# GLOBAL EQUITY OUTLOOK

## FIRST QUARTER 2018

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- The economy is stronger than official statistics suggest because of the mismeasurement of 'new economy' investment. Investment growth may well be outpacing total output.
- We are looking for rates to gradually move higher and economic growth to be sustained.
- As economic growth is broadening across countries and sectors, it can withstand the first couple of rate hikes.
- With continued supportive macro conditions and inflation unlikely to rise significantly, we remain constructive on global equity markets in the short to medium term.
- Economic momentum and earnings revisions have picked up in the US, leading us to be optimistic in the short term. Medium term we see the risks mounting.
- The economic recovery in Europe is broadening, allowing the margin and valuation gap with the US to narrow. We continue to view the region favorably, while being cognizant of its high beta to the economic and market cycle.
- Japanese equities have the potential to profit from both global and domestic dynamics.
- We recently turned more cautious on emerging markets given less attractive valuations after strong performance in 2017, the need for a global repricing of the Fed policy, and a better outlook for the USD. In the medium-term we remain optimistic on emerging markets with the expectation of higher normalized growth rates.

## HOW MUCH LONGER CAN MARKET CONDITIONS STAY "LAGOM"?

Over many decades, Sweden has established itself as a well-diversified, export-oriented economy. Despite being home to world-leading companies like Ericcson, Ikea, Atlas Copco and Spotify, very few Swedish words or expressions made it to the Oxford Dictionary. While one could argue the relative popularity of words like smorgasbord and ombudsman, the linguistic pickings of Swedish words in the English language are slimmer than the interest rate on Swede's checking account .[1]

As we consider the healthy equity returns of last year and the market outlooks for next, perhaps the time is ripe to champion a word from the Swedish lexicon: Lagom (pronounced /la-gōm/).

With no direct English equivalent, lagom's meaning approximates to "not too little, not too much". In essence, it neatly captures the favorable, goldilocks environment of broadly steady but non-accelerating global GDP growth and historically low interest rates that have characterized the last couple of years. This combination of stable growth, cheap money, and correspondingly low bond yields has helped to drive a revaluation of equities in most regions and sectors, and has encouraged investors to be nonchalant in the face of geo-political crises or tail-risks.

We started 2017 digesting the 2016 US elections and expected a sea-change in policy and rhetoric. The expectation of expansionary policies and tighter fed policies made "Global Reflation" the initial key macro theme. What we got instead was a more synchronized global recovery driven by global trade, economic nationalism that lost traction or attention, and a less aggressive Fed on the back of fading inflation expectations. As the yield curve flattened and the dollar weakened, the market switched back to growth mode, with a stronger risk appetite for disruptive growth than defensive growth.

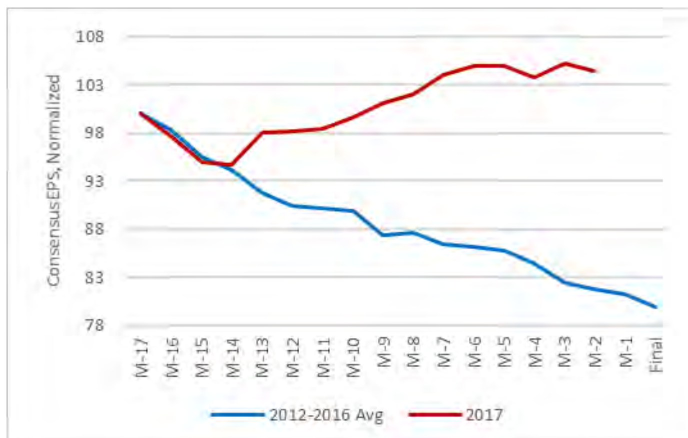
Improving economic conditions translated into well supported earnings estimates. Contrary to 2012-2016, bottom-up earnings estimates for 2017 held steady in the US and increased for International markets during the year .

