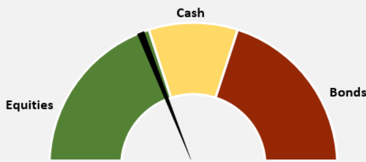
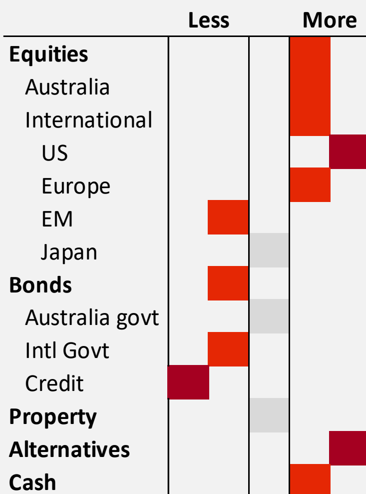
GLOBAL *engineer*

Q2 2018

Tim Rocks
Chief Investment Officer
Timothy Rocks

Asset Allocation





Preferences - Next 12 months

	Less			More	
Equities				■	
Australia				■	
International				■	
US					■
Europe				■	
EM		■			
Japan			■		
Bonds		■			
Australia govt			■		
Intl Govt		■			
Credit	■				
Property			■		
Alternatives					■
Cash				■	

Source: Evans & Partners

Spring Clean in Fall

The past few years have seen the best combination of factors for markets: improving economies, easy policy settings, low inflation and strong earnings. However, the major improvement in global growth may now be over and synchronised recovery may now give way to a more diverse range of outcomes.

- Momentum has changed most notably in China where economic data have been weaker and the renewed reform agenda is a further threat.
- The US cycle will be reinforced by a jump in government spending and the slow return of corporate investment. Similar factors are in play in Europe.
- The path to higher inflation now seems more inevitable and will force a faster pace of policy tightening.
- Australian conditions continue to improve led by a strong labour market and a better capital spending outlook.

RECOMMENDATIONS

These subtle changes in the macro environment may spark more significant market effects. We are recommending that investors spring-clean some of their higher beta assets where returns have been spectacular in recent years including commodities, emerging markets and high yield credit. At the same time if markets over-react to these changes we will be looking to take advantage of selected opportunities.

Some of our broader asset allocation recommendations are:

- Equities are still preferred to bonds given the potential for equity returns to be driven by the strength in earnings, however the gap will not be as great as in 2017. International equities are preferred to domestic equities assisted by our currency views.
- Within equities, we now favour the US market given the stronger macro conditions and potential for a higher $US. Europe is second given reasonable valuations and better prospects for earnings. We are neutral on Japan and recommend an underweight position in emerging markets.
- We have lowered our target for the ASX 200 to 6,000 based on our greater concern for bulk commodities and our assumption of some pressure on valuations.
- Within bonds, sovereigns are preferred over corporate credit and hybrids given extremely low levels of corporate and hybrid spreads. Australian sovereign bonds are preferred over their international equivalents.
- We assume a rise in the $US which will influence other currency markets. We expect some downside to the $A as commodity prices retrace and US rates rise relative to Australia. Our 12-month forward forecast for the $A is now $US0.73.

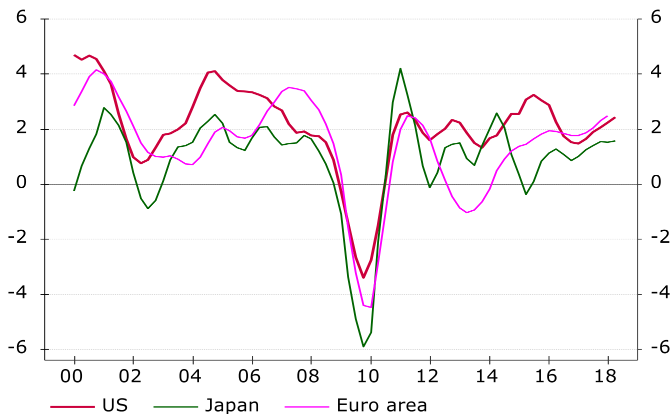
Spring Clean in Fall

The past few years have seen the best combination of factors for markets: improving economies, easy policy settings, low inflation, a benign risk environment and strong earnings.

