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# Americas CIO View

## Upside now worth the risks

## More U.S.-China tension is priced in

**In a nutshell**

- More U.S.-China tension is priced in.
- Interest rate is unlikely to surge above 3.5%.
- We see a low risk of a near-term correction.
- We change our "Next 5%+ Move" of S&P from Down to Up.
- We initiate an OW Communication Services, move Utilities from OW to EW.

Since late summer, we warned of two main threats to risk assets this autumn: U.S.-China trade tension and rising interest rates. Up until last week, the U.S. equity market shrugged off the escalation of tariffs on China imports and harsh rhetoric making a deal less likely. The quick 6.7% selloff from Oct 3-11 acknowledges that this is not simply a trade conflict with regard to certain goods, but rather part of deeper issues and battles between the U.S. and China - intellectual property, next generation IT development, global economic influence, and maybe other economic and geopolitical fronts. Therefore we believe there is no easy and quick resolution and the trade conflict may get worse before it gets better.

## Interest rate is unlikely to surge above 3.5%

The 40 basis points (bps) surge of the 10-year Treasury yield since late August caught the bond market off guard and spilled over to the equity market. But in our view the 10-year yield will likely stay between 3-3.25% until 2019 end on gradual U.S. Federal Reserve (Fed) hikes and tamed inflation. We don't think it will rise significantly above 3.5% for the rest of this cycle. The same uncertainties remain – interest-rate volatility, global trade conflict, emerging-market instability, Italian fiscal policy, still unsettled Brexit - but we think this pullback offers a good entry point for better upside through 2019.

## Will this pullback turn into a correction?

Since 1957, 5%+ S&P 500 dips happen twice a year on average, and 10%+ corrections happen once every 1.5 years. Of all the 5%+ dips, 40% of them turned into 10%+ corrections. The average selloff of all 5%+ dips since 1957 is 12.0%. But for those dips that didn't turn into a full 10%+ correction, the average selloff is 7.1%. The current selloff is 6.9% (from Sep 20 peak to Oct 11 trough) and seven months since the Feb 8 trough of the last correction. Full corrections usually happen only with significant negative shocks or big shifts on S&P earnings-per-share (EPS) outlook or interest-rate moves. We think existing uncertainties in the market aren't significant enough to trigger such scenarios. More companies should guide with higher tariff impact on their 2019 earnings and we see some cuts to 2019 consensus S&P EPS during the 3Q earnings season, but the cut is likely limited to 2-3% and we think S&P can still deliver ~6% EPS growth instead of the 10% expected now. We see a low risk of a near-term correction.

## We change our “Next 5%+ Move” of S&P from Down to Up

We see the risk-reward on S&P 500 more attractive now and therefore change our “Next 5%+ move” of S&P 500 from Down to Up. Our 2018 and 2019 yearend targets remain 2850 and 3050, which are 5% and 12% upside from the 2700-2750 levels. We believe the recent yield-curve steepening is fleeting. Yield curve should remain quite flat on weaker global growth outlook and no signs of inflation rising significantly above 2%. We think the 10-year Treasury yield will not trade significantly above 3.5% through 2019 yearend, mostly within a 3-3.25% range. This indicates the real 10-year yield stays below 1.5%, which is still supportive of an 18x price-to-earnings (PE) multiple (4% equity risk premium assumed) for S&P 500. Applying an 18x PE to our $161 and $171 S&P EPS estimate for 2018 & 2019 is 2900 and 3080.

## We initiate an OW Communication Services, move Utilities from OW to EW

Fot the S&P 500, we assign an overweight (OW) to the newly reclassified Communication Services sector, together with Tech, Health Care, Financials and Real Estate. Within the Communication Services sector we OW Entertainment and Interactive Media & Services, and EW Diversified Telecom and Media. We move Utilities from OW to equal-weight (EW) after its recent 10%+ outperformance vs. the S&P and with the 10-year yield likely staying above 3%. Real Estate is our preferred bond substitute play on its much lower-than-history valuation premium vs. the S&P and its inflation-hedging features. We continue to under-weight (UW) Energy, Materials, Industrials, Consumer Discretionary and Consumer Staples.

## Glossary

### Basis point

One **basis point** equals 1/100 of a percentage point.

### Brexit

**Brexit** is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

### Earnings per share (EPS)

**Earnings per share (EPS)** is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

### Emerging markets (EM)

**Emerging markets (EM)** are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

### Fiscal policy

**Fiscal policy** describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

### Hedge

A **hedge** is an investment to reduce the risk of adverse price movements in an asset.

### Inflation

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

### Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

### Risk premium

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

### S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

### Treasuries

**Treasuries** are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes

(2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

**U.S. Federal Reserve Board (the Fed)**

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

**Volatility**

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

**Yield curve**

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

# Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

Foreign Exchange/Currency – Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.

High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

Hedge Funds – An investment in hedge funds is speculative and involves a high degree of risk, and is suitable only for "Qualified Purchasers" as defined by the US Investment Company Act of 1940 and "Accredited Investors" as defined in Regulation D of the 1933 Securities Act. No assurance can be given that a hedge fund's investment objective will be achieved, or that investors will receive a return of all or part of their investment.

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