# 2017 Q'3 Outlook

RESEARCH

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## Summary

In this report we will explore why we believe the macroeconomic environment is generally favorable for global equities ex-US, going through Q'3, as well as how we will be tactically approaching commodity & bond markets. We will focus on the following factors:

- **Independent macro & equity forecasts**
- **Real corporate earnings**
- **Global growth, economic activity & investor sentiment**
- **Equity valuations**
- **Risks & potential sell-off catalysts**
- **Conclusions & portfolio positioning**

## Independent Forecasts

After pouring through large amounts of research from the likes of: Goldman Sachs, DBS Bank, Russell investment Group & Merrill Lynch, the consensus seems to be that global growth remains intact, companies continue to produce satisfactory real earnings growth, equity opportunities remain in markets outside of the US (valuation concerns persist in the US) where emerging markets are favored, and there is general neutrality surrounding bonds.

Equity volatility is to remain subdued, with Goldman mentioning "a large shock, e.g. recession or war, would be required to increase volatility", adding that "chances of recession in next 2 years = 25%." (More about how we will position for volatility once we conclude).

A number of concerns arise when looking at forecasts from economic research firm Trading Economics, with average G20 business confidence forecasts through to Q4 '17 = -12% from today's numbers, as well as an average forecast for the top 10 major stock markets = -6.48% through to Q'4 '17.

| Major | | Actual | Change Q4'17 | Change Q1'18 | Avg Q'4 forecast |
|---|---|---|---|---|---|
| United States | INDU | 21,173.69 | -7.43% | -6.49% | -6.48% |
| Japan | NKY | 19,909.26 | -9.59% | -8.59% | |
| Germany | DAX | 12,718.93 | -8.01% | -6.44% | |
| United Kingdom | UKX | 7,480.88 | -6.96% | -6.03% | |
| France | CAC | 5,273.06 | -7.83% | -6.89% | |
| Brazil | IBOV | 63,170.73 | -2.33% | -1.22% | |
| Italy | FTSEMIB | 20,745.87 | -6.01% | -5.04% | |
| India | SENSEX | 31,240.02 | -9.41% | -8.45% | |
| China | SHCOMP | 3,144.22 | -2.68% | -1.72% | |
| Russia | INDEXCF | 1,871.98 | 2.03% | 3.10% | |
| Canada | SPTSX | 15,372.14 | -3.72% | -3.07% | |
| Australia | AS51 | 5,670.45 | -1.60% | -0.54% | |

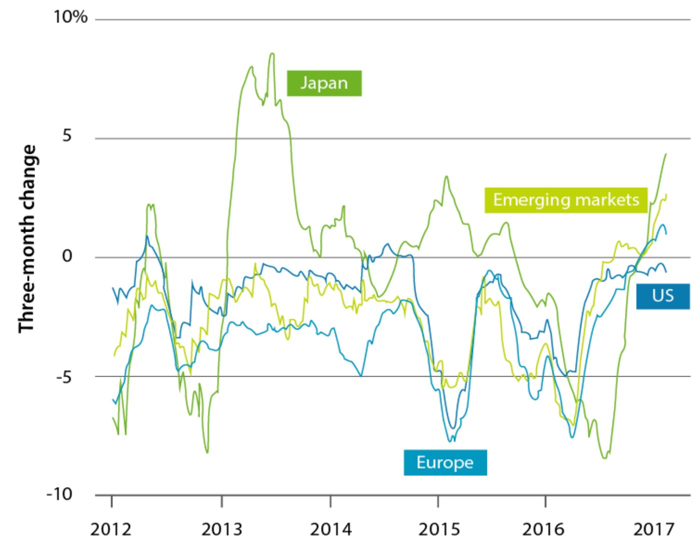
| South Korea | KOSPI | 2,363.57 | -12.84% | -12.00% | |
|---|---|---|---|---|---|
| Spain | IBEX | 10,890.74 | -9.28% | -8.27% | |
| Mexico | MEXBOL | 49,274.97 | 6.44% | -5.43% | |
| Netherlands | AEX | 524.37 | -6.17% | -5.22% | |
| Switzerland | SMI | 8,876.73 | -6.95% | -6.05% | |
| South Africa | JALSH | 52,117.82 | -4.45% | -3.49% | |
| Singapore | FSSTI | 3,237.19 | -6.40% | -5.47% | |
| Hong Kong | HSI | 26,059.72 | -11.74% | -10.59% | |
| New Zealand | NZSE50FG | 7,458.66 | -8.16% | -7.09% | |
| Euro Area | SX5E | 3,557.02 | -6.66% | -5.82% | |

***Tenzing Pacific Investment Management. *Tradingeconomics.com**
***G20 Stock Market forecasts**

## Real Corporate Earnings

Much of the ascendance in stock prices over the past year has come as a result of strong real earnings (corporate profits – inflation), which represents how much real economic value companies have been producing for their investors.

Realized earnings figures have been strong, while inflation remains subdued, mainly due to supply-side issues such as supply gluts in most commodity markets and weaker core inflation figures.




**Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, February 2017.**
**Note: The lines show the three-month change in the aggregate 12-month forward earnings estimates. The data are based on MSCI U.S., Europe, Japan and Emerging Markets Indexes.**

Real earnings look to remain strong, though the trend is leveling off in many developed markets. Emerging markets like Russia, India & Brazil are looking to post strong double-figures into 2018. While earnings remain robust, the figures, particularly in developed markets seem to be helped along by subdued core inflation figures, which average +0.31% into Q'4 '17 in G20 nations. This can only mean that economic activity remains slightly subdued, probably due to lack of productivity gains and weak wage growth, which is concerning as it would me that we are late into the earnings cycle which would justify shorter-term equity decisions.

## Global Growth, Economic Activity & Investor Sentiment

The World Bank reports that global GDP growth will be +2.7% in 2017, and +2.8% in 2018, improving from +2.4%

in 2016. This is positive primarily due to the fact that Chinese growth has stabilized and the country has avoided a “hard landing” in terms of posting weaker growth numbers than expected, which was of particular issue in 2015. As the world’s largest economy, it has been encouraging to see US commerce department upwardly revise US GDP growth figures from the 1st quarter up to 1.4%, up from the initial estimate of 0.7% in April. We believe that the Trump administration’s goal of 3%+ growth by 2018 is highly unlikely, particularly if tax reform proposals fail or are largely delayed, in which case this goal would be impossible.

For EMs and exporters it will be encouraging to know that the World Bank has projected global trade to grow by +4% in 2017 – the fastest pace in 3 years.

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|
| January | 104.6 | 100.8 | 92.6 | 86.1 | 114.3 | 106.6 | 108.7 | 94.5 |
| February | 102.6 | 91.8 | 86.6 | 91.4 | 122.7 | 105.0 | 106.6 | 91.2 |
| March | 107.4 | 97.3 | 91.6 | 88.1 | 120.3 | 116.6 | 114.8 | 96.9 |
| April | 99.4 | 97.3 | 87.1 | 93.0 | 119.0 | 113.8 | 108.6 | 97.4 |
| May | 88.4 | 104.3 | 86.5 | 94.9 | 118.6 | 121.4 | 106.0 | 102.6 |
| June | 91.2 | 99.2 | 93.3 | 106.8 | 119.3 | 127.1 | 105.7 | 101.0 |
| July | 96.5 | 102.5 | 94.3 | 107.7 | 115.6 | 113.2 | 98 | - |
| August | 92.0 | 88.1 | 91.0 | 104.9 | 120.1 | 109.4 | 89.7 | - |
| September | 88.1 | 90.0 | 87.3 | 101.3 | 123.9 | 116.6 | 95.5 | - |
| October | 88.2 | 95.2 | 81.2 | 95.5 | 115.8 | 114.0 | 99.2 | - |
| November | 96.4 | 99.4 | 80.5 | 91.2 | 113.7 | 107.3 | 97.6 | - |

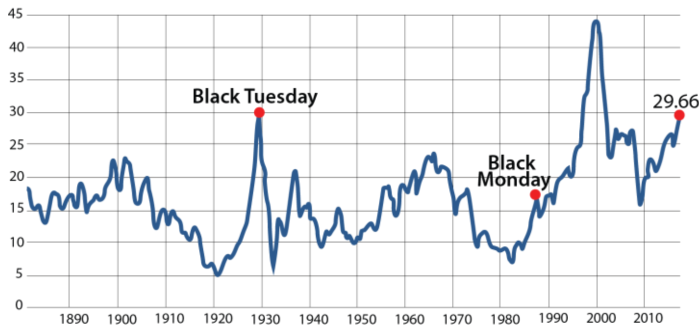
***State Street Investor confidence Index**

