thenavigator

Spring 2018

We might have been too exuberant, but I don't think we were irrational!

Following the melt-up in stocks we saw in January, we effectively then had the melt-down in February and March with all of January's excellent gains plus more given back. We did feel somewhat like a fish out of water in January time given that strong markets seemed to be somewhat of a consensus. Market participants who couldn't get in fast enough in January, couldn't wait to exit again at lower prices in February and March.

Call us old-fashioned, but we never found that a buy high, sell low investment policy made us any money.

So, what changed? In our opinion, absolutely nothing except for perception which can be a powerful psychological tool in markets.

There's something about Donald (Trump)

The 1998 movie, "There's something about Mary", focuses on the lead character (played by Cameron Diaz) in which pretty much the whole cast becomes obsessed with the lead character (Mary). Of course, it may be somewhat of a stretch comparing Mary to Donald Trump; however, the point we are trying to make is that markets have become somewhat obsessed to an unhealthy degree with POTUS and the constant media barrage he produces. The unconventional management style of using twitter to communicate and making quite bold statements, is something that markets have not seen before from a US president and, therefore, perhaps need time to adjust to.

Soap

Adult entertainers, playboy models, court cases, vested interests, military action, trade wars and power plays surrounding Government appointments, sound like a plot for a "Game of Thrones" episode rather than the US government. You really can't make this stuff up!

In reality, we should view it for exactly what it is – entertainment value in the strong melodramatic style of a soap opera. Whilst markets may currently be reacting (overreacting) to every twist and turn in the plot, it will only be a matter of time before, we believe, they become numb to the sensational headlines and focus on more important things like economic and corporate earnings growth. We expect a similar style of playbook to the North Korea crisis last year, where markets exhibited a bout of volatility until they got bored of it.

“All in all, it's just another brick in the wall” (Pink Floyd)

No, not the mythical border wall, but rather the wall of worry that markets have to continually climb before moving higher. At this point in time, we have worries over the imposition of tariffs (and possible trade war repercussions), continued worries over North Korea, recent tensions in the Middle East (Syria) and possible Russian retaliation, and a move, perhaps, back towards a cold war type of scenario.

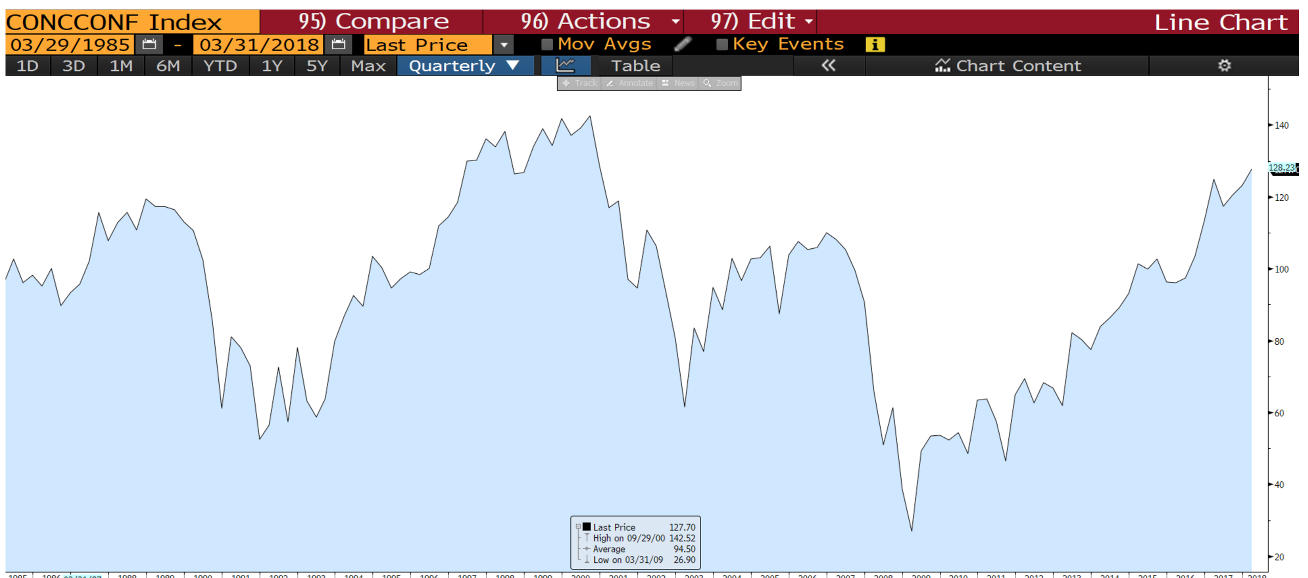
As if the falling US dollar, the US twin deficits, constant media barrage from the US President, BREXIT consequences, Italian political woes and global inflation were not enough to worry about, some people are questioning, whether we have reached a peak in US corporate profits growth and, whether the flattening yield curve in the bond market is predicting the next recession.

Walls always look smaller if you are taller or take some steps backwards and look at them from a perspective.

