OFFSHORE EQUITY

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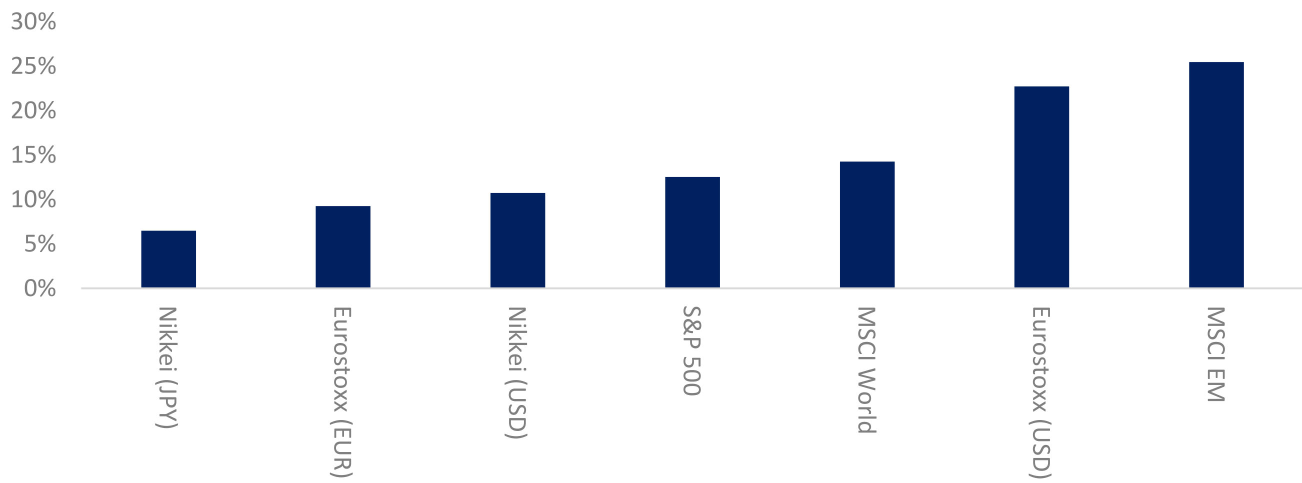
Global equities have clocked yet another quarter of strong returns: the S&P 500 gained 4% during the quarter, while European equities doubled this performance, delivering a very strong 8% price gain, when measured in US dollar terms. YTD, EMs have undoubtedly been the star performer in the equity space, with indices up 25% in US dollar terms, while European equities are up over 20% for the period. In an environment in which an acceptable risk-adjusted return for global equities is 7% p.a., these numbers are truly breathtaking (Figure 6.1).

The sizeable return differentials between regional markets reflect the major macroeconomic developments that have been unfolding over the year: the growing momentum of the economic recovery in Europe, which has reflected in euro strength against the US dollar, is also displayed in the region's equity market performance. Similarly, improvements in the EM credit cycles and strong commodity prices buoyed the resources and financial sectors which dominate EM equity indices.

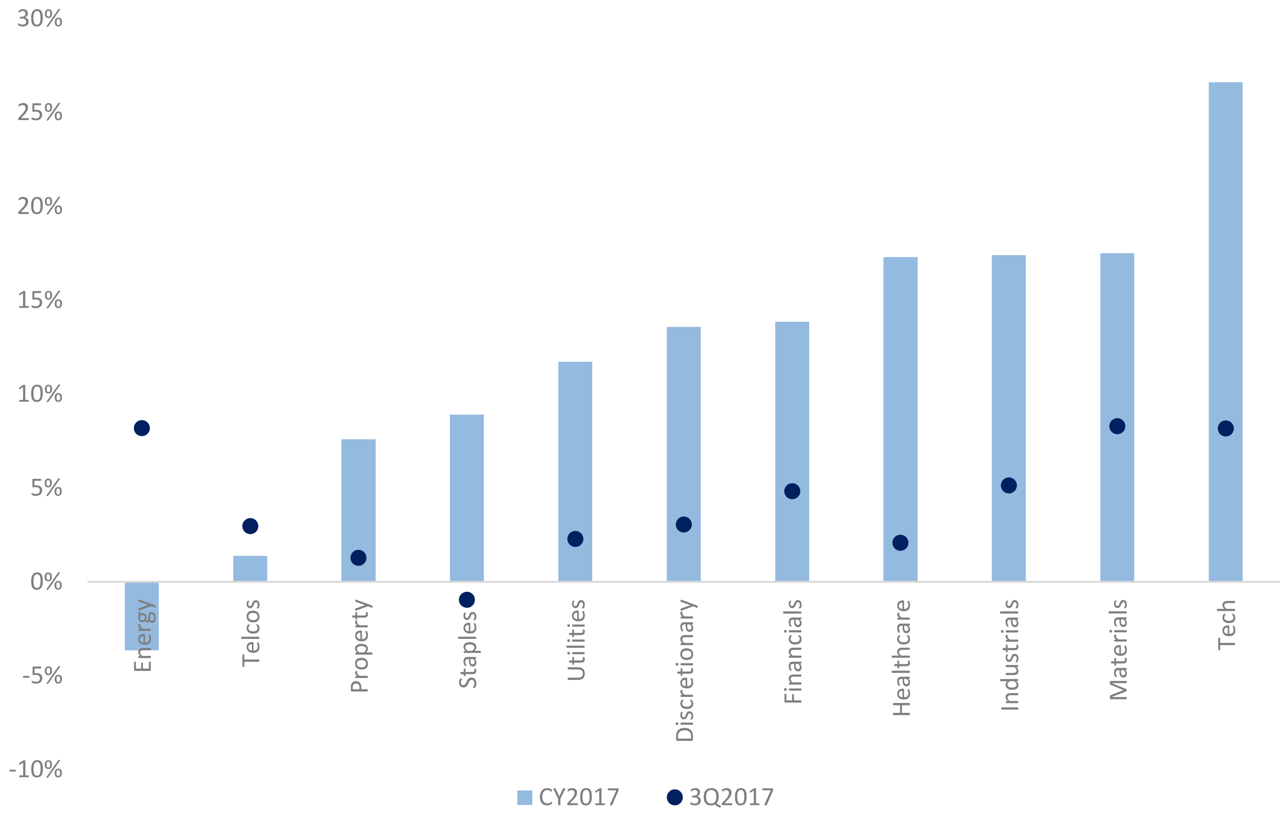
Our portfolios have benefited from our overweight allocation to equity during the quarter. Although we have reallocated capital to European and EM equities over the year, these are still relatively small in comparison to our holdings of US corporates. Similarly, our recent allocation to Energy has served us well during the past quarter, but we nevertheless remained underweight Materials and Energy, which were the star sectoral performers during the recent quarter. The latter reflects a generally conservative posture towards these highly cyclical sectors. From the perspective of the YTD, however, our sector allocation has worked very well, partly due to our large allocation to Technology, comfortably the top performer (Figure 6.2).

