thenavigator

Winter 2018

"I'm comin' up so you better get this party started", Pink

When looking at the performance of equity markets last year, and the very strong start we have in those same markets this year, they seem to have taken these lyrics to heart.

Assuming, as a working hypothesis, that markets take great delight in wrong-footing the maximum number of participants the majority of the time, I would conclude that, so far this year, they have been extremely successful.

Although we cautioned of a melt-up in stocks in the last newsletter, our comments seem to have fallen on a lot of deaf ears. Looking at the overall consensus opinion (which, by the way, is normally wrong) many believe that market opinion is optimistic. However, when you dig deeper and probe people`s outlook, the general response is that gains can`t be as good as last year, and even a return of 8-10% would be quite acceptable and welcome. I would class this as cautiously optimistic but hardly euphoric, and I would like to explain why we would do so.

Beyond Bullish

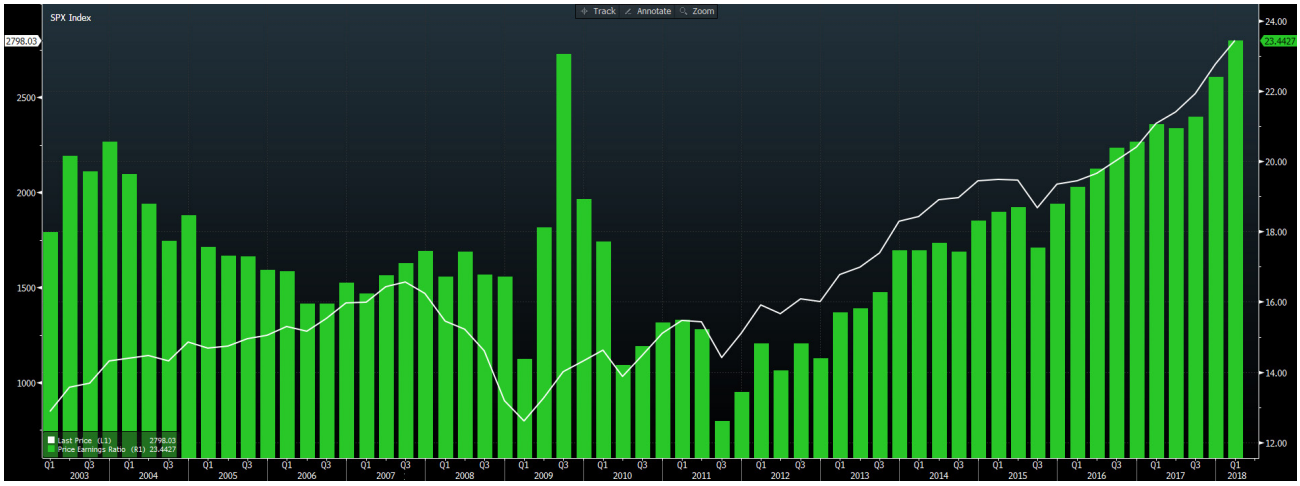
S&P500 Index (2007-2018) - From recovery phase to start of bull market

Source: Bloomberg L.P.

Effectively, looking at the above chart, an argument could be made (and it`s one we subscribe to) that the period of 2009-2012 was just a recovery period in markets from the catastrophe that 2008 brought. In fact, the bull market only began in 2013 when the S&P500 managed to advance beyond the levels set in 2007. This train of thought essentially means that this bull market is only 5 years old, and therefore, in harsh reality, it doesn`t matter for the time being, whether it is cyclical (short term, around 7 to 8 years in duration) or secular (long term, 15 years plus – the theory we subscribe to), as there are still further substantial gains to be made.

Whereas financial headlines like, "the strongest start for markets since 2003", may have made many investors worried about the durability and sustainability of the gains, we prefer to look into hard facts. Let us review the P/E ratio in the month of January since 2003 to the present.

Price / Earnings Ratio (PE) (2003-2018)
S&P500 Index



Source: Bloomberg L.P.

We can see quite clearly that in 2003, for example, the multiple on the market had been not exactly low and remained at levels that may have concerned investors for the next four years until they reached a point when they looked quite attractive, signalling that, in fact, it was high time to get out! The reality was that earnings were increasing over that four-year period pushing down P/E ratios steadily until earnings topped out.

Global Earnings Revision Index (2000-2017)

Source: Bloomberg L.P.

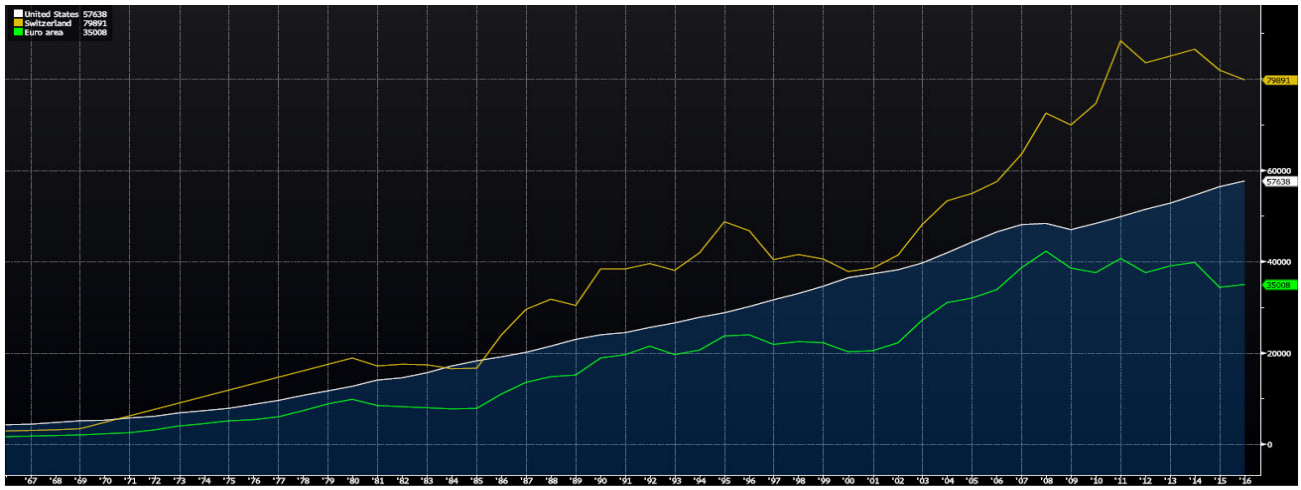
Looking at earnings revisions, the set up suggests pretty clearly that we are entering a period of higher earnings and positive earnings revisions similar to those we saw in 2003 and other periods.

I would like you to think in terms of…

Alice in Wonderland

No, I am not alluding to fairytales, but rather would like to encourage you to look at things in a topsy-turvy, upside-down and back-to-front way. Prepare for a suspension of disbelief!

GDP per Capita in USD (1967-2016)
USA, Switzerland, Eurozone

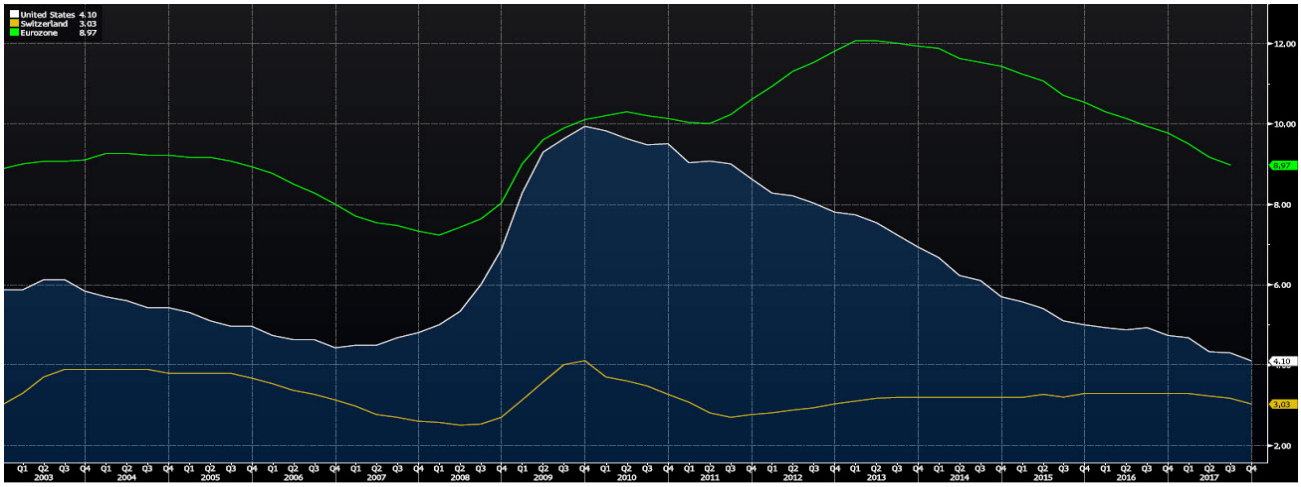


Source: Bloomberg L.P.

