Weekly Market Comment

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Source: Morten Morland on Donald Trump and steel tariffs; 3 April 2018

Could do better

April and the second quarter of 2018 carried on exactly where March and Q1 had finished – volatile. The financial media made a big story out of the fact that markets had not opened the second quarter as poorly since 1929 - mostly missing to mention that the 2-3% April 2 decline was less than what markets staged during more than one day during March. And just as before, the recovery was just as swift the following day, and stock markets ended the week broadly where they had started.

The week's erratic market movements appeared squarely the responsibility of Donald Trump, whose presidential threat and criticism of Amazon's business model triggered another wave of selling in the US Tech sector, whereas his renewed trade war sabre-rattling towards China spooked markets globally. We cannot be entirely sure whether he now regrets having previously claimed bragging rights for the stock market highs in January.

What we do know is that there is a widespread suspicion that the US tariffs are intended as bargaining chips for trade negotiations with China, rather than the opening salvo for a lasting trade war. Why else would US stock markets have staged one of their largest one-day recovery rallies in recent history (on April 3), when members of the Trump administration suggested that markets were taking the threat of a trade war too serious.

For the moment, the fundamentally more important developments for near term market action are the latest macro-economic data releases on the state of the global economy and the outlook for the Q1 corporate results updates. The former brought little in terms of surprises versus expectations. The picture from around the world is that economic expansion has downshifted from rapid acceleration to 'steady as she goes', which we discuss and reflect in our third article this week.

Growth expectations have slowed slightly, but growth remains solidly positive and more important

– synchronised across all major economies. It has been argued that stock market valuations are already pricing in a much more buoyant uptrend, but as we present in same article, we find that argument hard to follow, particularly since the stock market correction brought valuations back down to much less extended levels.

Analysts' earnings expectations for Q1/2018 corporate results are making us a little more nervous. Not because they are indicating the same or bigger slowing than the top down macroeconomic expectations outlook, but on the contrary, because they are anticipating yet another strong pickup in corporate earnings results, particularly in the US. More extraordinary still is that analysts have been increasing their growth expectations over the course of the quarter, when normally they start overly optimistic and pare back as the actual announcement period draws nearer.

Should companies indeed be able to meet expectations of more than 17% annual earnings growth, then this should return upside momentum to stock markets. If they disappoint, it will at a minimum bring ridicule over the company analysts community, but has also the potential to trigger more market downside volatility. We are not quite sure what to make of the disconnect between macro and company data and will be pleasantly surprised if company analysts are proven at least partially correct.

The US trade dispute with China clearly has the potential to upset the current benign economic outlook. More likely is that both sides will engage in intensive negotiations that will lead to China changing its trading conditions under the WTO from its current emerging market status to more developed economy parameters as seems appropriate for the now second largest economy on the planet. Neither side has a particular interest in causing collateral damage to their respective economy, but there is clearly a possibility that 2018 will bear some of the cost necessary to achieve what could well be improved trading conditions going forward.

Following on from a first quarter that brought an end to the Goldilocks expectations environment, by reintroducing real cost of capital through gradually normalising interest rates and corporate bond yields, the second quarter could turn into a period over which the assumptions of this new, yet 'old normal' economic and capital market environment are being tested. We should therefore expect continued bouts of market volatility, where recent lows may be retested until the economic and corporate news flow confirms that just because more normal market conditions are returning, industry and commerce are not about to falter. As before, our expectation is that reality will turn out to be far more middle of the road than the extreme outlook scenarios being peddled at either end of the market spectrum.

The Big Tech Scare – understanding the drivers

Technology stocks took another battering at the beginning of the week. Heavy losses from Amazon, Tesla, Microsoft and others drove a plunge in the sector and equities more broadly. The S&P 500 index was down 2.2% on Monday, its worst start to April since 1929. And the tech-heavy Nasdaq fared even worse, ending the day nearly 3% down. The rest of the week saw improvement in equities, with a rally on Wednesday putting the S&P back up to where it ended last week. But 'Big Tech' still lagged the rest of the pack, sinking lower in the sell-off and not climbing as high in the rally. As the chart illustrates, while the recent correction to US tech stocks feels sizeable, the sector is still in positive return territory for 2018, and up around 250% since the beginning of 2016.

