

Global Equity Observer

Not Out of the Woods Yet

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JANUARY 2019

The market ripped upwards in January, with the MSCI World Index rising nearly 8%, and in fairness, there was definitely some good news flow behind the recovery. Arguably, the three main wolves stalking the market in the fourth quarter were the Trade Wars, China and the U.S. Federal Reserve (the Fed), and all three areas saw some reasons for cheer in the month. The mood music on the U.S.-China trade negotiations seemed to improve, and China started pressing its stimulus buttons in earnest in a bid to revive growth. Most dramatically, Jerome Powell played the part of the Woodcutter rescuing Little Red Riding Hood from the wolves, as the Fed shocked the market, even experienced Fed-watchers, with its dovish tone in January, despite a spectacular U.S. jobs report that saw over 300,000 jobs added.¹

While recognising the improvements, we still remain cautious on all three areas, and suggest that the wolves are not yet slain and Little Red Riding Hood is not yet out of the woods. The last two years have taught us that there is nothing predictable about the progress of U.S. trade policy, and there is some way to go to make enough progress to defuse the 'bomb' of the extra tariffs on China due to come in on March 1. We would also argue that the main longer-term trade threat is around the technology sector rather than tariffs on industrial or agricultural goods. A deal on tariffs is distinctly possible, but a peace treaty in the technology area is much tougher. Technology is increasingly being seen across the U.S. political spectrum as the

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¹ Bureau of Labor Statistics, February 1, 2019.

battleground between the incumbent U.S. and the challenger China. The arrest of the Huawei CFO in Canada is one sign of this increased tension, which could end with global technology value chains being split into two separate systems, with dramatic implications for the technology hardware sector.

Equally, the success of the China stimulus is not a given. While the Chinese government has always pulled off its reflations in the past, and dragged the world economy with it—most notably after the Global Financial Crisis—the increasing size, complexity and indebtedness of the Chinese economy make it more difficult every time. In addition, the domestic and consumption focus of this year's effort may mean that less benefit is felt overseas.

Finally, while the dovish noises from the Fed are naturally a positive for asset markets, as the threat of automatic tightening has faded, the fact is that the Fed may be forced to tighten significantly as the labour market tightens. Unemployment is now down to 4%, and wage growth is creeping up, particularly amongst the lower-paid.²

Our caution about the January surge, and Little Red Riding Hood's safety, is not just around the three fears, or wolves, mentioned above. A further wolf is the fact that the world economy is in a synchronised slowdown. The sugar rush of the U.S. tax cuts is wearing off, Europe is seeing minimal growth, with the forward-looking PMIs (Purchasing Managers' Indexes) at their lowest since July 2013,³ and China has yet to see the

benefits of the move to stimulus. The worry is the effect that this existing slowdown will have on corporate earnings. It is aggravated by the margin pressures being felt in the U.S., where first-quarter earnings are expected to be down year-on-year as cost pressures bite. The healthy earnings growth expected for this year, with MSCI World Index earnings up 6% in 2019 and the U.S. growing earnings at over 10% by the fourth quarter, may well not be delivered.

Our worry is the effect of synchronized slowdown on corporate earnings

Given that earnings estimates drifted down in January, particularly in the U.S., the January market rise was entirely due to rising multiples. The MSCI World Index went from 13.4x next 12 months' earnings to 14.5x. This is not particularly high by historical standards, providing the earnings are actually delivered, which is far from certain given the slowing world economy. Markets are certainly not pricing in anything worse than a mild slowdown, nor are highly levered corporate balance sheets prepared for anything more severe. Given our anxiety about the outlook for earnings, we would continue to advocate owning compounders. The combination of recurring revenue and pricing power should protect revenues and margins, respectively, preserving their profits. They are also likely to be relatively immune from any financial distress if the corporate bond markets have a seizure.

² Bureau of Labor Statistics, February 1, 2019.

³ Source: IHS Markit. Data as of January 31, 2019.

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