Market Pulse

November 2018

Tilney Group's Chief Investment Officer Chris Godding discusses the macroeconomic ideas and research from November 2018.

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The next Brexit hurdle

The mid-December vote on Theresa May's Brexit proposal is the next hurdle for the Prime Minister, who has delivered remarkable energy to an unremarkable deal. Both the Remain and Leave camps object to the conditionality that has the potential to leave the UK in the upside-down world of being neither in nor out of the European Union indefinitely.

While the deal is unlikely to pass through Parliament without amendment, we do expect that the fear of a no-deal exit will be enough to win the day, providing relief for both business leaders and consumers. Apart from hope in the UK camp, the motivation for the EU to focus on a free trade deal with the UK after 29 March 2019 is, at this point, far from clear. As Rudy Giuliani once said, "change is not a destination and hope is not a strategy".

Provocative budget from the Italian Government

In addition to troublesome Brits, the European Commission has had to deal with a provocative budget from the Italian Government, submitted by the unlikely alliance of Luigi Di Maio and Matteo Salvini.

The initial proposal to target a budget deficit of 2.4% when expected GDP growth is optimistically forecast to be 1.5%, creates an interesting dilemma for the technocrats as it would not normally be acceptable under the rules of the Financial Stability Pact. The European Parliament elections are in May next year and, according to Gavekal Research, a tough approach regarding the Italian budget improves the odds that Salvini's Northern League populists will win enough votes to be able to disrupt the status quo in Brussels and Strasbourg.

After the election, it is likely that the coalition will look to compromise on the budget conditions quickly in order to secure the external funds that will be required to finance the €340 billion of debt that is scheduled to be issued or rolled over next year. The European Central Bank is cutting its bond buying programme next year and, without agreement on the budget, Italian Government debt (BTP) yields will continue to rise to a level that will threaten the very foundation of the Italian banking system.

Europe

The troubles in Italy remain a significant concern for investors and while a softening of the Italian position would be welcome, we continue to regard the euro with caution. In our view, what the Commission should avoid at all costs is a hard Brexit. This scenario would undoubtedly lead to a recession in Europe which the Italian economy and political mood is too fragile to absorb. The euro and sterling are intrinsically linked (see below chart) by the outcome of the Brexit negotiations and both would need to depreciate further in a hard Brexit scenario.

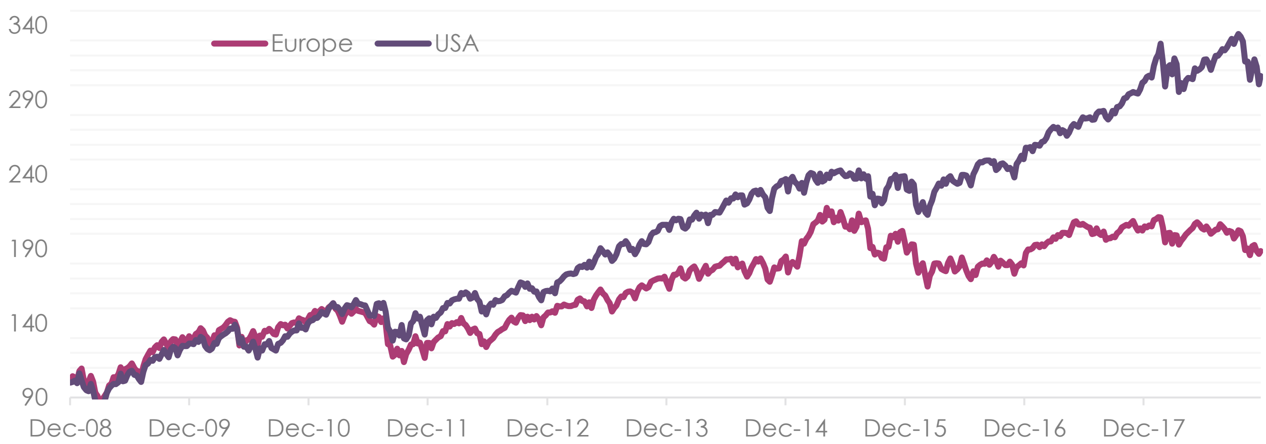
Dependent paths

In the context of the recent global equity market correction, European equities are now fairly valued in our view but not startlingly cheap. The euro area faces external challenges as well as internal, with the protectionist strategy in the US and weaker growth in China impacting exports.

We have a neutral stance in our allocation to European equities but would not expect them to lag the US in the future as much as they have in the past (see below chart). Over the past 10 years the European equity index has lagged the US equivalent by a staggering 117%. Profit growth alone in the US has exceeded European firms by over 80% in that period.

This drubbing has been driven by policy mistakes in Europe such as austerity that led to deflation and the dominance of oligopolistic tech firms in the US versus higher European exposure to State-owned industries and sectors vulnerable to deflation like telecom, energy, utilities, banking and insurance. In addition, equity buybacks of approximately 3% of market capitalisation every year in the US compares to net issuance of 1.7% in Europe. This last component alone would account for 62% outperformance over 10 years.

Will European stocks close the gap? (Performance rebased to 100)



Over the next 10 years, we expect these differentials to be much more balanced. The trade wars are looking more like a policy mistake for the United States, monetary conditions will tighten due to inflation and an escalating Federal budget deficit and we appear to be at a peak in the growth of corporate debt that has historically funded share buybacks.

US corporate debt

Shrinking the equity base through share buybacks has been a simple way for CEOs in the US to meet the return on equity targets that drive compensation. Low interest rates have aided the boom in share buybacks, with a significant majority being funded through corporate debt issuance.

Non-financial corporate debt in the US has risen 35% over the past 10 years to US$14 trillion and the ratio of debt to earnings before tax for the Russell 1000 companies is now above the last highs we saw in 2008. With forecasts for global growth coming down, investors are now beginning to worry whether these debt levels are sustainable and credit spreads over the past few months have widened significantly (see below chart) to reflect this.

In summary, if the debt-funded repurchase of shares in the US is coming to an end, an important tailwind for US equity performance will weaken, leaving future growth dependent on profit growth alone.

US credit spreads

Our view on equities in the year ahead

We reduced our exposure to US equities in September and have become incrementally more positive on the UK, emerging markets, the Asia Pacific region and Japan.

Part of our more constructive view on emerging markets is based on valuation. Emerging market equities now trade at just 10.4x their estimated earnings for 2019 and are cheap. However, realising value needs a catalyst and current tensions over trade between China and the US make that less likely in the short term.

Everything we witness from Donald Trump, Mike Pence, Robert Lighthizer and Peter Navarro suggests that the US will not waiver in its ambition and change tack. On the other side, the Politburo in China are likely to take a long-term strategic view with regard to trade rather than respond reactively to what they see as a short-term threat – leading to stalemate.

We believe the catalyst for equity markets in the year ahead is more likely to build in the following three ways. Firstly, the short-term indicators for US growth in early 2019 are pointing to a slowdown related to the impact of higher interest rates and an inventory accumulation caused by the trade tariffs. This slowdown will cause the Federal Reserve to either pause or adjust its hawkish tone and the US dollar will weaken. A weaker dollar would be a shock to the consensus and a material positive for the emerging markets where dollar liquidity is important.

Secondly, China is nervous about the impact of slower growth and particularly worried about solvency in the shadow banking sector. While stock market losses have already been a major hit to consumer sentiment in the Middle Kingdom, a series of failures of wealth management products could be very troublesome and destabilising for the establishment.

Therefore, the State has begun to ease financial conditions via a lower reserve requirement for the banks, lower taxes and a depreciated currency to inject some momentum back into the economy. The benefits of these policy shifts will gather momentum over the coming months and be felt both across the region and by key exporters to China.

Finally, our strategic rather than tactical view is that the economic blocks outside of the USMCA trade agreement area, such as Asia Pacific and Europe, will move to accelerate cooperation and free trade. Adam Smith originally proposed the benefits of free trade over mercantilism in the Wealth of Nations and using Smith's logic, the unilateral decision by the Trump administration for greater mercantilism will be a negative for the US economy in the long term.

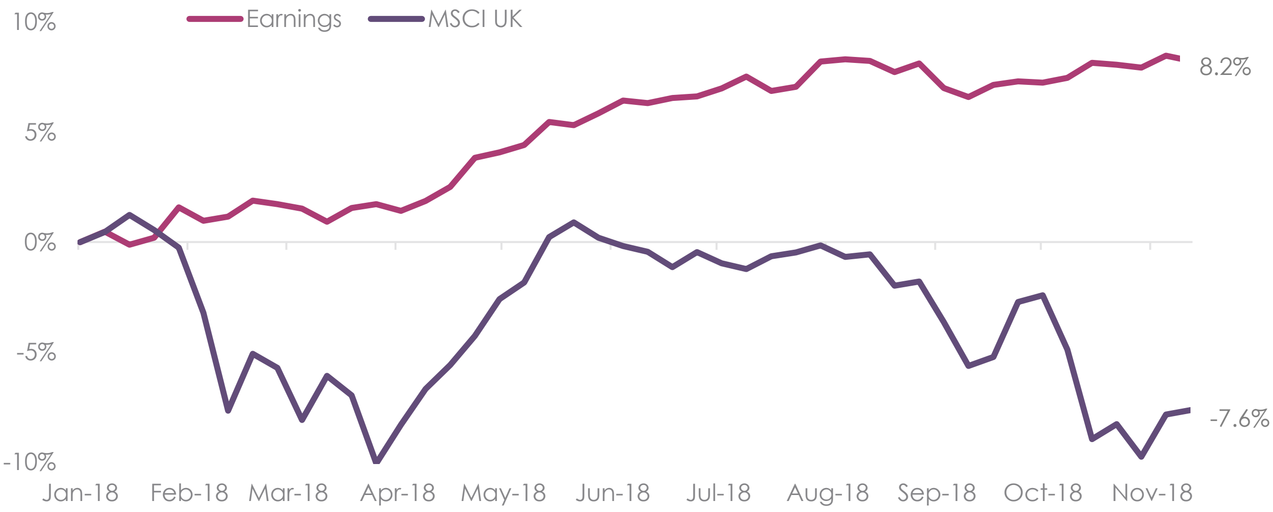
Hopefully, the US will change direction in two years (or six at worst) but in the meantime, we believe necessity is the mother of invention and that Europe, Latin America, Asia and Australasia will accelerate their cooperation and will mutually benefit from comparative advantage, stronger ties and stronger growth.

The 2019 outlook is becoming more promising

2018 has been a difficult year, as politics has dominated and volatility has returned. However, the valuation opportunity being offered in equity markets outside the US (see below chart) combined with the catalysts discussed above put us in a more optimistic mood for market momentum to improve in 2019.

While value and momentum alone are unreliable indicators of when to buy, when they combine they are very powerful. The short term still looks difficult and uncertainty abounds, but uncertainty creates opportunity and the outlook for next year is becoming more promising.

UK equities look cheap



For more information or if you have any questions, please get in touch by calling **020 7189 2400** or emailing contact@tilney.co.uk.

Important information

All data as at 29/11/2018

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