Source: Bloomberg, 6 April 2018

Broader technical and economic worries, teamed with company-specific issues, continue to weigh down the sector. Intel was hit badly by the news that Apple plans to move its CPU production in-house, while the fatal crash of a self-driving Tesla car served as a reminder that new technology does not mean that accidents cannot happen anymore. A particular standout was President Trump's twitter tirade against online behemoth Amazon. The President's accusation that Amazon costs the US Postal Service (and by extension the American taxpayer) "massive amounts of money", and particularly the assertion that "this will be changed", generated significant uncertainty over Amazon's future profitability for investors.

All of this isn't even to mention Facebook's ongoing Cambridge Analytica scandal and the surrounding debate over the social and political ramifications of big data. We wrote last week about how the wider debates around Big Tech translate into equity valuation worries. How do you value a company whose assets are by their nature intangible? And how much are Amazon, Facebook and Google worth in an environment where governments might start regulating the use of customer data and monopoly more harshly?

We believe these questions are playing a big part in the turbulence around the tech sector – forcing investors to consider what might happen to the stock market's golden children when the party draws to a close. We seem to be in the midst of a perfect storm for Big Tech, where political and social factors are intertwining with general market trepidation. But despite all this seemingly happening at once, the tech giants are each facing their own political dilemmas.

As we see it, there are broadly three issues which are coming to the fore in The Big Tech scare: the dangers and ethical problems of new technologies and automation, the political implications of big data, and the economic impact of the new monopolies in technology.

The first issue is exemplified by the problems at Tesla. Driverless cars present a great legal and moral difficulty. What should a driverless car do when a crash is unavoidable? Who's responsible when they do crash? These questions alone have spawned an entirely new field within the ethics of artificial intelligence, and they will only become more prominent as the cars become more prevalent. Without knowing in advance what kind of regulation there will be for their product, what's an appropriate valuation for Tesla?

The second issue is already visible in the Cambridge Analytica scandal. Modern technology has made it possible to amass a staggering amount of information about individuals with ease. When the Snowden files years ago revealed the extent of governments' spying on their citizens, worries over surveillance state and its threat to democracy were widespread. But what we see now is a different issue: citizens willingly – but likely unknowingly – giving their personal information to private companies who can use that information for potentially nefarious ends. The adage "if you're not paying, you're the product" is ever more apt as big data progresses. But without the ability to sell data for targeted advertising, the business model of Facebook, Google and Twitter comes under serious threat.

The third issue is potentially the most significant from an investment perspective, and one we think will become even more prominent in the months and years to come. New technology allows for businesses to rapidly achieve economies of scale, meaning they can quickly drown out the competition. In the case of Amazon, this is combined with two additional growth advantages which incumbent competitors would have lacked – no tax and zero cost of capital. Accepted by its shareholders as an entirely growth-based business model, where all profits are reinvested into research and development on new technologies and areas for expansion, Amazon has hardly ever generated profits (positive earnings). As a result, they have paid neither corporation tax nor dividends. These two factors make a cycle which has made Amazon and the other tech giants effective monopolies in their sectors.

Each issue has its own regulatory implications, but the laws which may come out of the monopoly debate could have the most impact. Antitrust legislation in much of the developed world is largely focused on physical goods, and so protection against monopoly in the virtual goods market is arguably outdated. But more importantly, current antitrust law throughout the world is almost entirely focused on remedying the supply-side effects of monopolies. That is, it protects against cartels and huge sellers driving up prices through a lack of competition. But price extortion is not an issue with the new monopolies; far from it, the reason other retailers are going out of business is because they can't compete with Amazon's low prices.

Where the tech monopolies have a potentially detrimental effect is on the demand side. By monopolising distribution, Amazon has enough buying power to force end producers to sell to them at extremely low prices. Producers have to take whatever Amazon, Apple or the others will give them. This can be clearly seen with Intel, whose ditching by Apple has left them cut adrift.

