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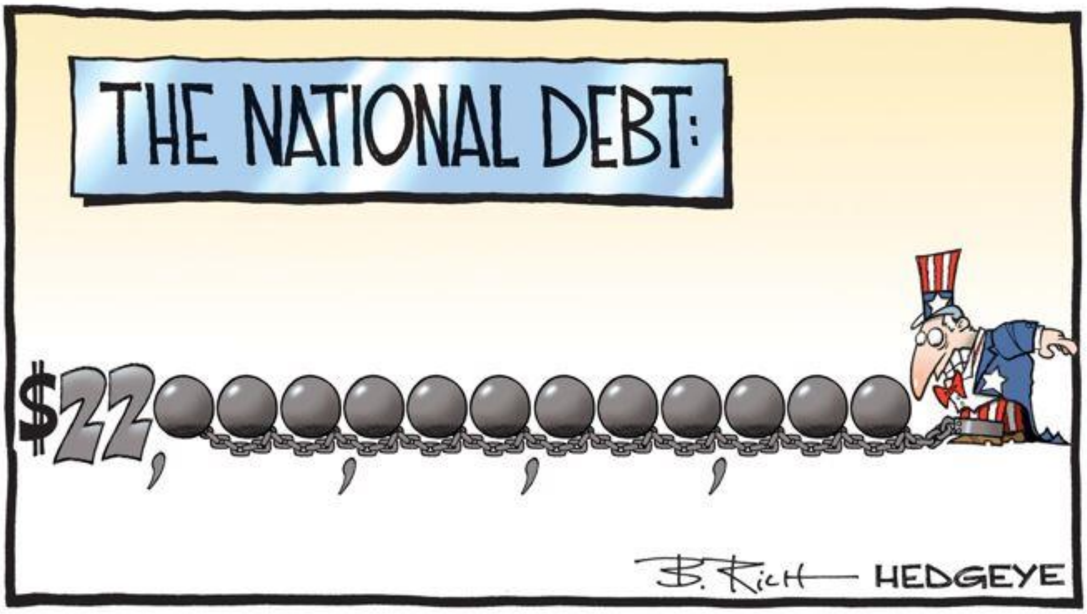


Hedgeye - The $22 trillion US National Debt shackle, 13 April 2019

Spring time from here?

It is quite incredible how much investor sentiment has changed over the past 4 months. At Christmas, equity markets had suffered a decline from their September highs, which had many market commentators suggesting that the end of this prolonged economic cycle and investor bull market must now surely be imminent. Fast forward four months and stock markets are up 10-15%, have thus recovered most of their Q4 2018 falls and already there is talk about the potential of an equity 'melt-up' as Goldilocks conditions appear to have returned.

After such a roller-coaster ride in market sentiment, it is worth taking a step back and asking what are realistic expectations for the coming months. Just as we strongly suggested that equity markets had assumed too pessimistic a view back in December, we now guide investors not to get carried away and extrapolate forward the strong year to date return picture. Many of our research providers and market commentators more widely note that the primary cause of last year's stock market sell-off – another episode of the 'bond market riot' – has fully reversed after central banks signalled that they would not allow bond yields get out of hand. As a result, the bond markets for the time being no longer pose an imminent threat to the stock market or the economy.

However, the global economic slowdown which was part and parcel of the 2018 equity market derailment is still in full swing and has led to a considerable slowdown in corporate earnings growth. The first batch of Q1/2019 earnings updates have confirmed this expectation, even if they have come in less bad than the average forecast of analysts had predicted. Such 'positive earnings surprises' are very much the norm almost every quarter and therefore it would be premature to suggest that the usual 4-5% improvement in actual earnings provides additional upside. It merely means that earnings may not quite have shrunk compared to a year ago but are just about in positive territory.

More important than the backward-looking earnings announcements are management's outlook statements and the wider economic news-flow. Management outlook statements were neither overly negative nor positive, but at least no longer speak of fears of significant activity slowdown. On the economic data side, the week provided a number of forward looking reports, which suggest that stock markets may not be wrong in looking forward more positively. This stems particularly from the latest Chinese figures, which suggest that the economy has begun to re-accelerate following a considerable 12 month period of slowing growth.

Europe's figures are lagging the Chinese and indicate that here the trough may only be reached in this quarter. Nevertheless, given European economies' dependence on a global trade volume revival, the good news from China initially gave European markets a boost.

