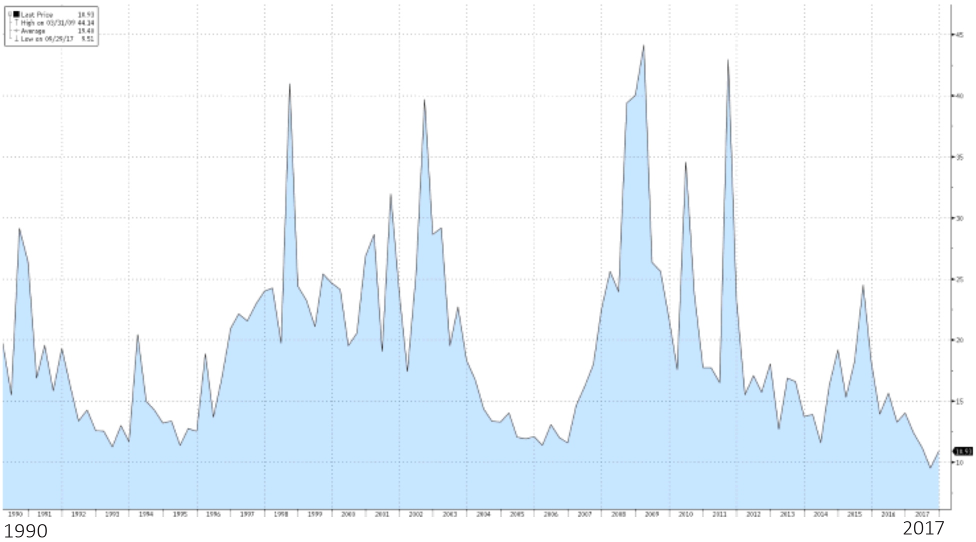
thenavigator

Autumn 2017

Calm before the storm?

Volatility Index (1990 - 2017)



Source: Bloomberg L.P.

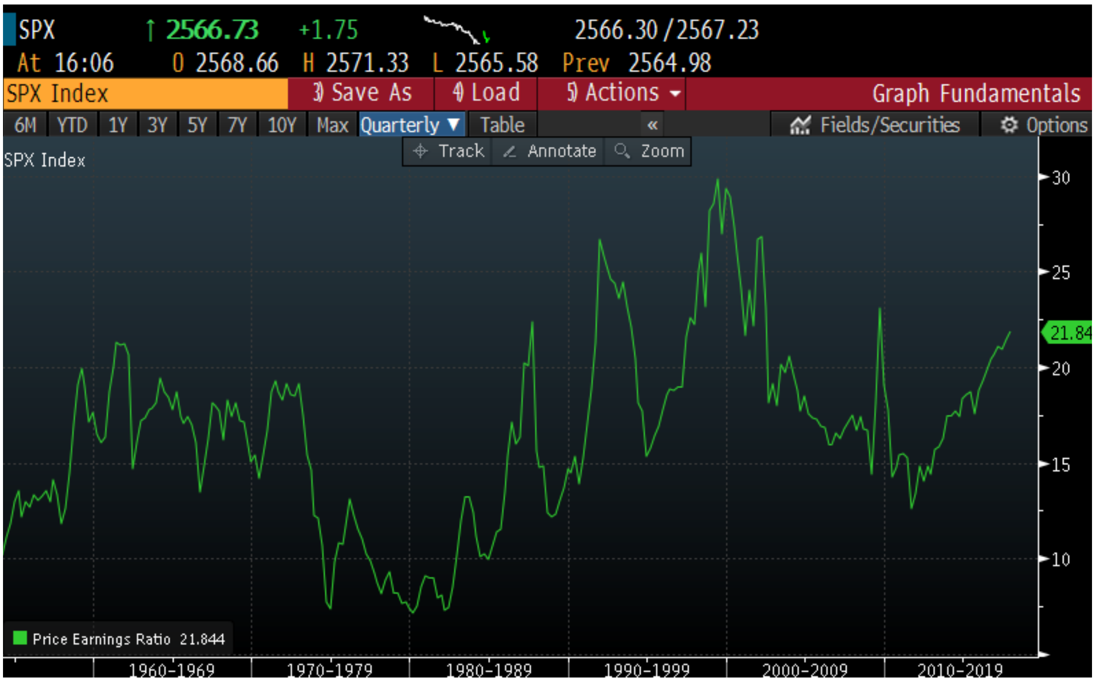
"Looking at the relatively low level of volatility in US equity markets, as measured by the VIX index (also referred to as the fear gauge by some), many observers remain concerned that investors have become complacent, and that we are nearing the end of this cyclical (read 7-8 years) bull market in stocks. An alternative explanation for the depressed level of volatility in markets could well be that the rise of passive investing (buying the indexes), computer driven strategies, Central Bank interventions (QE) and alternative strategies, like selling volatility, have all contributed to this current repression of volatility in equity indices.

Interestingly, volatility at the individual stock level has remained relatively high with large daily moves in "blue chips", not an uncommon occurrence, perhaps again partly due to the rise of passive investing and the decline in number of active investors (stock pickers). This can lead to interesting opportunities for those who are prepared to swim against the tide and take the time to do their fundamental research.

Markets have continued to grind higher and volatility has pushed lower despite many short-term challenges frustrating a large proportion of investors who are awaiting the imminent correction, which has been imminent for a considerable period of time for some investors. Of course, there are always plenty of things to worry about in markets and one frequently discussed is high valuations, especially for US stocks.

Looking at the hard evidence of historic PEs for the S&P500 since the index began, valuations are not at the highest level and even remain below the level reached at the end of 2009, at which point the PE ratio declined substantially due to a sharp earnings recovery. To put matters into perspective, it is important to remember that this year is the first year of real earnings growth coming from the S&P500 in over 2 years of essentially flat earnings growth. Looking at the valuation for the S&P500 on this year`s earnings estimates, the PE declines to a much more reasonable 19.5x versus next year`s estimates coming down to 17.5x – hardly the stuff of nightmares! Remembering the usual Wall Street game played by CEO`s of lowballing earnings forecasts and then beating them – the real forward PE

Price / Earnings Ratio (PE)
S&P500 Index (1954 - 2017)



Source: Bloomberg L.P.

"The mouse that roared"

It is the title of a 1959 British satirical commentary about a small country in the middle of Europe taking on a much larger foe. The title seems pretty apt for at least one event which is very much on investors' mind at the moment – the crisis in Catalonia.

The recent turn of events in Catalonia has unnerved investors and caused some short-term underperformance of European stocks versus their US counterparts, with some now talking about the Italian regions of Lombardy and Veneto wanting to separate from Italy whereas, in reality, all they really want is more autonomy. Of course, if we carry on this line of thought, none of Europe is safe, and even Bavaria has regularly complained about the high financial contribution it has to pay to Berlin.

It`s definitely time for a reality and fact check. In the recent (illegal) Catalan referendum, only 43% of the population turned out to vote and out of those 90% voted in favour of independence. If my mathematical calculations are correct, this represents under 39% of the overall Catalan voting population – hardly a clarion call to the founding of a new independent Catalonia. The likely scenario now is that autonomy from Madrid will be taken away temporarily until new regional elections are held, which is probably the only course of action the Spanish government can realistically take.

Rhetoric between both parties will no doubt remain heated, but looking once again at hard facts, given Catalonia`s 33% plus debt to GDP ratio (the vast majority owed to Spain) and the likelihood of this rising to 100% if they took on their proportion of Spanish debt (according to their size of GDP), they would immediately not qualify for entry into the Eurozone (debt to GDP needs to be below 60%). This is also ignoring the fact that any prospective joiner of the EU has to be unanimously agreed upon by all members. Last time I looked, Spain was an EU member which would veto any such joining attempt. Europe`s quick refusal to recognize the referendum result, Catalonia's large reliance on the EU (65% of its exports go there), and the very real danger that many businesses will relocate to other parts of Spain (some have already done so recently), it all makes it seem on the outer realms of possibility that an independent Catalonian state would succeed. This is without taking into account that over 35% of Catalonia`s exports go to Spain!

Whilst there is no denial of the large contribution Catalonia makes to Spain`s GDP (25%), it is one thing having your own flag, leader, parliament and police force, but quite another working out what currency to use, getting a central bank and all the other tedious but necessary details required to become an independent country.

Perhaps the best parallel would be to look at the secession attempts of Scotland to break away from the UK, which has been an off-and-on topic for many hundreds of years, and make the secession attempts of Catalonia, which started in 1922, look positively young. When the average Scottish voter realized the difficult economic reality that would be facing them, the majority of the population backed down, and the bid for independence is currently at a low ebb.

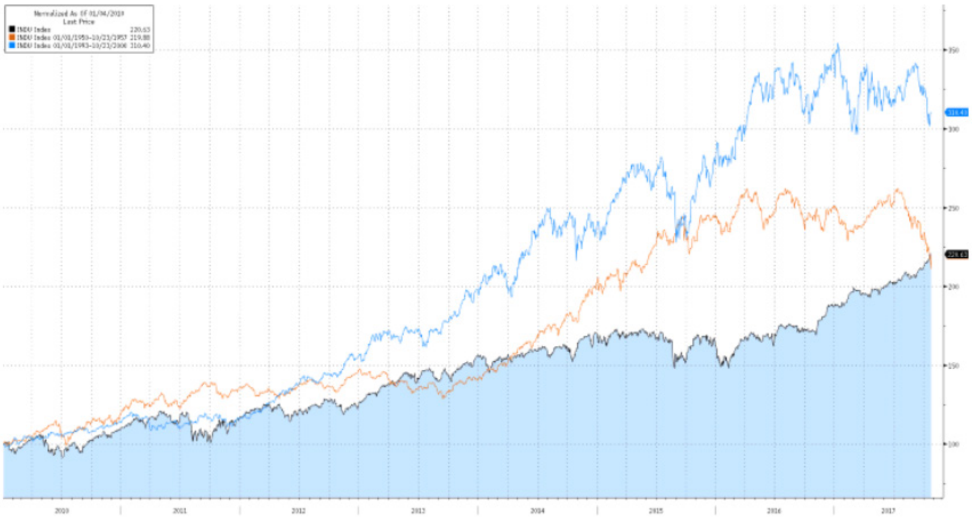
Another major course of concern is the bellicose rhetoric between the USA and North Korea, which we view as continuing in its current form with only the slight chance (let`s say 5-10%) of something disastrous happening. In fact, recent action taken by China in instructing regions to no longer buy coal from North Korea (its largest export) is likely to take a significant toll on the country's economy. It is also interesting to note that no major Chinese politician has visited North Korea since Kim Jong Un took power, which reflects the disdain they have for his regime. Of course, this may not stop people fretting over the current situation, but in reality, there is nothing you can do, and if there is something you can do, you probably have better things to do than to read this newsletter!

Prepare to be disappointed in the short- to medium term

One of my favourite investment quotes is by Sir John Templeton:

“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

Snap shot of previous bull market periods
Periods: 1950 – 57, 1993 – 2000, 2010 - 2017



Source: Bloomberg L.P.

Ladies and gentlemen, it would seem pretty evident that we are not at the euphoric stage of this bull market, and a convincing argument could be made that we are still in the skeptical stage, i.e.50% of the way through with plenty of room left to run. If I am wrong, and we are nearing the final stages of a cyclical bull market, we probably still have another 2 years to run.

Looking at previous bull markets, it seems obvious that in terms of gains this one has been particularly disappointing, however, not in terms of its duration. The final, euphoric stages of a cyclical bull market normally exhibit sharp gains and investors greed to get into the market at any price. In a secular bull market, the second half is normally the most powerful in terms of gains driven by increasing corporate earnings, increasing investor optimism and finally ending when we reach the point of euphoria.

Perhaps one of the major risks, as we approach the seasonally strong last quarter of the year, is the chance of a melt-up rather than a melt-down.

With the US having passed the budget recently, tax reform by year end looks like an imminent possibility and has not been fully priced in by markets, as yet. An easing of Catalan tensions and the move towards a grand coalition in Germany (likely to be Europe- and Macron-agenda friendly) could all cause a sharp squeeze upwards in markets as sceptical investors would be forced to invest for fear of huge underperformance (read: career risk).

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