This inevitably has a knock-on effect on wages, which could go some way to explaining the extremely lethargic wage growth seen over the past 10 years – despite unemployment falling close to the full employment level.

What's interesting is that these issues have lingered in the background for some time, but are only now coming to the foreground of public debate. Facebook's invasion of privacy is apparent to anyone who's noticed targeted ads on their smartphone, and farmers have been complaining for years that supermarkets have pushed their revenues so low that they have to adopt ever-more intensive methods – to the great detriment of the environment. But after wider markets fears about stretched equity valuations, the societal impact of Big Tech has shot to prominence. What came first, the market jitters or the political worries?

Whatever the case, now that politicians, the public and – most importantly – markets have noticed, there will likely be meaningful changes for the Big Tech superstars. Donald Trump's anger at Amazon suggests their era of free capital and no tax is coming to an end. The same goes for Facebook and their data practices; the wild west period for internet firms can't last forever.

In each case it could drastically change the business models and equity valuations of Big Tech companies. If they can't generate as much revenue from advertising, Facebook will have to find some other cashflow. And without the ability to constantly reinvest revenue, Amazon can't keep being an invincible growth machine.

Needless to say, this will have a big impact in how they are valued. As we argued last week, this is very far from being a death knell for Big Tech, it just means that they might no longer be the superstars of the equity world.

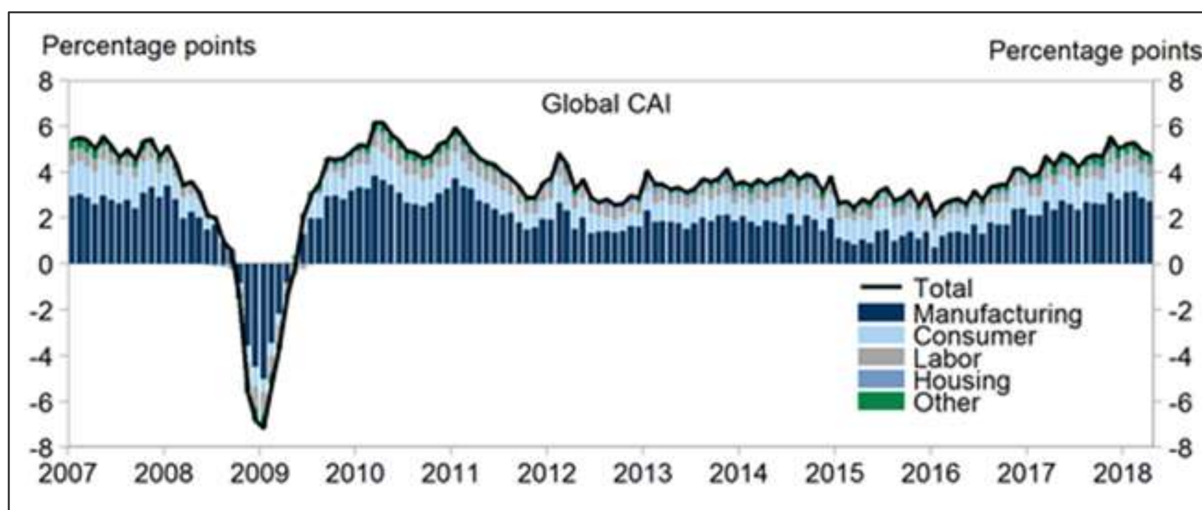
What's priced in? A global economy too hot or too cold?

The recent equity market corrections have led investors to ponder if they should buy the current dip, sell down or hold onto their positions and ride out the rise in volatility. The answer to that question hinges on the outlook for the global economy, since the underlying economy is what ultimately drives company profits and thereby stock markets.

The start of 2018 saw a benign Goldilocks environment: a highly supportive macro backdrop, low interest rates, expanding company profits and the additional fiscal stimulus of Trumps tax cuts. Where growth in equities had previously been more gradual, this environment sped up the rally, resulting in what we refer to as a 'melt-up'. This frenzy came to an abrupt end in February, and led to a stock market correction after investors became concerned that the economic growth was getting too hot, which would lead to higher inflation than anticipated. This would require a stronger response from central banks via faster interest rate increases, and thus remove one of the key 'Goldilocks' valuation parameters, i.e. lack of alternatives to equity investments.