We expect most if not all of the above scenarios to pan out ok, and it is highly likely that, as each worry has been discounted to the downside, there is likely to be the opposite effect, i.e., we expect a relief rally for risk assets as each worry evaporates over time.

Is there really anything major to worry about?

US Consumer Confidence Index (1985-2018)

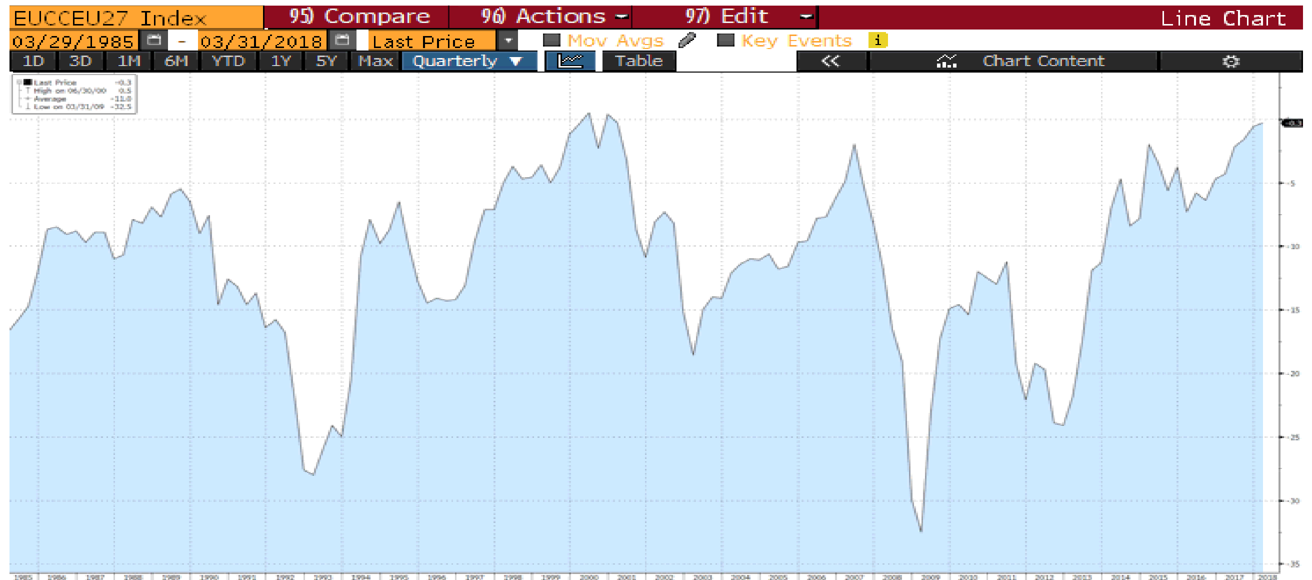


Source: Bloomberg **31 March 2018**

Looking at the above chart of US consumer confidence, we can see that levels above the 2007 period have been reached and we are fast approaching confidence levels not seen since the late 1990's.

The same data for Europe indicates pretty much the same trend.

Europe Consumer Confidence Index (1985-2018)

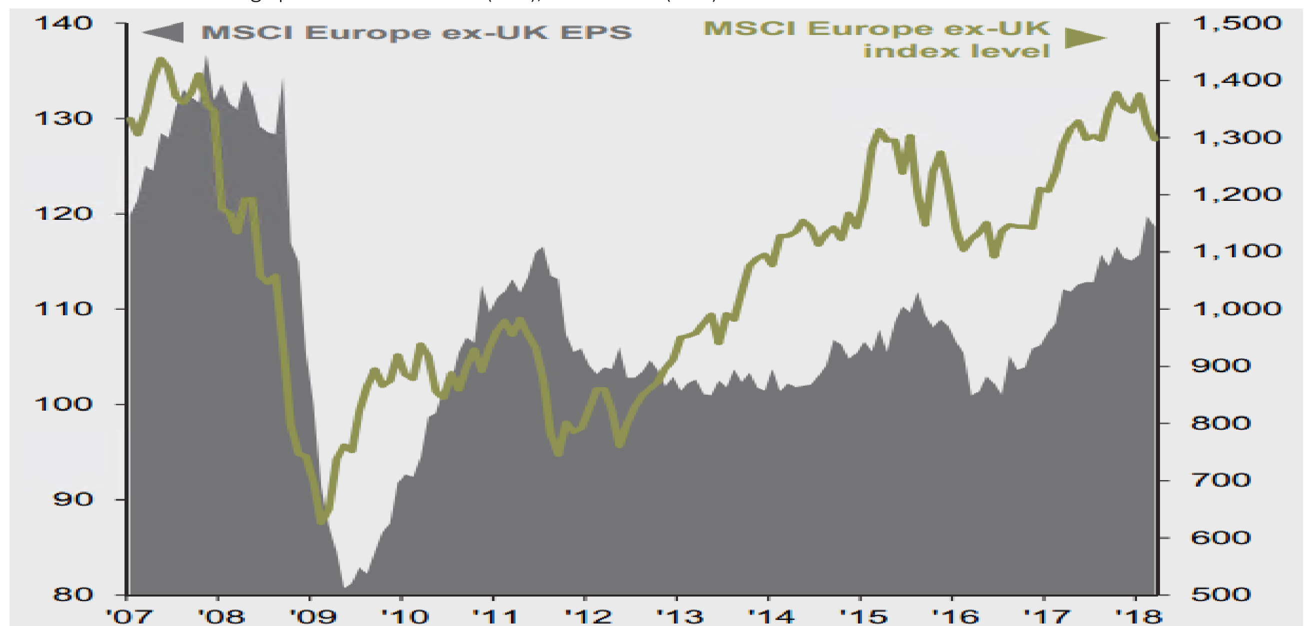


Source: Bloomberg **31 March 2018**

Looking at the earnings picture for this year, both the US market (as measured by the S&P500) as well as Europe's (as measured by MSCI Europe ex UK) are showing solid increases.

You will, no doubt, have noticed the green line on the following charts turning down (this represents the index levels). This could be viewed as being positive since it means that the price earnings ratio (valuation) of both indices has become more reasonable.

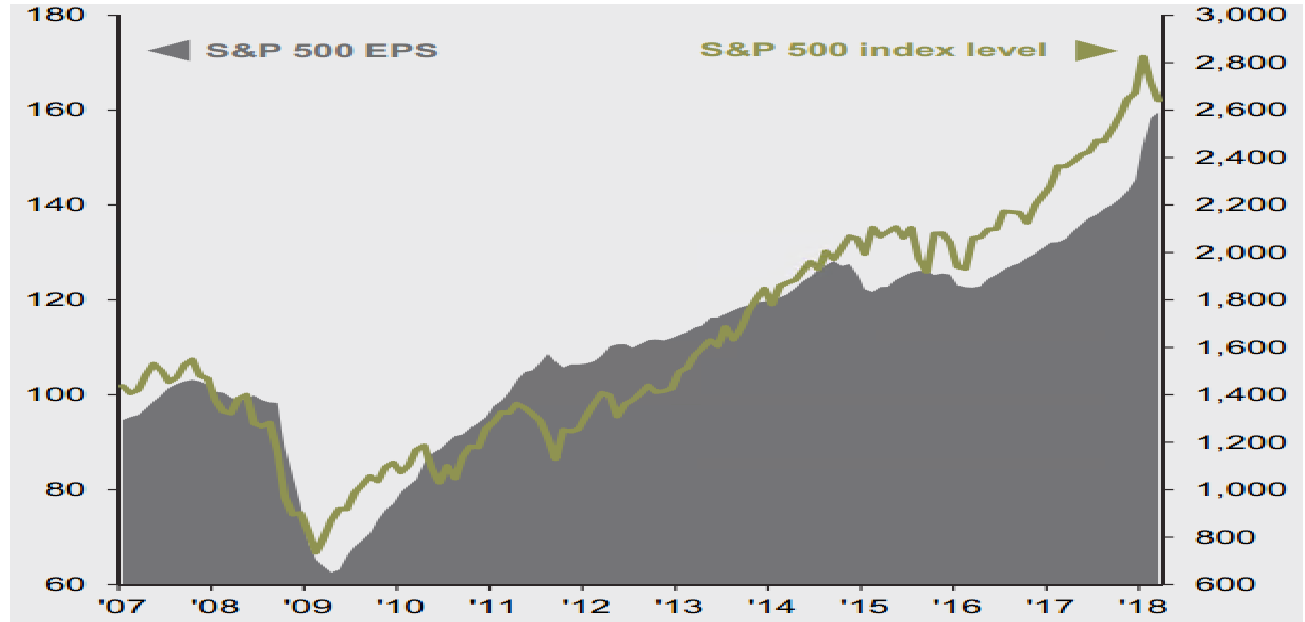
MSCI Europe ex-UK earnings and performance (2007-2018)
Next 12 months' earnings per share estimates (LHS); index level (RHS)



Source: J.P. Morgan Asset Management **31 March 2018**

S&P 500 earnings and performance (2007-2018)

Next 12 months' earnings per share estimates (LHS); index level (RHS)



Source: J.P. Morgan Asset Management **31 March 2018**

Whilst there is no doubt that this year, due to the US tax cuts, earnings from US companies will be significantly better than those from European companies, the forecasts for next year look surprisingly similar in terms of percentage growth.

This, combined with a strengthening euro, could perhaps explain the recent underperformance of European companies in local currency terms. The good news is that expectations for the upcoming European earnings season are still somewhat modest and, therefore, there remains a good chance that many companies beat expectations.

Whilst there seems little doubt that US interest rates will increase further this year, we expect the tightening to be gradual and longer-term bond yields to remain well anchored at current levels, given the modest inflation outlook.

Taking everything into account – modest interest rates, strong consumer sentiment, increasing GDP growth and strong corporate profit growth, we expect the path of risk assets to be significantly higher, once this bout of volatility eases. It will probably take a bit more time, but, in our opinion, we are closer to the end of this period than the beginning.

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