With bond markets having stabilised, yields are likely to remain range-bound and well below last year's peaks, which provides supportive financial conditions for the economy, but neither threat nor boost for equity market valuations. With economic conditions having stabilised as well and now displaying a mild upward trajectory, one could indeed describe this environment as somewhat of a Goldilocks environment, following last year's far more stressful economic and market conditions.

Following the substantial market recovery, however, such an environment does not readily support the notion of continued strong stock market growth. Without accompanying corporate earnings growth, a further rally would simply lead to overvalued market conditions, which investors these days are particularly weary about – as the Q1 2018 sell-off proved.

It is therefore more reasonable to expect that, from hereon, 2019 stock markets should only grind higher in lockstep with improving corporate earnings expectation and this is likely to be gradual but slow. As always, there are upside and downside risks to reasonable expectation scenarios. As we discuss in a separate article this week, China's activity rebound is real but perhaps not quite as forceful as some might expect.

And then there is always politics. Our cartoon at the top refers to Trump's 2017 decision to considerably expand the burden of public debt in order to finance a fiscal stimulus tax break package, in the hope that the ensuing economic boost would lead to tax receipt increases that would eventually balance the books. His embarking on a trade war with China rendered such expectations null and void.

Having outmanoeuvred himself on the fiscal side, the only way he can now turn things around for the economy before he seeks re-election next year is by making trade peace with China very soon and then not embarking on another lengthy trade war with Japan and Europe. Similarly, hopes for a European economic rebound could be quickly quashed by a new breakdown in Brexit negotiations.

However, unless either of these political challenges ends in absolute disaster (which, given recent experience, seems less likely than it may have appeared at the end of 2018), then economic and corporate earnings growth should not be affected enough to send stock markets tumbling. The same cannot be said about the impact of another bond market riot, which, over the past six years, have always proven to be detrimental to stock markets. Since they have every time been caused by strengthening economic growth encouraging central banks into monetary tightening, we will be more concerned about and watching for any signs of too strong a rebound of economic activity over the coming quarters than mild growth disappointments.

China grows but risks remain

China's equity bull run continues. On Tuesday, the CSI 300, representing the largest companies on the Shanghai and Shenzhen stock exchanges, shot up 2.8%, while the Shanghai Composite index added 2.4%. Chinese equities mostly traded sideways for the rest of the week, but Tuesday's big jump only added to what has been an extraordinary year so far for the country's stock market. At the time of writing, the CSI 300 is up over 37% since the start of 2019. Increased optimism around China's economy and the future of Sino-American trade relations have made Chinese stocks the best-performing in the world this year.

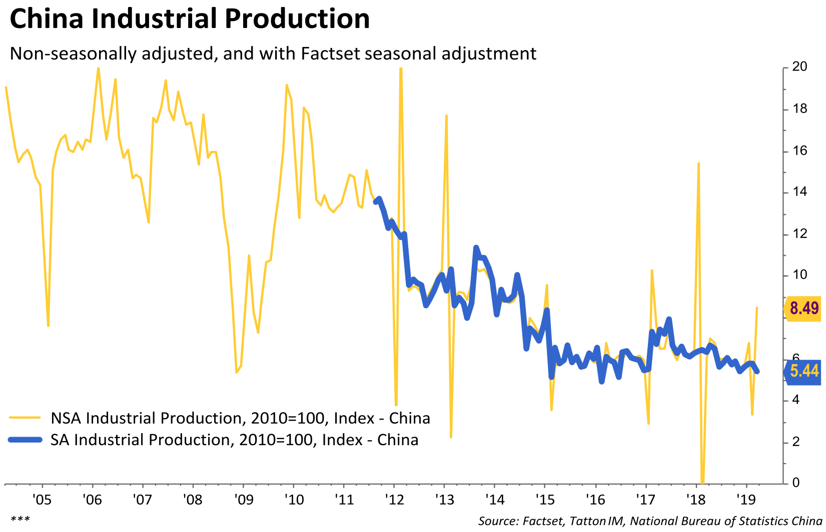
Further good news came on Wednesday, when the economic data repaid investors' positivity. According to official statistics, China's economy grew 6.4% year-on-year in real (inflation-adjusted) terms in the first quarter of the year. That is above the expected 6.3% figure, and the same as the growth rate in Q4 2018. While 6.4% is not massive by China's lofty standards, it shows stabilisation in the economy. That lends support to the notion that the government's stimulus program and an improving trade outlook are helping the economy out of its slowdown.