Then, in March, the opposite occurred. The underlying economic data softened, leading to concerns that the backdrop was becoming too cold, resulting in further falls in asset prices. This is why we wrote last week that the next round of macro-economic data releases would be quite important to assess likely market activity.

Compared to the markets swings, 'quiet and steady' comes mind as the adjective in relation to macro data. To illustrate, Goldman Sachs' proprietary indicators, such as CAI (Current Activity Indexes), which are known to predict the direction of global GDP quite accurately has remained close to cycle-highs for the past six months (see graph below). We do not find it surprising that activity would eventually moderate from such high levels and, while the magnitude of economic surprises has cooled, the trend remains both stable and positive.



Source: Goldman Sachs Global Investment Research, April 2018

The key economic data we were watching this week was the sentiment-driven Purchasing Manager's Indices (PMI), which have also been reliable indicators for the general direction of the economy. The heatmap from JP Morgan below shows a near synchronous 'sea of green' for all of

the world's developed markets since 2017. Compared to that, 2018 started with a global average of 53.4 in March, a smallish decline from the 54.1 reading in February.

A reading above 50 indicates that company representatives expect further growth in activity. With last year's acceleration slowing (but remaining solidly above 50), this suggests that it's just as unlikely that the global economy will overheat as it is that it will freeze. A moderate path looks the most likely.

The PMI readings from the Eurozone (EZ) on Thursday confirmed this cooling but stable hypothesis. The March Eurozone PMI printed at a healthy 55.2, a deceleration from February's frothy 57.1, capping a bumper end to 2017.

The driver behind the EZ slowdown appears to be "supply chain constraints", skills shortages and a stronger Euro, which have reigned in "output growth". These factors are less concerning than a deteriorating outlook.

In the UK, manufacturing activity remains solid at 55.1 in March, after expanding at a rapid pace in 2017. The sector continues to enjoy one of the longest periods of growth for nearly 50 years, aided by a weaker Pound. Only the construction PMI made disappointing news, with a fall into the sub 50 territory. However, the bad weather during March could easily explain this drop.

IHS Market themselves (PMI data provider) said of the decelerating global trend that, while activity levels have "come off the boil", they are still "running hot". Markit also said that it was "important to note that the slowdown generally represents a reduction in the number of companies reporting month-on-month improvements in business activity, as opposed to a rise in the number of companies reporting a deterioration in business conditions".

