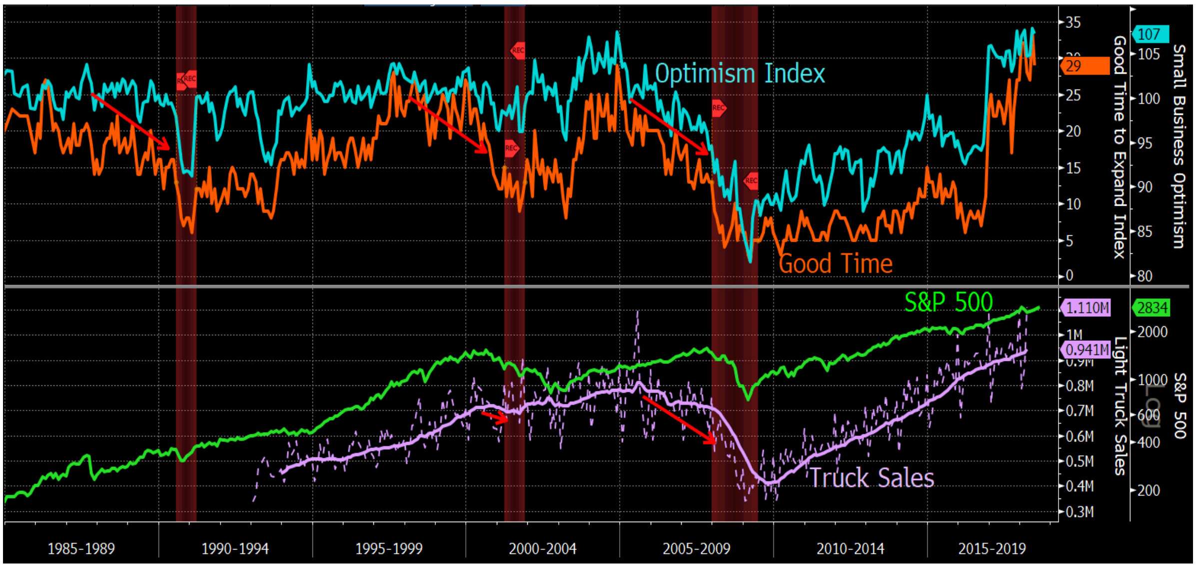


The current growth in capital expenditure (capex) for S&P 500 companies is accelerating, now at +12.5%. Nominal numbers are back at record levels. Interestingly, the overall US capex growth is now at +7.5%, implying most of these investments/expansions are happening in listed companies where we can share in the potential outcome.

Historically the swing to positive capex has been very positive for share prices (see the vertical lines and the green arrows following those events). Also, in this context, US durable goods orders are now growing at a healthy +7.3%. This is also reflected in the elevated levels of the CEO confidence index (currently a fifth higher than its long-term average).

These positive sentiments reflect well in US small company data:

US – Small Company CEO Optimism Index, Light Truck Sales vs S&P 500



The small company optimism index is at a record level. The small company 'good time to invest' index is equally at record levels. This is also the case for light truck sales, currently growing at +5.2% on twelve month rolling data.

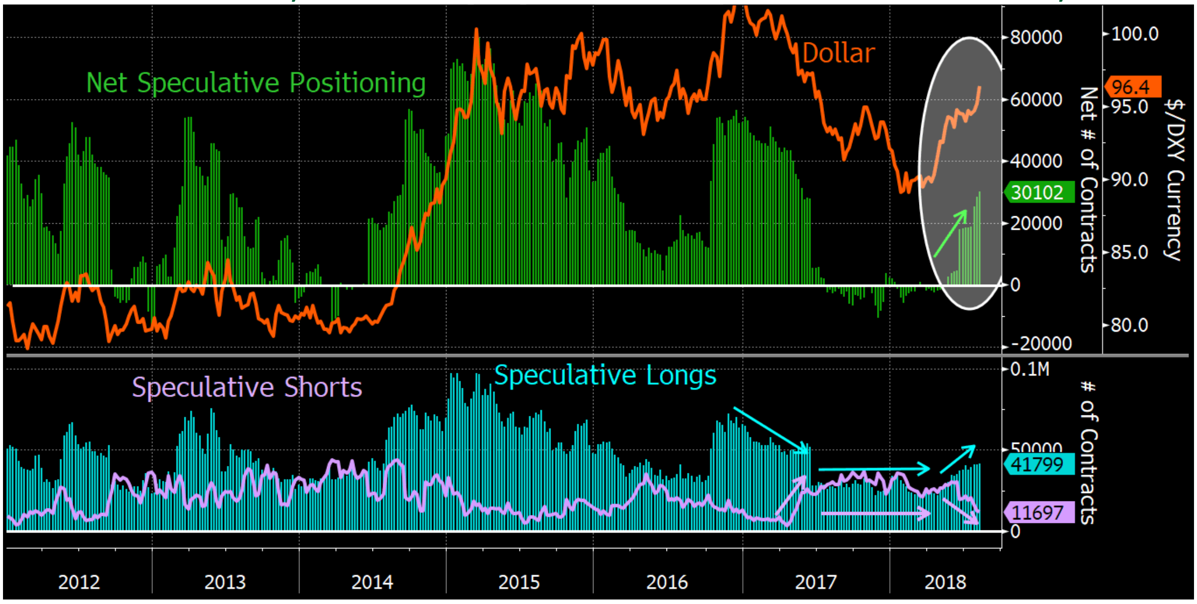
All three of these indices have historically provided early warning signals against upcoming recessions (see the red arrows) – which they clearly do not do currently.

