If 2017 was the year of global growth and equity bull markets and buy the dip mentality then 2018 has been the year of sell the rallies and doubt the growth.

In reality global growth has remained fairly robust and corporate earnings solid. It is the the fear of a change in this paradigm rather than proof thereof that has taken many global markets into bear territory. There are a some key concerns and worries being reflected in global markets and prices right now:

- The trade war talk between China and the US and the lack of a speedy resolution.
- The firm path of the US Fed in its pursuit of rate normalisation and withdrawal of liquidity and the threat of inflation (as yet unmaterialised)
- The fear that US economy is in the final stages the business cycle and that a recession is due within the next 12-18 months is now common cause
- The threat (once again) of a slowdown in China

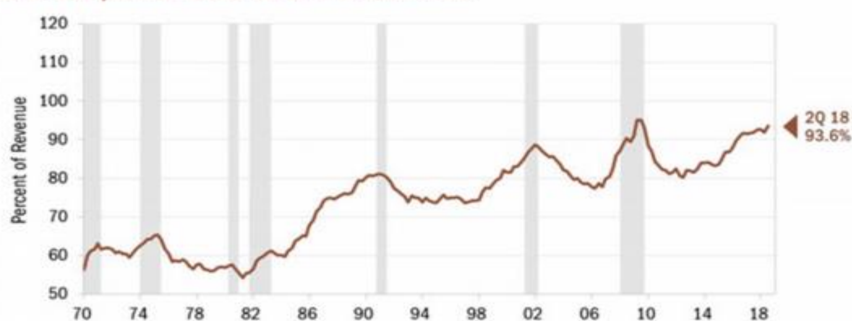
Where does this all lead to and what are some of the key ingredients for us looking ahead. In our opinion we address some of these below:

US Earnings

The US corporate earnings have been incredibly strong, supported by tax cuts and stimulus. Prior to the recent pullback, this was certainly in the price. The fact that earnings will slow down in 2019 is a given but it is crucial to remember that they will not be declining and rather growing healthily at an average of around 9%. Some form of slowdown is inevitable off this high base but it is by no means a situation where there is no growth. The forward 12-month P/E ratio for the S&P 500 is 15.6. This P/E ratio is below the 5-year average (16.4) but above the 10-year average (14.6).

The US Economy, Unemployment and Corporate Debt

The US economy continues to grow at a steady clip supported by the well known fiscal stimulus. What is unclear is how much capacity for future expansion is there in an economy with an unemployment rate at around 3.8% and the potential for significant upward price and wage pressure as a result. This is one of the key concerns of the US Fed. Inflation has thus far been surprisingly elusive however the steady commitment to the withdrawal of liquidity and the raising of rates does create some significant new risks. For example US corporate debt as a percentage of revenue is nearing the 2008 level.



Source: Heartland Advisors

If the US earnings begin to slow and profit margins begin to shrink as a result, added to the steadily rising debt service costs, the situation could become a major problem. This would lead to pressure on the high yield debt market, raising the cost of borrowing and further reducing liquidity, placing significant stress on corporate credit and the opening up the domino effect that this will have on the equity market and economy.

The high yield debt composite is a key indicator to watch for signs of stress, and as can be seen in the chart below, it is testing key support levels but has not yet broken down.

Inflation

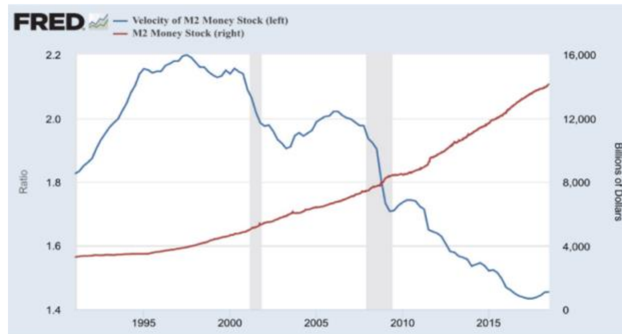
Given the importance of the Feds rate hike path the inflation and growth outlook is a key piece of the puzzle. While continuously undershooting expectations, inflation in relation to growth remains one of our key risk factors in the year ahead. It is clear that price stability is more important than the stock market to the Fed and the implied support from monetary and other easing is no longer an underpin to the market.

