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Keep calm and carry on

After a strong and possibly un-British reaction in our last newsletter, it’s now time to roll up our sleeves and sort out the mess!

When analysing the aftermath of BREXIT, nothing in fact has really happened except a sharp devaluation of GBP, but without the usual G7 telling off. The UK is still a part of the European Union, and Article 50 has not been triggered yet. Theresa May`s recent announcement, playing to the conservative party conference, that Article 50 will be triggered by the end of March next year, has caused another down leg in GBP.

Reading the graph there seems to be little technical support for the long term exchange rate development as many see the UK heading towards a hard BREXIT. With elections in France and Germany in the second half of next year, it seems unlikely that any special favours or deals are likely to be extended to the UK. Despite some economic data showing, that the UK economy has held up well, the harsh reality is that it is still way too early to tell what the economic impacts are likely to be.

British Pound versus US Dollar

Source: Bloomberg L.P.

However, the recent sharp drop in consumer confidence to the lowest level since September 2013 (excluding immediately post Brexit) gives an idea. Recent price increases by car manufacturers and some tech companies to allow for the depreciation of GBP mean, that the average man in the street is likely to find the cost of living increasing while wages stagnate. This is also likely to lead to an increase in inflation rate, which could put the Bank of England in rather an awkward position with regard to cutting interest rates.

You spin me right round baby (Dead or Alive)

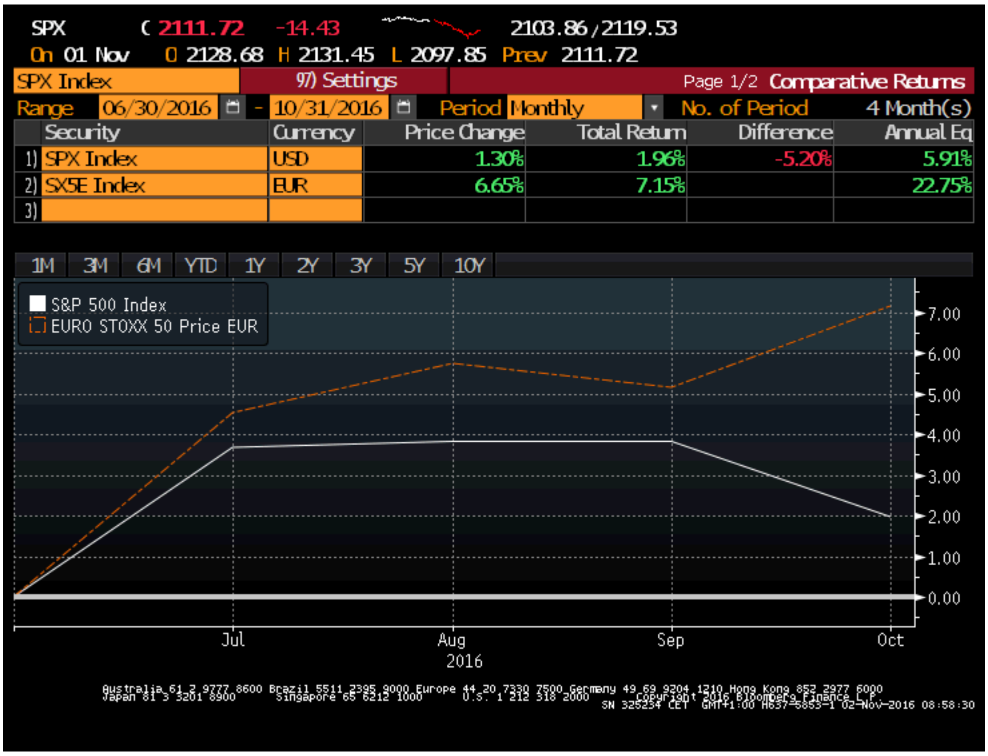
After a series of disheartening events for most of the year, many investors have been left dizzy and frustrated. Looking back to the beginning of the year, markets were in a permanent state of fear of an impending collapse in China. In 2014 and 2015 the Li Keqiang index - an alternative indicator for Chinese growth based on bank lending, rail freight and electricity consumption - was being quoted on a weekly basis, reflecting a hard landing of the Chinese economy. In 2016 the news flow seems to have mysteriously disappeared, perhaps because of the Li Keqiang index experiencing the strongest uptick in growth since 2009? Despite the Chinese economy growing at 6.7 percent this year, the things that have remained constant is the pessimism and the fear of an impending disaster.

Europe has been yet another region which has remained deeply unpopular as evidenced by a record 34 straight weeks of outflows from mutual funds, according to EPFR Global. While the virtues of European stocks seem to be obvious, the majority of market participants have not been yet prepared to subscribe to them.

On the back of Bloomberg data, the Eurozone stocks are trading at their lowest level since 2005 when compared to the US stocks. While estimates for S&P 500 earnings have been rising since 2009, profit forecasts for the Euro Stoxx 50 - although initially rising as well, culminated already in 2011. Thereafter, they have been moving in the opposite direction falling to an almost 7-year low earlier this year. Earnings in the Euro area companies are forecasted to grow at 13 percent in 2017 versus an expected increase of 14 percent for the S&P 500.

Despite this the Euro Stoxx 50 is trading at about 12.8 times estimated earnings versus a multiple of about 17 times for the S&P 500. On a price to book ratio basis the US companies are almost twice as expensive as their European counterparts.

Euro Stoxx 50 beginning to outperform S&P 500



Source: Bloomberg L.P.

From the end of the second quarter, when calculated in local currency, the European stocks have significantly outperformed their US counterparts – a trend which we expect to continue for a considerable period of time. Nevertheless, despite its recent outperformance, the Euro Stoxx 50 index is still down 6.5 percent year-to-date versus a gain of 4 percent for the S&P 500.

Everything to play for!

While there are many concerns out there – the hard Brexit, the US elections, the Italian referendum, the French elections, the German elections, let alone a bull market lasting seven and a half years - at no time can I remember a point when markets did not cause considerable worries of one sort or another.

We agree with the analysis delivered by The Leuthold Group concluding, that equities as an asset class still remain attractive versus bonds despite their recent rally. Whilst US stocks have beaten bonds by a bigger than normal margin since 2009, shares are still stuck near their historical lows relative to bonds over any interval longer than a few years.

The basic assumption is that riskier assets (stocks) should provide a reasonably higher return than safer investments (long-term government bonds). While stocks have beaten Treasuries by about 13 percent on an annualized basis since the bull market onset in 2009, the advantage disappears when viewed over a longer timeframe.

For a time horizon of 20 years for example, the S&P 500 has advanced at an annualized rate of 7.9 percent compared to 6.2 percent for 10-year Treasuries. This spread of 1.7 percent is smaller about 85 percent of the time than it has been since 1926. Such small spreads between equities and bonds have tended to indicate outsize gains for equities. The S&P 500 beat Treasuries by a median of 11.7 percent in the ensuing three years when the spread between bonds and equities has been this low.

So how is it going to happen?

Something fundamental is about to change

We are about to move from a bull market driven by monetary expansion to one that is propelled by earnings growth. And this could very well be one of the most exciting things for risky assets we have seen happening for quite a while. I believe this will ensure that the secular bull market we are in will last a lot longer than most people expect.

After five consecutive quarters of negative earnings growth for the S&P 500 it is quite likely, that for the first time since Q1 2015, corporate America will turn a profit. According to FactSet Research, earnings for the S&P500 will decline by 2.1 percent this quarter. However, this is usually a low-ball number. With just over half of the S&P 500 companies having already reported, the earnings beat rate stands at just over 6 percent. This is vitally important in helping to propel the market on the next leg upwards as valuations have risen (multiple expansion) despite the profit recession we have seen in US companies.

In Europe the case is even more extreme. After five years of falling, the earnings are likely to turn positive, and with valuations at depressed levels the European markets could very well react like a coiled spring.

We are well aware of nervousness ahead of the US elections and of the headline risks in Europe. Nevertheless, we expect monetary policy to remain loose for a considerable period of time (think snails here) and any volatility from the US election to remain short-lived as investors, who have remained on the side-lines, come back in. At the end of the day it is profits that matter most to markets and a move to a market driven more by fundamentals than a monetary expansion, is healthy.

With the upcoming elections in France and Germany Europe may be facing a fundamental change with the possibly new leadership. Some fiscal stimulus is also likely as certain German politicians are already talking about tax cuts ahead of the elections.

From the technical analysis perspective markets in Europe, Japan, and the USA are at an inflection point, and we expect them to break out decisively to the upside.

In this environment we expect active managers to outperform the passive ones significantly. From our perspective, the glass is half full not half empty.

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