EDISON

Illumination: Equity strategy and market outlook

June 2017

Published by Edison Investment Research

Global perspectives: A tipping point

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **Central banks take centre stage.** Judging by the market reaction to ECB President Draghi's most recent comments, a tipping point may have been reached. Peak monetary accommodation is now in the rear-view mirror and investors are becoming increasingly worried about tightening policy. We believe this adds weight to our cautious view on global equities but investors should also consider that overly pessimistic forecasts for an aggressive quantitative tightening could ultimately prove wide of the mark.
- **Equity market volatility is low but downside protection is in demand.** We struggle to understand why equity market volatility has fallen so much during 2017. However, this should not lull investors into a false sense of security as the price of put options indicates that downside protection is in demand. In our view, portfolios should not be built on the assumption that volatility will remain this low as the historical evidence for mean-reversion is strong.
- **Economic surprise indices have turned sharply lower on a global basis in recent months.** This move cannot be fully explained by seasonal or mean reversion factors. In turn, 2017 consensus earnings forecasts in the US and the UK are moving gradually lower and appear to have peaked in continental Europe. This is, in our view, another reason for equities to be on pause.
- **We believe we are entering a period of tighter monetary policy and ebbing economic momentum.** When combined with rich valuations for developed market equities, this can only warrant caution in terms of equity allocations.

A tipping point as monetary policy shifts

Central banks on both sides of the Atlantic appear to be becoming more hawkish

In recent weeks, policymakers at each of the US Federal Reserve, Bank of England and ECB have become notably more hawkish. This is a new development, as throughout the period 2010-2017 central bank balance sheets have been steadily expanding as the quantitative easing (QE) baton was passed around the globe. With asset prices rising strongly over this period, many commentators have been quick to infer that the end of QE signals market trouble ahead. While certainly a headwind, we believe investors should not rush to judgement. There remain many acts to play out in this story before it is finished.

In the US, a reduction in the size of the Fed's balance sheet is under active discussion. Fed Chair Yellen also recently commented that asset valuations are "somewhat rich" and that the US banking system is now sufficiently robust to withstand a decline in asset prices:

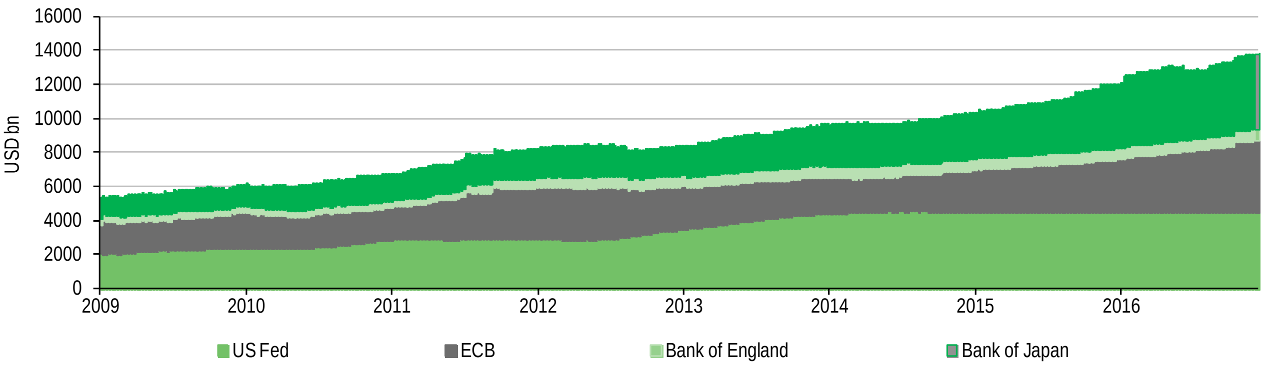
"...asset prices can move, they can cause losses to individuals who decided to invest in things that fall in price but we're worried about systemic risk and with a strong banking system...those kind of repercussions are not top of my list."

