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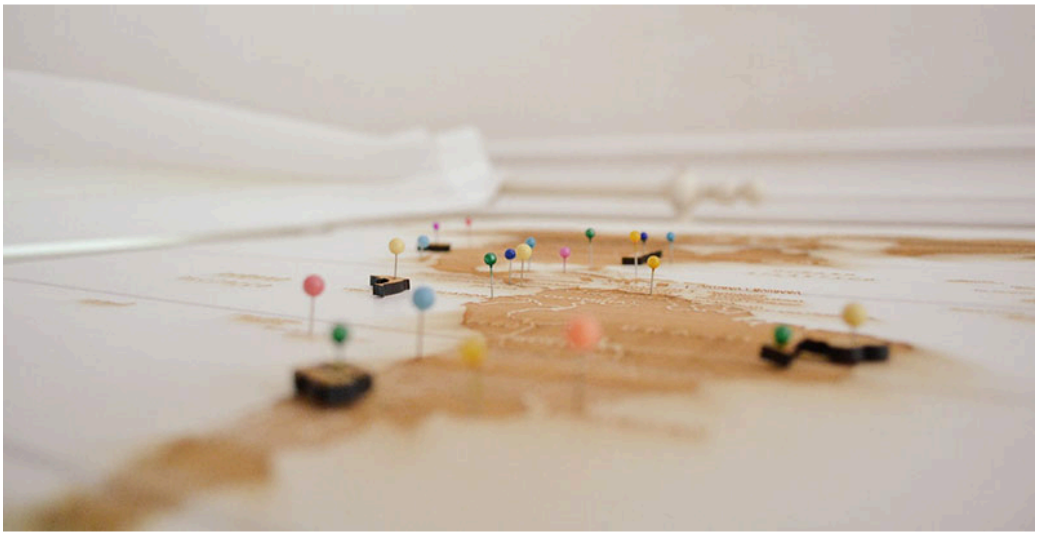
BILBoard April / May 2018 – Corporate earnings: seeing is believing



Earnings season has kicked off to a positive start and, if it materialises, a robust first-quarter earnings season should assuage investor concern that the market has become overstretched.

Looking through the volatility that has reared its head in markets, the sound macroeconomic backdrop remains largely unchanged. In the US, a confluence of strong data points such as business investment, industrial production and consumption allow inflation pressures to continue building. Capacity utilisation, for example, is ticking upwards and approaching the 79% figure deemed inflationary by the Fed. In Europe, economic readings have come down from elevated levels but still indicate that the economy is in an expansionary phase. Bolstered by the still-solid global economy, revenue growth, and higher cash flows stemming from December's corporate tax cut, earnings should continue to increase. In fact, PMI strength year-to-date suggests that corporate earnings could grow at a double-digit pace in the first quarter.

According to Bloomberg, 80% of S&P 500 gains have come during earnings seasons since 2013. The investment community and markets are on standby as the results from Q1 2018 are being disclosed. So far, so good, but it is early days. Considering the lofty estimates analysts have set for US earnings results, seeing will be believing for the majority of investors and a 'meet' rather than a 'beat' with regards to expectations will suffice to confirm confidence in corporate fundamentals.

Taking a longer view, S&P 500 earnings-per-share (EPS) growth is expected to peak at 20.7% in 2018. Whether the boost from tax cuts will continue to support profit growth beyond this calendar year largely depends on how companies use the extra cash to support increased productivity. As such, the guidance which accompanies the release of earnings data detailing how the funds will be employed is key. Buy-backs would appease markets in the very near term, but investments will make earnings more sustainable, keeping the equity bull healthy for longer.

Equities

Whilst geopolitical tensions and a potential trade war have dominated markets, economic activity remains robust, making it premature to take our chips off of the table in terms of our equity bets. Top line growth – a figure unaffected by cost-cutting or buy-backs - has been strong. Since January, equity technicals have improved and valuations no longer appear stretched; the S&P500 is now trading at 16.5x forward earnings. At the same time, investor sentiment is no longer showing complacency and typical end-of-cycle indicators are not flashing red.

We maintain overweights in select pro-cyclical sectors, giving preference to companies with solid fundamentals that have delivered positive surprises in the past two earnings seasons, and which have strong guidance.

In terms of Europe, consensus foresees only 7.3% EPS growth. We see room for pleasant surprises, and maintain our overweight in European Financials, which typically benefit from rising rates. To provide a degree of protection against potential strengthening in the euro, we also diversify into the stocks of mid-cap EMU companies, which tend to conduct a higher proportion of their business activities within the bloc.

The weaker USD continues to be a short-term driver for Emerging Market equities, and this region trades with an attractive 24% discount to developed markets, based on earnings multiples. However, whilst trade war talk and other risks float in the background, we continue to exercise caution.

Fixed Income

We believe that any potential overheating of the economy presents a greater risk to fixed income than to equities, at least in the near term. A reduction in accommodative central bank policies paired with rising rates make us especially reluctant on duration.

In the latest dot-plot released at the March Fed meeting, additional hikes for both 2019 and 2020 were added to forecasts, resulting in expectations of 3 in 2019 and 2 in 2020. 2 more hikes are expected for 2018.

Whilst being underweight government bonds and high yield, we are still mildly positive on certain segments of the investment grade bond universe. A bounce in hedging costs make the US market uninteresting at this stage, but across the pond in Europe, the outlook is more temperate. Significant support still flows from the ECB and talk is circulating that QE could be staggered beyond September 2018 so that the unwinding is gradual. Traditional low issuance in April should be a relief for the market - around EUR 16bn is expected, with EUR 37bn of IG bonds maturing within three months. At present, it is difficult to identify potential drivers of meaningful spread tightening, but at the same time, major widening from current levels also seems unlikely.

Whilst we have not adjusted our overall exposure to EM debt, within this category, we have swiveled out of the most risky tranche of the market (local currency bonds), and into hard currency corporates. In doing so, we reduce exposure to volatile currencies – something deemed prudent in view of increasing idiosyncratic risks (Russian sanctions, Brazilian politics, etc.). We are allocating the proceeds to EM hard currency (HC) corporates because the average duration is almost two years shorter for an ever-so-slightly lower yield-to-maturity of 5.59% (vs 5.87% for HC sovereigns). Further still, on average, HC corporates come with a better rating than HC sovereigns (BBB- versus BB+).

Overall, in light of increased volatility and some unsavoury headlines, it is easy to forget that we are still in an extremely benign macroeconomic environment which is expected to give rise to the strongest year of EPS growth since 2010. Earnings are one of the most powerful drivers of stock market performance over time.

Seeing is believing, and if Q1 earnings cross the high hurdle set by analyst estimates, we may expect a visible sigh of relief in stock prices.

Strategic Asset Allocation (SAA) & Tactical Asset Allocation (TAA) by risk profile and asset class

	Defensive			Low			Medium			High		
	Bonds: 100%			Equities: 15% - 45% Bonds: 55% - 85%			Equities: 25% - 75% Bonds: 25% - 75%			Equities: 40% - 100% Bonds: 0% - 60%		
Asset Classes	SAA	March TAA	Apr. TAA	SAA	March TAA	Apr. TAA	SAA	March TAA	Apr. TAA	SAA	March TAA	Apr. TAA
Equities				30%	36%	→ 36%	50%	65%	→ 65%	70%	90%	→ 90%
Bonds	100%	100%	→ 100%	70%	64%	→ 64%	50%	35%	→ 35%	30%	10%	→ 10%
Equity Allocation												
USA				9%	12%	→ 12%	15%	22%	→ 22%	21%	30%	→ 30%
Europe				15%	18%	→ 18%	25%	30%	→ 30%	35%	41%	→ 41%
Japan				3%	3%	→ 3%	5%	5%	→ 5%	7%	7%	→ 7%
Emerging Markets				3%	3%	→ 3%	5%	8%	→ 8%	7%	12%	→ 12%
Bond Allocation												
Government Bonds - Developed	50%	12.5%	→ 12.5%	35%	8%	→ 8%	25%	5%	→ 5%	15%	0%	→ 0%
Emerging Market Debt	10%	17%	→ 17%	7%	11%	→ 11%	5%	10%	→ 10%	3%	5%	→ 5%
Corporate - Investment Grade	20%	50%	→ 50%	14%	32%	→ 32%	10%	15%	→ 15%	6%	3%	→ 3%
Corporate - High Yield	20%	12.5%	→ 12.5%	14%	8%	→ 8%	10%	5%	→ 5%	6%	2%	→ 2%
Total return	0%	8%	→ 8%	0%	5%	→ 5%	0%	0%	→ 0%	0%	0%	→ 0%
Currency												
EUR	100%	95%	→ 95%	85%	88%	→ 88%	75%	80%	→ 80%	65%	72%	→ 72%
Non-EUR	0%	5%	→ 5%	15%	12%	→ 12%	25%	20%	→ 20%	35%	28%	→ 28%
Commodities												
Oil				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%
Gold				0%	0%	→ 0%	0%	0%	→ 0%	0%	0%	→ 0%

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