

ClucasGray Private Clients

Quarterly Commentary

December 2018

"The pessimist sees difficulty in every opportunity; the optimist sees the opportunity in every difficulty", Winston Churchill.

Global Outlook

Given the performance of global asset prices over the last quarter of 2018 we have chosen to focus this note on our thinking about the outlook for global markets.

The MSCI World Index lost -13% during the quarter, leaving it down -9% for the year. It was the worst December for the S&P 500 (-9%) since 1931. As depicted in the chart from Morgan Stanley below, equities were not the only assets to be subjected to a volatile shakeout. High yield credit spreads (a gauge of potential credit default risk) for example, were also impacted and are reflective of a much more cautious tone in financial markets.



Source: Morgan Stanley

Given this significant move in asset prices, major global equity indices have adjusted materially and have come back to more reasonable levels. The World Index (marked as MSCI ACWI in the chart above) is now on forward PE below 13 times, a significant change from a year ago, and towards the lower end of the 20 year range.

However, investors will understandably be asking themselves the question whether this move in global markets is merely a correction in the global cycle or the beginning of a more protracted downturn? We try to explore this by looking at it from the perspective of both valuations and other fundamental factors including earnings growth prospects.

Global Growth Prospects

ClucasGray does not attempt to forecast global growth figures and other key macro-economic variables. Rather we try to be cognizant of the key macro issues affecting the domestic and global economies in order to understand the implication that this may have on markets and on company valuations. Currently markets are trying to digest a number of macro-economic factors and the added political and policy instability clearly does not help. Investors are well versed on the US government shut- down, Brexit, and trade tensions between the US and China. We have no way of predicting these outcomes and again we do not attempt to do so.

Forecasts, such as the one below from Morgan Stanley, illustrate a slowing in global growth prospects from current levels. There is certainly a risk that these forecasts turn out to be too optimistic if recent data points are extrapolated. Other observations from the figures are that there is an expected slowing in key developed market economies and a reasonably stable outlook for emerging markets.

Morgan Stanley real GDP growth forecasts

	2018E		2019E		2020E	
	MS		MS	Cons.	MS	Cons.
GLOBAL	3.8		3.6	3.6	3.5	3.6
G10	2.2		1.9	2.0	1.6	1.7
US	2.9		2.3	2.6	1.9	2.0
Euro Area	1.9		1.6	1.6	1.5	1.5
Japan	0.8		1.3	1.0	0.6	0.4
UK	1.2		1.3	1.5	1.6	1.6
EM	4.8		4.7	4.7	4.8	4.8
China	6.6		6.3	6.2	6.1	6.0
India	7.7		7.6	7.3	7.5	7.5
Brazil	1.3		2.3	2.3	2.5	2.5
Russia	1.6		1.5	1.5	1.6	1.7

Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-weighted. Cons = consensus.

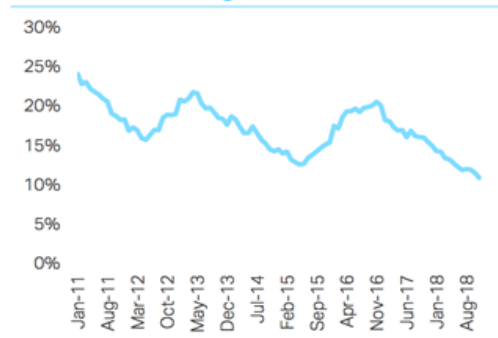
China is a key contributor to global growth and there have been some weak macro-economic data points recently which cannot be ignored - specifically the Chinese manufacturing numbers. This has elicited a more accommodative monetary response from the Chinese authorities. These stimulatory efforts are yet to show signs of traction but there is currently no reason to believe that they won't stabilize growth in due course.

Chart 1: China PMI



Source: CEIC.

Chart 2: Total credit growth



Source: CEIC.

