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END Q1 2017

In the US, the Fed announced its widely anticipated interest rate hike in March. This was accompanied by dovish commentary which suggested that only two further increases were likely this year – despite near-full employment and core inflation already bouncing around the Fed’s 2.0% target level [CHART 1]. This was well received by investors but also signaled that the Fed was not anticipating any near-term approvals of Trump’s extravagant promises.

Given the humiliating pushback the President suffered on the healthcare bill – from his own party – it is clear that he will not be able to bulldoze his way through Congress on other issues either. Healthcare was of limited importance to the market compared with the relevance of his promised tax cuts and fiscal stimulus measures. While the tax cuts appear likely to gain approval, the infrastructure and other stimulus plans are almost certain to face serious headwinds. The already high debt and deficit levels, and a fiscally-conservative Congress, suggest the outcome will fall well short of Trump’s objectives. (Remember it was the Republicans who pushed the US into the ‘fiscal cliff’ situation in 2012 when Obama attempted to force through excessively liberal spending plans requiring a huge budget deficit. Those congressmen are still there.)

Few economists have included any potential benefit from the new administration’s stimulus proposals in their projections. These are, in any event, unlikely to gain approval before late 2017 or 2018. But, even without these, the outlook for the US is fundamentally positive. The first quarter growth could well be disappointing but current PMI and other data releases point to a sharp improvement in the second quarter.

World economies are already experiencing a strong upswing. Growth is forecast to rise from 3.1% last year to 3.5% this year and 3.8% in 2018 – the highest rate of growth in five years [CHART 2]. This appears to be a synchronized uplift, driven mainly by emerging markets (4.6% and 5.1% in 2017 and 2018). Both Brazil and Russia bouncing back from recession and China’s resilient growth is boosting the Asian area in general. Among the majors, the US and Japan will be modestly higher and Europe is unlikely to be a drag this year (its PMI is at its highest level in nearly six years).

The main negatives to achieving even higher growth are rising inflation (trimming consumer purchasing power) and high debt levels (which will constrain stimulus programs).

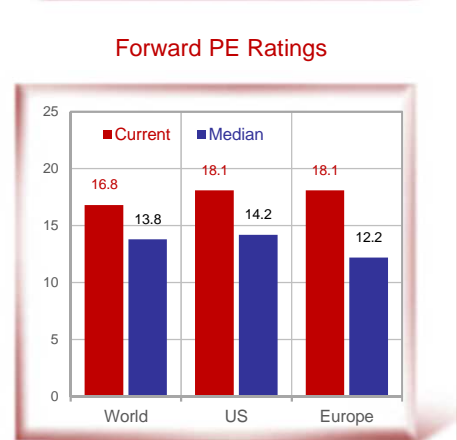
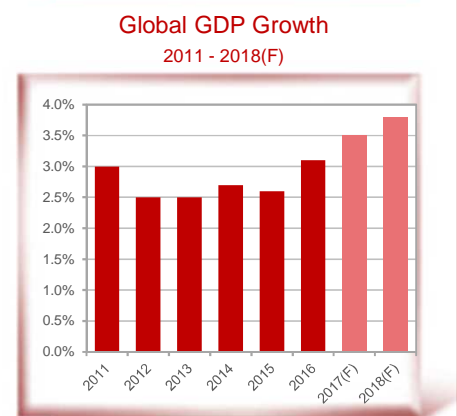
But, in general, there is much to be bullish about: world economies are recovering, global earnings growth is forecast to exceed 10% in both 2017 and 2018, balance sheets are modestly geared and cash rich, monetary conditions in most countries remain very accommodative and, for investors, the bond and cash alternatives continue to be decidedly unattractive.

Unfortunately, markets appear to be fully discounting the improved outlook. In the US, the forward p/e of 18.1 is 22% above the 10-year median of 14.2. The global forward number is almost as expensive at 18% above its median. [CHART 3] These elevated valuations are confirmed on several other metrics as well, confirming that world markets are priced at very demanding levels.

However, we should not underestimate the potential impact of sentiment on market performance. We could be entering the fairly typical late stages of a bull market, when fundamentals are overtaken by rising investor sentiment. Investors in general have yet to capitulate into equities.

The 1998 experience is, perhaps, the clearest example of the considerable impact of sentiment on equity returns. With the S&P index at 1024 in February 1998, the price/earnings ratio broke through the previous all-time high of 25 times. A clear signal to sell on valuation grounds! However, the market continued to surge, eventually peaking in March 2000 some 49% higher at 1527! [CHART 4] Not suggesting a repetition this time: just pointing out that the potential power of ‘animal spirits’ should not be underestimated . . .

Will sentiment prevail over value? An open question right now!



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