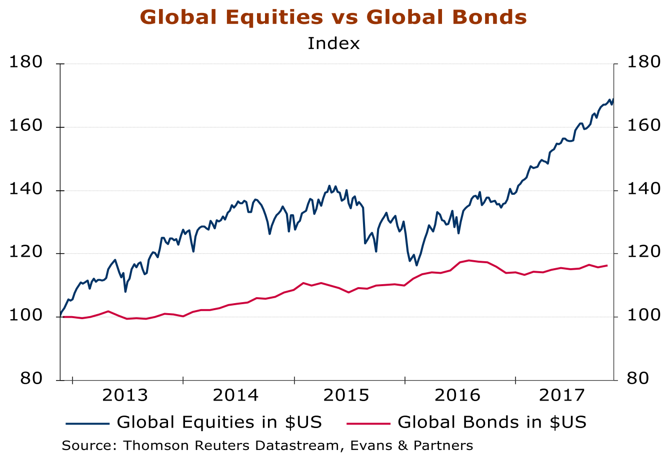
The View From The Outer

Tim Rocks – Chief Investment Officer

November, 2017

Can equities do it again in '18?

It has been a remarkable period for global equities since early 2016. Global equities have returned around 40% over that time, compared with a 2% return for global bonds. All the stars have aligned for equities over this period; better global growth and earnings has occurred at the same time as inflation has fallen, monetary policy has remained easy and the $US has weakened.



The other main reason that equity markets have been so strong is that earnings are surging. Earnings have grown by 17% over the past year, well in excess of GDP growth of around 3%, assisted by a jump in the oil price and weakness in the $US.

Looking forward, we expect that equities will continue to outperform bonds over the next year but by a much smaller margin. The key issues are:

- Equity valuations have not materially changed over the past year because equity indices have risen broadly in line with earnings. Equities also remain very cheap relative to bonds based on historical comparisons.
- Earnings will remain relatively healthy given the strength of the economic backdrop in the US and Europe. However some slowdown is likely – we assume earnings growth of 5-8% over the next year.
- We assume that inflation remains benign and the tightening in global monetary conditions will only occur slowly. A material rise in inflation would change the outlook and is the main factor for investors to monitor.

Implications and recommendation

Our conclusion is that equities are likely to outperform bonds modestly over the next year, by around 3%, but we will be watching earnings revisions, inflation and policy closely for a more significant turning point for markets.

We continue to have a preference for international over domestic equities based on better growth prospects and valuations offshore, and our expectations for a fall in the $A. Europe remains our preferred region based on very strong macro and reasonable valuations. European exposure can be gained through exposure to funds, ETFs (our preferred ETFs are IEU and ESTX) or direct stocks.

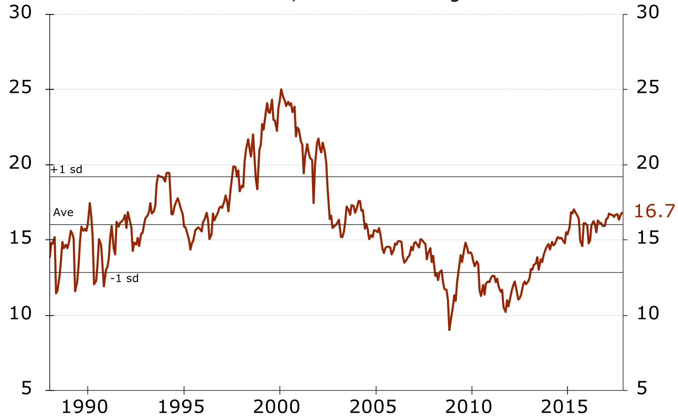
Valuations still support equities

Beginning with valuations, it is notable that the surge in equities has not materially changed valuations for global equities. The forward PE of MSCI World is around 17x, approximately where it was a year ago. This is slightly above long term averages but is not at an extreme. Relative to bond yields, global equities remain very cheap as shown by the large gap between the earnings yield and real bond rates; the extremely low level of bond rates means that equities remain the stand out asset class.

Our view is that valuations should only drive the bond vs equities decision when equity valuations are at an extreme and this is not the case at the moment.

