view from the OUTER

EVANS & PARTNERS

Tim Rocks
Chief Investment Officer
Timothy Rocks

Event risk roadmap

A large part of the market weakness since early October has been the number of event risks that have been hovering in the political and economic landscape for some time that are now coming to a head. Some have been resolved in recent weeks, while others are yet to be resolved.

Three of the major risks that were around in October and contributed to weak markets have now been resolved:

- The US reporting season showed strong results.
- The Iranian embargo has faded as an issue, because the US granted waivers to the eight countries that receive the most Iranian oil.
- The US midterm election results were in line with expectations.

Over the next few weeks, three more event risks will be in particular focus:

- Pressures around the Italian budget will increase.
- Critical dates for Brexit are approaching. A number of agreements and deals must be done to allow for Brexit on 29 March 2019. Even though the UK cabinet has now approved the draft deal, there are more steps in the process. A significant one will be approval by the UK House of Commons which must occur by 21st January.
- The trade war will be in focus in around the G20 meetings from 26 November.

Key dates for the Rest of the Year

Issue	Date	Event
Trade war	Nov 26-30	G20 Meeting
Italian budget	Dec 3	Eurozone Finance Minister Meeting
Brexit	Dec 13-14	European Council Meeting
Fed meeting	Dec 18-19	Fed meeting

Source: Evans and Partners

During 2019 event risk will generally remain high. Potential risks include:

- Trade war escalation with the risk that the US introduces 25% tariffs on all Chinese imports in January.
- The Chinese economic slowdown, which has recently intensified due to pressures in the property sector.
- A potential peak in the US economy.
- Further Federal Reserve (Fed) tightening and the impact on emerging economies.

Recommendation

Event risks are challenging for investors because the nature and timing of their resolution is hard to predict. We expect markets to remain volatile until there is more clarity on some of these issues and recommend that investors be patient and look for opportunities being created by the turmoil. Given the sharper falls in Asian and European markets, these are likely to be the first regions where we will look to redeploy capital.

Event risk roadmap

A large part of the market weakness since early October has been the number of event risks hovering around the political and economic landscape. A number of these have been resolved in recent weeks – the US midterm elections, US reporting season and the risk to oil prices from the Iranian embargo – while others remain unresolved.

Markets rallied immediately after the midterm election results, but have since fallen back. This is probably indicative of a pattern we are likely to see repeated over the next few months as a number of other risks come to a crescendo.

The adjacent tables summarise the major resolved, imminent and longer-term risks facing markets and the upcoming key dates for these risks.

Key dates for the Rest of the Year

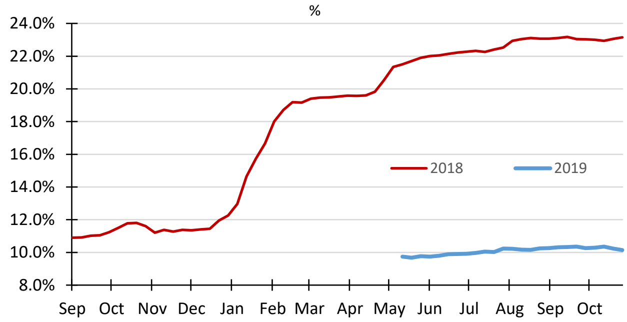
Issue	Date	Event
Trade war	Nov 26-30	G20 Meeting
Italian budget	Dec 3	Eurozone Finance Minister Meeting
Brexit	Dec 13-14	European Council Meeting
Fed meeting	Dec 18-19	Fed meeting

Source: Evans and Partners

Looking first at the recently resolved risks:

- The US reporting season has been strong. The number of companies beating expectations was broadly in line with the previous two reporting seasons and earnings per share (EPS) growth forecasts for 2018 and 2019 are broadly unchanged.

S&P 500 Earnings growth forecast



Source: Thomson Reuters Datastream, Evans & Partners

- The Iranian embargo has faded as an issue for oil markets. There was a risk that the US-imposed embargo on Iran could cause a spike in oil prices, since Iran is responsible for around 5% of global oil supply and the market was generally tight. However, the US has granted waivers to the eight countries that receive the most Iranian oil, which has reduced this risk. As a result, the oil price has fallen.
- The US midterm elections resulted in the expected outcome of a Republican-controlled Senate and a Democrat-controlled House of Representatives.

