FLAGSHIP ASSET MANAGEMENT

Winston Floquet | **END Q1 2018**

Backdrop

Despite solid economic and earnings growth globally, the past quarter has been characterised by massive volatility and weak equity markets worldwide. From the January market peak, the world market index collapsed by 9%, then rebounded by over 5%, before declining again by a further 6%. [CHART 1] While this volatility may be commonplace among penny stocks, to occur in the combined equity markets of the world highlights the extreme fragility of prevailing investor sentiment.

Economic outlook

Economic growth, globally, has peaked: key indicators such as PMI's and the Citi economic surprise index have rolled over – but this is from a high level and the underlying growth is still buoyant. Consensus GDP forecasts for both 2018 and 2019 remain healthy, at around 3.7%. [CHART 2] Central bank policy continues to be accommodative except in the US which is already tightening (but from a very low base). Certainly, on the macro front, there is little to concern investors in the short term.

Earnings outlook

The earnings outlook, globally, remains robust although upward earnings revisions are now only being recorded in four of the top nine economies. The US earnings revisions have been quite remarkable, thanks to tax reform. The consensus earnings forecast for the S&P500 for Q1 2018 was $32.45 on the date the tax cuts were approved by the House and Senate. Subsequent revisions have taken the forecast to $36.16 – a massive 11.4% increase! [CHART 3]

First quarter earnings in the US, due for release shortly, will have been boosted dramatically by the tax cuts: growth is being estimated at a stellar 17% year-on-year.

Valuations

This strong earnings growth and steep falls in equity prices, have combined to reduce the forecast p/e in the US from 18.5 (at the January peak) to 16.9 at quarter end – a two year low. This is still 15% above the 10 year median of 14.4 but is far less demanding than the 26% premium at the end of 2017.

In fact, on virtually every traditionally used valuation measure (except relative to bonds), equity markets remain statistically expensive. Of course, with the outlook for bonds so dire and cash returns so poor, the cheapness of equities vs bonds is quite compelling – but the downside risks are rising inexorably.

The recent trend of strongly positive earnings revisions is almost certainly over for now. Most of the US tax reform benefits are now baked in and, with the earnings revision ratio now starting to decline in most geographies, future upside in equity prices will have to come from valuation upgrades. Although the forward p/e's are now no longer as demanding, they are not cheap either. Given the fragile investor sentiment – so evident in the past two months – expansion of equity multiples could be expecting too much.

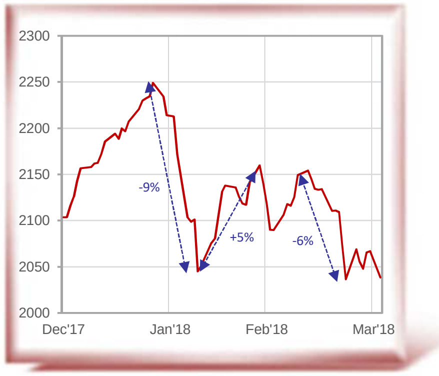
Outlook

The dramatic market fluctuations in the first quarter probably presage increasingly turbulent markets in 2018. While monetary accommodation remains supportive (for now) and economic and earnings growth provide solid underpins, there are challenging headwinds which cannot be ignored.

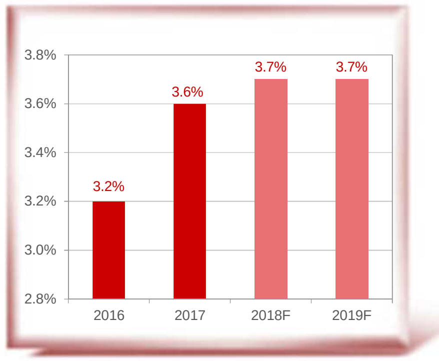
At least one of the major concerns – elevated valuations – has been alleviated to a large extent by the recent market declines and the strong earnings revisions. Nevertheless, equities will remain vulnerable to the pressures of the ballooning US trade deficit, increasing interest rates, the winding down of the Fed's QE program, rising protectionism, the unpredictability of the Trump administration and skittish investor sentiment.

Although South Africa has a new lease of life under Cyril Ramaphosa, it is unlikely to avoid downside pressure when international markets eventually roll over. In the attached chart the correlation of the SA and US markets (both measured in their home currencies on a log scale) is disconcertingly high. [CHART 4]

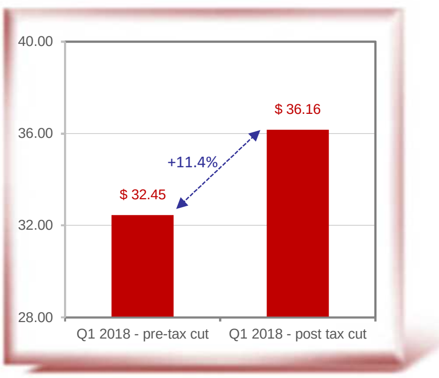
World Equity Markets
January 2018 to March 2018



Global Real GDP



S&P Consensus Earnings Forecasts



SA and US Market Correlation
January 2007 to March 2018

Flagship Asset Management (Pty) Limited
ICR House • Alphen Park • Main Road • Constantia • 7806 | Private Bag X21 • Constantia • 7848 • South Africa
Telephone +27 (21) 794 3140 • Facsimile +27 (21) 794 3135
Directors: WT Floquet CA(SA) MBA (chairman) | S de V Hudson BA LLB (ceo) | PD Floquet BCom CA(SA) CFA | NRO Brown BCom CA(SA)
www.flagshipsa.com | info@flagshipsa.com