

The Uphill Struggle for Equities

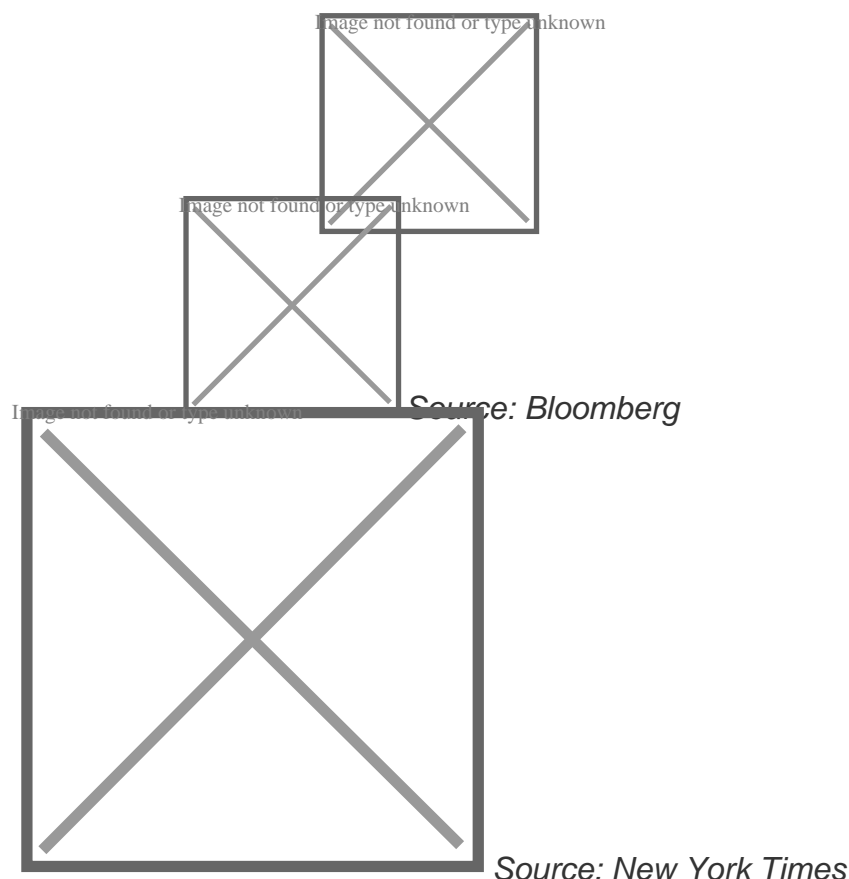
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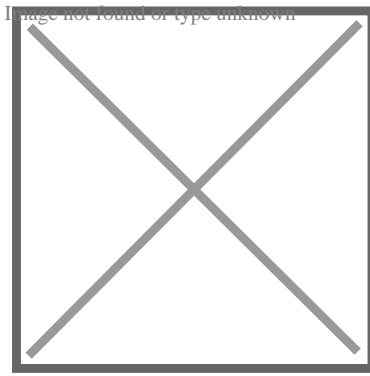
“There’s clearly a concern about a global growth slowdown.”

–ALEC YOUNG, managing director of global markets research, FTSE Russell

This week started on another low note, as US equities tumbled on weakness in energy and tech. On Tuesday, the S&P 500 temporarily slid 10% below its record September close, while the Nasdaq fell to nearly 14% below its August high. In an equity market that has skated by whimsically on the back of relaxed monetary policy and historically low interest rates for nearly 10 years, trouble has not oft been on the mind of the fully-invested, US-concentrated, passively-exposed, large-cap investor. It seems as if we might have reached a breaking point.

For those who follow some of the large financial publications and babbling talking heads, the bravado and posturing of those expecting the longest bull run in history to continue running has unquestionably shifted in sentiment. Just take a look at some of the headlines that populated the financial media on Tuesday:





Source: CNN

For those who, like Evergreen, have been on the skeptical side of the aisle during the late stages of this long run, it has been a lonely place to sit, playing defense, stress-testing portfolios, and waiting for value-based, sensible opportunities to reemerge.

