FLAGSHIP QUARTERLY COMMENTARY

FLAGSHIP ASSET MANAGEMENT

Winston Floquet | **END Q2 2018**

Global economy

The global expansion is now entering its 10th year, one of the longest on record. And yet it appears that it still has further to go. Although the synchronised upturn among global economies appears to be losing some of its cohesion, conditions remain robust.

However, business cycles across the globe are now beginning to diverge quite significantly. The US continues to power ahead, with the tax cuts and fiscal stimulus neutralising the impact of tightening monetary policy. Europe, on the other hand, is experiencing slower growth even ahead of the less accommodative ECB actions now being indicated. In Asia, activity levels remain relatively firm, despite slowing domestic demand in China.

Global financial conditions, fortunately, are generally still accommodative and do not, at this stage, pose a serious threat.

Economic outlook

Despite the less synchronised global growth, economists are forecasting an improving global economy in the second half – buoyed by strong labour markets, rising wages and firmer house prices. The consensus forecasts for 2018 and 2019 are 3.9% and 3.8% respectively. [CHART 1]

The threat of more intensified trade wars has not caused economists to lower their forecasts. And, indeed, the impact on economies as a whole is relatively small at present. Measures enacted thus far amount to only 3.7% of US imports. However, the impact will be greater than this tiny direct number suggests. Indirect effects arising from deteriorating sentiment, delayed expenditure decisions and supply chain disruptions could be a lot more severe.

Also, higher tariffs will fan the fires of inflation (which are, in the US, already at the Fed's target level). Should the trade conflict intensify, sentiment in equity markets could deteriorate sharply: already evident in China where equities have plunged into a bear market. Individual companies in targeted industries will be significantly affected (either positively or negatively). All in the name of national security!!!

Looking further out, the US already faces other potentially serious problems. The passing of a massive, fiscally-funded tax reform bill at a time of full employment was nothing short of reckless. This has saddled the nation with a budget deficit that will increase by at least 50%. [CHART 2] Funding this burgeoning deficit, at a time when the Fed is unwinding its balance sheet, will almost certainly ensure that US interest rates will be forced higher than generally forecast. Clearly a negative for growth.

Earnings outlook

While still growing at above trend levels, momentum in the global economy has peaked and is already being reflected in the Global Earnings Revision Ratio. (This measures the number of stocks where earnings estimates have risen vs the number which have decreased.) The aggregate global ratio has declined to 0.93 (more downgrades than upgrades) and the US is now the only major economy where the ratio is positive (at 1.35). [CHART 3]

Valuations

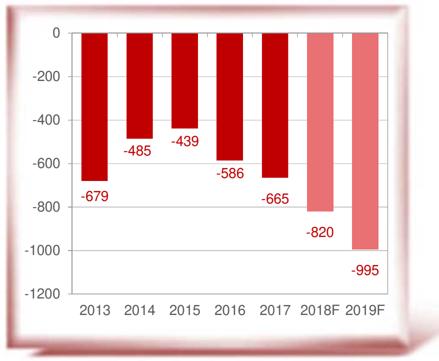
The widespread concerns about elevated US equity market valuations during 2017 have disappated: the market setback in February combined with the dramatic surge in earnings, have compressed price/earnings ratios sharply.

The earnings growth forecast for 2018 is 22% – quite something for an economy of this size. [CHART 4] The 12-month forward p/e ratio has contracted to 16.6 – just a whisker above the 5 year average of 16.2. Although still well above the 10-year average of 14.4, the worrying overvaluation seen last year is now no longer a major concern.

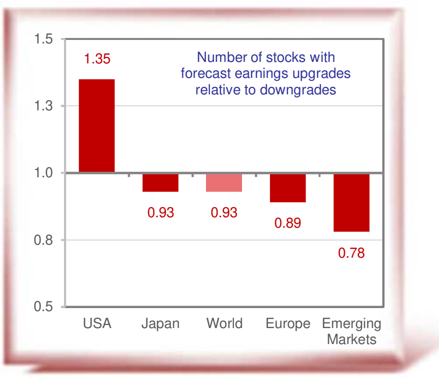
Given the continuing strength in global economies and the more reasonable valuations, the key risks to equity markets are now the rising interest rates in the US, the unwinding of the Fed's balance sheet and, of course, the potential for the trade spat to elevate into a full-blown war.

Global Real GDP

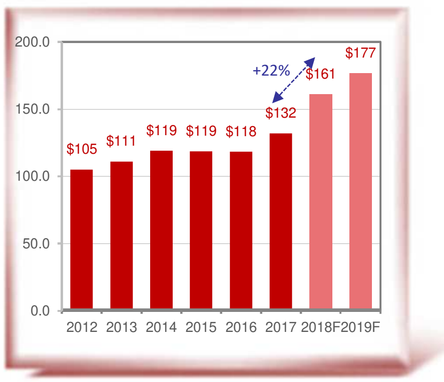
US Budget Balance ($bn)



Earnings Revision Ratio



S&P 500 Earnings Outlook



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