Figure 6.1: Stunning equity returns 2017 YTD



Source: Bloomberg; Anchor estimates

Figure 6.2: Equity sector performance for 3Q17 and CY2017 to date



Source: Bloomberg; Anchor estimates

Chinese Banks, in particular, form a very large proportion of the EM Equity Index. Although EM Banks have been strong across most jurisdictions this year, they hardly represent a homogenous asset class: the fortunes of Brazilian and Russian banks are tied largely to the commodity markets which drive these economies, while Chinese banks have been driven by concerns attached to rapid debt accumulation and the preponderance of state-owned enterprises (SOEs) in this market. The risk being that many such SOEs may well be 'Zombie' corporations, associated with the 'Old China', and being kept on financial life-support by state-owned banks.

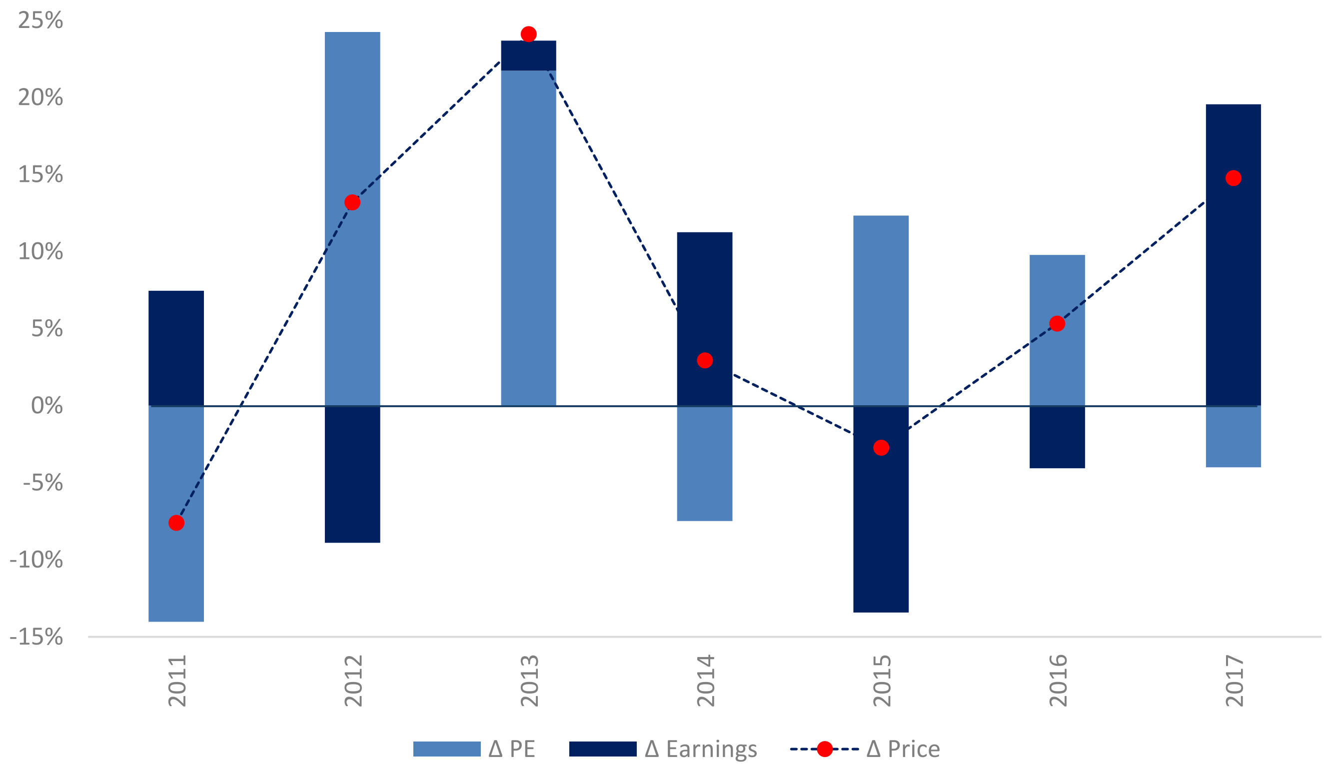
In the past year, however, a number of developments have taken place in Chinese banking which bode well for the sector and therefore also the broader economy. First, a degree of liquidity restriction was aimed at addressing the problems of excess debt accumulation and, potentially, the amassing of poor-quality assets. This was reflected in a rise in the Chinese interbank rate. Second, reporting by the major Chinese banks have indicated a clear improvement in the credit cycle: credit losses seem to have turned the corner, and banks have redirected lending away from sectors in structural decline. Perhaps in recognition of this progress, The People's Bank of China (PBoC) announced that it will cut the reserve ratio (RRR) in 2018 for certain large banks. This should both boost the profitability of banks, and reverse the foregoing (albeit modest) restriction on credit growth.

There are very many dimensions to the complex question of Chinese credit. Somewhat simplistically, however, one could say that recent developments involve a successfully navigated period of monetary tightening, associated with a general improvement in credit quality in the banking system, which has recently been followed by signs of renewed easing. The bullish consequences of these developments are already becoming apparent: Chinese GDP has actually surprised on the upside in the 2017 YTD, pushing many major global banks to raise their forecasts of Chinese GDP growth (as we too have done). Similarly, the share prices of Chinese banks have registered the improvement: the largest Chinese Bank, Industrial and Commercial Bank of China (ICBC), is up about 40% in US dollar terms YTD. This represents, one could say, the Chinese leg of the global reflation trade.

The importance of these developments for global markets cannot be overstated. China continues to be the largest contributor to global GDP growth, and the world's largest consumer of commodities. As such, a large proportion of the country's growth derives from debt-funded investment spending - developments in the Chinese credit cycle will have an effect on the entire world's growth dynamics. This improvement in China is also pointedly significant for the EM complex in general, for whom China is the major export destination.

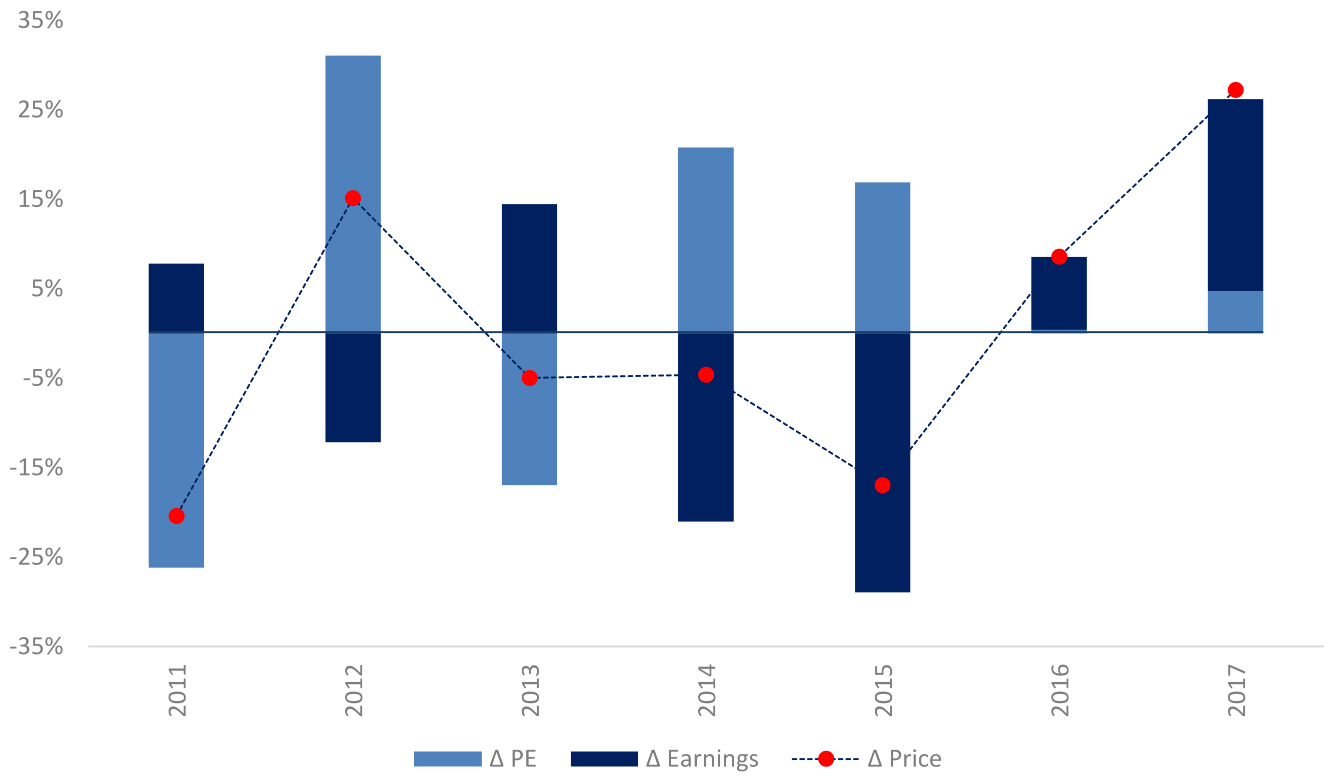
From a more general perspective, a truly singular feature of this year's equity market rally is that it has been driven entirely by earnings growth (Figure 6.3 and 6.4). This contrasts notably with the period after 2010 (the year of the post-recession earnings rebound), in which most years of strong performance have been driven by PE multiple expansion (e.g. 2012, 2013, 2016 in Figure 6.3). The pattern in EMs is somewhat different, but shares with DM equities a recent rally that is convincingly underwritten by strong earnings growth. This rally has also been associated with a remarkably stable forward earnings yield, for the past 3 years, in spite of an oscillating bond yield (Figure 6.5).