From a sentiment perspective, it seems that investors globally continue to remain bullish on the global growth story, with strong inflows into major equity ETFs and related assets. When looking at the State Street Investor Confidence Index the trend continues to be apparent, with an updated reading of 101, still far from the 7-year high of 127 reached in 2015, which is pretty solid from a contrarian perspective, indicating that sentiment remains high but not at extreme and at a potentially unsustainable level.

We have, however, seen sentiment subside in US markets, as many potentially crowed trades have been unwound in favor of better value in Europe and EMs. Valuation issues in the US are further compounded when looking at the Citigroup Economic Surprise Index, which tracks US economic data released, which was down from +60 in mid-March to -80 in late June. However, we’ve read comments from the likes of Merrill Lynch that the S&P can head +7% from current levels, indicating further potential for earnings surprises and a late-cycle bump as we head toward the end of ’17.

## Equity Valuations

Valuations are of particular concern in the US, after tremendous equity market performance over the past year, specifically after the recent presidential election. The rapid increase in stock prices has been questioned by many as unsustainable, as earnings have a tough task in keeping pace with asset prices. One key indicator providing evidence of valuation concerns is the Schiller P/E ratio (which incorporates cyclically adjusted price-to-earnings), which is currently the highest since just before the stock market collapses of 1929 & the end of the GFC of 07-08, & currently 2 standard deviations above the 134 year moving average.




***Schiller PE Ratio. Source: multpl.com**

### How are we approaching US equities?

Since we want to continue participating in the US growth story we are instead approaching strategic individual stock selections as opposed general equity index allocations.

There continue be many opportunities available in sectors like retail and healthcare, where the former has been challenged by large disruptions and new industry entrants, and the latter by pending, or the promise of pending changes to the healthcare law.

### What about outside of the US?

The picture seems pretty good ex-US. Real earnings for 16 major global stock indexes are forecast +8.6% going into Q1 '18. When we compared 5-year average price-to-earnings ratios to current P/E values, we've noted that 54% of majors could still be seen as relatively undervalued, with Malaysian equities providing highest margin of safety. More specifically, there is still some opportunity to take advantage of the mid-cycle in Europe, however, strategic stock selection might be favorable once again and it would be prudent to instead take advantage of the potentially weaker Euro going forward.

Otherwise, some real opportunities could lie in Russia and Brazil, which have been depressed YTD as a result of political issues and weaker commodity prices. Getting in at or close to the bottom of either economic cycle could pay off handsomely over the mid-term, but justifying an overweight position would currently not be prudent. In this case, we would favor a broad allocation to EMs, with more concentrated positions in Korean equities (although trade gains could already be priced in) and perhaps Vietnam, where economic & demographic fundamentals remain strong.

## Risks and Potential Sell-Off Catalysts

Global equities continue to remain hostage to correlations with US markets, and thus a loss of faith in the US growth story or valuations could lead to contagion fears around most majors. Specific catalysts could be: **1) the US congress failing to pass tax reform 2) risks to global trade or instigations of trade wars through new barriers by the US administration (however currently unlikely) 3) continued subdued inflation resulting in delayed Fed hike cycle**, leading to interest rate volatility and a spike in inflation. Other than that, according to Goldman Sachs, it would take a recession or war.

## Conclusions & Portfolio Positioning

While being skeptical of the global growth story going into 2017, we have slowly been converted into bulls through the realization of continual positive data, sentiment and the passing of a number of geopolitical risks, we feel comfortable overweighting equities ex-US, maintaining a small allocation to commodities to catch the short-term bottom and perhaps going longer bond duration to take advantage of subdued inflation.

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**In summary:**

- **Equities: overweight EM. Small, strategic short US + stock selection. Neutral Europe.**
- **Bonds: Longer duration. Favor allocation to active managers.**
- **Commodities: small position in broad commodity futures.**
- **Alternatives: invoice financing. Volatility futures (take advantage of bottom). Private Equity**

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