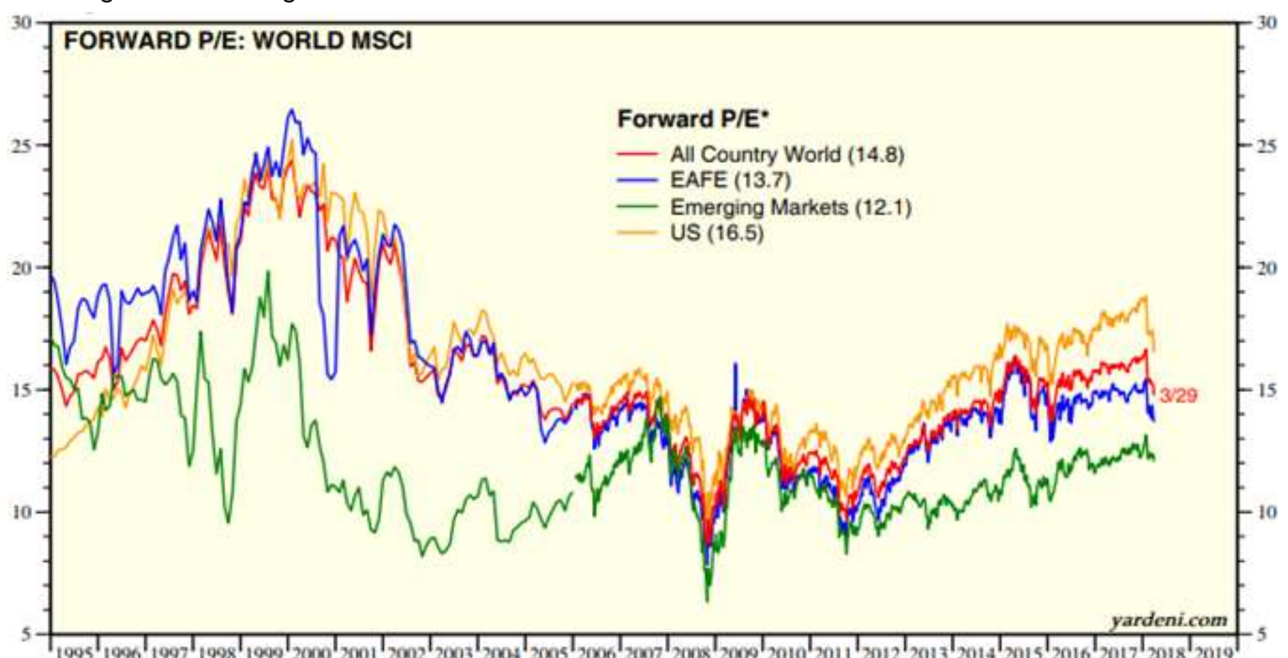
The Markit survey data suggests that global economic growth should remain robust, in the region of 3-3.5% (on consensus estimates) for both this year and next. Growth looks broad-based, driven by both industrial activity and business investment (capex).

In terms of the other factors effecting market valuation, inflation is rising slowly and away from the 'low-flation' levels of past years and towards more 'old' normal level of 2%. But, with wage growth not showing any signs of introducing significant pressure, price inflation remains relatively subdued in the face of solid growth.

Monetary policy in developed markets can therefore be expected to tighten only moderately in 2018, albeit at different speeds across the globe. In the US, the Federal Reserve continues to normalise both interest rates and its balance sheet at a steady rate, while the Bank of Japan and European Central Bank will likely refrain from doing the same before the end of the year. Nevertheless, our liquidity barometers are showing a tightening of monetary conditions, because companies have begun using surplus cash funds for capital expenditure to satisfy growing demand for their goods and services – just as one would expect when there is better use for funds then leaving them on deposit.

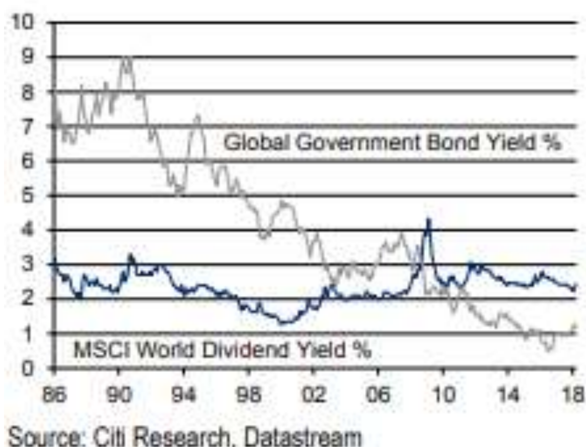
This broadly favourable backdrop should be supportive for equities over the medium term. On current estimates, 2018 is shaping up to be the 2nd continuous year of synchronised global EPS (Earnings Per Share) growth. As we lay out in the earnings forecast article, analysts have upgraded their expectations, with EPS up by 4% over the past 4 months alone to 15%, a reflection of US tax cuts.

On valuation grounds, the MSCI All Countries World Index trades on a trailing Price to Earnings multiple of 19x (i.e. current share prices divided by corporate profits of the last 12 months - LTM). This is not much above the 17x longer-run median. On a forward-looking basis (i.e. current share prices divided by expected earnings for the next 12 months - NTM), equities have de-rated to 14.3x, versus the long running average of 15x, as share prices have corrected but forecast earnings continue to grow.



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: Thomson Reuters I/B/E/S.

While absolute valuations had become stretched, equities still looked attractive relative to fixed income. The dividend yield for equities remains higher than bonds in all major developed markets, bar the US (See chart below). As a result, equities continue to attract flows, despite the recent up-tick in volatility. Year-to-date, $136 billion has flowed into equity funds and $66 billion into bond funds. This is off the back of a strong year in 2017, when a combined $900 billion flowed into equity and bond funds. This would suggest that investors believe that stock markets still have legs even



Source: Citi Research, Datastream

during the latter stages of the economic cycle.

In summary, the latest macro-economic data releases continue to provide evidence for synchronised growth in the global economy, but also that the acceleration that began 18 months has likely stopped – albeit at a relatively high growth run rate. This, together with subdued wage growth, should support a continuation of corporate earnings growth. Given relative equity valuations as per the aforementioned PE ratios, it would appear that, from the global economic backdrop at least, there remains further upside to equity markets.

Earnings season preview

As we have discussed many times, the US equity market has been trading at relatively elevated valuations for a while. There has been much discussion about what multiple of earnings can or should be justified. For context, we have included some recent measures of price to earnings multiples (using trailing and forward earnings) of FactSet’s US equity index.

Source: FactSet

To us, the questions now are what level of earnings expectations is baked into the next twelve months? And are these multiples on estimates of depressed earnings or elevated earnings? That is, are they easy or hard to match?

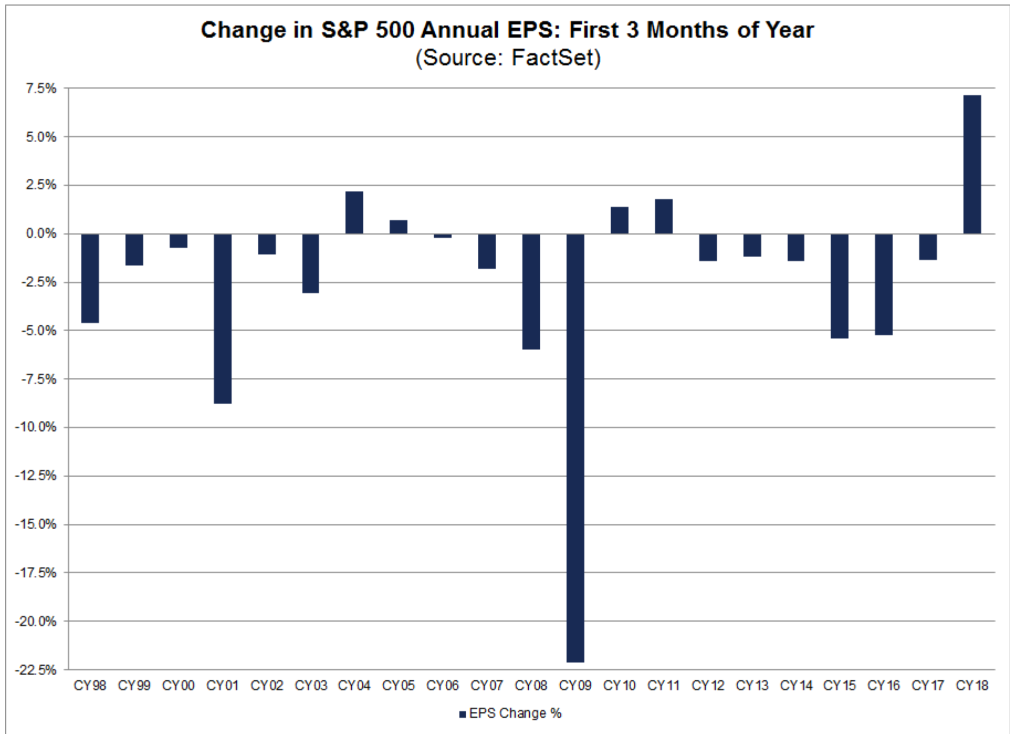
As we can see above, these multiples have diverged significantly over the last year. The green line of the forward PE ratio in the chart implies 2018 earnings will be significantly above those of the past year, which came on the back of high (but not peak) margin levels, and a recovery from 2016's slump in revenue growth.

Earnings estimates are either made on a "top down" or "bottom up" basis. Top down estimates are generally made by economists, while the bottom up ones are computer generated by stock specific analysts. The former look at broad factors like inflation, employment, wage levels, and so on and to try and come up with a good idea for the economy or market as a whole.

Bottom up estimates are, historically, more optimistic initially, and tend to get revised downward the closer to announcement it gets. Only a handful of companies have reported their Q1 2018 results so far, but some research from FactSet suggests there is historic bullishness amongst US analysts. Their insight article (https://insight.factset.com/record-high-increase-in-sp-500-eps-estimates-for-q1-and-cy-2018) is a short analysis of the US figures.

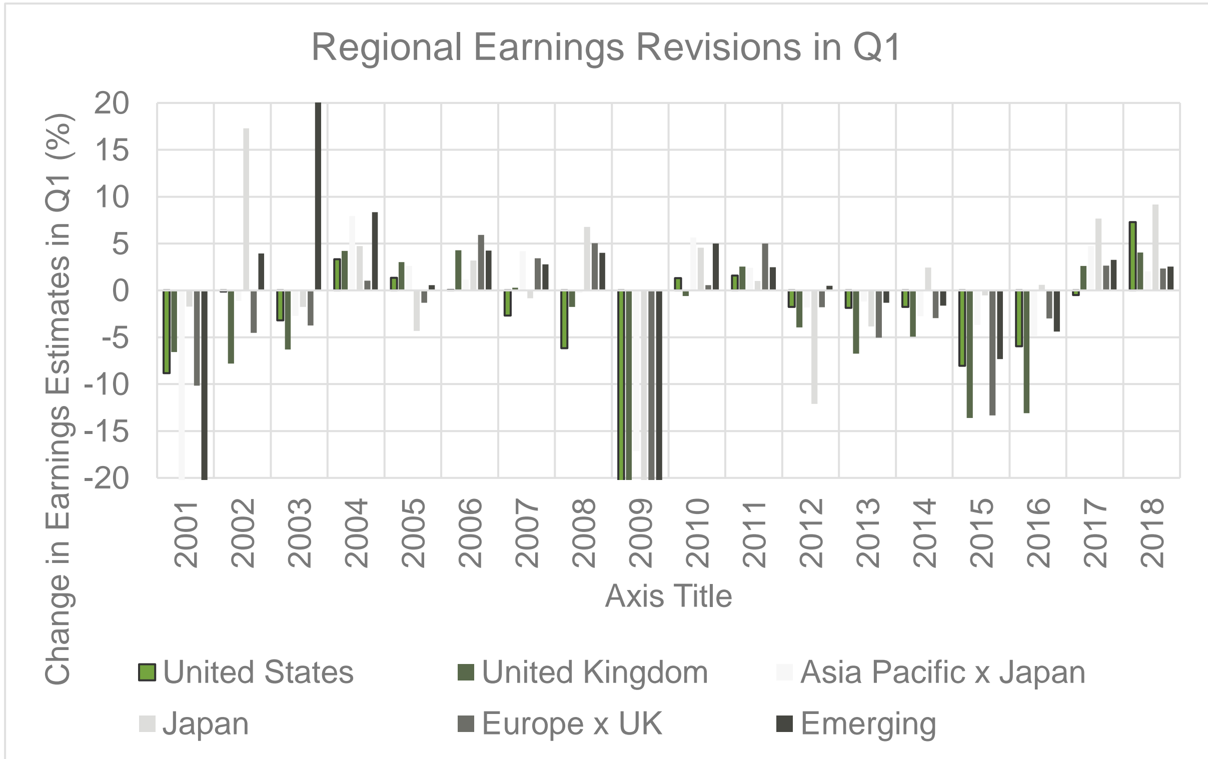
Comparing current expectations for Q1 earnings with the end of 2017, this is the first time since FactSet began tracking quarterly data in 2013 that we have seen an increase in US earnings estimates as we draw closer to the actual announcements. We are currently looking at an increase of 5.4% vs an average of -4.1% over the first quarter.

It is also by far the largest revision to annual earnings over the first three months of the year since 1998 (when they began tracking that), as shown below.



Source: "Record-High Increase in S&P 500 EPS Estimates for Q1 and CY 2018", FactSet, retrieved from: https://insight.factset.com/record-high-increase-in-sp-500-eps-estimates-for-q1-and-cy-2018 on 5th April 2018

We have extended this analysis to a broader set of major markets to see how exceptional these increasing earnings estimates are. The y-axis has been constrained to ±20% and the US is represented by the bars which have a dark outline.



Source: FactSet

Here we can see that, while these upward revisions in the US are a rarity, they are more common around the rest of the world. Perhaps non-US analysts begin the year with more realistic expectations! Estimates of earnings in EM and Japan have actually seen more upward revisions than down in aggregate in the last 18 years. Nevertheless, we can see this is a worldwide group of positive revisions in a way that hasn't been seen since 2011.

data from 2001	**United States**	**United Kingdom**	**Asia Pacific x Japan**	**Japan**	**Europe x UK**	**Emerging**
Up Revisions	6	7	8	10	8	12
Down Revisions	12	11	10	8	10	6
Rank of 2018 revisions	1	3	7	2	6	9
Current Revision	7.3	4.0	2.0	9.2	2.3	2.5
Average Revision	-2.8	-4.3	-1.5	-1.5	-2.7	0.5

Source: FactSet

It would seem that these improving earnings expectations are not isolated to the US; the UK and Japan have seen some of the best of the last 18 years.

The implication is that the conditions for these companies is either significantly better now than at the start of the quarter, or that they started the year with too pessimistic a view. Should an exogenous factor disturb the rosy environment stock analysts expect, forward earnings based valuations could rapidly look more stretched than they are now, across all major equity markets.

This scenario will certainly make us watch Q1 earnings results with even more interest than usual. If companies can deliver on these increasing earnings expectations, we may well see a resumption of markets moving upwards, if not, there may be some recalibration needed by analysts and markets alike.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7186.7	2.0	142.0	↘
FTSE 250	19543.1	1.0	186.6	↘
FTSE AS	3955.4	1.8	70.2	↘
FTSE Small	5641.2	1.1	61.3	↘
CAC	5263.8	2.6	133.3	↘
DAX	12254.1	2.6	313.4	↘
Dow	24131.6	0.1	28.4	↘
S&P 500	2635.7	-0.2	-5.2	↘
Nasdaq	6518.1	-1.0	-63.1	↘
Nikkei	21567.5	0.5	113.2	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	12.9x	13.4x	17.1x
FTSE 250	2.8	14.8x	14.2x	17.0x
FTSE AS	3.8	13.0x	13.5x	16.6x
FTSE Small	3.3	9.7x	-	-
CAC	2.9	15.5x	14.2x	15.4x
DAX	2.6	12.3x	12.5x	16.9x
Dow	2.1	19.5x	16.1x	15.3x
S&P 500	1.8	20.3x	16.5x	17.5x
Nasdaq	1.0	25.6x	19.9x	20.2x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MICRO FOCUS INTERN	15.3	DIRECT LINE INSURA	-8.1
WM MORRISON SUPER	7.3	PADDY POWER BET	-4.0
SHIRE	6.4	PRUDENTIAL	-3.5
IMPERIAL BRANDS	6.0	ST JAMES'S PLACE	-3.4
BP	5.5	RANDGOLD RESOUR	-3.1

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.41	0.51	OIL	68.0	-3.2
USD/EUR	1.23	-0.50	GOLD	1332.3	0.5
JPY/USD	107.08	-0.75	SILVER	16.4	0.1
GBP/EUR	0.87	0.98	COPPER	305.0	0.8
CNY/USD	6.30	-0.08	ALUMIN	2009.0	-1.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.392	3.1	0.04
US 10-Yr	2.774	1.3	0.03
French 10-Yr	0.732	1.5	0.01
German 10-Yr	0.492	-1.0	-0.01
Japanese 10-Yr	0.046	-6.1	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	1.5
Weighted Average Interest Rate (BoE)	-
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel