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STAYING THE COURSE: ARE INVESTORS TAKING ENOUGH RISK?

Despite some volatility bumps I believe our Goldilocks environment has longer to run with a sweet spot for equity appreciation as central banks signal ahead and tighten policy ever so slowly. I recommend that investors not be too fearful and instead capture the rest of the cycle by participating in global equity markets.

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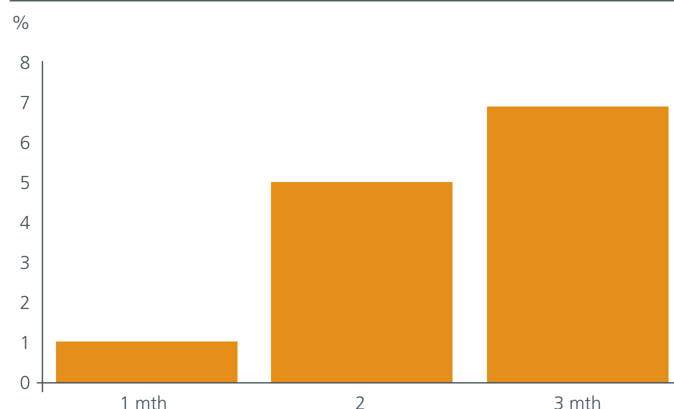
SUMMARY

Most investors expect volatility to rise structurally in the medium term as liquidity is withdrawn from the market due to the tapering of asset purchases by central banks. However, the prospect of severe lasting volatility looks unlikely: there are still high levels of liquidity and we expect central banks will most likely err on the side of caution in taking away the punch bowl, given that they have been nurturing this recovery for nearly a decade.

A combination of a gradual rise in volatility, an under-owned US equity market, robust economic fundamentals and improving earnings, argues for a continued appreciation in equity prices.

The breadth of the economic recovery, as illustrated by the number of countries with business sentiment indicators in expansionary territory, should encourage a broad based global recovery.

Fig.1: Median S&P Returns after Significant[1] Volatility Spike[2]



Some bond market yields are already reflecting greater optimism about a recovery than in 2014, the last time cyclicals were this strong.

True, monetary policy direction has changed; but it has been so well flagged, and rates are at such low levels, we should not expect it to cause surprise as it did in 1994. Fear may lead investors to miss out on the final leg of the economic cycle, when equity markets typically enjoy their strongest returns, before interest rates are eventually tightened too much and pull the economy into a recession. Can investors afford not to be fully invested in stocks today?

DETAILS

There remains a reluctance to believe that the US economy can return to levels of nominal growth it enjoyed before the Global Financial Crisis (GFC). Moreover, market participants are now weary of the inability for developed market economies to reach escape trajectory and for growth and inflation to power ahead. We've had several false starts over the years, most recently in 2014, and it's this reluctance and lack of belief in a traditional cyclical recovery that may well be the reason that equity markets continue to melt upward.

Many have argued that the gradual reduction in the pace of bond purchases by the Federal Reserve and other central banks will see volatility rise, as it did recently. Even if this is the case, spikes in volatility have not always resulted in negative returns in equity markets. Take for example, the period January 1996 to October 1997 when equity volatility as measured by the CBoE Volatility Index (VIX) rose by around 35%. Meanwhile global equities (measured by the MSCI all Country World Index) climbed almost 20%. More recently, during Quantitative Easing, investors have adopted a "buy the dip" strategy, where spikes in volatility are used to purchase risky assets at cheaper prices.

Central bankers, like all human beings, suffer from a behavioural bias evidenced in previous business cycles of setting interest rates too low. Prior to the GFC, Chairman of the Federal Reserve, Alan Greenspan, presided over a long period when monetary policy was too relaxed. This allowed the build-up of the ensuing credit bubble, and failed to take account of the effect of cheaper imported goods structurally lowering domestic inflation pressures.

After nearly a decade of monetary policy that has injected trillions of dollars in liquidity into the system to support asset prices and maintain the

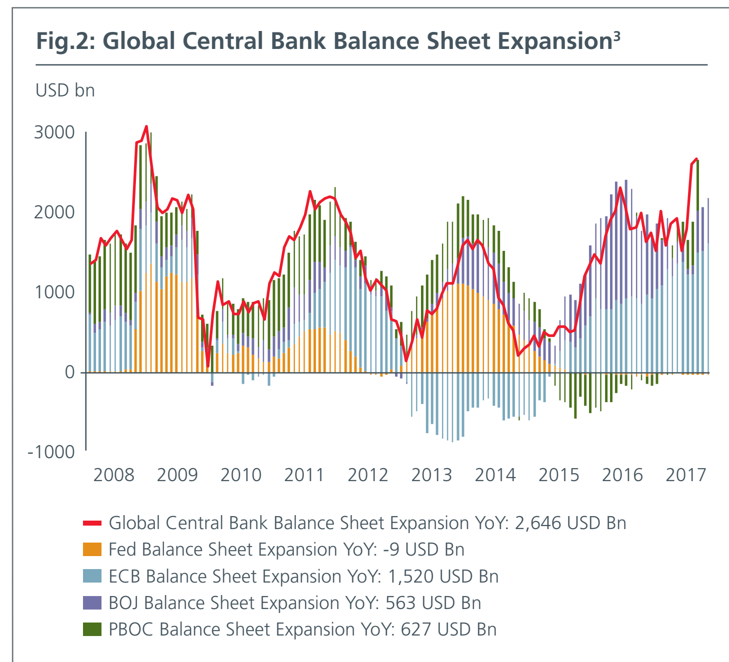


Fig.2: Global Central Bank Balance Sheet Expansion[3]

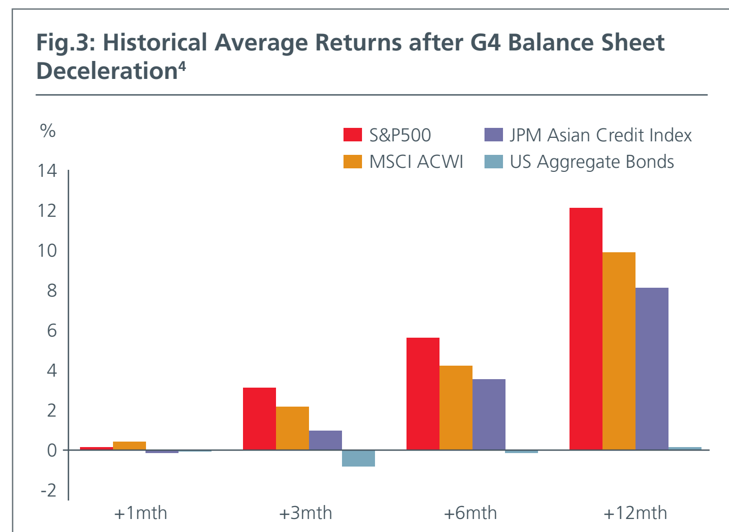


Fig.3: Historical Average Returns after G4 Balance Sheet Deceleration[4]

capital system, why would any central bank want to do anything other than tinker at the edges with existing policies? The prospect of aggressive tightening in monetary policy seems relatively low, as inflation still seems remarkably stable. The fear of derailing the recovery of economies by withdrawing stimulus too early should prevent significant spikes in volatility and, therefore, maintain an upward trajectory for equity markets in the near term.

Fear of derailing asset price momentum has also led central banks to communicate in a much more open fashion with market participants. The majority of US interest rate hikes delivered in this tightening cycle have been more than 60% priced into market interest rates on the day of the announcement. This has avoided significant disruption through an unexpected tightening.

It's not just the Federal Reserve that is underpinning asset price values and injecting liquidity into the market now. The European Central Bank, Bank of Japan, Bank of England and People's Bank of China have all engaged in similar policy. Does the fact that the ECB, Fed and BoJ are tapering policy, i.e. purchasing fewer assets, mean that equity markets are vulnerable? If history is any guide, a deceleration in purchases of the G4 does not necessarily result in lower equity markets.

ARE INVESTORS TAKING ENOUGH RISK?

This remains one of the most unloved bull markets in history, with investors unwilling to embrace higher risk investments such as equities, instead preferring those assets generating more stable returns from income. The growth in demand for such assets, e.g. infrastructure debt and equity funds, Real Estate Investment Trusts (REITS) and high yield bond funds, reflects investors' preference to purchase lower volatility asset classes rather than traditional equities.

However, as the global economy recovers, we should expect real interest rates to continue to rise, and cause the risk-adjusted attractiveness of these alternative, high-yielding assets to diminish.

Fig.4: US Yield Curve Slope (30 Year - 5 Year Yield)[5]

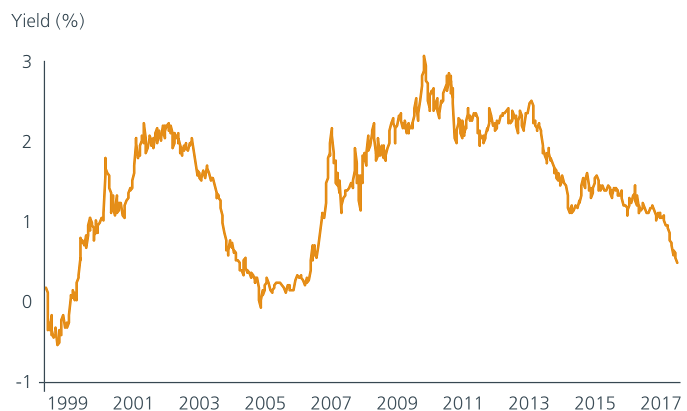


Fig.5: 5 Year US Real Yields[6]

ENOUGH OF THE FALSE STARTS?

The breadth of the recovery is the widest since 2014, with the number of Purchasing Manager Indices in expansionary territory at levels similar to that period. Whilst the PMIs rolled over in 2014, and ultimately the fundamentals in the global economy then disappointed, the big difference in 2018 is the bond market.

As investors have begun to have more faith in the recovery, the yield spread between long and short dated bonds has narrowed to levels well beyond that experienced in 2014.

Rising real yields are also reflective of improving growth expectations; although on

this measure shorter term real yields have not yet broken through 2014 peak levels. We need this growth cycle to continue and real yields to rise above 2014 levels to truly break the cycle of economic growth being restricted to the range we've enjoyed since around 2012.

Despite the bond market presenting signs that we are breaking out of the existing cycle, reflecting an economy that is finally growing strongly, investors are still not positioned in stock markets for this US-led economic growth train. The BoAML January 2018 Global Fund Manager Survey shows that asset managers are a net 17% underweight US equity markets, a position that has been in place for much of the last 3 years. In contrast investors have favoured European and global emerging market equities over the US.

This reluctance to buy stocks in a fast-growing economy can be partially explained by the over valuation of US stocks, using traditional methods, and yet valuation has historically been a poor timing tool for investment as under- or over- valuation can persist for many years before prices mean revert.

At the time of writing, this quarter is the first time since 2013 when analysts did not downgrade US earnings expectations going into the quarterly earnings announcements, and they still managed to surprise on the upside. This earnings improvement should allow valuation multiples to normalise and reduce the strength of the over valuation argument.

Admittedly certain sectors such as technology can be argued to be overvalued, but this sector is still some way from the levels of valuation experienced at the height of the 2000 technology boom, and on a free cash flow yield basis, we are not back to that era of low levels.

The late part of the economic cycle is typically defined by a final appreciation in equities, often the most violent. This ends when the impact of rate tightening pulls the economy into recession.

But unless the speed of Fed rate hikes increases dramatically, the final period in the cycle, just like the mid cycle, could last a lot longer than in the recent past.

Fig.6: NET % Asset Allocators say they are Overweight US Equities[7]

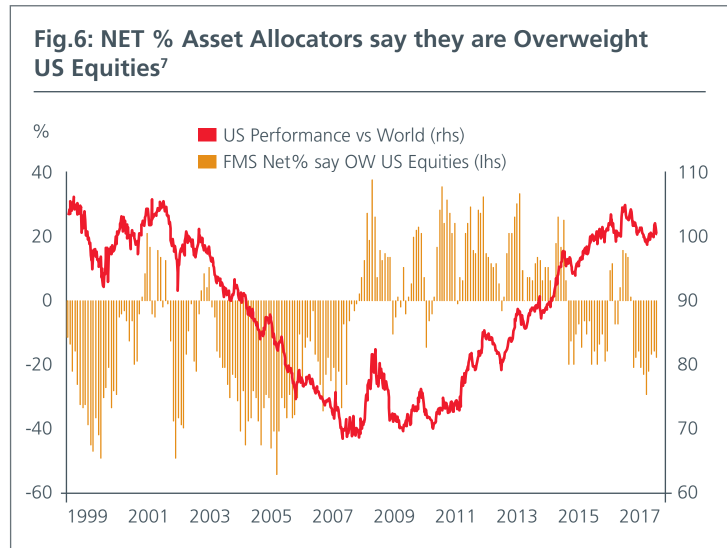
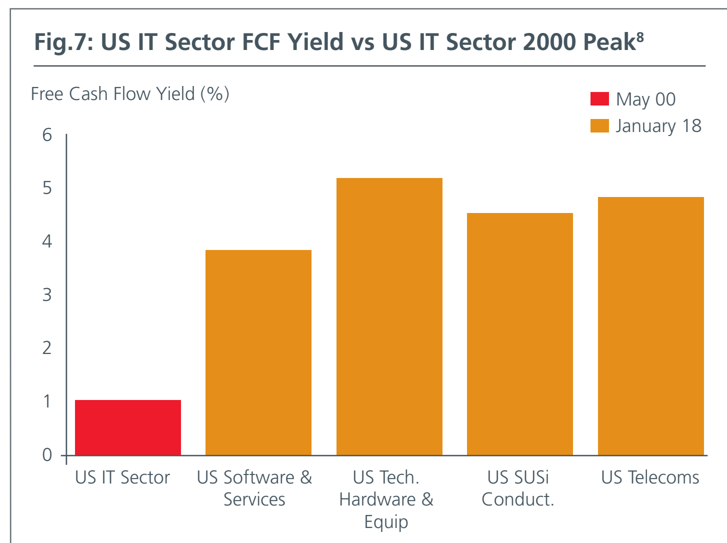


Fig.7: US IT Sector FCF Yield vs US IT Sector 2000 Peak[8]



Sources: [1]More than 40% increase in CBOE Volatility Index from 3mth moving average. [2]Datastream 31 December 1999 to 26 January 2018. [3]Thomson Reuters Datastream 18 January 2018. [4]Thomson Reuters Datastream 31 March 2009 to 18 January 2017. [5,6]Thomson Reuters Datastream January 2018. [7]BofA Merrill Lynch Global Fund Manager Survey. [8]Thomson Reuters Datastream 31 January 2018.

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