One other feature worth noting is that key central banks (US and Europe) will continue to look for opportunities to remove stimulus and raise rates as they have articulated in a clear manner. It is important to remind ourselves that they are doing this because they feel that the underlying economies are in reasonable shape to allow them to do so. It is not our central view that they will do this irresponsibly. Weaker growth and or a lack of inflation, should it materialize, could well lead to fewer rate hikes in key economies.

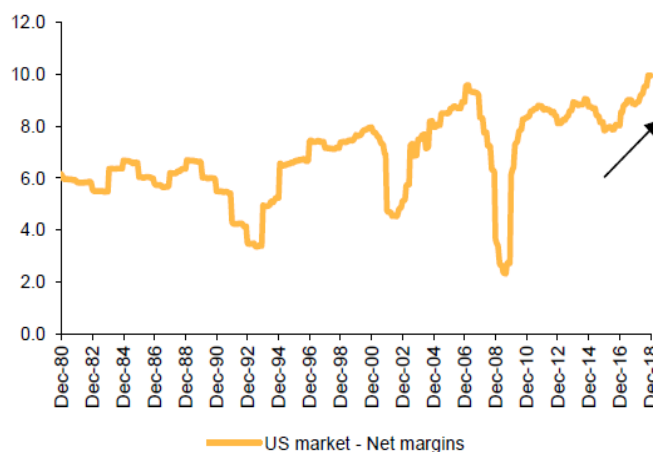
Our conclusion is that after such an extended period of global growth (now 10 years in the making), we think that it is natural that there are signs of slowing across global economies. We do not however believe that there is likely to be a global recession or a recession in the US in 2019.

Earnings Prospects and Valuations

The relevance of the global growth backdrop is the extent to which it has an influence on the earnings prospects and cash flows of companies and the implication for valuations. We have previously referred to the interplay that exists between earnings prospects and valuation (reflected in PE's) and how we strive to stress test this dynamic in our investment process.

At a high level and having regard to a slowing global growth environment, it does seem prudent for us to expect a more modest outlook for earnings. With wage pressures building and interest rates on the rise in certain developed economies, it is right to reflect on the extent of expansion in margins. Corporate margins in the US for example are at all-time highs dating back to 1980. We need to question the degree to which this can continue across sectors and economies.

US Corporates: Net Margins (Source: Datastream & Macquarie Research)



Source: Datastream; Macquarie Research, January 2019

Of course this high level observation is not true for all companies and markets. There will undoubtedly be companies which, whether for structural or other reasons, are able to grow at above average levels. We continuously strive to look for opportunities in specific companies, regions and asset classes where the degree of pessimism reflected in current prices is not justified. The table below gives some indication of the current 12 month forward PE ratings and earnings growth estimates for key global indices.

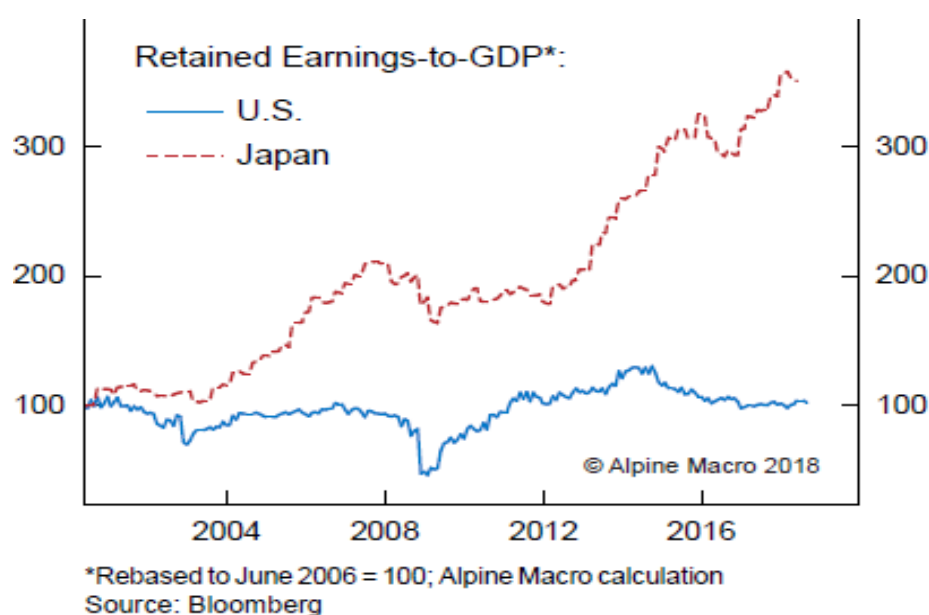
Global Index Summary: Bloomberg Estimates