In this week's EVA, we are presenting an article published by Louis-Vincent Gave, a partner at Evergreen Gavekal and someone who has been dubbed the smartest man in Asia. As you will read, Louis makes his case for why global equity markets face an uphill battle under current economic, policy, and trade conditions. The question facing investors today is whether the recent crack in both US and global equity markets is a buying opportunity, or whether it is a sign of a much larger fissure still to come.

If you have followed our [Bubble 3.0 series](#), you're well aware that we believe the latter is a much more likely reality. However, for individuals invested in actively-managed and strategically opportunistic portfolios like Evergreen's, challenging market conditions could bode fruitful for the patient investor. We further believe a year-end rally could occur, particularly for some severely beaten-down sectors, partially due to the two items Louis mentions at the end coming to fruition. If so, it will likely be a rally to sell into and then be prepared to buy.

THE UPHILL STRUGGLE FOR EQUITIES

By Louis-Vincent Gave

Last week saw the MSCI World turn in its sixth negative week (-1.51%) in eight, while the only sector to record gains over the last two months has been utilities; cyclical sectors like materials, industrials, IT, energy and consumer discretionary have mostly entered correction territory (see left-hand chart below). As Paulie from The Sopranos might have put it, the period since mid-September has been one that most investors would rather "give back to the Indians". Failing that, there remains the question of what to do about equity exposure. Is this a dip to buy, or will the environment remain harsh?

Falling back on basics may help answer this question. Specifically, everyone knows that an equity price should be a stream of future earnings, discounted by an interest rate on to which a risk premium is tacked. In that respect, equities are a three-part equation whose components I'll now review:

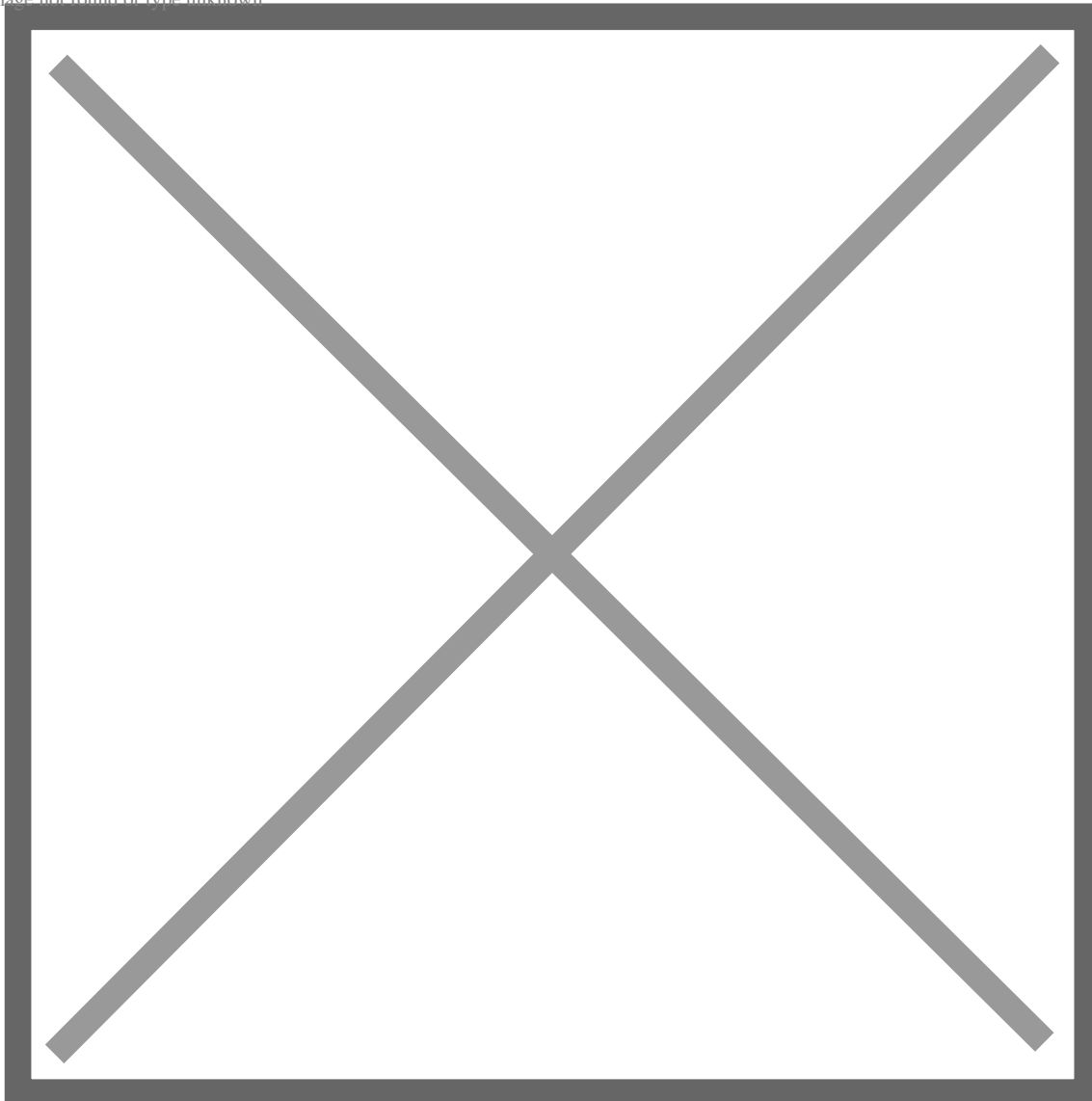
1. Future earnings

Until recently, it could be argued that US equities' massive outperformance this year was squarely due to strong earnings. Sure, US profits were boosted by Donald Trump's tax cuts, which helped fuel financial engineering and record share buy-backs. But, so what? At the end of

the day, investors buy a stream of earnings and US corporates had been delivering in spades.

Yet, it is increasingly clear that US profits have stopped growing much faster than everywhere else (see right-hand chart below), which may explain why US equities have stopped outperforming. The question is whether earnings can pick up from here and drive equities higher. Based on the market's response to recent company reports, the answer seems to be no—the likes of Google, Amazon and Apple have all released earnings that beat expectations, yet their stock prices have done poorly. More broadly, the Wall Street Journal recently noted that 161 companies in the S&P 500 recently announced better-than-expected earnings, yet saw their stock prices pounded.

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Thus, if US equities are no longer going to rise on the back of strong earnings, can non-US markets pick up the slack? Certainly, the earnings of non-US firms should get a boost from a stronger US dollar and lower oil prices. At the same time, earnings growth in emerging markets and Europe in recent years have been driven by overall Chinese economic growth. And today, there are few reasons to think that China's economy is set to re-accelerate. Combine that reality with uncertainties surrounding US trade, the roll-over in global ISM surveys, the fact that OECD leading indicators have gone negative, a possible structural downturn in global auto demand (linked to demographics and the rise of ride-sharing), and a roll-over in key real estate markets

(US, UK, Canada, Australia, Hong Kong) and it is hard to get overly enthusiastic about the prospect for earnings growth in the rest of the world. And this brings us to the second component in the equity pricing equation:

2. Interest rates

Looking at interest rates across the G7+1 in 2018, the following can be noted about five-year government bond yields: they have fallen in China (almost to US levels for the first time since 2007); stayed flat in France, Germany and Japan; risen slightly in the UK; climbed sharply in Italy (for political reasons) and risen in the US. Looking ahead, it can be argued that Chinese yields will fall more, but the associated economic weakness would raise doubts about World ex-US earnings growth. Of course, the same could be said of US yields if US growth starts to disappoint and UK yields could revisit their lows on the back of a Brexit-induced recession.

The one country where a near-term fall in yields may boost equities is Italy, but this assumes some kind of budget deal between Brussels and Rome. Yet with European Parliament elections looming, the odds have to be for other European bond yields to rise; whether in France (following this weekend's widespread anti-Macron "yellow-jackets" demonstrations); Greece where banks are making new post-2016 lows and protests are turning violent, or Spain, where the Catalonia situation is yet to be resolved. And this cheery thought brings us to the third element in the equity pricing equation:

3. Risk premiums

Anatole puts the recent drop in global equity markets down to higher risk premiums, stemming from the threat of a trade war, the Italian-European Union standoff and medium-term rise in oil prices. He remains upbeat on the grounds that oil prices have corrected, the Italian situation looks contained to Italy, and the upcoming G20 meetings may pave the way for a trade compromise. My concern is that these may be yesterday's concerns, when the following loom:

- **Corporate bond market trouble:** Of the US\$6trn pile of outstanding US investment grade corporate debt, about half is rated one notch above "junk". This is unprecedented and leaves the market vulnerable to any slowdown in economic growth, which would likely trigger downgrades and bankruptcies. Indeed, with General Electric suddenly finding the commercial paper market closed, the broader US corporate debt market seems to be waking up from its central-bank induced slumber. Over the past decade, the US energy sector has been a steady debt issuer, which does have broader implications: when oil prices are "too high" (as in 2008 and 2011), they choke off the consumer, but when they are "too low" (as in 2016), they threaten bankruptcies and a slowdown in US industrial production (as energy-related capital spending collapses). Today, we seem to be in the sweet spot between oil prices being neither too high, nor too low. Hence, it's noteworthy that spreads on energy bonds have been widening.
- **Bank stock underperformance:** Banks have historically been the beating heart of most economies, ensuring that money flows through the system. Thus, it is a worry when they lag the rest of the equity market. Granted, the recent underperformance of bank stocks could be put down to factors like Deutsche Bank having never properly cut its book after 2008, Goldman Sachs facing 1MDB-related issues, Italian banks suffering for being Italian, just as Chinese banks suffer for being Chinese. Still, after a decent 2017, when bank stocks broadly managed to keep up with a rising global market, 2018 has seen them lag by more than -10%. Moreover, this underperformance is surprising given that higher interest rates—at least in the US—are supposed to boost lending margins.
- **Fall in economically sensitive prices.** Since August, the Baltic Dry Index has fallen -42%,

copper prices are down -15% since June and Semiconductor shares (SOX index) are in bear market territory. Basically, key pricing measures of economic activity point towards a slowdown. And by and large, the combination of a tightening Federal Reserve and slowing growth is seldom a happy one for equity risk premiums.

Putting it all together, it seems as if we will need a policy change for global equity markets to make new highs. That would mean President Trump changing tack on trade (which would help reduce risk premiums), or the Fed loosening monetary policy (which would help reduce interest rates). Failing that, the equity price equation is likely to stay challenged in the coming weeks.

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE *

- Large-cap growth (during a correction)
- Some international developed markets (especially Japan)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 6%-12%
- Gold-mining stocks
- Gold
- Select blue chip oil stocks
- Investment-grade floating rate corporate bonds
- One- to two-year Treasury notes
- Canadian dollar-denominated short-term bonds
- Select European banks
- Short-term investment grade corporate bonds (1-2 year maturities)
- Emerging market bonds in local currency (start a dollar-cost-averaging process and be prepared to buy more on further weakness)
- Mexican stocks (due to the recent severe selloff, we are adding back exposure to a Mexican REIT that we sold materially higher)

** Some EVA readers have questioned why Evergreen has as many 'Likes' as it does in light of our concerns about severe overvaluation in most US stocks and growing evidence that Bubble 3.0 is deflating. Consequently, it's important to point out that Evergreen has most of its clients at about one-half of their equity target.*

NEUTRAL

- Most cyclical resource-based stocks
- Mid-cap growth
- Emerging stock markets; however, a number of Asian developing markets appear undervalued
- Solar Yield Cos
- Large-cap value
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Intermediate municipal bonds with strong credit ratings
- US-based Real Estate Investment Trusts (REITs)
- Long-term investment grade corporate bonds

- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Short euro ETF
- Long-term Treasury bonds (due to the decisive upside break-out recently by longer treasury yields, close out positions for now and wait to re-enter should the yield approach 4%)

DISLIKE

- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)
- Preferred stocks
- BB-rated corporate bonds (i.e., high-quality, high yield; in addition to rising rates, credit spreads look to be widening) * **
- Short yen ETF
- Dim sum bond ETF; individual issues, such as blue-chip multi-nationals, are attractive if your broker/custodian is able to buy them

* Credit spreads are the difference between non-government bond interest rates and treasury yields.

** Due to recent weakness, certain BB issues look attractive.

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