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GLOBAL EQUITIES: P/E DE-RATING IN PROGRESS

Spotlight

Global Investment Committee

UBP
UNION BANCAIRE PRIVÉE

Key points

- *The broad-based sell-off in global equities has fully retraced the gains made from February 2018's lows. Even world beating technology shares have fully given up the 8% gains seen over the summer.*
- *Notwithstanding the month-to-date declines, investors should keep in mind that the underlying P/E compression trend in place all year may remain a headwind to total returns moving into 2019. Indeed, a repeat of the February-March P/E compression could see a further 5% fall in S&P 500 P/Es.*
- *Though strong economic growth and a supportive earnings outlook remain encouraging, ECB policy risks have risen in light of recent developments while the recent US-Mexico-Canada Trade Agreement may increase pressure on China in 2019.*
- *Our preferred equity positioning in favour of hedge funds and capital protected equity exposure remains valuable as US and global equity markets continue to unwind premium valuations AND in the face of on-going geopolitical risks moving into year-end.*

P/E de-rating trend to continue into 2019

With the month of October having historically seen some of the most dramatic declines in US and global equity markets in recent history, it is hardly surprising that the near 5% decline in global equities over the month-to-date has raised significant concerns among investors.

Indeed, the recent rise in risk–free rates around the world, the stand-off between Italy and the European Union over its budget, and the drumbeats of US–China trade tensions have all been cited as contributing to the sharp declines.

P/E de-rating in progress

Sources: Thomson Financial and UBP

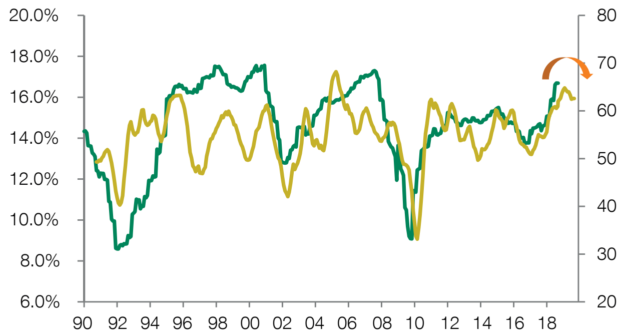
Though these concerns are clearly warranted (and explored later in this report), the underlying trend at play through much of 2018 has been a de-rating of equity market price–earnings multiples, aggravated by rising interest rate and geopolitical concerns.

In fact, the expansion of P/E multiples which have contributed as much as 40% of the total return in the S&P 500 since 2011 has pivoted to become a drag on total returns in 2018, offsetting nearly half of the benefit of corporate earnings growth over the year-to-date.

With the decline month to date, S&P multiples are sitting on the cusp of pricing in an economic slowdown similar to the one that took place in 2015–16. However, should the market look to price in a move in yields similar to what happened in early-2018, it would equate to a **further** 5% P/E compression from here.

Moreover, though economic indicators remain robust, investors should keep in mind that the positive economic and earnings momentum of 2018 may well be behind us. In particular, with the leading New Orders component of the key Institute of Supply Management survey (chart) having inflected, investors should be especially wary about the prospect of seeing many persistent upside surprises to earnings looking into the new year.

US Corporate returns also look set to peak



Sources: Institute of Supply Management, Bloomberg Financial L.P. and UBP

So, looking into 2019, investors will face equity markets where multiples seem likely to continue to present a headwind to total returns AND, unlike the 20%+ seen in 2018, earnings growth will not only be more modest (8-10%), but the potential for upside surprises seems likely to be somewhat limited.

Bond yields to continue to rise...

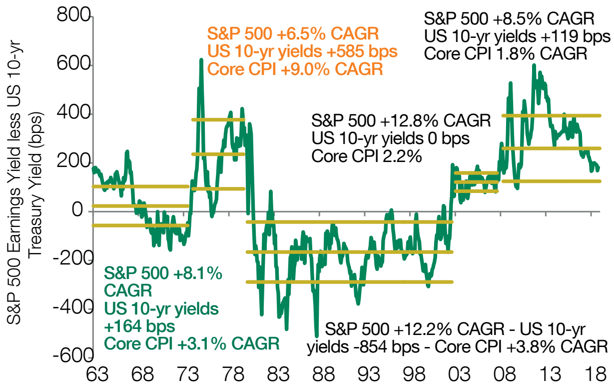
Bond yields look set to continue their rise. While many cite the increase in long-term government yields as a catalyst for the recent sell-off, we view the rise as part of the continuing normalisation of long-term yields which should see US 10-year yields re-rate towards 3.5%. (For more detail, please see *US Bond Yields: Where to from here? October, 2018*.)

While the move in US yields has been sharp and similar to that seen in early-2018, it has not been significant enough for a dramatic shift in the stock-bond picture. For the rise in yields to become a deeper cause for concern for markets, there would have to be a more pronounced shift in the inflation outlook or a fundamental decline in the growth outlook for the US/global economy.

With US inflation data for September reported on 11 October coming in below expectations and core inflation remaining stable at 2.2%, inflation is expected to stay within a 2-2.5% range looking ahead. Upside risks admittedly remain, with tight labour markets and emerging upward pressure on wages.

Looking at the stock-bond relationship that has been in place since 2008, investors should keep in mind that any testing of the upper end of the stock-bond ratio has previously coincided with crises (2008-09 and 2011-12) and/or an economic slowdown (2015-16). With a lack of indicators of slowdown on the horizon, we see little prospect of that dramatic de-rating of equity versus bonds in the months ahead.

A re-pricing like the February-March move in yields could compress P/Es by an additional 10%



Sources: Bloomberg Financial L.P. and UBP

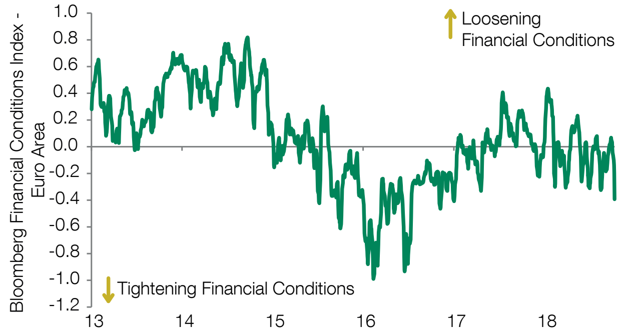
New risks in the eurozone emerging

Beyond rising rate concerns, anxiety about the Italian budget negotiations overhangs markets in Europe. However, as spreads between Italian and German government yields are now approaching 2011-12 crisis levels, it looks like any material threat to the eurozone is already priced in.

While we remain broadly optimistic that a compromise will eventually be struck between Italy and the European Union, a more difficult challenge now lies ahead for the European Central Bank. Recent activity has meaningfully tightened financial conditions in the single currency area from a more neutral bias for much of the year, approaching levels last seen in the global slowdown of 2015-16 (chart).

With the end of QE in early-2019, the ECB will need to be careful to guard against a more significant tightening of financial conditions as they transition into early-2019. Thus, while specific Italian risks (assuming a compromise can be struck) are well priced, tight financial conditions combined with the start of quantitative tightening have created a new risk facing investors moving into 2019.

Tight Eurozone Financial Conditions pose an ECB challenge



Sources: Bloomberg Financial L.P. and UBP

Trade war risks but more likely a risk for 2019

The new trade agreement struck between the US, Canada and Mexico while a relief for North American economies contains a provision limiting the ability for signatories to enter free trade agreements with 'non-market economies' by allowing the remaining parties to terminate the agreement with six months' notice.

This clause (chapter 32.10) appears designed to limit China's access to American markets via bilateral free trade arrangements with Canada and/or Mexico, further isolating the world's second largest economy from a trade perspective. This reinforces our belief that the 'trade war' is in reality a strategic confrontation initiated by the US against China (please see, US China Trade War: From Checkers to Chess, September, 2018).

However, with the next round of US tariffs set to come into play in January 2019, we expect trade risks to rise only after November's US mid-term elections at the earliest and more likely in early–2019 with the full imposition of the tariffs announced in September.

Capital protected strategies and hedge funds preferred

Even with the sharp declines in October, risk-reward facing investors remains asymmetrically skewed towards risk entering 2019. With the economy and earnings looking set to continue growing in the coming year, equity risk remains our preferred exposure vis-à-vis the challenges evidenced in fixed income markets in 2018.

However, in light of the asymmetry, we encourage investors to look towards capital protected exposure where available. Indeed, our capital protected exposure in the UK, Japan and Emerging Markets has helped shelter investors from recent volatility. Moreover, we expect our recent introduction of capital protected exposure to US/European equities to provide similar refuge for investors looking towards year-end.

In addition, with earnings-driven returns in 2019 expected to be mitigated by ongoing P/E compression, alpha-oriented hedge fund strategies should provide increasingly valuable uncorrelated returns for investors in the coming year.

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October 2018

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