INSIGHTS September 2017

THE LONG VIEW: FED COULD THREATEN SANGUINE GLOBAL OUTLOOK

Jeff Schulze CFA
Director and Investment Strategist
ClearBridge Investments

Key Takeaways

- Most signals related to earnings, revenues and overall liquidity suggest U.S. equities still have room to run.
- A coordinated global expansion provides further support to a continuation of a bull market across U.S. and international markets.
- The Federal Reserve presents the greatest current risk to stocks and the economy as it embarks on balance sheet deleveraging and a likely transition of its policymaking board.

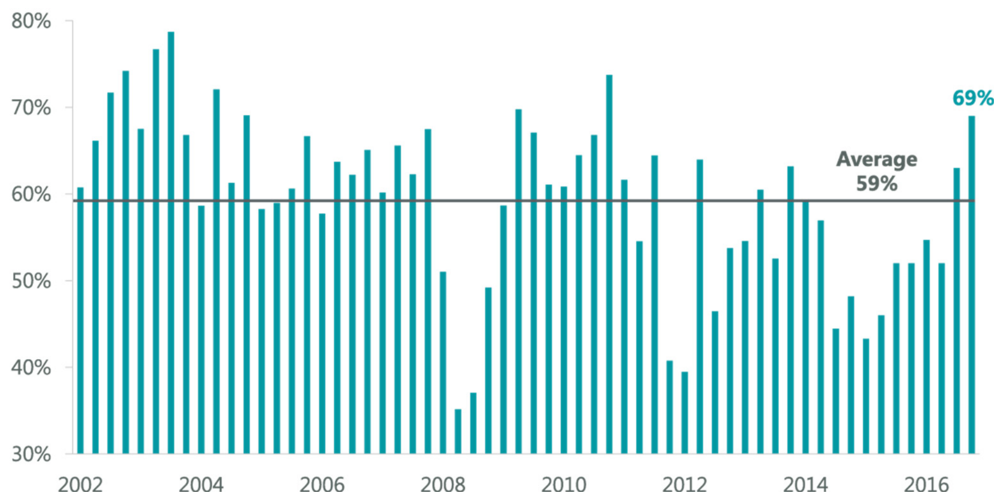
The unrelenting move up in the markets has taken quite a number of investors by surprise since the election. Many who feared the worst when Trump was elected increased their cash positions in preparation for trade wars as well as political dysfunction. The market therefore did what it seems to do best: it zigged when many expected a zag. And it zigged higher without really looking back. The market smartly was looking through the reflationary windshield instead of the deflationary rearview. Now, 11 months later, we find ourselves in a unique situation. The global economy hasn't fired on all cylinders like this since 2010. U.S. equity markets are at levels where frequent market tops have occurred, yet recessionary risks are minimal. Our U.S. recession dashboard reflects a very low chance of an economic downturn in the next 12 months, with only one variable - corporate profits - sending a warning sign.

U.S. earnings have been strong and revenue growth has been steady. In fact, the percentage of companies that beat their earnings estimates hit 73% in the second quarter, well above the 23-year average of 64%. The percentage of companies that beat their sales estimates was even more impressive at 69%, dwarfing the five-year average of 54% and long-term average of 59% (Exhibit 1). You would have to go all the way back to mid-2011 to see a higher revenue beat percentage. This is a refreshing sign. If there's been a knock on this recovery, it's been the lackluster revenue growth. Year-over-year comparisons will get harder from here, but hurdles for the next two quarters can be overcome. The base effect of a weaker dollar should lower the bar for exceeding earnings for the upcoming quarter. In our opinion, 4.5% consensus earnings growth should be easy to achieve. And liquidity, a bullish catalyst we cited last quarter, is abundant. In fact, a 10-week moving average of the Chicago Fed National Financial Conditions Index has reached its easiest level since 2014 and its second most supportive point over the past 35 years.

FOR PUBLIC IN HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

Brandywine Global • Clarion Partners • **ClearBridge Investments** • EnTrustPermal • Martin Currie • QS Investors • RARE Infrastructure
Royce & Associates • Western Asset Management

Exhibit 1: More Companies are Beating Revenue Estimates



Revenues for S&P 500 Index companies through the second quarter of 2017. Source: Strategas Research Partners.

The global picture is the best we've seen in a decade. For the first time since before the global financial crisis, all 35 countries tracked by the Organization for Economic Cooperation and Development (OECD) are on track to grow. Global risks, broadly speaking, have dissipated throughout the course of 2017. Europe has distanced itself from a potential populist uprising as an extremely accommodative monetary policy continues to ease conditions in the currency bloc. Importantly, the Single Supervisory Mechanism (SSM), the ECB's banking oversight authority, has swiftly managed the bailouts of several European banks. This provides the framework for unwinding the large number of bad banks throughout the periphery. Two of the banks were in Italy and the equity and subordinated bondholders were bailed in. Unlike in Spain, the Italian authorities spared senior creditors, many of which were retail investors who were not aware of the inherent risks. This removes an important barrier in fixing the Italian banking system and lowers the perceptions of overall systematic risks on the continent. Let's not forget that Europe went into its second recession in 2011 while the U.S. continued to muddle through. The tread on the European economic tire is much less worn than ours, and should provide a nice investment opportunity for the next few years.

China continues to walk the tightrope of trying to meet their short-term growth targets while implementing the policies necessary for a more sustainable medium-term growth path. It's clear that the financial risks are material in the next few years, especially if its debt-fueled stimulus does not slow. But the evidence appears to point to a growth slowdown rather than the emergence of a crisis. China has not run out of structural growth drivers, though these are often overlooked. Further urbanization, rural land reform, supply-side reform, state-owned enterprise reform and financial system reform can all be mechanisms for growth of the Chinese economy over the next decade. Also, according to the IMF and OECD, large household savings rates are close to 40%, which can provide abundant funding for new debt. As long as this massive amount of capital can be redirected to where it is needed, the chances of a hard landing remain low.

Fed Policymaking Board to Change

The only major risk we see in the near term lies with the Federal Reserve. Stanley Fischer's unexpected retirement increases the number of vacancies on the Fed Board from three to four. Janet Yellen will likely depart the Fed after her term as chair expires in February of next year. No chair since Paul Volcker has stayed on after their term as chair expired. If that is indeed the case, Trump will have the ability to appoint five of the seven voting members on the Fed within the next 12 months. No president since the Fed's inception has had this much of an opportunity to reshape our central bank. If we get a more hawkish committee that is more inclined to normalize rates faster than the current policy path, equities would not respond very well. There are clues that give us comfort in this administration's preferred direction.

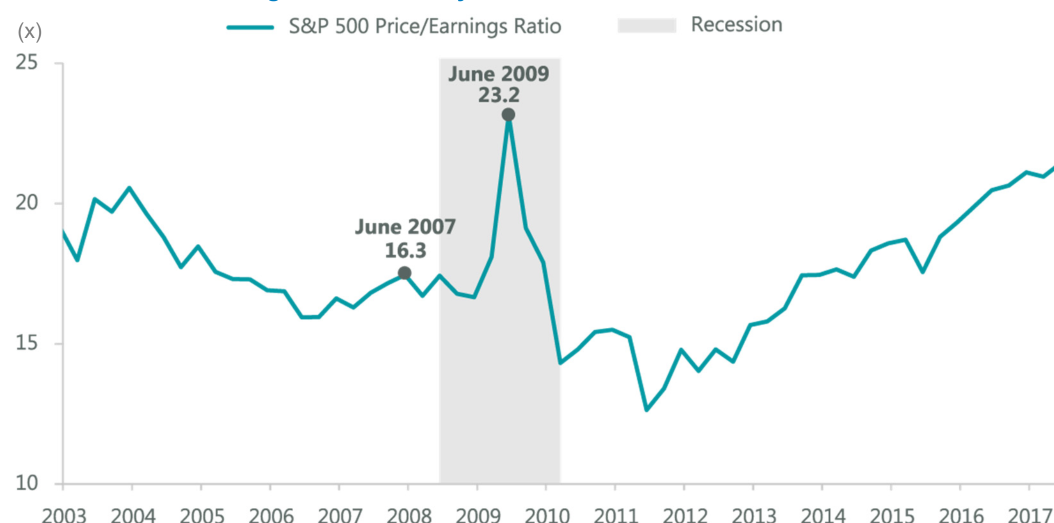
FOR PUBLIC IN HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

Trump has talked about renegotiating U.S. debt. He has openly expressed his desire for a weak dollar, which is unique, since presidents don't usually comment on the currency markets. But if you think about where Trump was successful in his campaign, the area that turned the tide in the election, it was where manufacturing was once strong — in the rust belt. A weak dollar would make U.S. goods more attractive internationally and would be a shot in the arm to our manufacturing base, helping to alleviate some of his constituency's stress and to "help make America great again."

This insight suggests that Trump will install a dovish Fed — likely one more dovish than the current board. A more politically motivated and less independent Fed would be more inclined to stimulate the markets on weakness and let the economy run hot. Remember, the Fed's fingerprints are on almost every recession since its inception. Most recessions are caused by over-tightening at the end of the cycle due to inflation concerns. A newly established Fed may purposely fall behind the curve in raising rates in the hopes of a weaker dollar and thus inflation. The chances of a policy error from inflation-phobia would be lessened, allowing this cycle to continue unabated by monetary tightness. Of course, if we do begin to see substantial inflation pressure, volatility in the fixed income and equity markets would awaken very quickly.

The Fed's change in policy toward quantitative tightening does introduce a level of uncertainty into financial markets in the near term. The Fed has done a fantastic job in preparing the markets for this day through forward guidance. However, there remains an execution question: the Fed has quite a bit of experience raising and lowering rates, but it does not have any experience reducing the size of its balance sheet. The Fed will go from buying US$1 trillion of securities to selling US$1 trillion. That excess supply will be absorbed by the market but it may be at the expense of higher yields.

Exhibit 2: Price/Earnings is Not the Only Indicator to Watch



Source: Bloomberg. Data as of 25 September 2017.

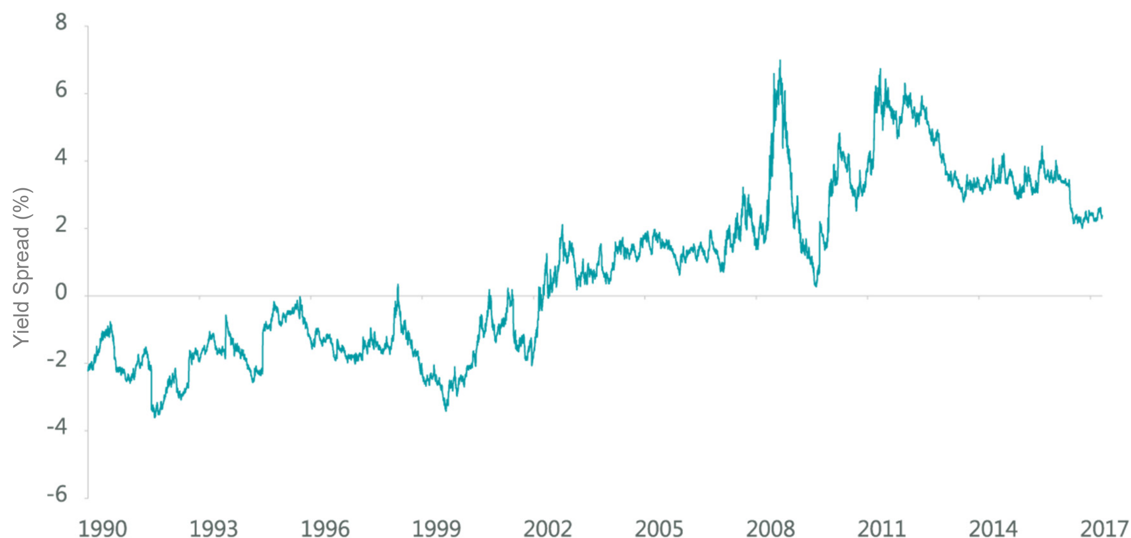
If the Fed is a risk going forward, valuation is a front and center concern today. An econometric model of earnings multiples based on current levels of inflation, rates and taxes would suggest that the S&P should trade around 20x earnings. But the market never stops at fair value; it always goes way below where it should during bear markets and way above where it should in bull markets. P/E can be a useful valuation tool, but it shouldn't be used as the Holy Grail for investing. Exhibit 2 is a great example of how Price/Earnings ratio (P/E) can be misleading. Of the past 15 years, we've highlighted June 2009 and June 2007. In hindsight, these two months were the best and the worst time to have bought the market during this timeframe, and P/E would have given you the opposite signal as an investor.

As a metric, earnings yield has had a better track record for calling major market tops. Exhibit 3 shows the spread between the earnings yield of the S&P 500 to the yield of the 10-year Treasury. In doing this, you are essentially comparing the yields for each asset class to see the relative value of each. The difference between the two has been very negative (10-year Treasury yields more) or slightly positive (S&P 500 yields more) at the end of the

FOR PUBLIC IN HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

three most recent major bull market tops (Exhibit 4). Today, the spread is very positive, signaling an undervaluation for equities. In order to see a major top, either rates need to rise substantially or equities need to get more expensive. It would not be a surprise to see both rise to narrow this spread and cause equities to move closer to or above fair value over the next couple years.

Exhibit 3: Spread Between S&P 500 Earnings Yield and 10-Year Treasury



Source: Bloomberg. Data as of 25 September 2017.

Exhibit 4: Valuation Levels at Top of Three Major Bull Markets

Quarter	E/P Yield	YTM 10-Year Treasury	Spread
Q4 1961	4.5%	4.1%	0.4%
Q2 1987	4.7%	8.4%	-3.6%
Q1 2000	3.6%	6.0%	-2.4%
Current	4.6%	2.2%	2.4%

Source: FactSet. Previous periods based on quarter end values. Current period as of 25 September 2017.

E/P Yield: Earnings yield; YTM: Yield-to-maturity.

Despite most signs currently flashing positive for equities, the market is likely set up for a correction in the not-too-distant future. The S&P 500 has not had a 5% drop in over 14 months and it's been 19 months since a 10% correction. Markets can have these pullbacks without an obvious catalyst. But we feel we are not close to a major market top. There is quite a bit of skepticism in the investment community nine years into this bull market. Our travels across the country continue to affirm that there is still quite a bit of disbelief in the market's resilience. Classic bull market tops see broad retail participation and unsolicited stock tips from taxi drivers. When everyday people are talking about stocks, there's no one left to buy and the market runs out of momentum. We are not there yet.

FOR PUBLIC IN HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

LEGG MASON
GLOBAL ASSET MANAGEMENT

Brandywine Global
Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
RARE Infrastructure
Royce & Associates
Western Asset Management

Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long term, actively managed investment strategies.

- Over US$752 billion* in assets invested worldwide in a broad mix of equities, fixed income, alternatives and cash strategies
- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

* As of 31 August 2017.

IMPORTANT INFORMATION

Source: Legg Mason and ClearBridge Investments. This document is based on an update from ClearBridge Investments, a subsidiary of Legg Mason. The views expressed are opinions of ClearBridge Investments as of 29 September 2017 and are subject to change based on market and other conditions without notice and may differ from other investment professionals or from those of the firm as a whole. This document is for information only and does not constitute a financial promotion or other financial, professional or investment advice in any way. All data, opinions, estimates and other information are provided as of the date of this document and may be subject to change without notice. Where past performance is quoted, such figures are not indicative of future performance. This document does not constitute an offer or solicitation to buy or sell any units or shares in any fund. **INVESTMENT INVOLVES RISKS**. The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Please refer to the most current offering documents for further details, including the risk factors.

If this document is distributed in Macau, this may not be used other than by the Distributors.

Any views expressed are opinions of the respective investment affiliates as of the date of this document and are subject to change without notice based on market and other conditions and may differ from the views of other investment affiliates or of Legg Mason as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. The mention of any individual securities should neither constitute nor be construed as a recommendation to purchase or sell securities, and the information provided regarding such individual securities is not a sufficient basis upon which to make an investment decision.

Neither Legg Mason nor any officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this document or its contents. The information in this document is confidential and proprietary and may not be used other than by the intended user. This document may not be reproduced, distributed or published without prior written permission from Legg Mason.

This document has not been reviewed by the Securities and Futures Commission in Hong Kong or Monetary Authority of Macao in Macau.

Issuer: Legg Mason Asset Management Hong Kong Limited.
HK1710016