MSCI World Index

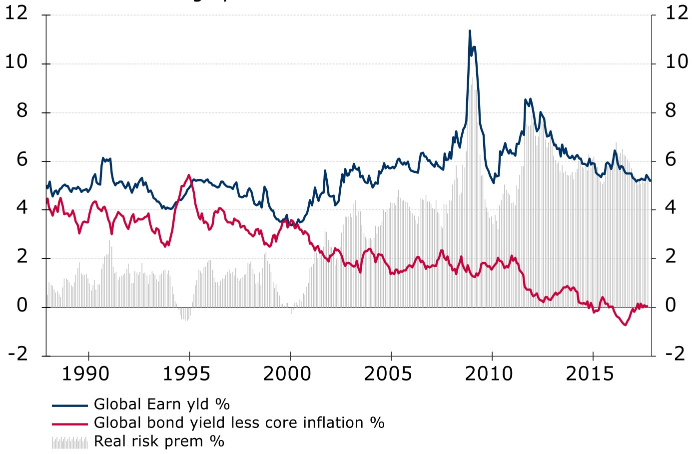
PE Ratio, Forward Earnings



Source: Thomson Reuters Datastream, Evans & Partners

Global Earnings Yield vs Bond Yield

Earnings yield and Real Global Bond Rate %



Source: Thomson Reuters Datastream, Evans & Partners

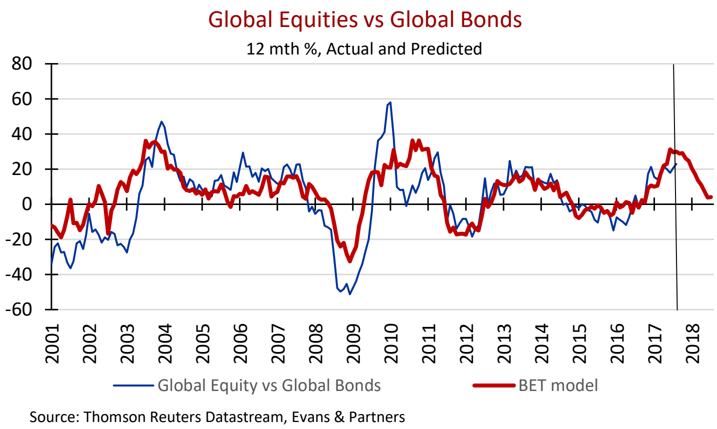
The macro stars have aligned

When we consider the outlook for equities we consider five macro factors:

- Global growth momentum. There has been clear acceleration in economic momentum all year led primarily by Europe and the US but partially offset by some recent deceleration in China. Going forward it is unlikely that global GDP growth will accelerate much further particularly as China slows.
- Earnings. Earnings growth has been remarkably strong over the past year, as we will discuss below, and earnings have consistently been revised up. This was particularly evident in the recent US reporting season where more than 70% of companies reported earnings ahead of analysts' expectations.
- Inflation. Whether core CPIs in key regions are rising or falling is critical because it influences the future direction of monetary policy. Over the past year inflation has been remarkable benign given the lift in economic activity.
- Monetary policy. The absence of inflation has meant that monetary policy remains easy across the globe. Even though the US Federal Reserve is now raising rates, it has been able to do so at a leisurely pace. The ECB continues with quantitative easing although it may start withdrawing some liquidity through 2018.
- $US. A weaker $US generally supports equities through the effect on reported earnings, as we will discuss below.

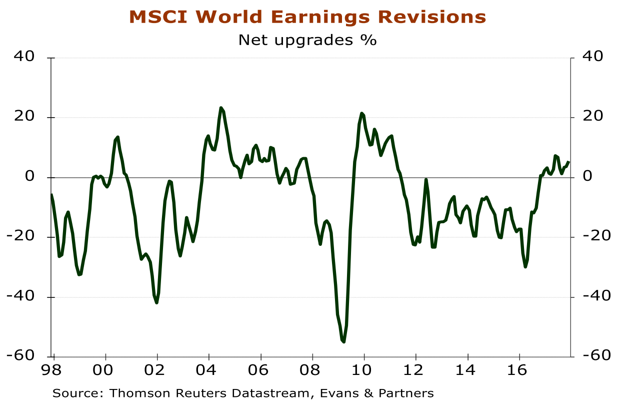
What is remarkable when we look at these factors is that for most of this year all of these variables have been pointing to equity outperformance. It is a rare event for all the stars to align; for better global growth and earnings to occur at the same time as falling inflation, easy monetary policy and a weakening $US. It is more often that that better growth momentum is balanced by higher inflation and tighter policy.

Going forward, conditions will not be as conducive and we expect growth momentum, policy and the $US in particular to be more challenging for equities. To hone in on a forecast, we combine these factors into a Bond Equity Timing (BET) model. The model is still forecasting equities to outperform bonds over the next year although by a much tighter margin of around 3%.



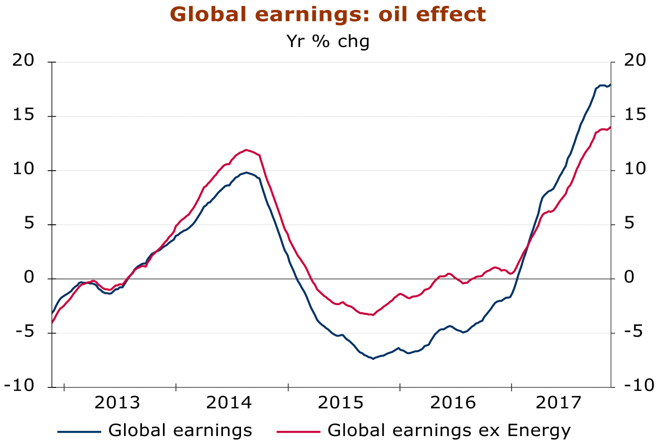
Major tailwinds for earnings

The other main reason that equity markets have been so strong is that earnings have been surging. It is no surprise that earnings have accelerated with a better economic conditions but the extent of the bounce has been surprising. Earnings have grown by 17% over the past year well in excess of GDP growth of around 3%. This has continued into the most recent reporting season where over 70% of companies in the US beat earnings forecasts.