So, what are the prospects of prevailing conditions remaining "just right" for the bull market in equities to extend? There is ample evidence from the Eurozone, Japan, and commodity markets that economic buoyancy is broadening. As regional GDP growth rates start to re-converge after several years of idiosyncratic and divergent trends and false dawns, we have seen positive earnings revisions proliferate in International markets and corporate confidence indicators point toward further expansionary activity. The U.S. macroeconomic cycle is much longer in the tooth, as solid corporate earnings have recently been due as much to decent revenue growth as to cost cutting and financial engineering.

FIGURE 1. S&P 500 EPS CONSENSUS FORECAST


Source: S&P

FIGURE 2. MSCI EAFE EPS CONSENSUS FORECAST




Source: MSCI

FIGURE 3. A GLOBAL SYNCHRONIZED RECOVERY TAKING HOLD AS MEASURED BY PMI

| | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 |
|---|---|---|---|---|---|---|---|---|
| Global | 50.6 | 50.4 | 51.1 | 52.7 | 53.0 | 52.6 | 53.3 | 54.5 |
| USA | 51.5 | 51.3 | 51.5 | 54.3 | 53.3 | 52.0 | 53.1 | 55.1 |
| Japan | 49.1 | 48.1 | 50.4 | 52.4 | 52.4 | 52.4 | 52.9 | 54.2 |
| UK | 51.3 | 53.0 | 55.7 | 55.9 | 54.3 | 54.2 | 56.1 | 56.3 |
| Euro Area | 51.6 | 52.8 | 52.6 | 54.9 | 56.2 | 57.4 | 58.1 | 60.6 |
| China | 49.7 | 48.6 | 50.1 | 51.9 | 51.2 | 50.4 | 51.0 | 51.5 |
| India | 52.4 | 51.7 | 52.1 | 49.6 | 52.5 | 50.9 | 51.2 | 54.7 |
| Brazil | 46.0 | 43.2 | 46.0 | 45.2 | 49.6 | 50.5 | 50.9 | 52.4 |
| Russia | 50.8 | 53.5 | 53.1 | 56.6 | 56.3 | 54.8 | 54.8 | 56.0 |

Source: Bloomberg

[1] Swedish taxpayers overpaid their taxes by SEK40bn in 2016, as they can earn higher interest on the subsequent refunds than is available on savings accounts. The Riksbank central repo rate remains at -0.5%.

## The low capex and inflation conundrum

Low capex intensity and a lack of inflation during this recovery has puzzled economists. Many point to lower potential GDP on the back of weak productivity growth, aging demographics, lower participation rates, and the fact that we had to go through a big deleveraging phase first. While there is certainly an argument to be made that wage inflation and rates will react with a lag to the continued strength in the economy, there are good reasons to believe that macro-economic statistics are underestimating the strength of the economy and corporate profitability because of the way "new economy" investment growth is accounted for.

The underestimation in economic statistics stems from:

- Most new economy investments are expensed rather than capitalized.
- Costs are underestimated because they exclude stock based compensation.
- As the "gig economy" grows in importance, capital stock is transferred from the corporate sector to the household sector (accounted for as consumer durables).
- Cloud Computing is changing how companies think about IT investment in a way not captured by economic statistics.
- Data is now seen as a new factor of production, but is basically priced at zero.

Redburn[2] estimates that because of this, the economy is 3.5% larger than it looks, that corporate profits are understated by 23% and that nominal investment/GDP is much closer to the peak of the past economic cycles (close to 19% versus the reported number of 16.5%).

Capital/Technology has become increasingly competitive versus labor due to lower cost (financing, outsourcing, Moore's law) and improved productivity (technological improvements). As technology substitutes labor at an increased rate, wage growth and overall inflation are subdued, while simultaneously supporting growth. If productive capital stock is underestimated, there should also be more slack in the economy than reported.

New economy investment is a key driver of improved capital efficiency and lower capital intensity, and is supporting profitability, cash generation, and therefore, equity valuations. The economy and equity market may well have additional capacity to grow without generating much inflation. Interest rates can stay low and economic cycles can become longer and less volatile, a potentially supportive combination for equity valuations (because the discount rate could be over-estimated and the profitability under-estimated).