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

5. CURRENCY RISKS

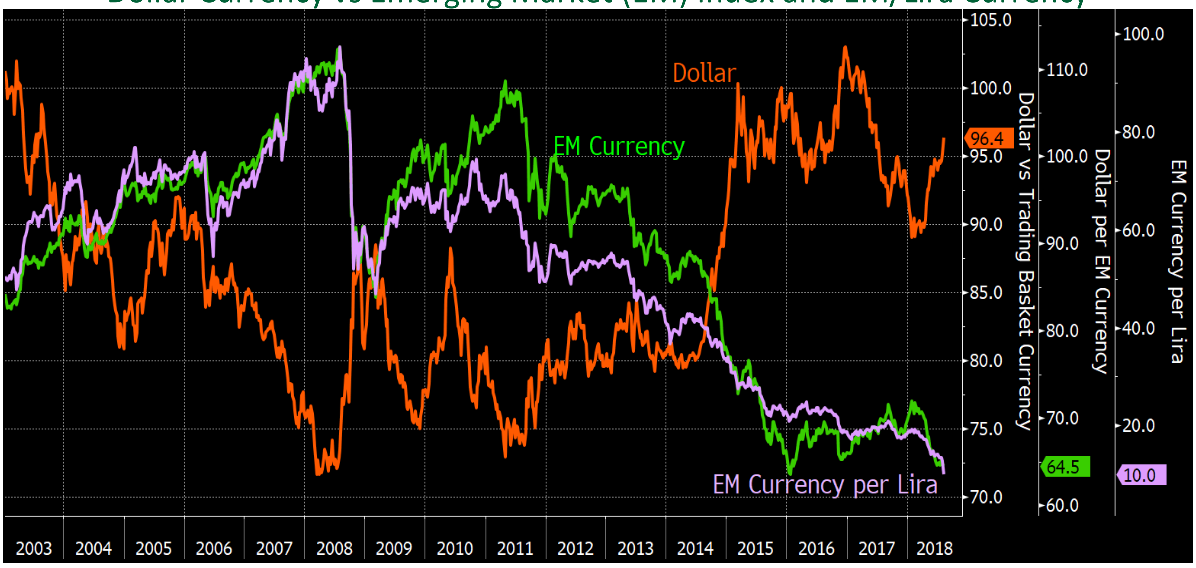
We have written recently about the technical breakthrough the US Dollar made. This strength continues, and seems to attract more currency investors:

US Dollar Currency Non-Commercial Futures Contracts vs Dollar Currency Value



The net number of long less the number of short contracts has been neutral for a year (second half 2017 and first half 2018). This net number has recently been rising sharply, and along with that the value of the currency reflecting this directional change closely (see the highlighted area). The strong economy and rising interest rates may further support this trend. Apart from the potential restraint on the US economy and world trade that a too strong Dollar may cause, the effect on emerging market currencies can be very detrimental:

Dollar Currency vs Emerging Market (EM) Index and EM/Lira Currency



The strong Dollar has profound effects on EM currencies. Our chart above further shows the Turkish Lira specifically in the context of the EM currency index, and how weak it has been even against those currencies. All this further increases our conviction to rather invest in emerging economies through globally operating businesses – imagine an investment now in a pure Turkish franchise. The Istanbul Borsa 100 index delivered a return of -42% over the past three years compared to the MSCI World's return of +32% in Dollar terms.

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

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