So it's interesting that the data release was met with a muted reception by markets. This is probably because, after the impressive rally this year, the good news was already priced into Chinese stocks. What is more, despite the higher than expected growth, the outlook for company earnings remains shaky. Last year, a liquidity driven economic slowdown and the looming threat of a tariff war with the US crushed sentiment and handed Chinese markets a beating. But investors have bet big this year that Beijing's measures can turn things around.

There is a danger that this optimism is overdone. As we have pointed out here before, the current round of Chinese stimulus is unlikely to look and feel like previous rounds. Beijing simply cannot afford to loosen credit conditions and pump huge amounts of liquidity into the economy as they did back in 2015/16. Dealing with the credit bubble that inflated as a result is exactly what began these problems in the first place.

But that is fairly well known among investors. What is more pertinent at the moment is that we have not yet seen the economic strength to back up a rally this strong. Even according to official figures (which many suspect are significantly overstated) domestic demand weakened in Q1. That is a worrying sign for the government, who have made boosting consumer demand a key goal in their fiscal stimulus drive. This domestic weakness was covered up by a larger gain in export growth, with the resulting net exports making their first positive contribution to GDP growth since 2017.

Much has been made of the better than expected industrial production data. But there are a few things to note about this. For starters, the long Chinese holiday in February means that any large gain seen in

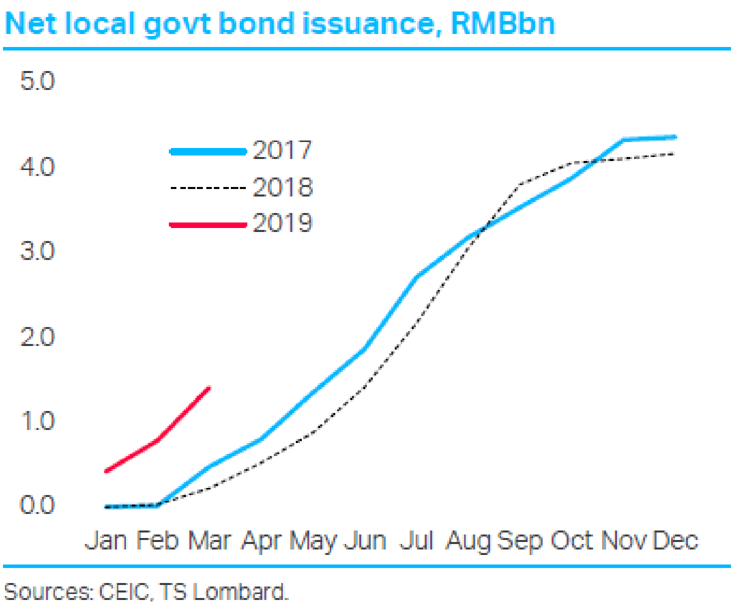


March needs to be put into perspective. The bump up in growth disappeared after taking seasonality into account.

There has been a rise in government spending. This year, for the first ever time, Beijing allowed local governments to issue bonds in January and February. The result was a Q1 net bond issuance six times higher than the previous year. However, while significant now, it still could amount to the usual annual front-loading.

China usually follows a pattern in its fiscal policy: spending huge amounts in the first half of the year and then tailing off towards the end. With extra front-loading having come in January and February, the drop off in spending in the second half of the year could be even more pronounced. If so, investors who bet on government spending boosting the economy all throughout 2019 will likely be disappointed.