However, there are two major risks to this scenario. The future profitability of this new productive stock is difficult to estimate and measure. Given that the stock's capital is badly measured or has no market price (data), it is left up to the market to determine that value. While we are certainly not there yet, the risk is that the market overestimates the size or speed of the gains of these technological changes.

From a cyclical perspective, the risks to growth and inflation seem more to the up than to the down and it appears likely that 2018 will mark the year when the Federal Reserve normalizes its monetary policies in a more metronomic manner. Higher interest rates and treasury yields could provide a de-rating overhang for equities. Additionally, other central banks could begin to follow in the Fed's wake and commence the unwinding of their own quantitative easing measures, albeit at a measured pace. In this case, the best analogy for equity investor sentiment may be another Scandinavian-inspired English term, "Stockholm Syndrome" or the situation in which a captive group becomes increasingly sympathetic to, or influenced, by their captors over time. The bond market "taper tantrum" in 2013 provided a taste of the extent to which monetary policy has underpinned investor heuristics in recent years. Central banks appear to have been consciously shrewder in articulating their policy intentions and timeframes of late. However, the extent to which investor sentiment is held hostage by further monetary policy normalization will help to determine whether financial conditions remain "lagom."

[2] Redburn, "Economics Cloud Nine", November 8, 2017.

## Regional Views

**Figure 4. Regional Metrics** (as of 12/31/17)

| | Price/Book | ROE | Trailing P/E | IBES P/E | Dupont Capital Normalized P/E | Dupont Capital Normalized Growth |
|---|---|---|---|---|---|---|
| MSCI USA | 3.3 | 13.5% | 24.4 | 18.7 | 20.6 | 5.4% |
| MSCI Europe | 1.9 | 9.4% | 20.3 | 15.0 | 16.7 | 4.5% |
| MSCI Japan | 1.4 | 9.0% | 16.1 | 14.6 | 18.8 | 3.9% |
| MSCI EM | 1.8 | 11.8% | 15.1 | 12.2 | 13.9 | 8.0% |

Source: MSCI, FactSet, DuPont Capital as of 12/31/17. ROE and Trailing P/E are for the trailing 12-month period ending 12/31/17. For illustrative purposes only.

### *North America: Short term growth acceleration, mounting risks*

Strong economic growth (nominal GDP close to 4%) and reasonably steady inflation (around 2%) should keep the business cycle in expansion mode and support earnings growth (8% ex-tax reform). Tax reform is providing further upside and may not be fully reflected in estimates. JP Morgan estimates the impact could be as high as 8 to 10%. A pickup in the economic surprise index and earnings estimates combined with tax reform recently turned us slightly more constructive on the US market in the short-term. Further earnings growth is certainly required as rising bond yields, historically high valuations, and high leverage represent the key risks for the US market. With those risks likely come higher volatility and the potential for volatile sell offs.

### *Euro-zone: A broadening economic recovery*

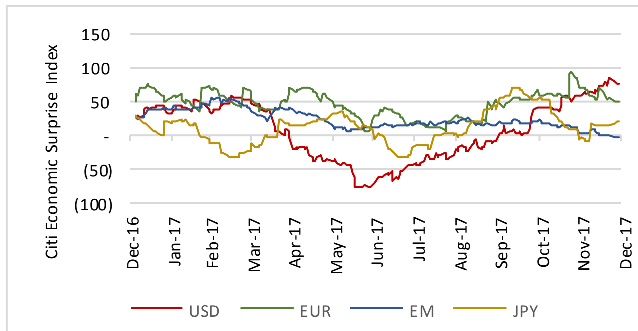
Growth prospects in the Eurozone remain solidly underpinned despite the region entering its fourth year of above-trend growth. Having lagged substantially for several years, growth in capex and investment can provide more depth to the recovery. Growth rates and investment intentions in France and Italy are starting to catch up to the healthy levels seen in Germany and Spain.

With elections coming in Q1/Q2, most investors remain focused on political risks in Italy, while ignoring the acceleration in the economy and improving sentiment indicators. Better economic conditions should help ease the worries of creditworthiness and debt sustainability in Italy, and the new electoral law puts the bar for real political disruption very high.

### *Japan: Profiting from both Global and Domestic dynamics*

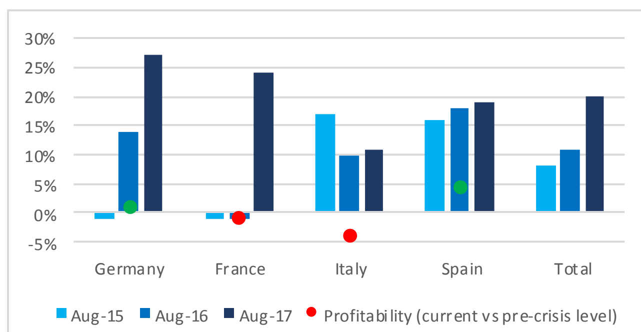
Gradually increasing bond yields and healthy global growth provide a positive backdrop for Japanese equities. Lower bond yields and a stronger JPY represented a headwind for equities in the early part of 2017, but did not prevent the corporate sector from reporting better than expected earnings. Japan has seen some of the best earnings revisions globally on the back of synchronized global growth and resilient domestic demand. While the adoption is rather slow, the return profile of Japanese companies is steadily improving on the back of improved corporate governance and capital allocation.

**Figure 5. North America - Citi Economic Surprise Index**



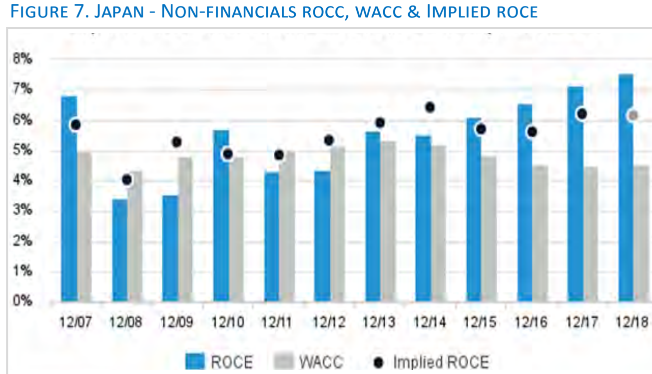

Source: Citigroup, Bloomberg

**Figure 6. Eurozone - EU net Corporate capex intentions (2015-2017)**




Source: UBS

**Figure 7. Japan - Non-financials ROCC, WACC & Implied ROCE**




Source: Redburn

*Emerging markets: now more growth oriented than cyclical*

We recently turned more cautious on Emerging Markets. Improved economic momentum in the US and a re-pricing of Fed expectations should be supportive of the USD, but a temporary headwind for Emerging Markets. At the same time, we are seeing some softness in Chinese economic data and the EM Economic surprise index. Last, the strong performance in 2017 narrowed the relative valuation gap with other regions.

It is interesting to note that 2017 performance was largely driven by a handful of Technology stocks; Tencent/Naspers, Alibaba, Samsung Electronics and Taiwan Semiconductor accounted for 11.5% of the index's 37.7% return. Relative performance and changes to the index have made the MSCI EM index heavily skewed towards Asia (>70%), as well as Technology (28%) and Financials (24%), making it much more of a growth and rate sensitive index than a play on global industrial production.

Figure 8. Emerging Markets - MSCI EM 2017 Return Contribution

| | No. Securities | Market Cap | Percent Benchmark | Cont. to Return |
|---|---|---|---|---|
| Top 5 Contributors | 5 | 588,769 | 14.9% | 11.51 |
| Next Cohort Contributing ~ Same as Top % | 54 | 859,038 | 21.8% | 11.63 |
| Next Cohort Contributing ~ Same as Top % | 301 | 1,347,099 | 34.2% | 13.01 |
| Remaining Positive Contributors | 340 | 697,688 | 17.7% | 3.08 |
| Negative Contributors | 199 | 450,679 | 11.4% | (1.56) |
| **Total** | **899** | | | **37.68** |

Source: MSCI, FactSet with analysis performed by DuPont Capital.

## Style and sector preferences

US tax reform and gradually increasing rates bode well for a more value oriented style, but merit caution in low volatility sectors. We believe it is too early to give up on certain growth areas in technology as the surge in global semiconductor sales highlights how technology has become a structural driver of growth. We expect this trend to continue for the next couple of years.

Besides our interest rate expectations and style preferences, we think there are a couple of structural arguments to being more constructive on the financial sector. Since the Great Financial Crisis, the sector has been held back by a multitude of factors that are now either finalized or in the beginning stages of normalization. Regulatory requirements and litigations are largely finalized; putting the industry in a position to return excess capital to shareholders. Interest rates are in the beginning stages of normalization as Central Banks are winding down their QE programs. The industry has also made a commitment to digital transformation within the segment, and capital outlays associated with the effort are nearing their peak. However, the benefits of such expenditures have yet to be realized. Overall, we expect financials to deliver above normal earnings growth over the next few years with improving ROE's and higher capital returns with a lower risk profile.

Cyclicals should enjoy good operating leverage and earnings growth at this stage of the economic cycle. Valuations look a little stretched however, and it is difficult to see sentiment indicators like the ISM or CESI improving further. Companies that stand to benefit from a better capex cycle or strong domestic growth should be best positioned.

## Conclusion

2018 presents us with a more challenging starting point as a flatter yield curve and higher valuations make hedging risk positions more difficult. While we will likely see more divergence and volatility, the global equity market will continue to be driven by top down and macro related events like Chinese economic growth, the impact of the US tax cuts, and more importantly, the direction of interest rates. The economic growth is broadening and we see few indications of a short-term downturn. A sustained increase in market volatility, trends in corporate profit margins and changes in the shape of the yield curve are the key metrics to monitor going forward. We expect the Fed can increase rates a few more times before the yield curve inverts, and until then there should be some life left in the economy and the stock market. In the short-term the market is focused on earnings growth, but in the medium term financial and monetary conditions will determine the valuation levels. The equity market allergy to rates and risk will become apparent at some point in time.

## ABOUT THE AUTHORS:

Lode J. Devlaminck, Managing Director, Global Equities, is the lead portfolio manager for the firm's EAFE and Global Equity strategies and is also a portfolio manager on Emerging Markets Equity strategy. Mr. Devlaminck is a member of the DuPont Pension Trust Investment Committee and the DuPont Savings Plan Investment Oversight Committee. Prior to joining DuPont Capital in 2014, Mr. Devlaminck was a Senior Portfolio Manager and Sector Specialist of Global Equities at Hermes Fund Managers in Boston, Massachusetts; a Portfolio Manager at Fortis Investments in Boston, Massachusetts; a Global Sector Manager at Fimagest in Paris, France; and a Financial Analyst at Generale Bank in Brussels, Belgium. Mr. Devlaminck joined the investment industry in 1989. Mr. Devlaminck holds a Master's degree in Applied Economics from the University of Antwerp, in Antwerp, Belgium.

Andrew J. Smith, CFA, Senior Portfolio Specialist, is the primary point of contact regarding our equity investment activities, providing insights into the philosophies, processes and portfolio positioning of our fundamental and structured strategies. He also conducts fundamental research in the Industrials, Materials and Energy sectors. Prior to joining DuPont Capital, Mr. Smith worked as a Portfolio Manager and Global Equity Analyst at Hermes Fund Managers. Previously, he was a member of the Global Equities Team at Fortis Investments, and held analyst roles at Schroders and the Financial Times Group in London. He joined the investment industry in 1998. Mr. Smith holds a B.S. in Economics from University College London, UK. He is a member of the CFA Institute and holds the UK Investment Management Certificate (IMC).

## ABOUT OUR FIRM:

DuPont Capital has a long history of institutional asset management. Our parent company, DuPont (a wholly owned subsidiary of DowDuPont) established a retirement pension plan for employees in 1942, and in 1975 created a separate pension management division.

In 1993, DuPont Capital was established and became an SEC registered investment advisor. We share our parent company's history of innovation and, over the years, have been on the forefront of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income, and alternative investments.

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