Taken together with Fed Vice Chairman Fischer's observations that markets have in part been driven higher by increased risk appetite and that close monitoring is warranted, investors have been warned twice in recent days that the Fed believes risk premia are too low at present.

At the Bank of England, a relatively tight vote on interest rates this month surprised markets. Governor Mark Carney initially indicated after the meeting that, in his view, now was not yet the time to tighten policy. However, this week he conditioned his view on the outlook for UK business investment, which, if firm, could mean "some removal of monetary stimulus is likely to become necessary", thus significantly clouding the picture.

ECB President Draghi has also suggested that to keep the stance of monetary policy constant as the eurozone economy improves, policy should be dynamically tightened. Draghi's comments in particular seem to have pushed markets over a tipping point; although his speech in Portugal was, in our view, anodyne, it triggered one of the sharpest daily increases in global bond yields for a number of years. In fact, the comments were shortly afterwards said by Reuters, quoting sources within the ECB, to be misinterpreted. However, with three of the world's most influential central banks taking, or being perceived to take, a more hawkish tack, the scope for an air pocket in global equities has clearly increased.

Exhibit 1: Central bank balance sheet expansion 2010-2017



Source: Thomson Reuters Datastream

The impact of central banks' purchase of government bonds in recent years on asset markets should also not be underestimated. With total assets of the world's major central banks close to

US$14trn, central banks have absorbed over 25% of the value of developed market bond markets. This has pushed government bond yields lower and, combined with forward guidance on interest rates, lowered the discount rate and risk premium on a wide variety of riskier assets, including corporate bonds and equities. The policy has also significantly reduced sovereign funding costs and not just in the periphery of Europe.

Now there is increasing concern in the market about the transition to market-determined government bond yields over the course of 2018-2019. The most obvious implication is that a return to higher market-based yields implies higher discount rates for other assets. It is difficult to argue this point. For example, a wholly unanticipated increase in real rates of only 1% would, all other things being equal, imply a significant decline in the fair value of developed market equities.

However, such an increase is already partly discounted. US Fed Chair Yellen has been as clear as she can be on the slowly rising trajectory of the neutral interest rate. Furthermore, all other things are unlikely to be equal. In a scenario of higher real rates, growth would be stronger, offsetting the impact.

Therefore, we could rewrite the assumption that the end of QE and start of monetary tightening will necessarily lead to a major market crash as an assumption that the world's monetary policymakers will necessarily make an enormous policy error. While certainly a non-zero probability, it would require additional constraints on policy to make it a base case.

Most obviously, should the US economy slow through Q3 the US Fed is fully at liberty to change its view on both the appropriate level of its balance sheet and the trajectory of interest rates. The ECB is also able to change course even if it is running into constraints in terms of eligible securities for balance sheet expansion. It is easy to forget that, just as the ultimate extent of global QE was wholly underestimated by the market several years ago, forecasts for quantitative tightening are equally subject to a high degree of uncertainty.

However, a dangerous constraint would be rapidly rising or significantly above-target inflation. Fortunately there is little evidence of this at present, with the exception perhaps of the UK. What may be closer to policymakers' thoughts, however, is that even as the US Fed has raised rates, broader financial conditions (including measures of credit and equity risk premia) have eased over the last six months. Especially in the eurozone, where monetary policy has been targeted at reducing financial risk premia, in many respects this may be viewed as mission accomplished.

Policymakers seem at present to fear getting behind the curve. According to Draghi, rising asset prices and improving business confidence would justify a tightening trajectory of monetary policy just to maintain a steady level of policy accommodation.