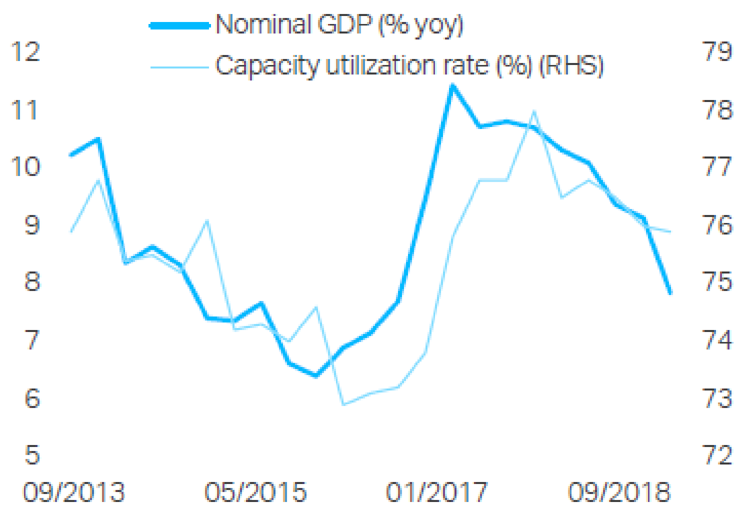
Even if they aren't, there are question marks around how beneficial increased industrial production will



be for the economy. There isn't much good in the government instructing producers to make more if it is just going to sit in a warehouse inventory. Unless demand rises to meet this increased production, it will just end up being a dampener on inflation. We might see that necessary demand rise in the next few months, but so far, the signs have not looked overly promising.

That brings us to perhaps the most important point. If bulging inventories drive inflation lower, nominal growth is in danger of remaining soggy as well (while still delivering the target real growth). According to our research providers TS Lombard, Chinese nominal growth ran at 7.8% in Q1. This puts serious pressure on companies, who usually require high levels of nominal growth to meet the interest payments on their debt. If nominal growth falls any lower, we will likely start to see more defaults from Chinese companies – regardless of what the real growth figures say. The government are very aware of this problem. So, if lower nominal growth persists, we should expect to see even more stimulus measures

Nominal GDP decline raises profit risks



Source: CEIC.

from Beijing.

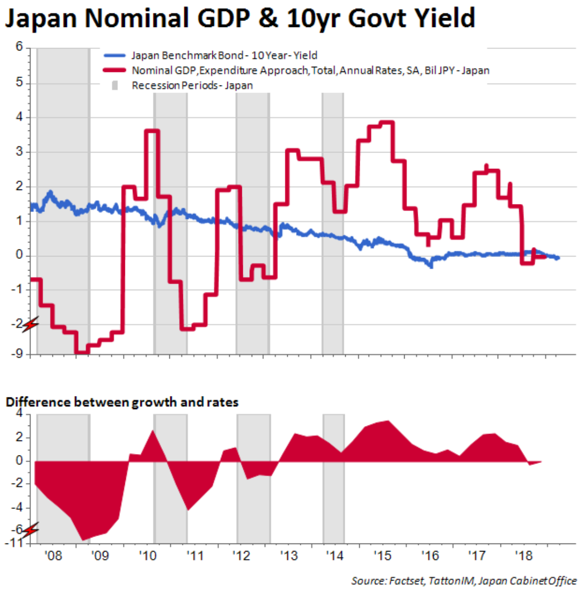
The good news is that we do not currently expect that to happen. While the current data is not showing a significant rebound in the Chinese economy, it does look as though things have improved somewhat. And while Beijing is not the be all and end all for the Chinese economy, their commitment to pulling China out of the slowdown is without doubt. The key question for us now is not whether government measures will be effective, it is whether they will be as effective as markets seem to expect. On that front, things are far less clear. China is improving, but risks remain.

