FOR INVESTMENT PROFESSIONALS ONLY

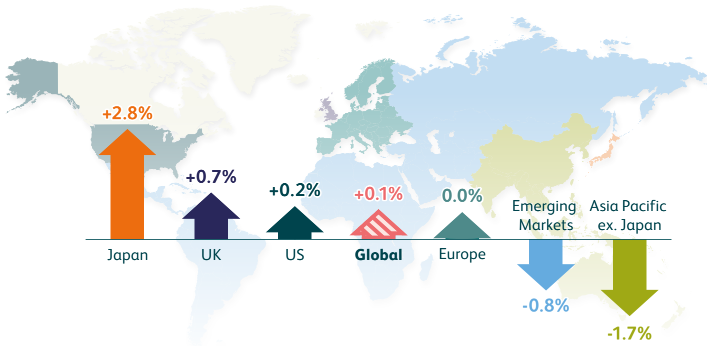
M&G INVESTMENTS

Equities market perspective

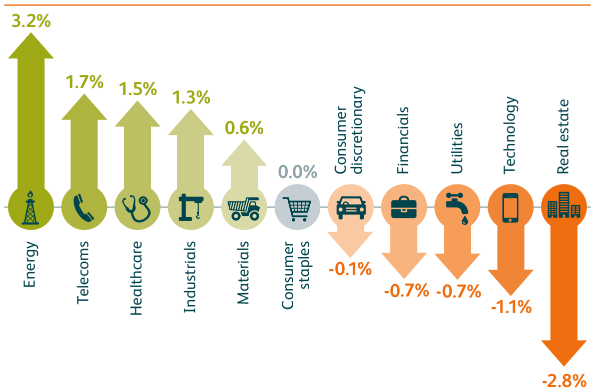
Ritu Vohora – Investment Director October 2018

Market summary

Regional performance – Sep 2018



Global sector performance – Sep 2018



Global equities: Global equity markets made small gains during September but posted strong performance overall in Q3. Japanese equities led during the month, boosted by a weak yen, whilst Asia Pacific ex Japan and emerging markets lagged. Energy dominated sector returns, supported by a strong oil price, alongside telecoms and healthcare. In a trend reversal, technology lagged. There has been a growing divergence between US and Chinese internet leaders, with Tencent and Alibaba lagging their US peers. Style performance was mixed in Q3, with value outperforming in Asia ex Japan and emerging markets, but lagging elsewhere.

UK: Brexit negotiations continued to weigh on the region, as the EU appeared to reject the UK's "Chequers" proposal for a deal. Despite this, UK stocks outperformed the broader European market, with energy stocks leading.

Europe: Geopolitics drove markets sharply lower. Italy unveiled a deficit-widening budget that put it on a collision course with the EU. European companies with relatively high exposure to emerging markets also detracted.

US: The S&P500 posted its best quarter since 2013 despite ongoing trade wars with China. The Fed raised US interest rates by 25bps, with another rate rise expected in December, amid robust economic growth and a strong job market.

EM/Asia ex Japan: Escalating trade tensions between China and the US, as well as dollar strength and expensive oil, weighed on the region.

Other: Oil posted the longest streak of quarterly gains in more than a decade, as market concerns grow about Iranian sanctions and an impending supply crunch.

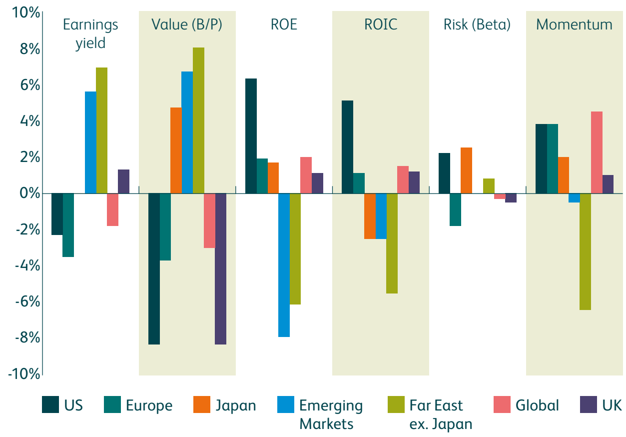
Market data

Total returns (%)	MSCI AC World		FTSE All-Share		S&P 500		MSCI Europe		MSCI Asia Pac x Jap		MSCI EM	
	Sep	YTD	Sep	YTD	Sep	YTD	Sep	YTD	Sep	YTD	Sep	YTD
GBP	0.1	8.2	0.7	0.9	0.2	14.7	0.0	1.8	-1.7	-1.8	-0.8	-3.9
EUR	0.7	7.8	1.1	0.5	0.7	14.3	0.5	1.4	-1.2	-2.1	-0.3	-4.3
USD	0.5	4.3	1.0	-2.8	0.6	10.6	0.4	-1.9	-1.4	-5.3	-0.5	-7.4

	MSCI AC World	FTSE All-Share	S&P 500	MSCI Europe	MSCI Asia Pac x Jap	MSCI EM
Valuation (P/B)	2.4x	1.8x	3.5x	1.9x	1.6x	1.6x
(P/E)	17.3x	12.6x	21.5x	14.9x	12.8x	12.3x
(P/E FY1)	15.9x	13.6x	18.3x	14.4x	12.9x	11.8x

Source: Datastream, MSCI indices, S&P indices for the US, as at 30 September 2018. Total returns in GBP.

Style update: what's in vogue? Q3 2018



Source: Macquarie, as at 30 September 2018. Long minus short portfolio – ex-financials (market cap weighted).

Currencies: percentage change over month and YTD (Majors vs GBP)

	Aus. Dollar	Yen	Swiss franc	Euro	US Dollar
Sep	-1.0%	-2.9%	-1.7%	-0.6%	-0.9%
YTD	-4.3%	3.0%	3.3%	0.2%	3.6%

Source: Datastream, 30 September 2018.

Theme of the month: Mind the gap – US vs ROW

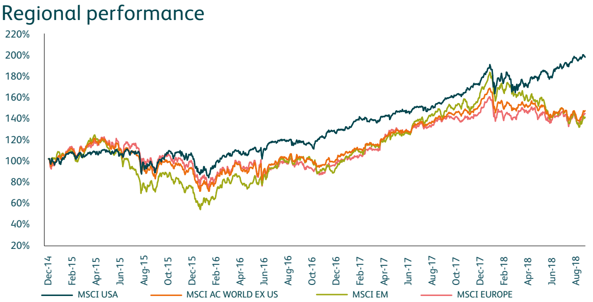
Key points

- Global growth remains robust in aggregate, but patterns are no longer synchronized
- The US economy and stock market has continued to diverge from the rest of the world (ROW)
- A re-convergence of earnings growth expectations between US and select non-US markets should narrow the current valuation gap

Global equity markets sit at an important juncture. They have diverged sharply this year, with the US roaring to new highs, while most non-US equity markets have faltered since hitting cyclical peaks earlier this year. **The outperformance of US versus the rest of the world has now hit historical extremes.** Indeed, a successful strategy over the past eight years has been to own **US stocks against other regions, and a preference for growth over value.** There is a strong correlation between these two strategies. But are we nearing an inflection point?

US and global ex-US performance divergence

Regional performance



Source: Factset, 26 September 2018

Global growth in aggregate remains robust, but patterns are no longer synchronized. While the fiscally boosted **US expansion goes on, growth in Europe and Japan has slowed, Chinese efforts for deleveraging have led to some moderation,** and the outlook for parts of emerging markets has deteriorated. The combination of trade tensions, higher oil prices and tighter dollar liquidity are weighing not only on China and other emerging markets, but also on export-reliant developed regions such as Europe.

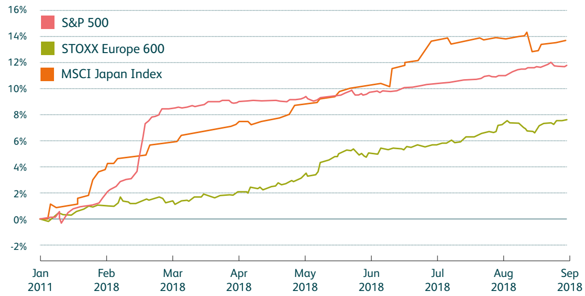
The **US is comparatively insulated** and still retains **several advantages, including superior domestic economic growth momentum, strong corporate earnings** – boosted by this year's tax cut – and dollar appreciation. Rising trade tensions coupled with slow-but-steady Fed rate hikes have seen **investors flock to the safety of the US,** boosting US dollar-denominated assets. The latest Bank of America Merrill Lynch fund manager survey shows the **largest overweight to US equities since 2015**. The US is now the top equity region. But with relative outperformance and valuations looking extended, is all the good news now priced in?

The rich US valuation premium by itself is unlikely to be a catalyst for a reversal of relative share price performance. However, combined with stretched relative performance, any shift in underlying earnings fundamentals could trigger a swing in performance.

The divergence in **stock market moves contrasts with the similar path of analysts' earnings estimates for companies across the US, Japan and Europe.** Analysts' consensus estimates for earnings over the next 12 months are rising at a high single-digit to low double-digit pace across all three regions.

Similar path for earnings

% change in consensus estimates for EPS over next 12m

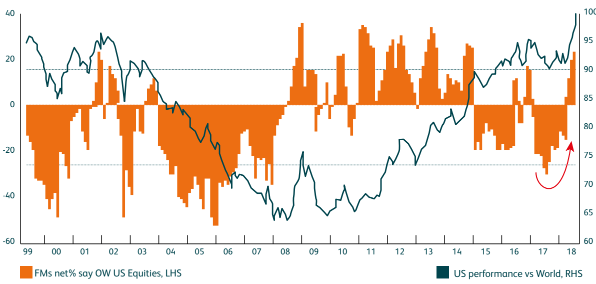


Source: Charles Schwab, Bloomberg, 9 September 2018

The divergence in performance and earnings estimates may be attributable to widening differences in the degree of confidence in those forecasts due to tax cuts and trade tensions, among other factors, affecting the relative growth outlooks. Although earlier this year economic data were better than expected in the US, they were worse than expected in Europe and Japan. **The economic surprise indices now reveal that data in the US, Europe, and Japan are coming in close to expectations.** If economic data begin to come in better than expected more broadly across all regions, it is possible that **performance divergence may unwind, as confidence in the earnings outlook improves outside of the US.**

Largest overweight to US equities since 2015

Asset allocation: US equities



Source: BofA Merrill Lynch Global Fund Manager Survey, September 2018

A shift in relative earnings momentum would coincide with the **one-time boost from US tax reform and fiscal stimulus starting to wane. A re-convergence of earnings growth** expectations between US and select non-US markets should **narrow the current valuation gap.** That would also argue for value to do better than growth, especially in the US, as momentum starts to roll over.

Near-term **risks have risen, but that can help the long-running bull market to continue,** as lack of investor enthusiasm means there is room for markets to grind higher. Risks exist on both sides – pullbacks are possible, but so are breakouts to the upside. As ever, selectivity will be important in the months ahead.