July 2018

Global Equity Outlook for Q3 2018

For the second quarter, the S&P 500 was up 3.4%, while non-U.S. developed markets (as measured by the MSCI EAFE Index) were down 1.1% and Emerging markets (as measured by MSCI Emerging Market Index) were down 7.8%.

A question arises as to whether the bull market in the global markets which we have experienced since the end of the Financial Crisis has room to run. We have found that since 1970, there have been 8 episodes of the global markets going down more than 20%, about once every 6 years. Most (5 out of the 8 declines) of the 20% or more declines in the global markets were associated with major shocks which caused a double-digit earnings declines. Those 5 double-digit earnings declines occurred during the 1970's during the 1st OPEC Oil Embargo, in the early 1980's during the Iranian Revolution and the 2nd Oil Embargo, in the early 1990's during the Gulf War and Oil Price Spike, in the early 2000's during the Tech bust, and in 2008/2009 during the Financial Crisis. Currently, by our estimates, the global growth picture still looks good. For 2018, global GDP growth is forecasted at 3.0% (including emerging markets) and earnings growth at 17%. For 2019, these numbers are 2.8%% and 9%, respectively. What we conclude is that although the global bull run has lasted almost 10 years, it can continue as long as there are no major shocks to disrupt the growth numbers.

That said, there are risks to this scenario. The risks are both economic and geopolitical. The US Fed is looking for two further hikes this year and for four next year which will make financing more difficult. Global PMI's are below their recent peak levels. The possibility of a major trade war has been causing volatility in the global markets. If substantial trade tariffs are put up for goods coming into the US and other markets retaliate with tariffs on US exports, global growth will be dented. Tariffs will be a drag on corporate earnings. Italy's new populist government with its Euroscepticism has raised concerns. The fate of NAFTA and the outstanding issues of the final Brexit agreement, such as the protocol on Ireland, are still to be determined. The relations between the U.S. and China and the effect of Chinese financial deleveraging are issues to be grappled with.

In terms of our equity weightings around the world, while we are still overweight emerging markets, we are reducing overweight. Emerging markets remain attractive on a valuation basis, with the average emerging market trading at 11.6x forecast 2018 earnings, which is well below the 14.8x multiple in developed markets. However, outside of the value category, emerging markets have lost some of their luster. For example, whereas emerging markets benefited over the past year or more from substantial sovereign spread declines, spreads have widened recently in some key emerging markets. Nonetheless, we continue to overweight Taiwan where valuation ratios are attractive, and its risk indicators are generally favorable, including a low beta and a large current account surplus relative to GDP. In addition, Brazil and Colombia as overweights where markets are inexpensive, and the currency is very undervalued. We also are overweight several inexpensive markets in Eastern Europe.

While the recovery in Continental Europe is still continuing, the momentum seems to have slowed. GDP forecasts have been accelerating but more modestly than last year. We are overweight in several smaller markets in Europe. Ireland's ranking has improved this month, due to upward revisions to company earnings and GDP forecasts. Austria, Portugal, and Norway are all overweighted. Austria has cheap valuations, Portugal has strong upward company revisions and narrowing sovereign spreads. Norway benefits from a positive terms-of-trade trend due to firm oil prices and has an undervalued real exchange rate. We are underweight Germany and France where valuations are not inexpensive, and GDP forecasts for 2018, while positive, are not being upgraded.

In Asia, we have tapered our overweight in Japan, which is looking less attractive in our growth category. GDP forecasts for 2018 have been downgraded by 0.2% over the last six months. Also, our overweights in Singapore and Hong Kong have come down a bit. In the case of Singapore, upward company earnings revisions look weak, and GDP forecasts for 2018 are not as rosy as six months ago. For Hong Kong, the real exchange rate has become somewhat overvalued.

In summary, we expect that the bull market can continue as long as positive global GDP and healthy earnings growth stay in place.

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