Risk		Status
Resolved		
US mid-term elections 6th November	✓	As expected
Iran embargo 4th November	✓	Waivers granted make embargo meaningless
US reporting season October/November	✓	In line with previous quarters
Potentially imminent		
Italian budget standoff	?	Europe is likely to fold eventually. The next major deadline is the Eurozone Finance Minister meeting on 3rd December.
Brexit deal is meant to be agreed in 2018 and implemented by 29 March 2019	?	Even though the UK cabinet has now approved the draft deal, there are more steps in the process. A significant one will be approval by the UK House of Commons which must occur by 21st January.
Lingering		
Potential increase in US tariffs to 25% - January	✗	Could escalate into 2019. Trump/Xi are likely to meet at the G20 meeting from Nov 26 but recent comments suggest that the US is unlikely to compromise.
Chinese economic slowdown	✗	Has worsened but policy support is starting
Emerging market pressure from higher US rates	✗	US rates will continue to rise
US economy peak in 2019	✗	Fiscal effect peaks around Q2 2019

Source: Various press reports, Evans and Partners

Imminent risks

With some of the US political risks fading for the time being, the focus is going to shift to Europe where the Italian budget and Brexit risks are both reaching climaxes. The precise outcomes are too difficult to predict but it is likely that markets will be sensitive to the ongoing news flow.

- The Italian budget standoff is likely to be resolved by one party capitulating, and this is most likely to occur around the time of the EU Finance Ministers meeting on 3 December. If it is not resolved, the EU has the option of imposing fines on the Italians – something it is unlikely to do.
- The nature and timing of the Brexit outcome remains unclear despite the UK cabinet's recent approval of the draft deal. Investors are likely to be sensitive to news flow, as a number of important dates occur. Brexit is due to occur on 29 March 2019 and before that time a number of key steps need to occur, including EU Council approval (most likely on Dec 13/14), House of Commons approval (by 21 January) and then final ratification by the UK and Europe by the end of March. Any one of these steps could blow up into a crisis that could include the collapse of the UK government.

Lingering risks

Even though some of these event risks are fading, or will peak soon, other risks will linger into 2019 and new ones could emerge.

Trade war

The trade war will return as a focus in coming months. The next key date is the G20 finance minister and leader meetings in Argentina from 26 -30 November. It is looking increasingly likely that Presidents Trump and Xi will meet at that time.

The best-case outcome from the meeting would be a pause in the trade dispute. Note, however, that even if there is some in-principle agreement, this will not signal the end of the dispute. This is because the escalation in hostilities is about more than just trade; it is about the US trying to suppress broader Chinese development. And there are some key areas on which China is unlikely to give sufficient ground to satisfy the US.

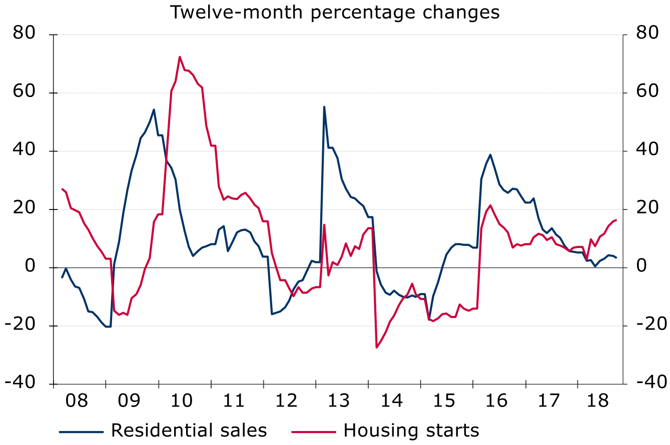
It is more likely in our view that no meaningful deal will be struck, and the US will progress to the next phase of tariff implementation from January next year. This is rumoured to be a 25% tariff on all Chinese imports into the US.

The China slowdown

A critical issue for next year is the extent of the slowing in the Chinese economy. The largest risk for now is the funding squeeze facing property developers. Property construction has been the strongest part of the economy for two years. But now sales are slowing and developers cannot get funding, construction will likely slow. This is occurring at a time when other parts of the economy are also slowing, particularly infrastructure spending and consumption.

China property sales and starts

Twelve-month percentage changes



Source: Thomson Reuters Datastream, Evans & Partners

The extent of the funding squeeze can be seen in the sharp rise in credit spreads for US dollar debt. The chart below shows that the average cost of US dollar debt has jumped from 6% to 11% over the past year. Defaults are also rising.

FIG 7: Chinese vs. Asian high yield corporate bond yields

Investors are desperate for some sign of significant policy response to arrest the slide in the economy. To date, there has been some discussion on policy easing – but no meaningful measures have been implemented.

A potential peak in the US economy

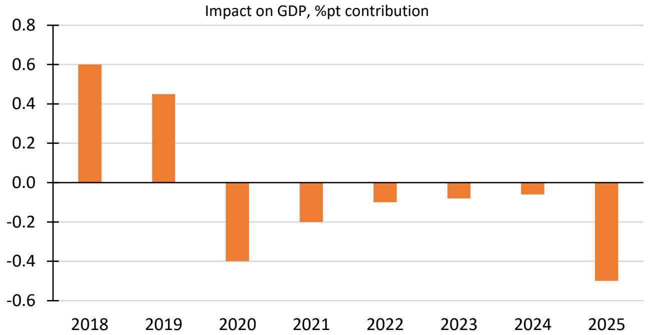
One of the biggest issues for markets in 2019 is whether the US economy can continue its strong recent performance.

Our base case is that much of this performance has been due to one-off items that will reverse, or fade in 2019, making it highly likely that the US economy will weaken. These factors are:

- Tax cuts and fiscal stimulus. Estimates from the Congressional Budget Office are that the economic effects of Trump's tax cuts and spending increases will start to fade from the middle of 2019. These are estimated to have added 0.6% to the economy in 2018 and are expected to add another 0.4% in the early part of 2019.

Trump spending and tax cuts

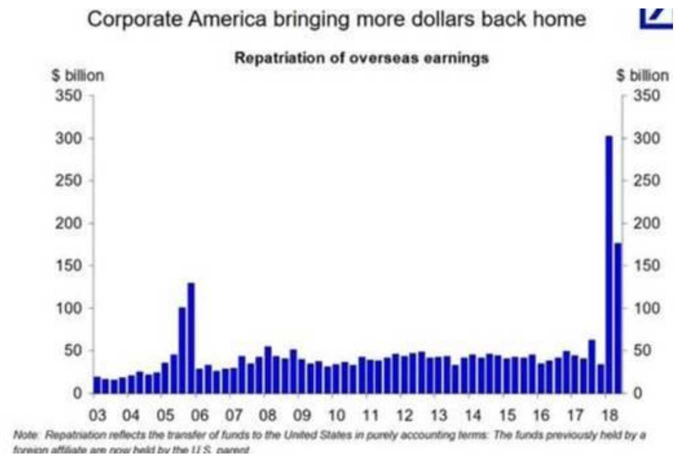
Impact on GDP, %pt contribution



Source: Congressional Budget Office, Evans and Partners

- The trade war and tariff increases have both actually had a positive effect on the US economy in 2018. Exports to China surged in the early part of the year as Chinese buyers sought to transact, before prices rose. There has also been a surge in household purchases of some items, such as whitegoods, where prices will rise once tariffs are introduced. These effects represent a bring-forward of demand, and therefore should lead to a broadly commensurate fall in demand in 2019, once tariffs are in place.

There is also the risk of a greater impact on the stock market, given the material impact tax changes have had on the earnings of US companies. Tax cuts are a large part of the reason why US earnings are forecast to grow by around 23% in 2018. The impact on share prices has been even larger, because of a surge in buybacks. Tax changes have encouraged a jump in the repatriation of overseas earnings back into the US, and it appears the majority of this money has been used to fund a jump in buybacks. In 2019, both earnings growth and buyback activity are likely to slow significantly.



Source: Deutsche Bank, Evans and Partners

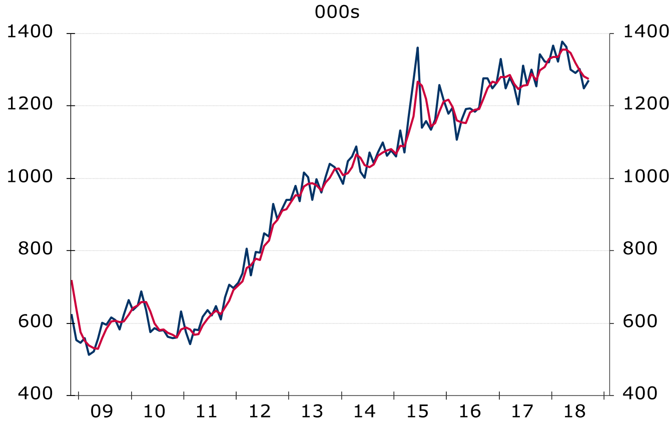
Fed tightening and the impact on emerging economies

The final issue for markets is whether ongoing Fed tightening will have a material effect on either the US economy, or emerging markets. Given a tightening labour market and accelerating wages, it looks likely that the Fed will raise rates by another 1% over the next year. This is already starting to cause strains in two main areas:

- The US housing market is showing signs of peaking as mortgage rates continue to rise. Mortgage rates have risen because of the higher bond rates and quantitative tightening. The Fed purchased a large proportion of mortgage-backed bonds as part of its quantitative easing program and now it has started reducing its holdings of these bonds, liquidity has tightened and mortgage pricing has been affected.

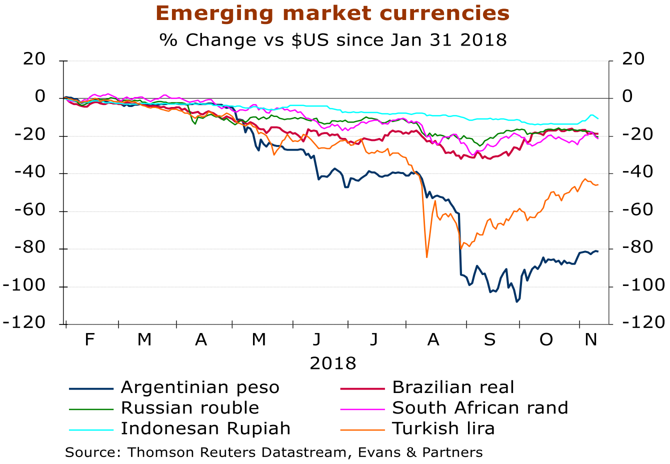
US New Housing Permits

000s



Source: Thomson Reuters Datastream, Evans & Partners

- Emerging economies have come under significant pressure for similar reasons. Many emerging economies raised substantial amounts of debt when rates were low and credit was readily available. Funding markets have now tightened. There has been additional pressure from the rise in the US dollar, which has increased the local-currency value of US dollar debt. There were initially significant impacts on Turkey, Brazil and Argentina. Recent news flow has been better in these countries, but their vulnerability to further rate rises is a significant question for 2019.



DISCLAIMER, WARNING AND DISCLOSURES

This document is provided by Evans and Partners Pty Ltd (Evans and Partners) ABN 85 125 338 785, holder of AFSL 318075. The Financial Services Guide of Evans and Partners Pty Ltd contains important information about the services we offer, how we and our associates are paid, and any potential conflicts of interest that we may have. A copy of the Financial Services Guide is available on our website at www.evansandpartners.com.au or by using the following link (EAP FSG).

This document is not a product of the Evans and Partners Research Department and is not intended to be a research report (as defined in ASIC Regulatory Guides 79 and 264). Any express or implicit opinion or recommendation about a named or readily identifiable investment product is merely a restatement, summary or extract of another research report prepared by Evans and Partners that has already been broadly distributed. You may obtain a copy of the original research report from your adviser or from our website at www.evansandpartners.com.au/research.

Please refer to the document entitled 'Research Conflicts of Interest Disclosure' available for download from the Important Disclosures section of our website (eandp.com.au).

The information is general advice only and does not take into consideration an investor's objectives, financial situation or needs. Before acting on the advice, investors should consider the appropriateness of the advice, having regard to the investor's objectives, financial situation and needs. If the advice relates to a financial product that is the subject of a Product Disclosure Statement (e.g. unlisted managed funds) or offer document investors should obtain the relevant offer document and consider it before making any decision about whether to acquire the product.

The material contained in this document is for information purposes only and does not constitute an offer, solicitation or recommendation with respect to the purchase or sale of securities. It should not be regarded by recipients as a substitute for the exercise of their own judgment. Investors should be aware that past performance is not an infallible indicator of future performance and future returns are not guaranteed. Any forward-looking statements are based on current expectations at the time of writing. No assurance can be given that such expectations will prove to be correct.

Any opinions and/or recommendations expressed in this material are subject to change without notice and Evans and Partners is not under any obligation to update or keep current the information contained herein. References made to third parties are based on information believed to be reliable but are not guaranteed as being accurate.

This document is provided to the recipient only and is not to be distributed to third parties without the prior consent of Evans and Partners.

EVANS AND PARTNERS DISCLOSURE OF INTERESTS

Evans and Partners and its respective officers and associates may have an interest in the securities or derivatives of any entities referred to in this material. Evans and Partners does, and seeks to do, business with companies that are the subject of its research reports.

DISCLAIMER

Except for any liability which cannot be excluded, Evans and Partners, its directors, employees and agents accept no liability or responsibility whatsoever for any loss or damage of any kind, direct or indirect, arising out of the use of all or any part of this material. All information is correct at the time of publication; additional information may be available upon request.