17 January 2019	12 M PE	12 M DY	2019 Earnings	2020 Earnings
Msci World	12,91	3,0%	9,4%	7,6%
S&P 500 Index	13,81	2,4%	10,8%	7,8%
Dow Jones Indus. Avg	13,29	2,7%	9,1%	5,0%
Nasdaq Composite Index	16,74	1,3%	16,3%	14,3%
Euro Stoxx 50 Pr	11,00	4,5%	9,0%	6,0%
Msci Em	10,00	3,6%	12,0%	2,8%
Msci Japan	11,41	2,8%	3,1%	6,1%
Msci Ac Asia X Japan	10,50	3,3%	12,0%	1,5%

Growth rates of between 9% and 11% seem high on the face of it. However, even taking into account the potential for a more muted earnings outcome, our observation is that the extent of the recent adjustment to market valuations is not justified. The ratings for many global markets are now cheap relative to their longer term history and in addition are offering decent dividend yields. One such example is Japan.

Japan is now on a forward PE multiple of 11,4 x this includes earnings expectations of just 3% for 2019. In addition to modest growth expectations, Alpine Macro highlights that corporates in Japan are (and have been) accumulating vast sums of retained earnings. They have not been investing or returning this cash to shareholders. The combination of valuation support and the state of corporate balance sheets makes this an interesting investment case.

Japanese Corporates – Retained Earnings (Source: Alpine Macro)



Conclusion:

As has been characteristic of global markets over recent years, we should expect a bumpy trajectory in the path forward. With the global economy slowing, it is prudent be more circumspect about the prospects for earnings growth, however the recent correction in asset prices and valuations does not seem justified and has provided long term investors with a good entry point or an opportunity to add to their exposure to global equities.

If there is any interest to engage further, please don't hesitate to get in touch with us.

Kind Regards

The ClucasGray Team

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Annexure: Return Table – 31 December 2018