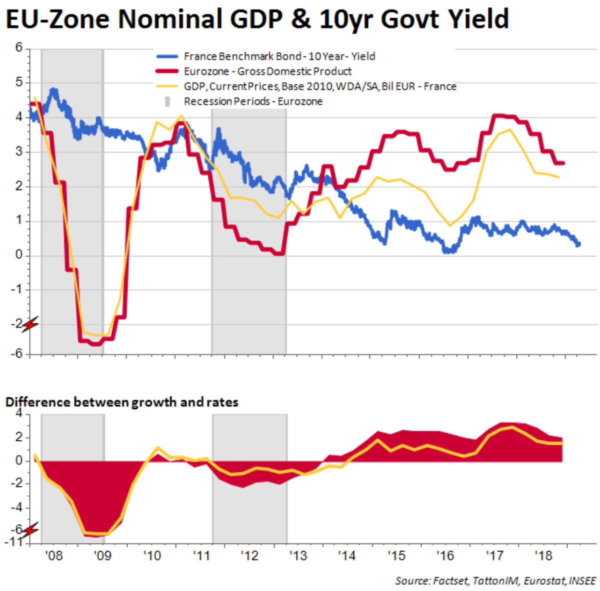
Japan losing some of its shine

By some measures, the Japanese economy has been producing more than its relatively scarce resources can sustain in the long-term, a situation referred to by economists as a "positive output gap". We wrote about this a couple of weeks ago – explaining how that tightness could be a catalyst for consumers and businesses to spend and invest. To do that, both sectors of the economy need to expect jobs to remain plentiful and well-paid for a long time. Otherwise, instead of spending, they'll save. We believe that the spending will occur, and Japan's growth will shift to a structurally stronger level. However, we acknowledge an increase in the risk that both consumers and businesses may end up saving the near-term gains, and that the domestic economy remains stuck in the doldrums.

An indicator of spending/investment stability is the difference between an economy's growth and the rate of interest paid for taking no risk. In the long-term, if an economy grows more strongly than the risk-free pay-out, the benefits should go to takers of risk. If the economy pays risk-takers less than those taking no risk, nobody will take any risk and the economy will tend to spiral towards very low levels of dynamism.

The charts below show Japan and the Eurozone since the Financial Crisis. Japan looked to be moving away from that spiral, having spent much of the previous 20 years in the deflationary trap. The Eurozone was slower to move away. However, the recent slowdown has shown that Japan seems unable to hold growth above government bond yields. Despite recent concerns, the eurozone's growth rate is higher and more stably positive.





Like most equities, Japanese stocks have fared okay this week. On Wednesday, the Nikkei and the Topix, Japan's main stock indices, edged up 0.25% and 0.26%. That is hardly a big gain, but when you factor in the disappointing news-flow, it is interesting that equities managed to hold their ground.

On the data front, we saw some disappointing releases and revisions. Trade data from March showed 2.4% year-on-year (yoy) growth in Japanese exports, below the 2.6% figure expected by economists. Imports were even more disappointing, growing just 1.1% yoy against expectations of 2.8% and well below the revised 6.6% figure for February. Industrial production for February was also revised down to 0.7% from an initial 1% reading. When you combine this with the disappointing business sentiment surveys released a few weeks ago, overall Japan is looking lethargic.

As well as the dreary data, this week it was revealed that the Bank of Japan (BoJ) will become the largest owner of Tokyo-listed shares by next year. According to Nikkei calculations, at current pace the BoJ's quantitative and qualitative easing (QQE) program – which unlike any other central bank includes the large-scale purchase of equities – will see them overtake a large government pension fund to become the country's largest holder of exchange-traded funds. As of March, the BoJ already owns 4.7% of the top section of the Tokyo Stock Exchange.

This raises serious concerns for the central bank. It may be distorting the makeup of Japan's equity market ("eroding market discipline" according to an OECD report). It may also mean that the BoJ's outsized presence will leave them without much left in the tank to boost a stalling economy.

Despite this, equities managed to nudge higher. This was likely more to do with China than it was Japan itself. The Chinese economy grew 6.4% yoy in Q1 2019, beating expectations. This, coupled with improvements in industrial production, fixed-asset investment and retail sales, has lent support to the recent investor optimism around China, showing that the government's fiscal stimuli are working. That is good news for Japanese exporters, who were hurt by China's economic slowdown in 2019 after coming to rely on their fast-growing neighbours.

Regular readers will know that we have been relatively positive on Japan for a while. Last year, the global slowdown emanating from China took its toll on Japan, due to their heavy Chinese exposure. By the same token, this put the country in a good position to take advantage of the expected economic recovery this year, as Chinese fiscal stimulus and a rebound in global risk sentiment made Japanese stocks – which have some of the lowest valuations around – look attractive.

However, recent developments have caused us to reconsider this position. Economic activity in Japan this year has been slower than we expected, even after the meagre 0.7% growth managed last year. This slow nominal growth puts pressure on the central bank, as it forces them to resort to ever looser or more unconventional monetary policy in order kickstart the economy.

But the problem is that – as their outsized ETF ownership shows – the BoJ has already exhausted most of the policy options at their disposal. We wrote last week about a similar problem facing the ECB: With both short and long-term interest rates so low, bank profits take a huge hit, as banks cannot realistically offer customers interest rates below the zero bound (otherwise they would just decide to hold cash).

In the European case, this zero-bound problem is compounded by a political one: The decision-making structure within the Eurozone makes it harder for the ECB to take effective measures. The BoJ does not have this problem; there is no political union to navigate. But in Japan, the economic fundamentals are arguably worse. With GDP growth so low, there is not much of a gap between long term interest rates and growth. And with such high levels of debt (particularly government debt) this means the incentive to spend and invest is much lower. The economy just isn't offering a high enough return.

What makes the situation worse is that it is clear the low growth problem is a long term structural one, due in large part to Japan's ageing demographic (the native population declined by 430,000 last year alone). That is why the BoJ have had to resort to a more radical QQE than anyone else – buying not just government or corporate bonds but equities too. The bank's unprecedented policy measures have undoubtedly helped to support the economy and financial system, but the fact that low growth and weak demand persists shows that more needs to be done. The problem is it's not clear what more can be done.

However, while we are no longer as positive on Japan, that is not to say we have become outright negative. Japan's long-term structural problems are well known, so their equities are priced accordingly. That is why Japanese stocks have some of the best valuations around, with QQE causing a wide spread between equity returns and bond yields. That means there is still value to be found. In particular, if global (and Chinese) growth does rebound strongly, Japanese equities are well-placed.

But the risk is what happens if it does not. If global growth fails to bounce back significantly, Japan – with its already meagre growth and weak internal demand – could lose out. And the recent weaker-than-expected data out of Japan has made that risk more likely. We are not pessimistic about Japan's prospects this year, but our optimism has faded.

Untangling the confusing Q1 corporate earnings update picture

It's quarterly earnings season again, with most announcements due over the next few weeks. Q1 earnings are likely to be more mixed than in previous quarters and macro momentum appears consistent with negative rates of EPS growth on a year-on-year (YoY) basis in both Europe and the US.

But that does not tell the whole story. While expectations have seen sharp declines in the last few months, they could now be too low, giving way to the potential for positive surprises, further underpinning market momentum.

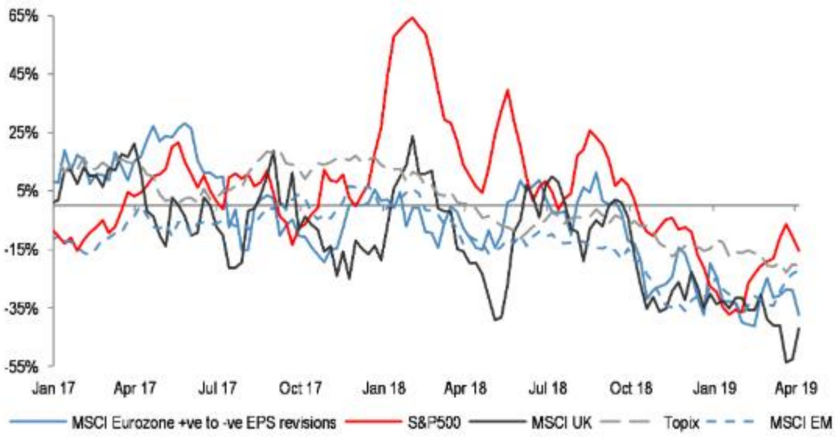
The main question for investors is: how will Q1 earnings be received?

Will investors 'look through' a more mixed backward-looking picture on the belief that the second-half of 2019 and beyond will get better. Or, will they worry that the powerful Q1 rally in risk-asset prices is now running on empty?

We believe there are several reasons to be more optimistic. First, let's acknowledge that the bar for this quarter has been raised, given higher equity prices already incorporate some measure of an earnings recovery in future. Even stocks that warned on profits in Q4 saw share price gains, given that, at the start of 2019, the market looked oversold in terms of both prices and sentiment levels.

Additionally, we have seen a large risk reversal, with those betting on further declines (short interest) having reduced their positions. We have also experienced a recovery in sentiment and a re-rating on equity valuations (P/E multiples); again, some optimism on future earnings has already materialised.

Figure 2: EPS revisions for key regions



Source: IBES

With those negatives out of the way, let's look at the positives.

The cuts to earnings expectations over the past few months have been large (around +10% negative swing) but further EPS cuts have sharply slowed in recent weeks, leaving open the possibility that companies might beat lowered estimates. JP Morgan estimate that US EPS growth rates for Q1 have fallen from +9% in October last year to -2.5% today and from +10% down to +3% for all of 2019.