The backbone to the recovery has been global GDP that started a two year upswing in early 2016 when China implemented a significant round of stimulus. Further support came from the long-delayed revival of Europe after a lost decade since the financial crisis.

GDP growth by region

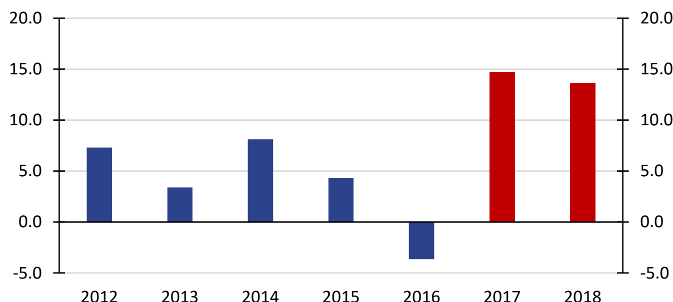
Annual percentage changes %



Source: Thomson Reuters Datastream, Evans & Partners

The resurgence has been so powerful for shares because it flowed through directly to profits. Earnings responded sharply after a decade of cost cutting and constrained investment heightened operating leverage. Global earnings grew by around 15% in 2017 and may repeat this in 2018.

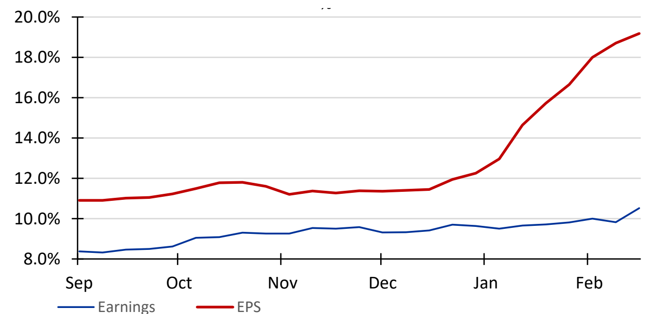
Global earnings growth (%)



Source: Datastream, Evans & Partners

The good news on earnings extended into the February reporting period. US company reports have rarely been better with around 80% of companies beating expectations and 2018 EPS forecasts increasing by 8%.

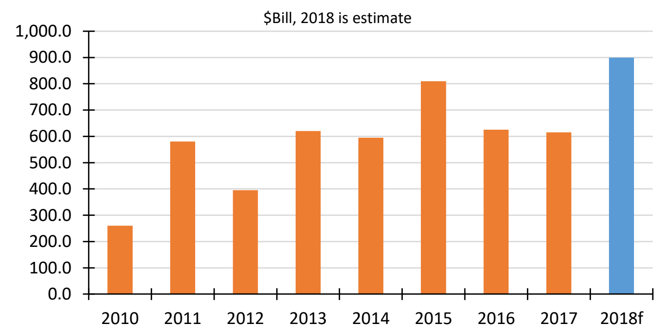
S&P 500 2018 Earnings growth forecast (%)



Source: Thomson Reuters Datastream, Evans & Partners

The upgrades to EPS came from the better economy and US tax changes. The scale of US share buybacks also surprised; companies are repatriating more foreign profits due to tax changes and using the funds to buyback more shares. Buybacks increase earnings *per share* by reducing the number of shares on issue.

US stock buybacks



Source: Thomson Reuters Datastream, Evans & Partners

The share market response to these developments was so powerful in 2017 because better economic activity was accompanied by falling inflation and very easy monetary conditions. This cocktail will not be repeated in 2018. Even though economic momentum may be sustained, inflation is slowly emerging and central bankers are tightening more aggressively. In the next section we look at some of these complications in more detail.

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Global growth as good as it gets

The improvement in global activity may now be over. For example the global purchasing managers index (PMI), a leading business survey, recently peaked after rising steadily since 2016. We do not expect conditions to deteriorate significantly but markets respond to incremental information flows and these will not be as positive as they have been.

Global PMI

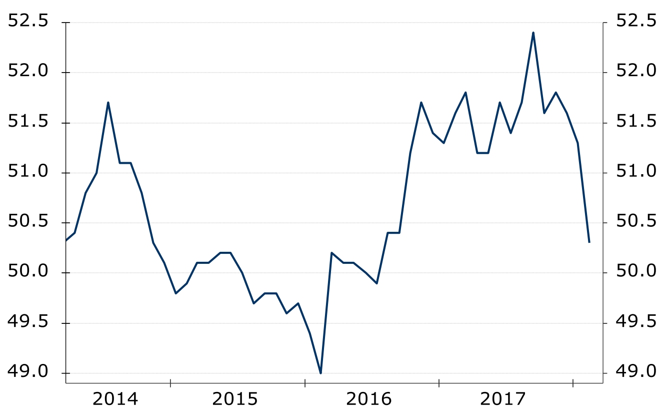
Source: Thomson Reuters Datastream, Evans & Partners

We are expecting that the synchronised global recovery will now give way to a more diverse range of outcomes. Of most concern is China where there has been a deterioration in a range of data in recent months. Data we monitor closely include the Purchasing Managers Index (PMI), electricity production, freight and credit.

This weakness reflects the completion of a range of projects that were commenced in early 2016 when credit conditions were eased. There has also been some tightening in property ownership rules that is affecting construction activity in the major cities.

China manufacturing PMI measure

Index, 50 = no change

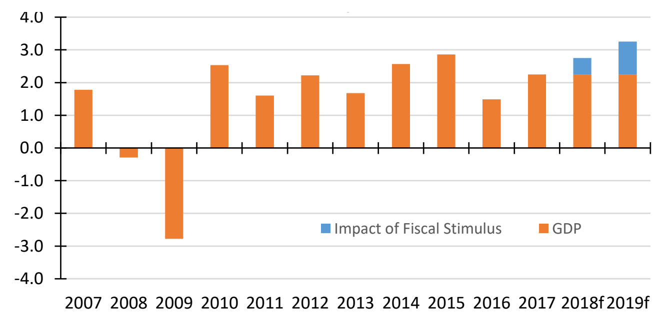


Source: Thomson Reuters Datastream, Evans & Partners

Offsetting the weakness in China is likely to be strengthening conditions in the US. The recent deal between Trump and congress on spending is set to boost GDP by around 1% over the next year. This could be further assisted by business investment that has languished in recent years but where prospects are improving.

US GDP with forecasts

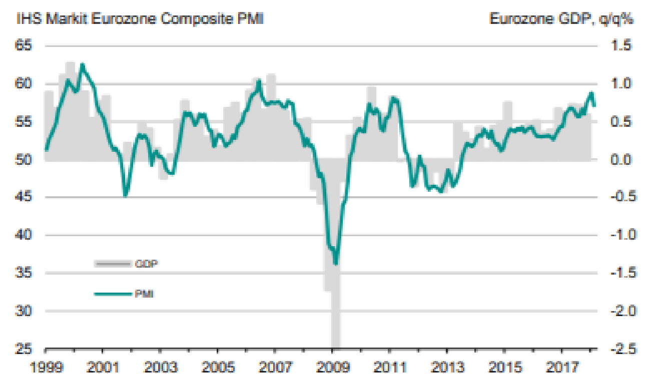
Real annual growth %



Source: Thomson Reuters Datastream, Evans & Partners

Europe is somewhere in between. The European recovery surprised most observers in 2017 but now there is less scope for surprise. Conditions will remain healthy driven, similar to the US, by government and business investment but the good news is now mostly in the market.

Markit Eurozone Composite PMI



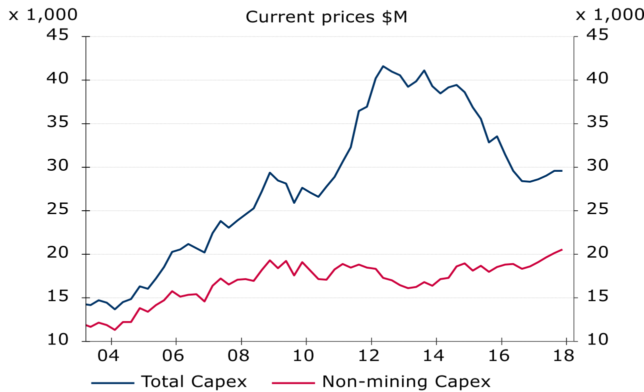
Source: IHS Markit, Eurostat

Australia lagging again

The Australian economy appears more robust than for some years but the hangovers from previous booms in mining and housing linger.

The good news is that the risks of a significant downturn due to crashes in housing or mining have receded. Mining investment is rising again and while housing activity is slowing there is little evidence of collapse. There is also renewed investment in emerging sectors like education and tourism.

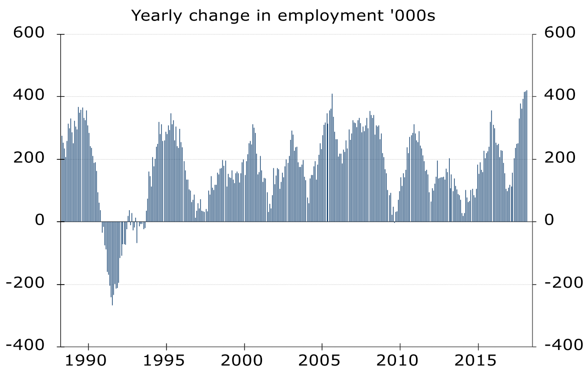
Australian capital expenditure



Source: Thomson Reuters Datastream, Evans & Partners

These emerging sectors are also boosting the labour market and contributed strongly to the 400,000 jobs created across the country last year.

Australian new jobs



Source: Thomson Reuters Datastream, Evans & Partners

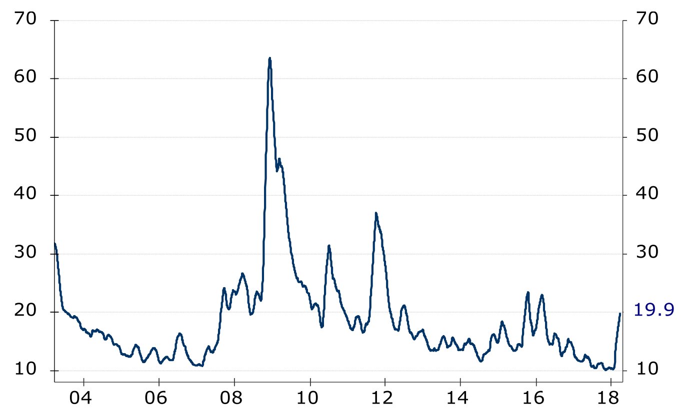
However this better news may be tempered by pre-emptive policy tightening by the Reserve Bank (RBA). We fear that the RBA will be keen to raise rates above emergency levels and may commence this in 2018 – even if the inflation rate remains relatively low. Such a move is a necessity for economic stability in the medium term but will create some economic headwinds and, given high levels of household debt, cause further weakness in the consumer sector.

A more normal risk environment

Risk has been artificially suppressed over a number of years by a range of factors including quantitative easing and the emergence of short-volatility exchange-traded funds (ETFs). This is now changing. Many of the short-volatility funds were shut down after being heavily affected by the market gyrations in January and February. Central banks have also started the slow unwinding of quantitative easing. Higher perceived levels of risk will be a headwind to equities.

US CBOE VIX

Implied volatility %



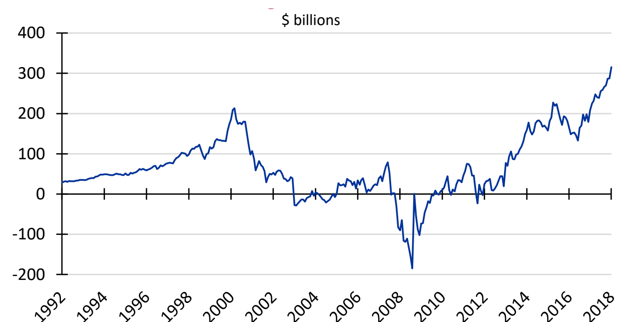
Source: Thomson Reuters Datastream, Evans & Partners

Margin lending

Perceptions of low risk encouraged risk-seeking behaviour by investors including more margin debt in the US and higher hedge fund leverage. In fact margin debt levels are now even higher than at the peak of the tech boom and the last cycle.

More volatility in markets may now result in some of that margin debt being withdrawn and this will be another headwind to equity markets. There is already evidence of a sharp reversal in hedge fund leverage.

Net margin debt on NYSE



Source: Thomson Reuters Datastream, Evans & Partners

Inflation rising

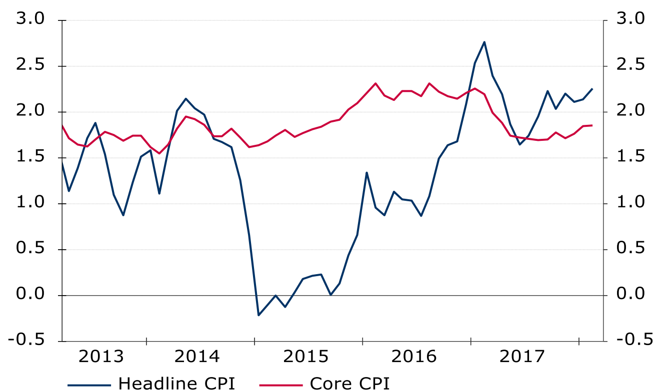
The US inflation rate fell in 2017 but has changed course in 2018. This partly reflects the unwinding of a number of one-off factors but is also the inevitable consequence of building cost pressures, tightening capacity and greater pricing power of companies as demand improves.

Higher inflation and expectations for more aggressive action by central banks will be another contributor to a higher risk environment in 2018.

Overall we expect that the rise in inflation will, however, be contained to a manageable level because of structural deflationary forces from the growth of e-commerce and the increasing globalisation of product and labour markets.

US CPI

Twelve-month percentage changes



Source: Thomson Reuters Datastream, Evans & Partners

Trump's trade tension

Another potential driver of risk aversion will be concerns over an escalating trade war induced by President Trump.

Our starting point is that a full-blown trade war is unlikely. Instead we interpret Trump's recent announcements and his comments around Chinese trade imbalances as the first stage in a negotiation.

The endgame is that he would like a deal on improved intellectual property protection and better access for US trade into China particularly for companies like Google and Facebook that are currently banned. His "hard" talk is an attempt to enter negotiations from a position of strength. China should be willing to deal because the stakes are high and because some reforms in these areas are probably already envisioned under its renewed reform program. China will also expect that Trump could be easily placated if there are some wins that he can announce before the midterm elections that will be held in November this year.

Even though we expect a benign outcome, this posturing and heightened political tension could add further to the risk environment in 2018.

Trade between US and China

TOP 5 EXPORTS TO CHINA IN 2016	VALUE (USD BILLIONS)	% OF TOTAL PRODUCT EXPORTS TO CHINA
Transportation equipment	25.6	9
Agricultural products	17.3	26
Computer and electronic products	17.1	8
Chemicals	13.4	7
Machinery, except electrical	8.2	7

TOP 5 EXPORTS FROM CHINA IN 2016	VALUE (USD BILLIONS)	% OF TOTAL PRODUCT EXPORTS TO CHINA
Computer and electronic products	161.5	43
Electrical equipment, appliances and components	40.4	40
Miscellaneous manufactured commodities	39.5	34
Machinery, except electrical	30.4	20
Apparel and accessories	30.2	36

Source: US Census Bureau, Economic Indicators Division, USA Trade Online

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Where to spring clean?

Given the changing macro and risk environment, we recommend a lightening of portfolio risk and an increase in cash weightings. We will, however, be looking to take advantage selectively of any market over-reactions over coming months. Overall we remain overweight equities relative to bonds and cash but we will be more selective in the period ahead and recommend that clients take profits in some of the higher beta asset classes. Three broad areas stand out: commodities, emerging markets and high yield credit.

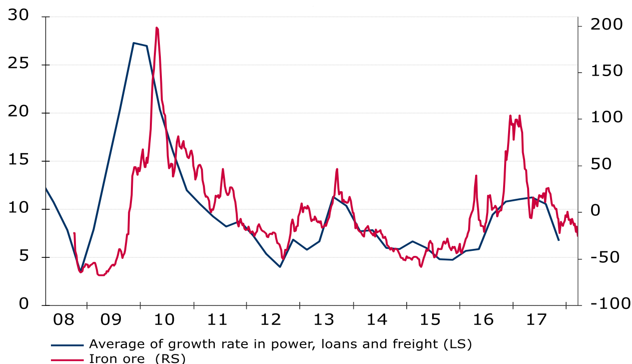
Commodities and resources

Industrial commodities and Australian resource companies are highly sensitive to swings in Chinese growth as shown by the relationship between iron ore and some measures of Chinese growth in the chart below.

We find it surprising that the iron ore price has remained relatively high over the past few months and do not expect this to be sustained. This will feed through to the resources stocks over the course of 2018. The bulk commodities, iron ore and coal, are the most dependent on China and are the most at risk.

Iron ore vs Chinese growth

Annual growth %



Source: Thomson Reuters Datastream, Evans & Partners

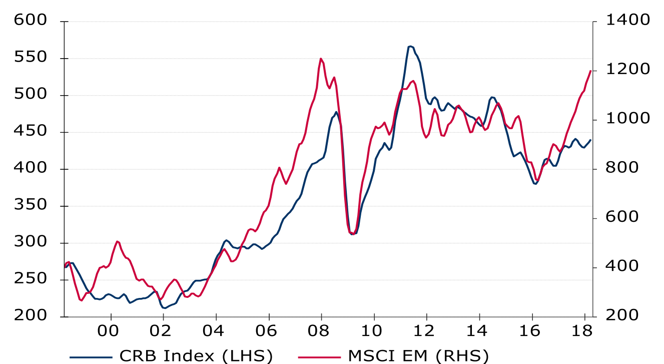
Emerging market equities

Emerging market equities were standout performers last year. This partly reflected improving strength in a number of large emerging markets including Brazil, Russia, India and Korea. The weakness in the $US also played a major role as many emerging market currencies are linked to the $US.

During 2018 we expect weakness in the Chinese economy and a turnaround in the $US to be headwinds to emerging markets. A weaker China will matter directly because China is now the largest constituent of emerging market indices. Indirectly a weaker China will be a drag on EM equities as it is the largest customer for many exports from other EM countries like Korea, Taiwan and Brazil through its demand for tech goods and commodities. The chart below shows the tight correlation between EM equities and commodity prices over time.

Commodities and Emerging Market Equities

Index



Source: Thomson Reuters Datastream, Evans & Partners

High yield credit

The final asset class that appears vulnerable is high yield listed corporate credit. The chart below shows that spreads on US high yield bonds are close to cyclical lows.

Corporate credit is vulnerable because it is traditionally an asset class that is sensitive to the risk environment, as shown by the sharp sell-off that occurred in 2015. The unwinding of quantitative easing by central banks also looms. Corporate credit has been directly affected by QE because the European central bank purchased a significant proportion of outstanding corporate bonds. The chase for yield also saw investors migrate from the sovereign to the corporate sector.

US high yield bond spread

Percentage point spread to US 10 year

Source: Thomson Reuters Datastream, Evans & Partners

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