ClucasGray								
Data to:		2018-12-31						
DOMESTIC MARKET	Ticker	SPOT	Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share	JALSH Index	52 737	4,09	-5,33	-11,37	-11,37	1,33	2,66
JSE All Share TR	JALSHTR Index	7 730	4,25	-4,88	-8,53	-8,53	4,33	5,77
JSE Top 40	TOP40 Index	46 727	4,63	-5,64	-11,05	-11,05	0,67	2,41
JSE Top 40 TR	TOP40TR Index	6 829	4,76	-5,25	-8,31	-8,31	3,55	5,44
JSE SWIX TR	JSHRALTR Index	19 413	2,90	-3,98	-11,67	-11,67	3,69	5,92
JSE CAPPED SWIX TR	J433TR Index	21 595	2,59	-3,79	-10,94	-10,94	2,95	
JSE MID CAP INDEX	MIDCAP Index	69 848	3,00	1,95	-12,96	-12,96	3,66	3,04
JSE Resi TR	RESI20TR Index	2 692	12,59	-5,00	17,77	17,77	21,03	-0,83
JSE Fini TR	FINI15TR Index	9 309	1,24	-0,35	-4,09	-4,09	7,30	9,80
JSE Indi TR	INDI25TR Index	12 415	2,74	-6,84	-17,87	-17,87	-1,94	5,43
Property TR	JSAPYTR Index	1 841	-1,06	-3,99	-25,26	-25,26	-1,19	5,70
GLOBAL MARKETS (Local Currency)	Ticker		Month	Quarter	YTD	1Y	3Y	5Y
MSCI WORLD INDEX TR	NDDUWI Index	5 412,1	-7,60	-13,42	-8,71	-8,71	6,30	4,56
MSCI All Country WORLD INDEX TR	NDUEACWF Index	223,0	-7,04	-12,75	-9,42	-9,42	6,60	4,26
S&P 500	SPXT Index	4 984,2	-9,03	-13,52	-4,38	-4,38	9,26	8,49
Nasdaq	CCMP Index	6 635,3	-9,48	-17,54	-3,88	-3,88	9,84	9,70
Euro Stoxx 50	SX5T Index	6 200,9	-5,28	-11,47	-12,03	-12,03	-0,14	1,97
Nikkei TR	NKYTR Index		-10,28	-16,78	-10,29	-10,29	3,68	6,15
Shanghai	SHCOMP Index		-3,64	-11,61	-24,59	-24,59	-11,01	3,34
FTSE 100	TUKXG Index	5 950,4	-3,49	-9,64	-8,73	-8,73	6,75	3,88
MSCI Emerging	NDUEEGF Index	445,4	-2,66	-7,47	-14,58	-14,58	9,25	1,65
GLOBAL MARKETS (USD)	Ticker		Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share TR	JALSHTR Index	7 730	0,90	-6,28	-21,19	-21,19	6,93	-0,64
Euro Stoxx 50 TR	SX5T Index	6200,89	-4,13	-12,70	-16,20	-16,20	1,63	-1,75
Nikkei	NKY Index		-7,71	-14,58	-8,63	-8,63	6,74	5,08
Shanghai	SHCOMP Index		-2,50	-11,69	-26,91	-26,91	-10,82	3,04
FTSE100	UKX Index	6 728	-3,54	-11,66	-14,03	-14,03	1,73	-1,44
MSCI Emerging	NDUEEGF Index	445,44	-2,66	-7,47	-14,58	-14,58	9,25	1,65
Exchange Rates	Ticker		Month	Quarter	YTD	1Y	3Y	5Y
ZAR/\$	USDZAR Curncy	14,35	-3,44	-1,45	-15,86	-15,86	2,48	-6,46
ZAR/£	GBPZAR Curncy	18,32	-3,58	0,59	-9,57	-9,57	7,04	-1,07
ZAR/€	EURZAR Curncy	16,46	-4,83	-0,27	-10,79	-10,79	0,72	-2,67
ZAR/AUS \$	AUDZAR Curncy	10,12	0,16	0,93	-4,75	-4,75	3,51	-1,58
ZAR/BRL	BRLZAR Curncy	3,70	-3,28	-5,85	1,25	1,25	1,77	3,59
\$/£	GBPUSD Curncy	1,28	-0,04	2,13	5,62	5,62	4,70	5,09
\$/€	EURUSD Curncy	1,15	-1,33	1,18	4,48	4,48	-1,82	3,56
\$/CHF	CHFUSD Curncy	1,02	-1,72	-0,01	0,72	0,72	-0,70	1,88
COMMODITY PRICES	Ticker		Month	Quarter	YTD	1Y	3Y	5Y
Oil (Brent)	COA COMDTY	53,80	-9,70	-34,01	-14,10	-14,10	-0,18	-9,22
Copper (3 month LME)	LMCADS03 COMDTY	5965,00	-3,77	-4,68	-17,69	-17,69	8,23	-4,12
Platinum	PLAT COMDTY	795,65	-0,42	-2,61	-14,49	-14,49	-3,78	-10,29
Iron Ore	ISIX62IU Index		8,87	6,71	-0,47	-0,47	17,53	-11,99