POUR SOME SUGAR ON ME…

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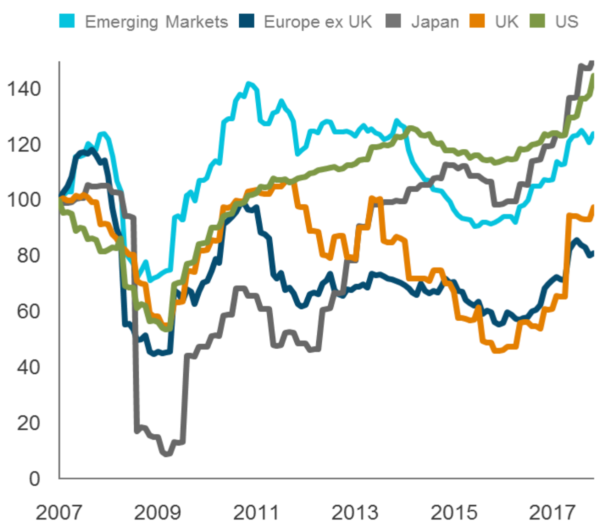
Def Leppard – 1987

Two fundamentals of equity markets are key to understanding why the equity bull market has aged well and may have further to run, albeit with a different narrative to last year.

1. US corporate profits: Pour some sugar/tax cuts on me



SOURCE: [Ministry of Health, Labour & Welfare, Statistical Office of the European Communities, Bureau of Labor Statistics]/Haver, Morgan Stanley Research, FactSet Economics. As at 31 August 2018.

Whether or not you agree with US President Donald Trump's policies, corporate profits in the US look to be rising by a compounded 40-50% over the calendar year periods spanning 2017-19. This is in part due to the direct impact of corporate tax cuts and in part due to the overall acceleration of US economic growth, as a cyclical upswing meets stimulative fiscal policy (all set against monetary policy that remains pretty loose, domestically and globally).

2) Valuations: Going down, from a non-extreme start point

SOURCES: FactSet, MSCI. As at 31 August 2018.

With corporate profits going up and markets moving sideways (everything ex-US) or down (emerging markets) in 2018, valuations on a P/E basis have trended just below the 20 year+ average. Not cheap, not extreme, just average.

Our perspective?

We don't think valuations are extreme in a world of positive earnings and economic growth, and we don't see a bubble. We need to be selective, but valuations alone won't end the equity cycle at these levels as many bears would tell you: the emergence of a crisis or the development of a valuation extreme, yes; a long-term average valuation no.

That being said, we do see deceleration in the back half of 2018 and into 2019. That will require some thought and throw up some stock opportunity, because investors don't like deceleration. It's understandably perceived as negative and its also confusing – even if the end point is still decent growth, which is our base level assumption. 'Sell it now; buy it back later' is often the regime in such instances, but that's a regime we can exploit if we stay focused on which companies are oversold and underpriced on a long term earnings power basis.

Equity market valuations and earnings fundamentals are still giving us plenty to play with in terms of the ability to generate returns for clients. While the landcape is harder now than it was in 2017 with all its positive surprise, this is still a market with which we can work as forward-looking, growth-oriented stock pickers.

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