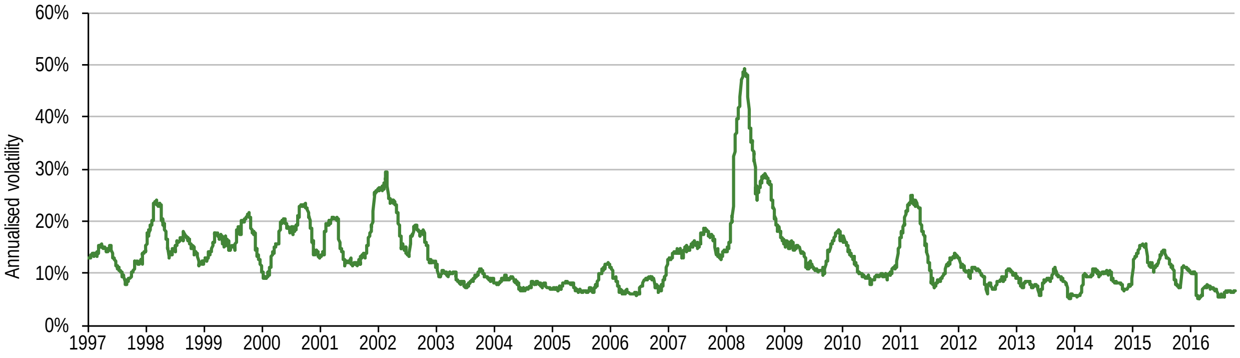
We believe central banks' recent change of tack (or even just change of emphasis) adds weight to our prior views that investors should proceed cautiously at present. The comments from policymakers on asset prices do not mean that a policy error is inevitable, but they are a shot across the bows of the market as central banks try to lower the risk of financial instability and mal-investment.

Volatility: Low, but skewed to the downside

We struggle to understand why market volatility has fallen so much in 2017

One of the notable aspects of equity markets during 2017 has been the rapid fall in market volatility. Trailing 90-day realised volatility for the S&P 500 reached 7% in recent weeks (Exhibit 2). Over the last 20 years, these levels are matched only during a brief period over 2005-2006. We do not see an especially strong parallel with 2005, as at that point US equities were still moderately valued and the US economy was expanding after a mild recession. We believe investors are once again becoming complacent; but also note the skew towards higher priced put options suggesting that, within the options market at least, downside protection is at a premium.

Exhibit 2: S&P500: 90-day realised volatility



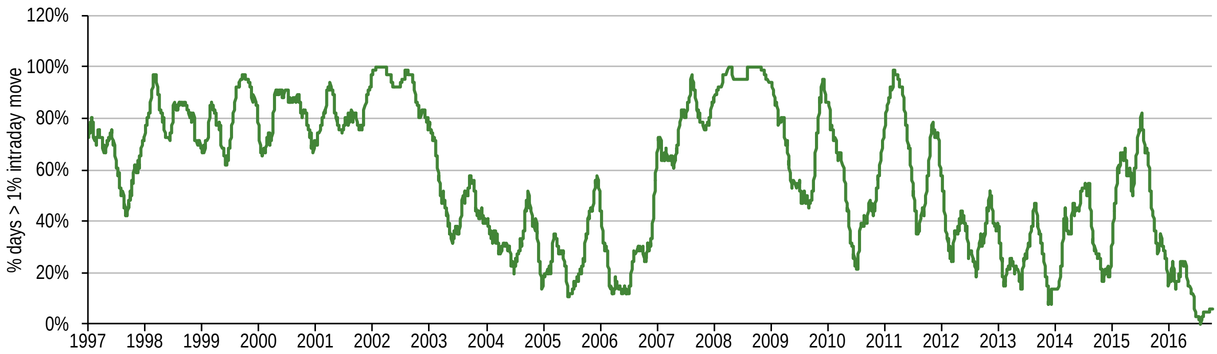
Source: Thomson Reuters Datastream, Edison calculations

The decline in volatility on an intra-day basis is even more marked, with only 6% of recent trading days experiencing an intra-day range of greater than 100bp (Exhibit 3). On this measure, markets are more placid than at any time since 1997, a remarkable shift from only one year ago when intra-day volatility was much higher.