There have been two contributing factors to the strength in earnings growth:

- A jump in the oil price. The jump in the oil price over the past year has contributed around 4% to the growth in earnings over the past year as is apparent from the chart below that compares global earnings growth with and without the energy sector.
- The weakness in the $US. A falling $US is a significant tailwind to earnings because many companies report in $US. Around 60% of companies (by market cap) report in $US even though only around 30% of earnings are actually made in the US. This means that a falling $US artificially inflates reported global earnings growth; over the past year this effect has been around 3 percentage points.



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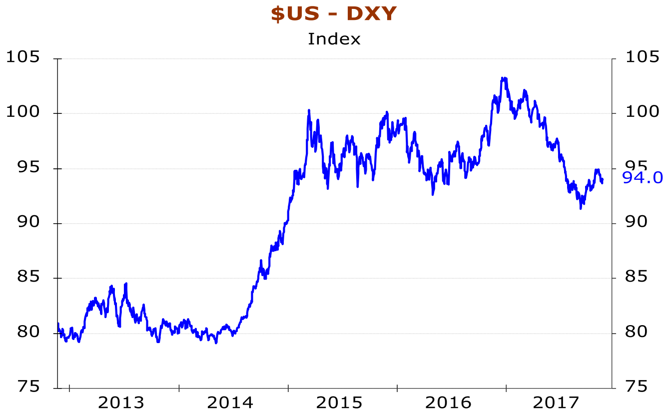


Source: Thomson Reuters Datastream, Evans & Partners

What are the risks?

Looking forward, this analysis suggests that the key issues for determining whether the equity run can continue are:

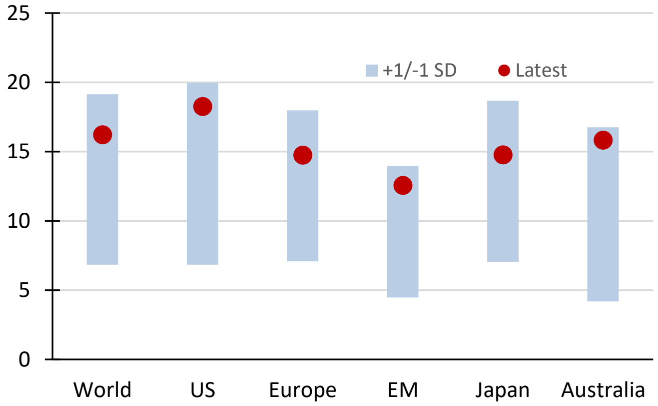
- How quickly will earnings growth fade as oil prices stabilise and the $US rises? We assume that earnings will remain relatively healthy given the strength of the economic backdrop in the US and Europe. However some slowdown is likely – we assume earnings growth of 5-8% over the next year. This is less than current analysts' forecasts so suggests some downgrades through 2018.
- Will inflation start to rise and force a more aggressive policy response from central banks? Policy will be less supportive next year as the Fed tightens and the European Central Bank slows its pace of quantitative easing. However if inflation begins to rise both central banks will need to move more aggressively. There has recently been some reacceleration in prices at the manufacturing level in China and the US; we will be closely watching whether this flows through to higher consumer prices.

Our conclusion is that equities are likely to outperform bonds modestly over the next year but we will be watching earnings revisions, inflation and policy closely for a more significant turning point for markets.

Implications and recommendation

We continue to have a preference for international over domestic equities based on better growth prospects and valuations offshore and our expectations for a fall in the $A. Europe remains our preferred region based on very strong macro and reasonable valuations. European exposure can be gained through exposure to funds, ETFs (our preferred ETFs are IEU and ESTX) or direct stocks.

Forward PE by region



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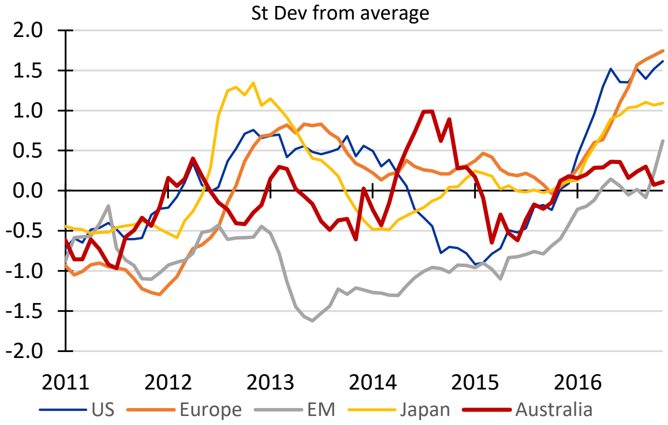
Macro Momentum by Region



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