	Q1 '19e EPS growth, %y/y			
	US	**Europe**	**Eurozone**	**Japan**
Energy	-21.8%	12.0%	16.6%	-8.7%
Materials	-15.7%	-35.3%	-36.7%	7.3%
Industrials	1.6%	8.4%	-0.3%	19.8%
Discretionary	-3.4%	-5.9%	-4.6%	7.0%
Staples	-2.4%	17.8%	22.2%	-7.7%
Financials	1.8%	-7.7%	-6.9%	-8.6%
Health Care	4.2%	7.5%	5.3%	-6.8%
IT	-6.1%	6.1%	-2.1%	0.3%
Com. Services	-5.7%	-1.7%	7.6%	-15.6%
Utilities	-0.5%	-6.2%	-1.8%	46.5%
Real Estate	2.6%	23.8%	14.0%	0.4%
Market	**-2.5%**	**-1.8%**	**-4.0%**	**3.4%**
Cyclicals	**-4.4%**	**-9.5%**	**-15.0%**	**9.2%**
Defensives	**0.9%**	**4.6%**	**5.6%**	**-4.8%**

Source: IBES, J.P. Morgan, *Japanese numbers refer to Q4 '19

As the above table shows, it's a similar picture for companies in Europe (expected Q1 EPS growth -1.8%), the UK, Emerging Markets and Japan – with negative revisions recorded across all regions (particularly the UK with its Brexit uncertainties). This is not so different from the experience of the last few quarters: a cut in expectations followed by an upside beat in actual earnings. What is different this time is that analysts are expecting earnings to show negative growth.

At a sector level, the earnings of cyclical firms in Europe (those with higher leverage to economic growth: consumer discretionary, raw materials, autos) have come under more pressure and forecast to contract -9.5% in line with a softer macro backdrop. Interestingly, Defensive sectors (those with lower leverage to growth: healthcare, utilities, defence, consumer staples) in Europe show around 5% EPS growth, leading to a spread between cyclicals and defensives of 14%. In the US, this spread is just 5%.

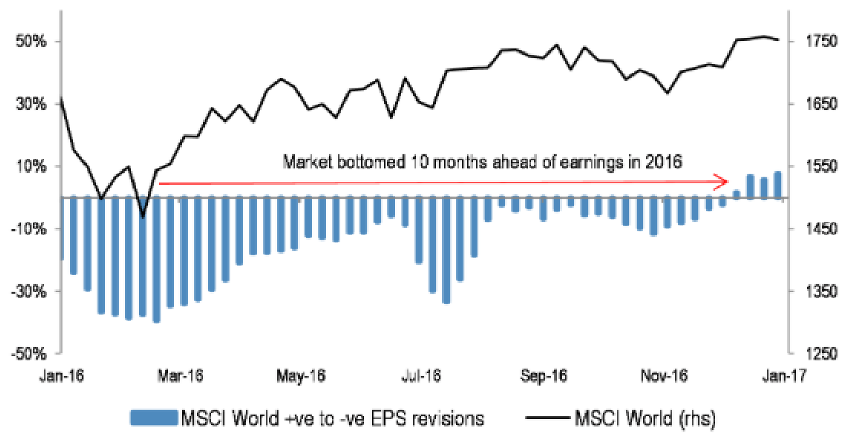
The European cyclicals/defensives spread looks overdone, given that this is a lower level than even the worst point in 2016, when the economic backdrop was more negative than today. We note that EPS forecasts for US energy stocks are -21% YoY lower. Some of the downgrades reflect the fading out of last year's corporate tax cut, but oil prices are down just -5%, suggesting the negative revisions could be overdone

The number of negative versus positive earnings pre-announcements are now at three-year highs. It is possible this ratio could deteriorate further, but there's only so much bad news that could materialise, given the current slowing (but still generally positive) macro backdrop. Indeed, the current level of this ratio can be a contrarian signal, as JP Morgan highlight. Historically, from the current negative/positive pre-announcement ratio level, returns on the S&P 500 Index on average are higher over the next 12 months. This goes against the typical bearish argument that you cannot buy stocks before earnings stop deteriorating.