Figure 6.3: MSCI World – Earnings and PE components of price changes, by calendar year



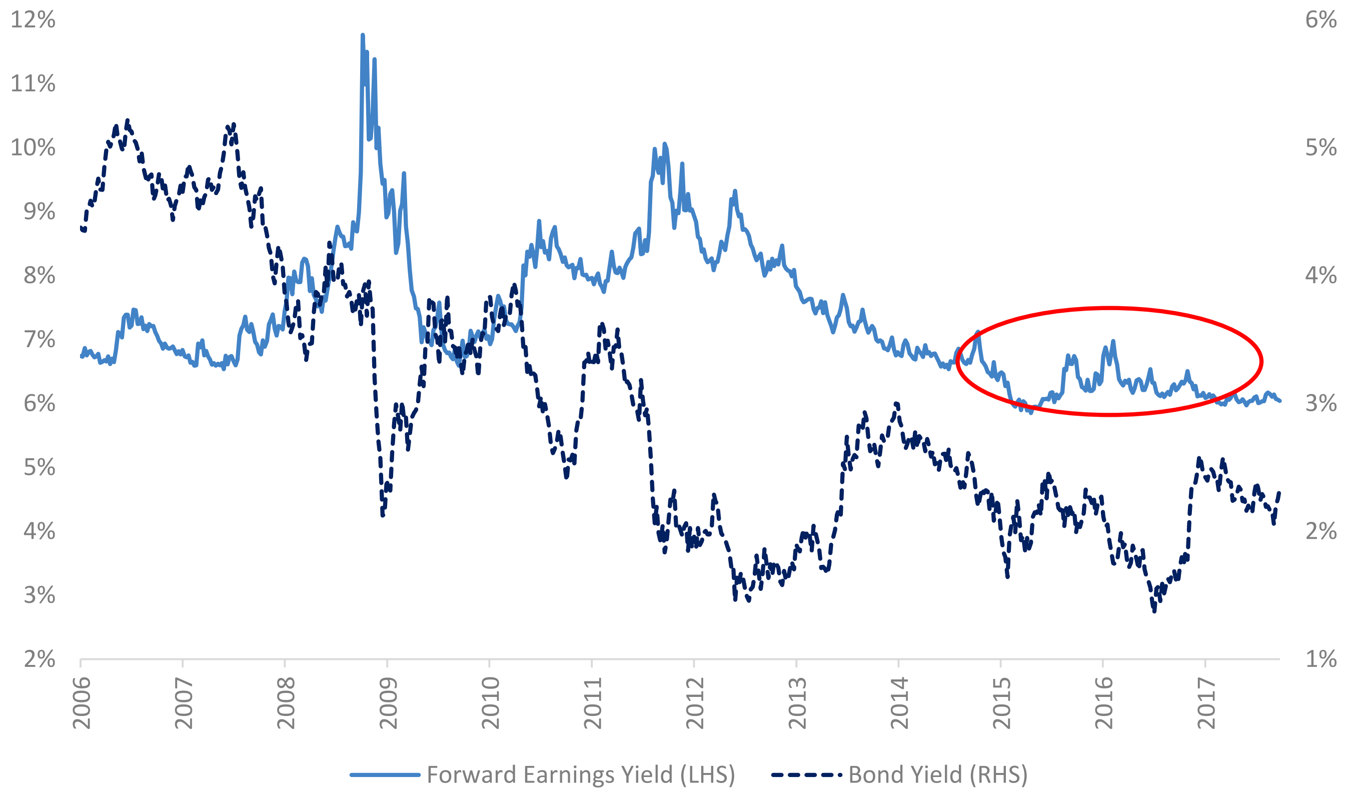
Source: Bloomberg; Anchor estimates

Figure 6.4: MSCI EM – Earnings and PE components of price changes, by calendar year



Source: Bloomberg; Anchor estimates

Figure 6.5: MSCI World forward earnings yield – stable around 6-7% for the past three years



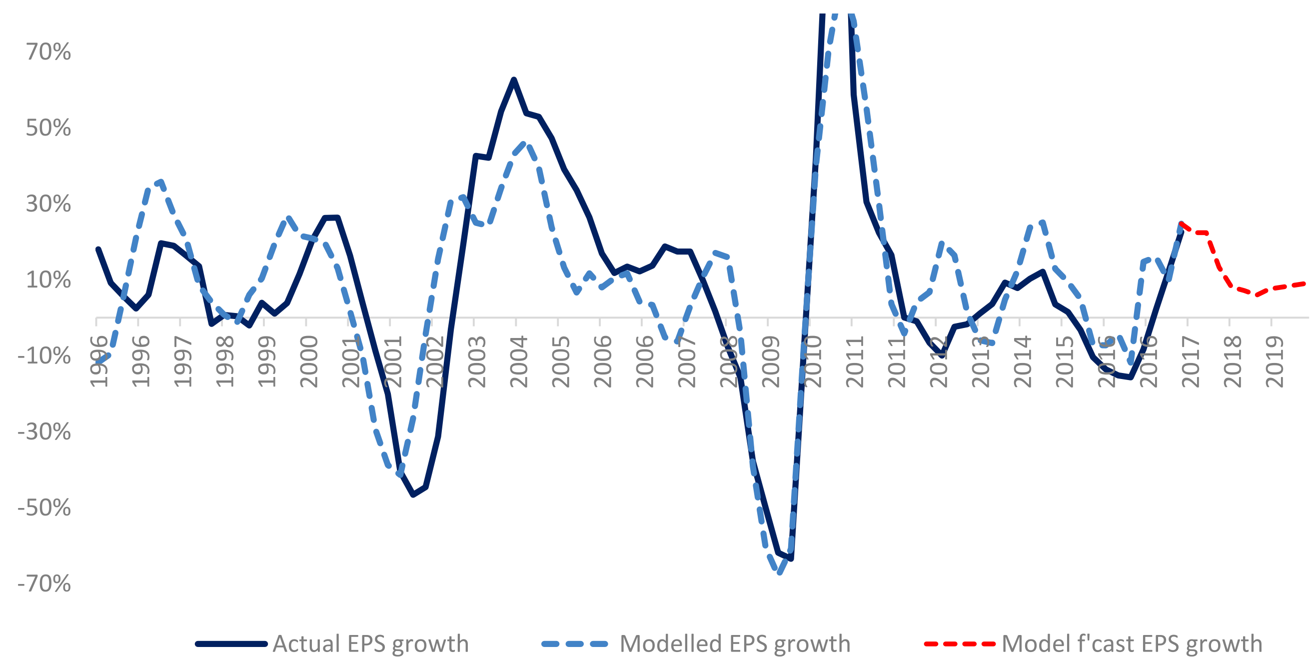
Source: Bloomberg; Anchor estimates

We shall now shift gears from a largely backward-looking analysis to a discussion of our expectations for future returns. Global equities, in our view, should deliver about 7% in US dollar terms over the next 12 months. This estimate of market upside is driven entirely by expected corporate earnings growth with no anticipation of a market rerating. Bottom-up analysts' earnings expectations are for MSCI World earnings to grow by c. 10% in CY2018. Our top-down estimate of corporate earnings, which is based on our forecasts of macroeconomic variables (GDP growth, the US dollar, the oil price, etc.), is for 8% earnings growth in CY2018 and CY2019, respectively. Our forecasts have stuck with the more conservative two-year forward earnings growth number of 8% (Figure 6.6).

In an environment of monetary normalisation, rising rates could put pressure on PE multiples that appear to have been inflated by ultra-low rates. In a 'normal' world, one in which markets have not been distorted by quantitative easing (QE), it is more normal for equity prices and bond yields to be positively correlated (e.g. rising bond yields and rising equity prices are both associated with a growth environment). Worrying about the converse case – that rising bond yields may cause falling equity prices, or at least a PE compression – is a reflection of the new era into which we now appear to be heading: normalisation of such unprecedented monetary stimulus has never happened before, and the consequences are not well understood.

With this concern in mind, it is particularly encouraging that we are currently in an environment of a 'normal' correlation between bond yields and equity prices: that is, equity prices are rising with rising rates (Figure 6.7). This validates the view that rates are still low enough, and economic growth strong enough, for rising rates to remain a bullish signal for equities. Although this variable has been quite volatile, its current levels suggest that tactically, if not strategically, the reflation trade is again the basic thesis driving global markets.

Figure 6.6: Top-down MSCI World earnings growth estimate



Source: Bloomberg; Anchor estimates (model adjusted R square is 0.66)

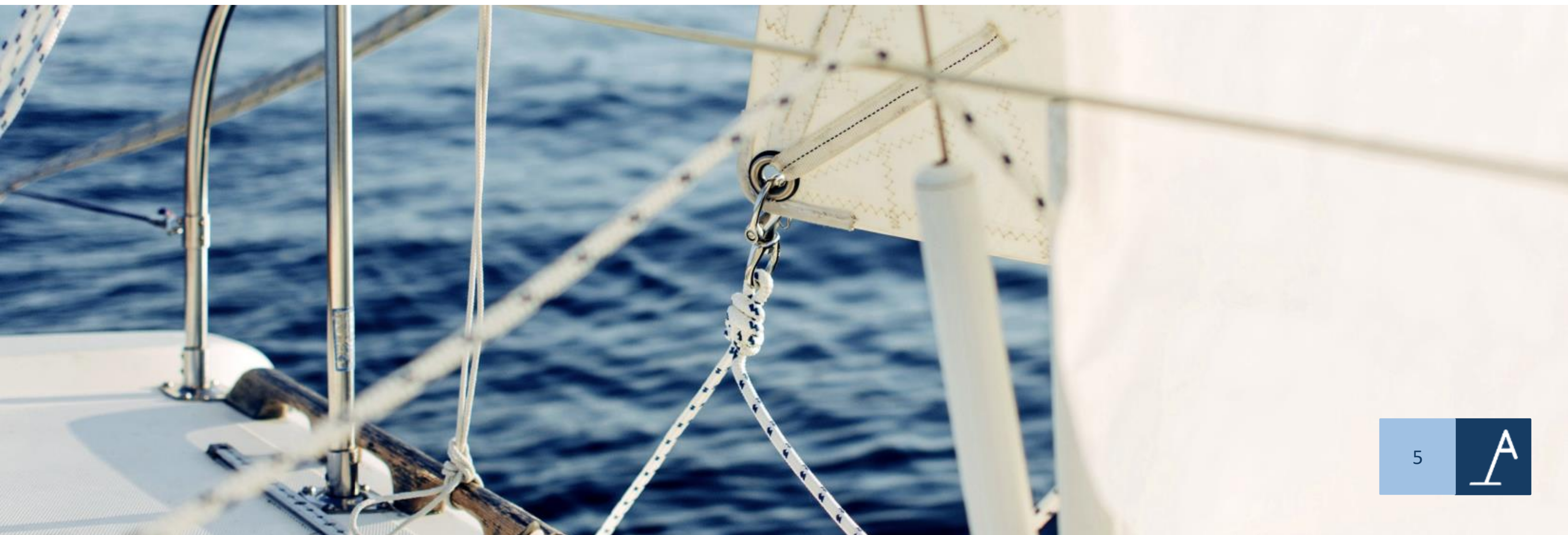
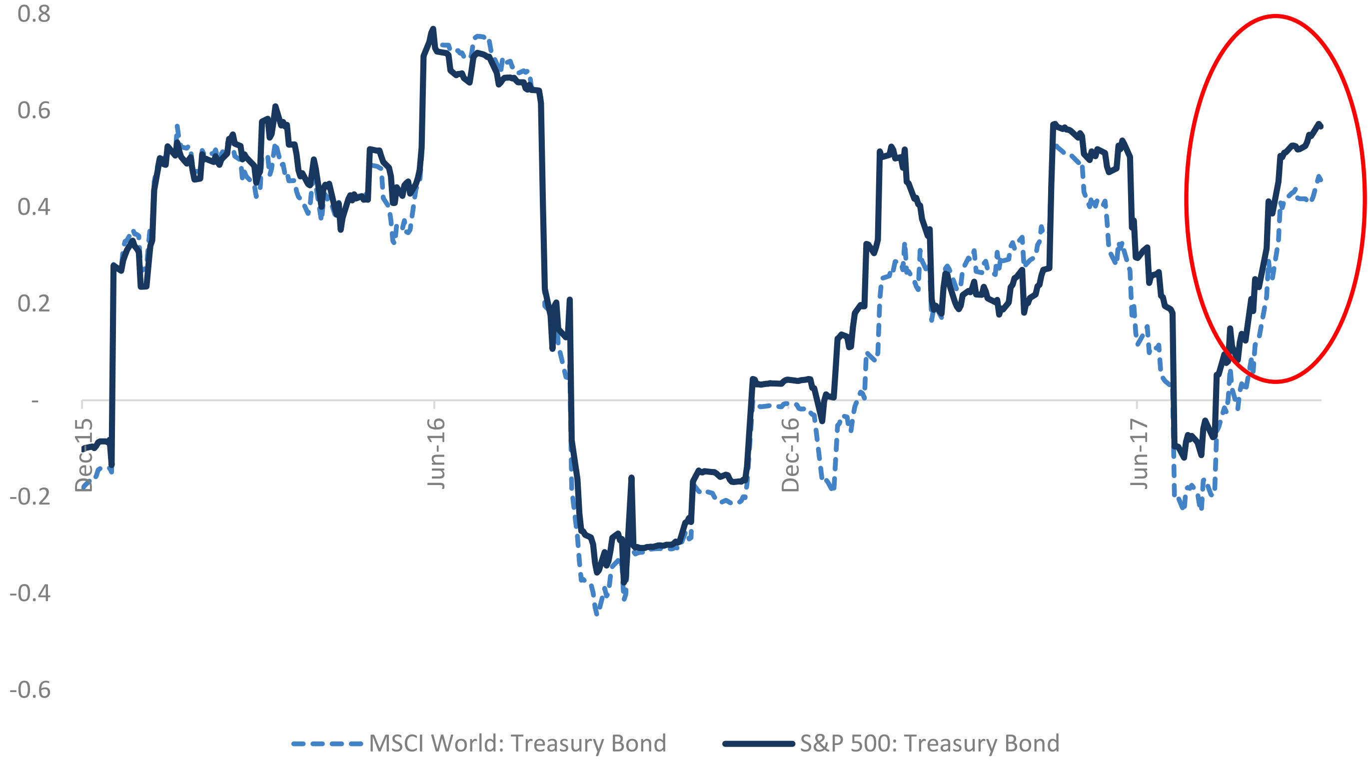


Figure 6.7: Rising correlations between equity prices and bond yields



Source: Bloomberg; Anchor estimates

We have, nevertheless, assumed a modest derating (minus 3%) of global equities over the coming year. This is in order to reflect our view that certain key markets are moving into a late stage of their business cycle. Historically, such a stage has been associated with lacklustre equity returns. The corollary of the preceding analysis of business cycles (see Section 3: Global Macroeconomics) is a consideration of the classic bear-market indicators for equity markets. This involves a consideration of the fundamental tension which animates this report, that between the "beautiful normalisation" and the flashing orange lights of the US business cycle. Six classic bear-market indicators are:

1. *Very low unemployment*. This typically marks the end of the business cycle, and a 'choke point' at which further GDP growth feeds into spiralling wage pressures (rising unemployment is more likely to coincide with a bear market, and is therefore less useful to investors who require a leading indicator). As is well known, the US economy is currently at full employment and consequently this signal could be interpreted as a flashing red light. It is also the case, however, that the US labour force participation rate is quite low (Figure 6.8), hence actual unemployment may be higher than the headline number suggests. This is reinforced by the lack of wage pressures at present.

2. *Yield curve flattening into negative territory*. It is indeed true that the US yield curve has been flattening during the current year (Figure 6.9). While we heed this signal, we note that curve flatness appears to be, to a significant degree, the result of QE; further, the curve has not dipped into negative territory.

3. *Tightening monetary policy*. This is usually brought about by a late-cycle spike in inflation, or the forebodings thereof. While there is not even a hint of either, at present, global central banks are normalising rates from entirely abnormal levels; similarly, the early stages of the end of a decade of QE are now upon us. Higher rates do carry the risk of stifling growth, as a reversal of QE comes with the risk of draining the liquidity, which may have been the dominant driver of asset returns for much of the past decade. Our view, however, is that rate hikes will not exceed modest levels for some time.

4. *High Manufacturing PMI*. As with low unemployment, this apparently counterintuitive signal can flag an economy operating at full capacity, from which the natural path is downwards. ISMs are most bullish when they are recovering from low levels. In the case of the US, a very strong manufacturing PMI may be a cause for concern, suggesting a peak in the manufacturing cycle.

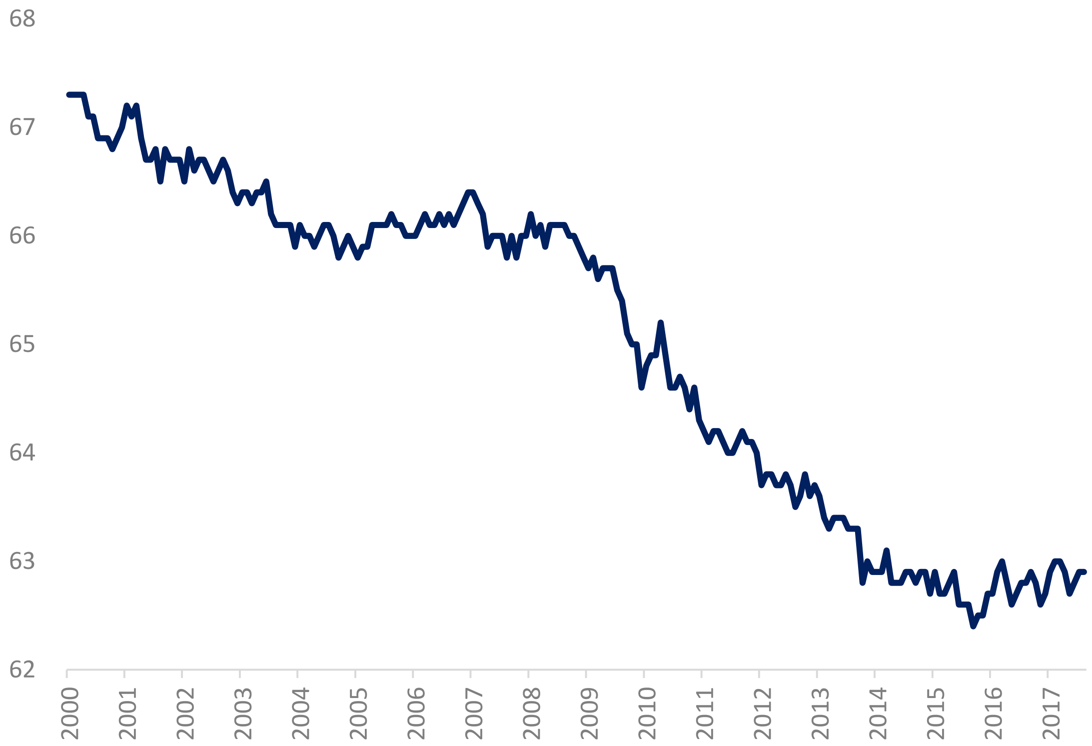
5. *An ageing expansion*. The current US expansion has lasted about 8 years, in-line with the average expansion since the 1970s. While we agree that the US is entering a late stage of its business cycle, we believe it will last for an abnormally long period. We note, further, that were a recession to arrive, the likely fiscal response would be sufficiently dramatic (the memory of the GFC still haunts policymakers) that the equity market may have a fiscal, if not a monetary, put option.

6. *Demanding valuations*. Our judgement is that global equities are fully valued, but not expensive. This squares with our overweight position in equities because we allocate capital in terms of the relative attractiveness of asset classes. We view equities as marginally more attractive than bonds and cash, while conceding that the value proposition is less compelling than it was in January of this year.

While none of these indicators are flashing a red light, they do all appear to be flashing an ambiguous orange. Although the bull market in US equities is entering a mature phase, commensurate with the maturing of the US business cycle, we believe it to be entering a period of ‘lacklustre’ performance rather than one characterised by negative returns. The economy has not yet reached any choke-points that could precipitate a recession, and there is, as yet, little sign in the data that the status quo of gradual expansion is under threat. In such an environment, particularly given the synchronicity of global growth, it would be excessively prudent to take money off the table and cut our global equities allocation from its longstanding overweight position.

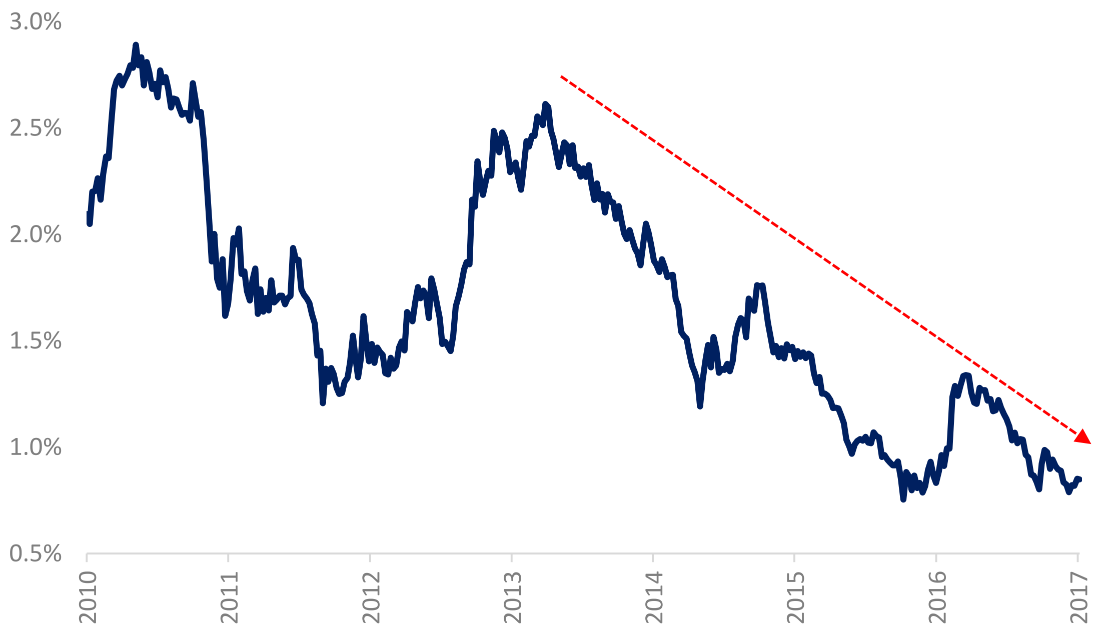
In summary, global equity markets are in a phase in which strong price performance is being validated by similarly strong earnings growth, global GDP growth appears to be in a synchronised and self-reinforcing period of resilience, and equity prices are moving in their ‘normal’ positive correlation with bond yields. This is a reflection of what has come to be called the “beautiful normalisation”. Although business-cycle analysis suggests that some of the world’s major economies may be moving into late-stage cycles, we argued that this will most likely be abnormally long. Similarly, although a consideration of classic bear-market indicators would advise a degree of caution at present, they are not, in our view, sending a strong enough signal to warrant the downgrading of our overweight call in offshore equities. Rather, when taken together, these various strands of analysis suggest a period of positive but lacklustre returns from offshore equities.

Figure 6.8: US labour participation rate



Source: Federal Reserve Bank of St Louis

Figure 6.9: A flattening US yield curve (10 year – 2 year treasury differential)



Source: Bloomberg; Anchor estimates

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