Healthy rather than slowing global growth can absorb slowly rising rates to manage inflation, while supporting decent corporate earnings. If the slowdown in global growth is coupled with rising inflationary pressures leading to ongoing Fed hikes and ECB stimulus unwind et al this will pose significant risk to the market as the risk reward outlook will become far less appealing.

What are some of the lead indicators for the risk of rising inflation:

The tight US labour market running above full capacity has not yet led to meaningful wage growth pressure but the risk is clearly to the upside barring an economic slowdown.

The US banks excess reserves are falling and the velocity of money is



rising.

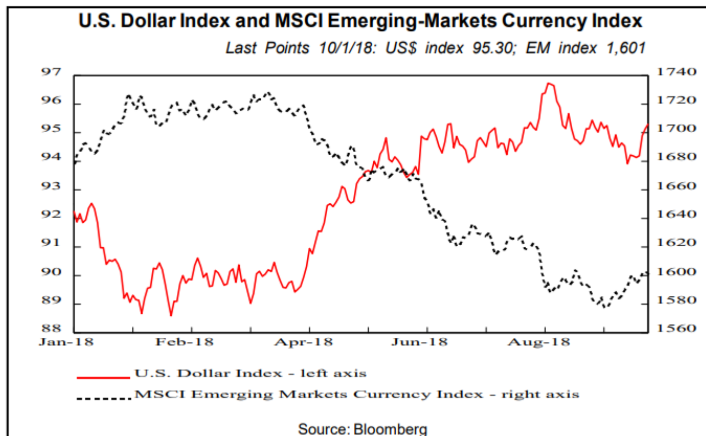
Source: @OccupyWisdom

Regulatory action again major corporates is still happening with technology stocks currently in the firing line. This is being led out of Europe but signs are the US will follow this path too.

The Trade War is driving both real and expected prices up around the world. (Inflationary expectations are one of the most powerful inflationary forces - think of Japan).

What about the Dollar:

The EM equity, bond and currency sell-offs can be closely tied to the relentless USD strength over this past year. This strength can largely be attributed to the fact that the US economy is growing faster than the Eurozone and the Japanese economy and is closing the gap on China to some extent as well. Add to this the fact that the Fed is raising interest rates well ahead of its peers. The significant USD yield pickup relative to countries like Germany and Japan provides a significant underpin to USD demand. The concurrent weakening of EM currencies has forced a number of central banks to raise rates to offset currency weakness (and inflation) while faced with decelerating growth. The USD strength is not helped by the shortage of dollars globally as significant amounts of USD denominated debt falls due over the next 2 years.



What about China

There is limited firepower globally to reignite global growth as the major regions of Europe and Japan are still in stimulus mode, and the US has already used its tax cut.

As previously discussed a number of times, the infrastructure spending that has been a growth driver for so long has left China with significant debt and excess capacity. The key challenge facing them is how to deleverage and transform the economy over the long term without triggering a financial meltdown. Yet, there remains significant capacity and willingness for fiscal stimulus in China over the near term.

China does not want a trade war and will be the bigger loser in a prolonged ‘cold war’ around trade, given the domestic challenges they face. We believe that some sort of compromise is made in relation to the trade war over the next 3-6 months. The US has some valid demands and the voter support base is thus far still in support of this push for change.

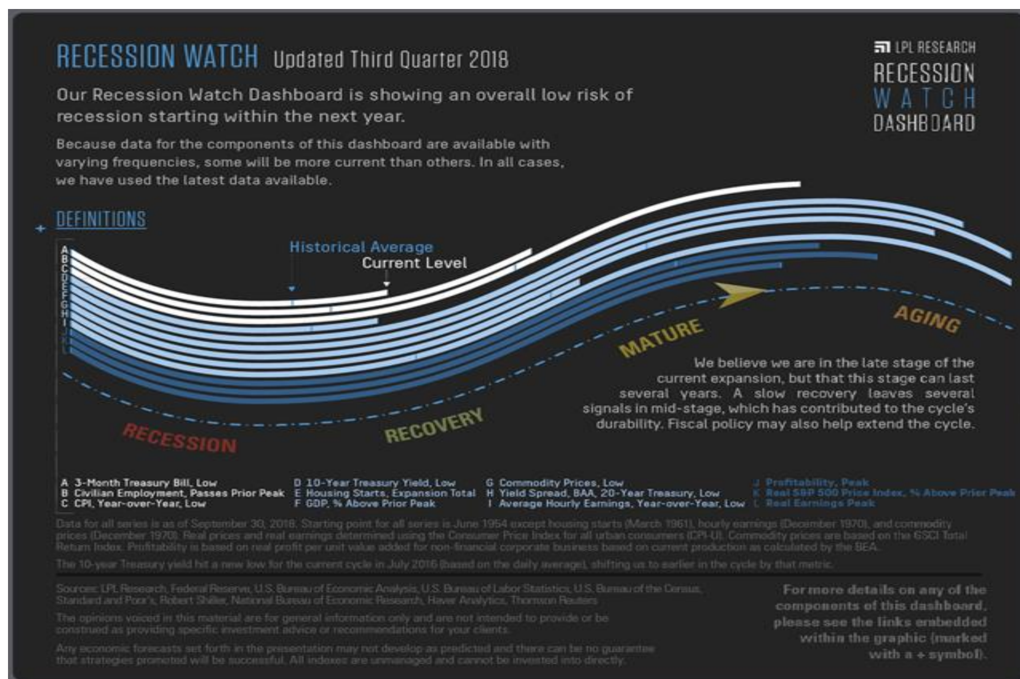
Convergence of major risk factors:

We note that the banking and financial sectors of Hong Kong, Europe and the US have all broken long term support in this rising rate environment which traditionally favours such sectors. This is certainly a warning that the risk factors playing out right now are real and have the potential for real economic damage.

The potential risk being face is clearly reflected by a look at the monthly chart of the FTSE 100, This is a globally reflective index. It has been breaking out of an 18 year base but it threatening to break back below its 1999-2000 highs which while not confirmed is a clear risk indicator.

The global (specifically US) equity outlook:

So where does that leave the outlook for 2019? Are we in the start of a bear market or have we simple been through a sharp correction? By most educated measures the consensus expectation is fast becoming that the US will enter a recession within the next 18 months. This is a reasonable assumption given the Feds history of triggering recessions during its hiking cycle and given with how late in the cycle the US economy already is. However some research indicates that given the low trajectory of growth this late cycle path could be still extended for a number of years



Having said that we note also some key factors about the market:

- Credit spreads are not yet blowing out (as per the above),
- US price:earnings valuations are around the 5 years average and slightly above the 10 year average.
- Despite the concern over 2019 earnings, they are still forecast to grow in the 7-9% range.

History has shown that major bear markets result from 1) recessions, 2) commodity spikes, 3) aggressive Fed tightening, 4) extreme valuations, and 5) excess that eventually needs to be worked off.

We do not see points 1-4 as having been in play however the excess that is artificially low interest rates, excessive government debt and monetary stimulus over the past 10 years is hard to ignore and when this unwinds the outcome will potentially be devastating. What is totally unclear is what exactly triggers this unwind (rapid inflation, agressive rate rises, trade wars etc) and whether this has begun or whether there is a lot of room to keep kicking the can down the road as has been done for the previous 10 years. We watch the signs carefully and recognise that a balanced approach is prudent.

Sectors that have structural growth playing out over many years will offer opportunities for those who are patient and willing to avoid the noise. We think particularly of sectors and themes that are here to stay such as technology (AI, online payments, data, semiconductors, robotics and cybersecurity), healthcare, biotechnology, new age metals (vanadium, lithium, copper). Major sell offs have the potential to present once in a decade opportunities.

In South Africa, many stocks are trading at their cheapest since 2011. We note that a big component in this 'cheapest' statement assumes their earnings as forecast are achievable. As with any investment the attractiveness is a function of what you are paying versus what earnings or return you expect to see over the investment period. In this area the greater the margin for safety you have the better and we believe there is a significant margin of safety in a stable and improving political economic climate. We continue to see SA exposed assets as a good risk reward investment, however the catalyst for returns will be visibility.
Key factors in this outlook:
The lack of clarity on land reform along with the outcome of the 2019 elections creates uncertainty which is keeping most foreign and local businesses and investors on the sidelines for now. Perhaps not enough credit is being given to the Ramaphosa government that is quietly making significant headway in a number of key and influential areas such as SOEs, the stance on corruption, and foreign and local business investment partnerships.
We have often stated that many of the SA focused companies have become incredibly operationally efficient having fought through a muddling economy for a number of years now. The mid to upper LSM SA consumer has been deleveraging in the face of political uncertainty creating some surplus credit capacity.
One of the single biggest stumbling blocks to investment, credit demand, purchasing or any major decisions is uncertainty about the future. Any election, political or other such issues that can be resolved will add layers of

structural certainty to both corporates and individuals confidence to invest, spend, borrow and make other decisions.

It is clear that any traction in the economic and GDP outlook will have an outsized effect on the profitability of corporate SA, such is the operational gearing.

We believe there is significant pent-up investment demand by South African companies for investment opportunities in South Africa. Many corporates that have been chasing the holy grail of offshore/hard currency earnings have had their fingers badly burnt and may well refocus their energy and investments into the opportunities closer to home. It is well known that SA corporate as a whole is cash flush.

Looking back at 2018 it has arguably been the year of the unexpected:
To say the year has thus far been challenging is an understatement as brick by brick the veil of 'SA management quality' has been torn down. On the plus side, corporate governance, management credibility and poor disclosure have become entrenched in the top investment factors in SA given the spate of corporate disasters over the past 12 months. Deep dive analysis and skepticism are now the order of the day.
It is well worth mentioning some names just to highlight the sheer volume of once great 'share price performers' if not quite all great companies or market darlings that have fooled long time investors:
Steinhoff: enough said
Seduced by management and the lure of hard currency:
Aspen, Mediclinic, Brait, Resilient, Nepi and co, Netcare
Lost their way along the acquisition trail:
EOH, MTN, Ascendis, Invicta, Woolworths

This has proved once again the old adage that over the long term, stock prices move in line with the intrinsic value of the business.

As much as we are bullish, the reality is that the outlook for SA looks fairly binary:
Positive scenario:

- Land reform is resolved easily and quickly, along with outstanding mining charter issues
- Elections run smoothly - Mr Ramaphosa has enough power to entrench the right people in the right places and make a real dent on corruption,
- The trade war is resolved and EM moves back into favour,
- Global growth holds up well enough for SA to benefit and,
- Investment into SA from both local and foreign sources picks up rapidly and the upside scenario of GDP and corporate earnings growth starts to gain real traction

Negative scenario:

- Mr Ramaphosa is undermined from within the party and continues to lead with one hand tied behind his back
- Global growth hits a massive speed-bump any one of the global risk factors mentioned earlier hit hard
- SA muddles along at flat to receding growth, entering a prolonged recession

What is clear is that we have a number of self help opportunities in SA that could lead to significant equity market upside after 3-4 years of consolidation. For these to bear maximum fruit, however, we need the assistance of global markets and sentiment which is anything but a self-help lever.

Overall world markets face some uncertain outcomes, any of which could prove to be major turning points. (We have not even covered Italy or Brexit in the report above). The heightened volatility in global equity markets is here to remain and will continue as long as liquidity is slowly being withdrawn from the market and we expect the next 12 months to be just as difficult as the last 12 months.

The key is not to assume any one outcome both locally or globally is a foregone conclusion but rather to have a plan, closely monitor the facts and outcome probabilities and invest accordingly.