swisspartners
Advisors

thenavigator

Winter 2017

Everything is as clear as mud!

Now that we have got past the US election, with markets having been in a buoyant mood since the result, many are questioning – have we come too far too fast?

Whilst we acknowledge that there has been a sharp upward movement in US equities since the election, and that there may be some scope for short term disappointment, especially, if some of the fiscal measures (like tax cuts or infrastructure spending) take longer to materialise than originally anticipated - timing such an event may well be a fool`s game.

Looking at the progress the S&P 500 has made over the last two years up until the US election, the gains have been incredibly muted (basically flat). However, since the election, the US market has essentially broken its sideways movement of the last two years. In the very short term the gains may seem too sharp, they are in fact, rather moderate over the last two years.

Whilst the trailing valuation on the S&P500 doesn`t look cheap at 21x, however, next year`s valuation at 15x appears much more reasonable.

S&P500 Index (2015-2017)

Source: Bloomberg L.P.

So where does this leave us? In short term the US equity market could be vulnerable to disappointments over the promised fiscal measures. However, market corrections can happen in various formats, e.g. sector rotation (we have seen some of this already), or the market could just move sideways.

US corporate earnings, in our opinion, are likely to once again beat expectations, and this could have a significant cushioning impact to any market declines.

One thing does seem pretty certain and that is – volatility is likely to increase. Making portfolios "tweet proof" could be an interesting strategy for investors this year. You just have to look at the price movements of traditional Swiss pharmaceutical stocks to see that we are not in a normal environment. Sectors that seem to be exposed to this phenomenon are biotechs/pharmaceuticals, defence companies and car manufacturers.

While banks have remained relatively immune, we guess that this could be about to change. To try to "tweet proof" a portfolio, one needs to think in populist terms. The perception of an average US consumer is that drug prices are too high.

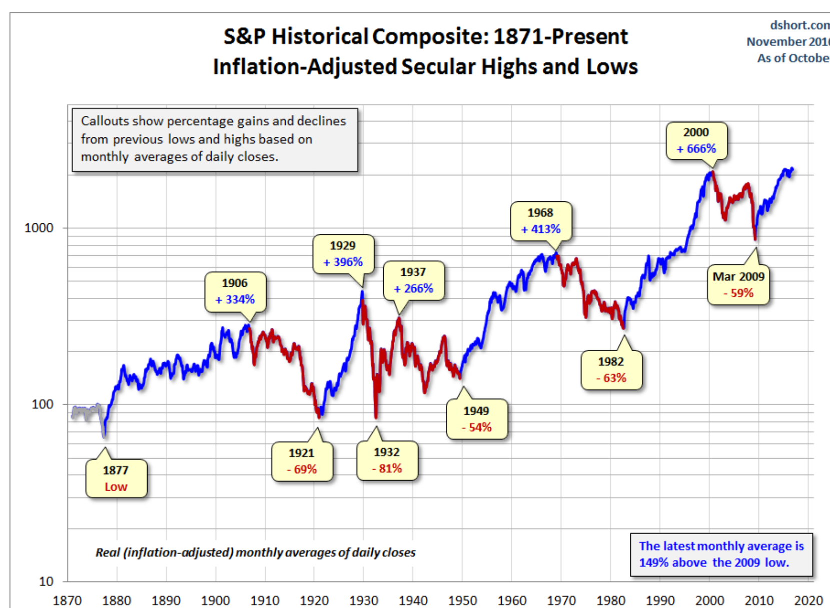
When looking at banks, we think that the average US person believes they are making too much money, especially, after what happened in 2008. Therefore, "tweets" about the banking sector are unlikely to cause anyone to shed a tear (except for the banks) and would be populist in their nature.

Sectors that have remained relatively immune are technology, media and commodities.

Volatility brings opportunities, and taking the biotech sector as an example, where a lot of value can be found at the individual company level, buying these stocks on a big headline/tweet day may not be a bad strategy for making money.

Sometimes the picture is clearer from a distance

We still believe that we are in a secular bull market (15-20 years) rather than a cyclical one (around 7 years).



Source: dshort.com

Looking at the S&P500 in inflation adjusted terms, where we have only recently taken out the 1999 highs, and if we are correct, we see that the markets have significantly further to run in both time and percentage gains.

For a secular bull market to occur, we need significant catalysts, which we now have in terms of the rise of populism and a seismic shift in terms of new leadership. The US has led the way, but Europe is not far behind with next major elections being France, where a much more business friendly government is likely to be appointed. This is a huge change that should not be underestimated. Even in Germany, where it seems likely that the status quo will be maintained (I wouldn`t rule out anything just yet, given that German elections are towards the end of the year), there has already been a significant change with tax cuts on the way and the German consumers starting to open their wallets.

In fact, when looking at the Eurozone, economic data has been rather encouraging (not that anyone has really taken notice!) with manufacturing and service indicators clearly above 50 (expansion territory) and European car sales at a nine-year high.

This year we expect the underdog – European equities – to outperform their US counterparts, as investors start to focus on their relative undervaluation and improving growth prospects. European equities also have significant appreciation potential due to the inbuilt corporate gearing. For every 1 percent increase in GDP growth rate, US corporate profits increase by 10 percent, whilst in Europe, every 1 percent increase in GDP growth rate translates into 20 percent corporate profits growth. We remain constructive about US equities, but think that the next year offers more potential, as the full effects of deregulation, tax cuts, and infrastructure spending start to work their way through the economy.

10- and 30-years Treasury Bond Yields (2007-2017)

Source: Bloomberg L.P.

If you go down to the woods today…

There has been a lot of speculation about whether US bonds are now in a bear market. The trick to survive bear attacks is figuring out, what kind of bear it is that is attacking you: a teddy bear - hardly the stuff of nightmares, a koala bear - more vicious than they look – they have sharp claws, or a grizzly bear – most likely fatal. Given that we have been in a multi-decade bull market for bonds, we expect the decline to be perhaps more gradual than many think. In our opinion, a bear market in US bonds would be confirmed by the 10-year pushing through the 3 percent level and the 30-year breaking the 4 percent level. These were the old 2013 taper tantrum yield highs.

One must also be cognisant of the fact that the largest holder of US Treasuries is actually the US Government, and that with the large amount of US debt, every increase in interest rates increases the amount the Government has to pay to service its debt.

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