It is not obvious to us what is driving the shift towards such a low-volatility trading regime at this juncture. Calm markets have also hurt US broker profitability in the first quarter. The popularity among investors of volatility ETFs (despite the dire price performance due to the steep contango in volatility futures) does not appear to be related to the decline in volatility. The market value of the top five US volatility ETFs has remained static at US$1.5bn year-on-year, albeit with a brief peak at the time of the US election.

While implied and realised market volatility may be low, this should not lull investors into a false sense of security. The premium for deep out-of-the-money puts (implied volatility of 24%) compared to similarly out-of-the-money calls (implied volatility of 12%) highlights the relative demand for portfolio protection and ample supply of call sellers.

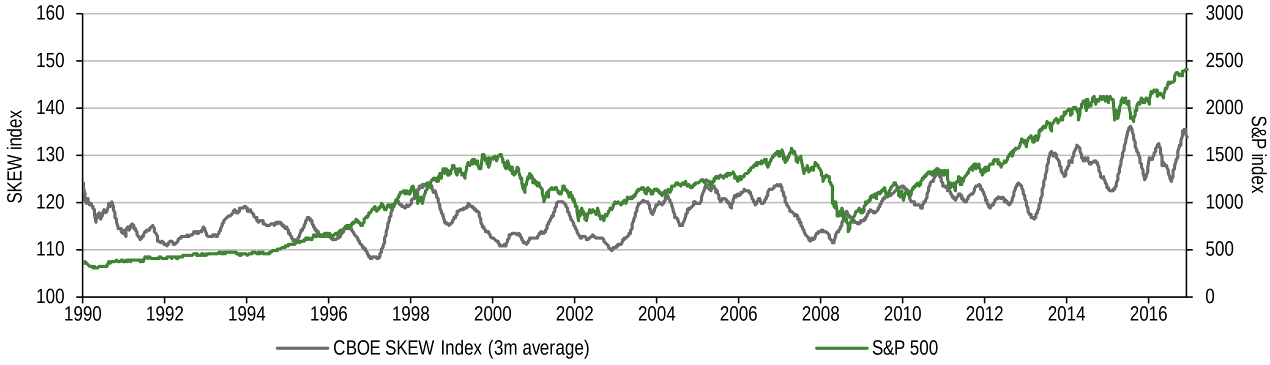
Exhibit 3: S&P500: Percentage of days with an intra-day range > 100bp



Source: Thomson Reuters Datastream, Edison calculations; based on trailing 90 days

In fact, the CBOE SKEW Index (Exhibit 4), which measures the degree of deviation implied in options prices from the Black-Scholes model and as such provides a measure of downside tail risk, is currently at a record level. While by no means a perfect indicator of medium-term trouble within the equity market, skew was elevated ahead of the original dot-com collapse and the global financial crisis. We believe investors should at least satisfy themselves that they understand why this index is currently at record levels and why downside protection is relatively expensive at present.

Exhibit 4: CBOE SKEW Index



Source: CBOE. SKEW Index reflects market-implied expectations of a tail risk event, based on put option implied volatilities.

It is possible the low level of current market volatility is in part due to an ample pool of natural sellers willing to give up equity upside in return for option premium, given current market valuations. In turn, hedging activity by dealers would act to depress short-term realised volatility. However, if true and should the market gap lower, this technical support for the market would be expected to diminish.

Outside of the technical aspects of the options market, it is understandable that investors as a whole perceive that some of the risks have grown smaller; the populist tide in Europe appears to be in reverse and the economic data from the region has also improved dramatically. Earnings growth forecasts for the US, the UK and continental Europe remain close to 10% for 2017 and have been on a rising trend in continental Europe in the earlier part of the year, even if estimates have now stalled. China did not slow as many anticipated in 2016, even if recent data is equivocal.

However, we would prefer to weight longer-term factors more heavily when constructing portfolios. Portfolios should not be built on the assumption that volatility will remain this low as the historical evidence for mean-reversion is strong. Although many investors may have become habituated, global monetary policy remains very loose and global debt levels remain extraordinarily high.

Equity investors should also recognise there has been a substantial retracement of bond yields during 2017, reflecting ebbing perceptions among bond investors for growth and inflation, and as a result global yield curves have flattened.

Just as the short-term improvements in the eurozone economies have put investors at ease and compressed risk premia in Europe this year, still high levels of debt/GDP mean the vulnerabilities remain in the event of a slowdown. Equity valuations, notably in the US, remain extended and this remains true even when the US technology sector is excluded from the calculations.

It would be tempting to view the decline in market volatility as an opportunity to invest in it, perhaps via volatility ETFs. However, investors concerned about the downside need not pay for the upside volatility exposure implicit in many volatility ETFs. In addition, as we have noted, downside protection is significantly more expensive than upside exposure. The implied volatility of 24% for out-of-the-money puts does not strike us as a bargain, for example. Our preference would be to keep the portfolio strategy simple.

In preference to adding to portfolio complexity with derivatives exposure to hedge risk, we believe investors should first reduce equity exposure and raise cash by taking profits in positions close to target prices and use out-of-the-money put options only judiciously, given current implied volatilities and the drag on portfolio performance due to time value decay.

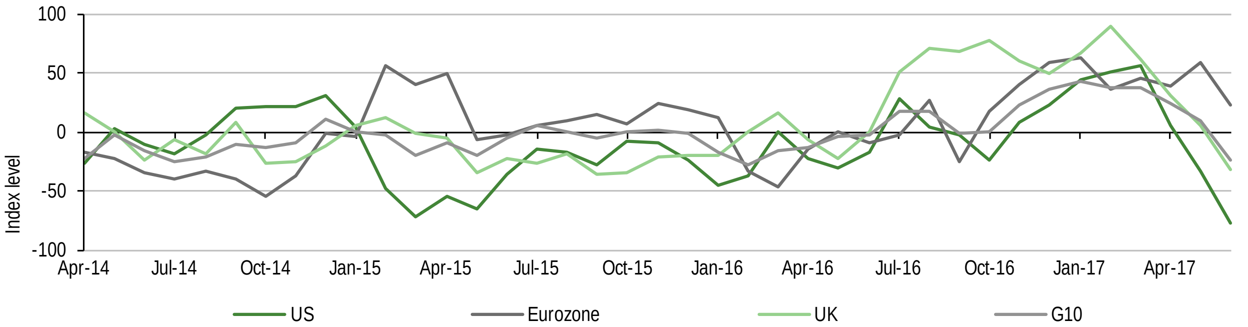
Equity risks are rising: Economic surprises turning lower

Economic surprise turns lower and positive earnings momentum eases

We are viewing with increasing concern the mounting evidence of disinflation in industrial commodity and energy markets. Economic surprise indices, Exhibit 5, have turned sharply lower on a global basis, a move which cannot be fully explained by seasonal factors. In this context, we were surprised by the relatively hawkish recent policy statements by the US Federal Reserve and Bank of England. For now, earnings growth forecasts near 10% for each of the US, the UK and continental Europe remain intact but we also detect ebbing momentum in this data compared to six months ago.

Economic surprise indices are moving sharply lower and while some of this may be seasonal, the rapid drop when combined with declining bond yields points to a genuine shortfall in activity versus earlier expectations.