History has shown that one does not need to see a return to positive EPS revisions in order to buy into equities. According to JP Morgan, markets typically rise 30% before earnings start to stabilise and we are currently 20% off the December lows. One example is the '15-'16 mid cycle correction, where stocks had had already reached their lows in Feb '16, even though EPS revisions kept falling every single week until the December of that year.

The lag between the market rising and a recovery in earnings revisions in '98, '03, '09 and '16 was between 5 and 10 months. During each time period, cyclical stocks rose more than defensives before EPS revisions turned positive.

Equities don't wait for +ve EPS revisions in order to rebound… in 2016 stocks started to rally as much as 10 months ahead of stabilisation in revisions…



It's worth highlighting the fact that EPS revisions remained in negative territory during much of the last 10-year bull market. Since January 2009, weekly EPS revisions were negative almost 65% of the time, while equities rose on 60% of those weeks. Again, this supports the view that you don't need a backdrop of positive EPS revisions for equities to move higher.

While it's still early days (just 9% of firms on the S&P 500 have reported, 6% in Europe and 10% in Japan) some positive trends are observable and are just above the lowered forecasts. On current numbers, S&P EPS is up +0.4% and Japan is up +2.9%. Sales are running at +3.6% for S&P and +2.2% in Japan.

Looking forward, it's possible that investors will begin turning their attentions to earnings in the second half of 2019, like the turnaround seen in 2016. There are several positive factors that suggest an earnings inflection point is getting closer: the significant liquidity injections in China at the start of this year, which should help domestic activity levels, and a further stabilisation of the economic data in Europe and the US managing to maintain momentum. As a result, current full-year earnings growth forecasts across the world could end up looking low.

Lastly, further support might come from robust sales growth and the fact that corporate profit margins remain healthy (themselves closer to turning more positive). It is possible that global equities will eventually push back towards all-time-highs and maybe even break new ground before investors need to start repositioning for the next recession – whenever it eventually arrives.

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CAMBRIDGE
INVESTMENTS LIMITED

23rd April 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7462.7	0.6	43.5	→
FTSE 250	19833.3	1.1	212.1	→
FTSE AS	4085.4	0.7	27.7	→
FTSE Small	5599.2	1.1	60.7	→
CAC	5577.0	1.7	92.9	→
DAX	12212.6	2.3	275.1	→
Dow	26517.6	1.4	374.6	→
S&P 500	2895.7	0.3	7.3	→
Nasdaq	7676.3	1.1	81.4	→
Nikkei	22090.1	1.7	378.7	→
MSCI World	2160.9	0.6	13.3	→
MSCI EM	1096.4	0.8	8.9	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.5	13.2	13.3
FTSE 250	3.2	25.1	13.7	14.1
FTSE AS	4.5	18.6	13.2	13.4
FTSE Small	3.8	83.7	10.9	14
CAC	3.1	18.7	14.5	13.4
DAX	3.0	15.4	13.5	12.6
Dow	2.2	16.9	16.3	14.9
S&P 500	1.9	19	17.5	15.9
Nasdaq	1.0	24.3	21.4	17.8
Nikkei	2.0	16.3	15.2	18.7
MSCI World	2.5	17.8	16.1	15.2
MSCI EM	2.6	13.4	12.9	12.1

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
TUI AG	9.2	Hikma Pharmaceutic	-7.1
Paddy Power Betfair	9.1	Bunzl	-6.4
Prudential	6.6	Centrica	-3.9
easyJet	6.6	AstraZeneca	-3.4
ITV	6.5	Smith & Nephew	-3.4

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-0.41	OIL	71.8	1.3
USD/EUR	1.12	-0.12	GOLD	1273.8	-1.5
JPY/USD	111.95	-0.26	SILVER	15.0	0.1
GBP/EUR	0.86	-0.26	COPPER	293.0	1.5
CNY/USD	6.71	0.15	ALUMIN	1850.0	-0.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.196	4.0	0.05
US 10-Yr	2.563	2.7	0.07
French 10-Yr	0.372	12.0	0.04
German 10-Yr	0.027	400.0	0.04
Japanese 10-Yr	-0.027	50.9	0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.68
3-yr Fixed Rate	2.00
5-yr Fixed Rate	2.04
Standard Variable	4.27
10-yr Fixed Rate	2.58

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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