Is this for real? One way of looking at things may be to assume that the European region has substantial room to grow GDP per capita versus a country like Switzerland, for example, which could make itself uncompetitive if this number went substantially higher.

The same train of thought could be applied to unemployment levels.

Unemployment Rate in % (2003-2017)
USA, Switzerland, Eurozone



Source: Bloomberg L.P.

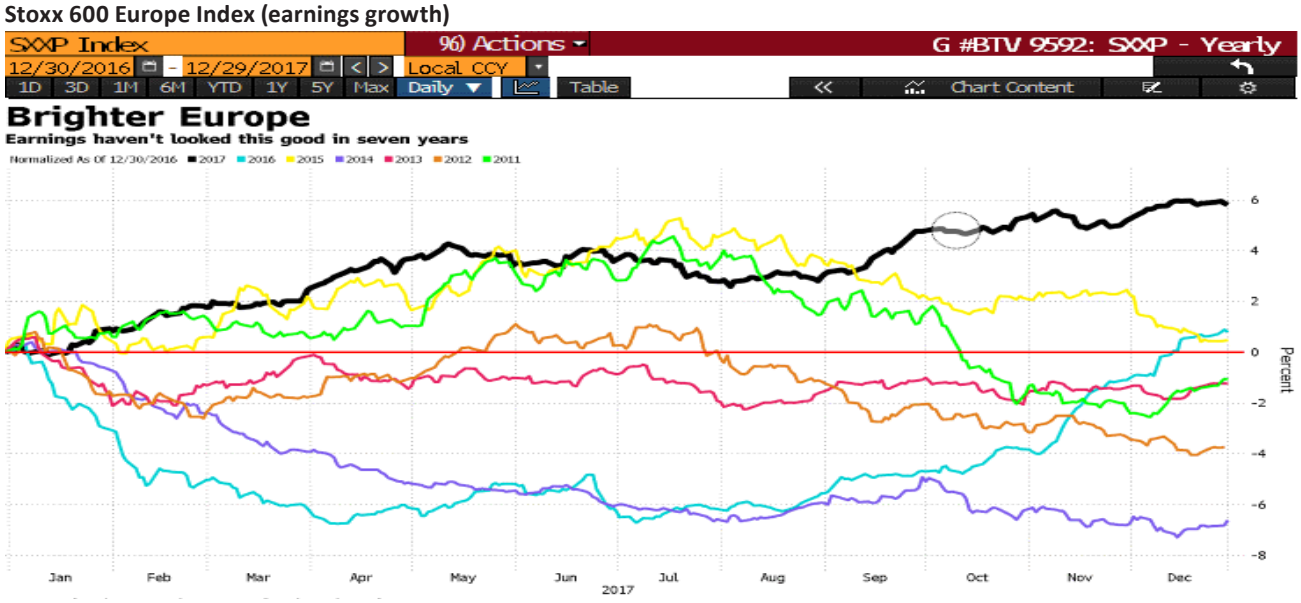
How likely is it for the US or Swiss unemployment rates to decline substantially from current levels whilst the European, despite making substantial progress from peak levels, could decline significantly further?

US equities versus Europe (1990-2018)

Source: Bloomberg L.P.

Although we have talked about it ad nauseam, the fact is that the underperformance of European equities versus their US counterparts has reached unsustainable levels, and could be now finally at the turning point, given the earnings outlook and the more European friendly agenda driven by the French President, Macron.

Stoxx 600 Europe Index (earnings growth)



Source: Bloomberg L.P.

But what about the sell-off in the bond market?

Once again, we prefer to deal with facts.

Bond bear market?

Source: Bloomberg L.P.

In 2013, the US 10-year Treasury hit a 3% yield and ended the year at the level. This was the truly frightening result for equity markets (remember, Europe was still in the depths of the Eurozone crisis).

Back to the future?

Equity markets during last yield rise in 2013

Source: Bloomberg L.P.

Be prepared for gains in risk assets as good as last year, and perhaps even better for an extended period of time. Of course, the progress is unlikely to be linear. However, we believe any dips (if there are to be any) should be bought strongly.

Just as it is impolite to turn up too early to a party, it is just as rude to overstay your welcome. And so, we always keep one ear open to when and where the music volume decreases.

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