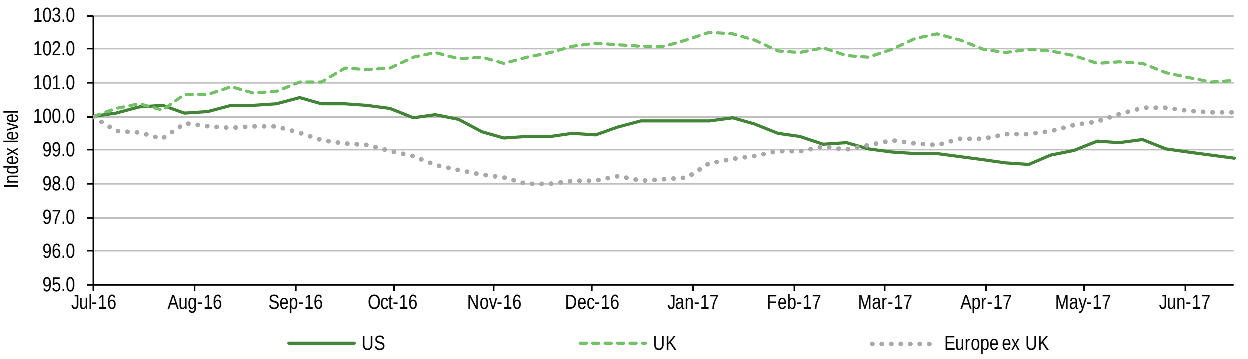
Exhibit 5: Economic surprise indices moving sharply lower in recent weeks



Source: Thomson Reuters Datastream/Citigroup

In terms of earnings momentum, our equal-weighted 2017 earnings revisions indices for the UK and US have been falling in recent weeks (Exhibit 6). Earnings momentum is highly correlated to market performance over the short term and, in view of this data, we believe price momentum for UK and US equities may slow over the summer months. In continental Europe, which has been the surprise outperformer for 2017 to date, over the last month our earnings revision index has fallen since the end of May. While it is clearly too early to tell if this is a new trend, it is consistent with the declining economic surprise index for the region.

Exhibit 6: Earnings revision indices falling in the US, the UK – and peak reached in continental Europe?



Source: Thomson Reuters Datastream/Citigroup

The declining momentum in economic activity has clearly been noted by global bond markets as yield curves have flattened significantly since Q1. Flat or inverted yield curves have clear slowdown or even recessionary implications.

In this context, it was something of a surprise to us to see both the US Federal Reserve and the Bank of England publish relatively hawkish policy statements in recent weeks. There is clearly a nervousness among investors with 2018 looming, which may represent the first year since 2010 when aggregate central bank balance sheets may be shrinking rather than growing.

We can understand the wish of the ECB to defer the discussion on what to do with its own QE programme until later in the year, to avoid an involuntary tightening of monetary conditions, but the cost for investors is added uncertainty.

Based on the data we have to hand, we believe global markets are now set to trade sideways – at best based on relatively high valuations and a tightening trajectory of US monetary policy and declining earnings momentum.

If the US Fed sticks to its current course, we may even see an uptick in volatility in Q3 until investors are able to form a view on profits expectations for 2018. There is, in our view, limited benefit in joining in the performance chasing at this point in the year. European equity ETF inflows may have reached record levels recently but in some respects the economic momentum appears to have already peaked.

Conclusion

Recent weeks have brought central banks' intentions for monetary policy into focus. The signals from the US Federal Reserve appear to be that US monetary policy will continue to be tightened even as near-term US economic momentum is somewhat weaker when compared to earlier in the year.

Furthermore, Fed Chair Yellen has been clear that repercussions from lower asset prices are not at the top of her agenda. This is, in our view, a significantly less market-friendly Fed, at least compared to previous years. In addition, Draghi's comments add to the perception that peak monetary accommodation is in the rear-view mirror. However, there is a distinction between headwinds and hurricanes; we do not believe policy error should be the base case at this stage.

In terms of the real economy, we note that economic surprise indices are falling faster than would be expected by seasonal factors and 2017 earnings forecasts are now declining modestly in the US and the UK.

Last month, we wrote that markets were likely to drift higher over the summer – unless the US Fed adopted a more hawkish tone or started to address asset prices more directly. While we suggested such a policy stance was a low-probability outcome, it has happened.

We would be careful to remember that nothing is certain and especially the pace of any prospective quantitative tightening. However, tighter monetary policy and ebbing economic momentum, when combined with rich valuations for developed market equities, can only warrant caution in terms of equity allocations.

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
United States

Sydney +61 (0)2 8249 8342
Level 12, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia