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Illumination: Equity strategy and market outlook

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Global perspectives: Renormalisation means…

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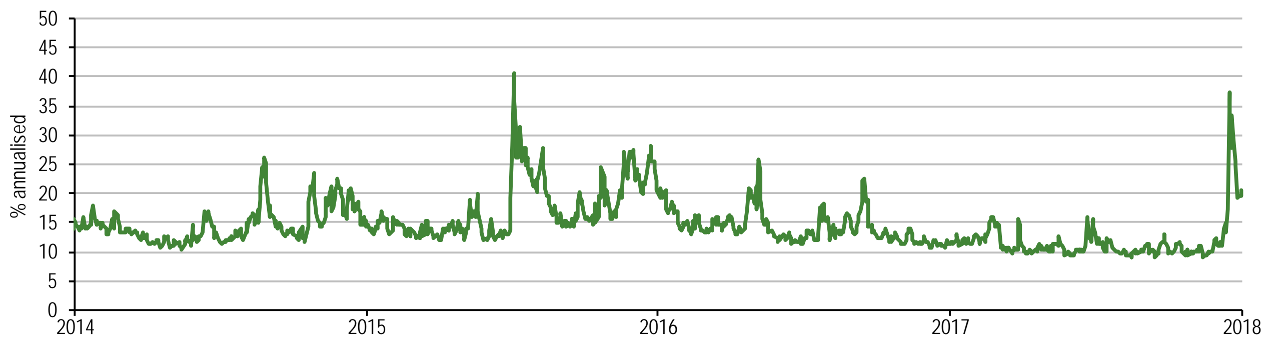
- **The standout market event during February was the discontinuity in equity market volatility.** From close to record lows in the final days of January, US market implied volatility jumped to over 50% annualised a few days later. No single trigger or fundamental change provides a satisfactory explanation. Our suspicion is that investor complacency in a period of tightening monetary policy is to blame.
- **Renormalisation of monetary policy will over time have a much broader impact on asset prices, in our view**. As volatility returned to interest rate markets we expected a follow-through to equity market volatility, even if not as abrupt. The elephants in the room in terms of monetary policy renormalisation remain equity and credit risk premia, which are still very low (or, in other words, valuations extended) in a historical context.
- **We do not have a model that tells us whether these other investment parameters will normalise gradually – or suddenly, as was the case with equity volatility.** The recent volatility experience does, however, add to the weight of evidence of market risk premia also reverting back to more normal levels as monetary policy is renormalised. We continue to believe the point of maximum equity market exposure was much earlier in this cycle.
- **There has, however, been no evidence in recent weeks that economic fundamentals are weakening**. Economic surprise remains positive and profits forecasts robust, especially in the US following tax reform. Policy-sensitive US two-year rates have been moving sharply higher, reflecting increasing investor confidence in growth. If the expectations for strong profits growth can be maintained, the normalisation of valuations may yet only have a relatively modest impact on market prices, namely as a period of sideways trading as bond yields and interest rates rise.
- **All of the previous points only serve to highlight the features of a top-of-cycle investment landscape.** While recognising the growth dynamic is strong for the moment, we continue to believe equity portfolios should now be tilted towards sectors that have offered a degree of resilience. Market volatility is, in our view, likely to settle at this new, higher level and portfolios should be managed accordingly. Bond yields may have risen substantially since we highlighted anomalously low yields in December, but on balance the risks still appear to the upside for now. Carefully researched specific growth- or event-driven situations should still be favoured over broad market exposure, in our view.

Volatility spike: Investors have only themselves to blame

The only mystery is why markets were so placid in the first place

Perhaps controversially, we view the intellectual horsepower being consumed by the legions of writers commenting on every second's movement in markets over the last few days not dissimilar to the wasted electricity consumed to validate speculative bitcoin transactions. Both activities appear, in our view, to be of relatively modest economic value, even if there is currently heightened demand. There have been, in a historical context, only modest declines from the highs for major stock markets, albeit concentrated in the stronger local currency year-to-date performers of the US and Japan. In volatile times, investors must remain focused on the long-term outlook.

Exhibit 1: Jump in market volatility likely to prove sustained



Source: Thomson Reuters Datastream

Volatility is where the action has been. Various 'short' ETF volatility products that can be distributed to retail investors lost almost all their value overnight as market volatility spiked up to 25% annualised from record low levels (Exhibit 1). Counterparties may be hedged, but US legal claims cannot be excluded. We had expected volatility to increase in 2018, but perhaps not by so much in one day.

The time-series of volatility suggests that a spike is followed by a sustained period of higher (although not necessarily extreme) volatility and we expect this to be the case in this instance. The fundamental driver for increased equity market volatility remains, in our view, the renormalisation of monetary policy and the consequent return of volatility to interest rate markets. It remains to be seen how much portfolio de-risking will be required from funds that explicitly or implicitly target a specific level of volatility, although the rebound in markets later in February suggests the episode is contained.

We do not subscribe to the view that rising bond yields were 'responsible' for the overnight surge in market volatility and index declines. Yields were, at the start of 2018, inconsistent with continued strong economic growth and both policymakers and institutional investors would have known this. Instead, we believe recent events more closely resemble avalanche risk. The long period of low volatility and confidence in a rising stock market had engendered a complacent market structure liable to fracture with very little provocation.

In fact, the equity market declines following the rise in volatility were modest, with the S&P 500, for example, down a maximum 12% from the high but now trading at the same level as recently as December. Thus, market valuations that were previously extended have eased somewhat but are still not below long-run averages. The declines in the stock markets to date also would not, in our view, represent an implicit financial tightening that would materially alter the direction of Fed rate policy. The comments by New York Fed President Bill Dudley that the market declines were "small potatoes" confirms this view.

In volatile markets, it is very tempting to judge the merit of an investment on potential short-term performance and this contributes to surge in demand for commentators to explain why a particular level or event might represent the 'bottom of the market'. Such a short-term focus can also paralyse investment decision-making.

We cannot with any certainty predict such a magic level and therefore make no prediction on short-term market direction. Instead, we believe investors are better served in volatile times by remaining focused on company fundamentals, where the economy is in the cycle and the likely long-term expected return on any investment.

Renormalisation means… renormalisation – of all variables

Other investment parameters are yet to revert to normal levels

It is now clear that in US interest rate markets the Fed's message that policy will be tightened in 2018 has finally got through. Fed fund futures and Fed 'dot-plot' indications for the likely level of US interest rates at the end of 2018 have now effectively converged. Outgoing Fed Chair Yellen's more esoteric arguments about why this divergence existed previously can now perhaps be put aside for the more straightforward explanation that investors did not believe Fed policymakers would raise interest rates so quickly in 2018.

In fact, while the renormalisation of US interest rates during the period 2014-2017 was an exercise in gradualism, the policy-sensitive US two-year rate has since then been rising just as smartly as in prior cycles (Exhibit 2). The confident tone of US policymakers earlier this month clarified that the US Fed saw no need to be thrown off course by the brief correction in US equity prices. As a result, US two-year rates have pushed on to highs of 2.25%, levels not seen since 2009.

In this top-of-cycle environment, constrained by the low levels of US unemployment and rising inflation pressure, there was always the risk that the benefits to equities from tax stimulus would be eroded by commensurately tighter expectations for monetary policy and this appears to be proving to be the case.

Exhibit 2: Not-so-gradual increases in US two-year yields in Q1 2018

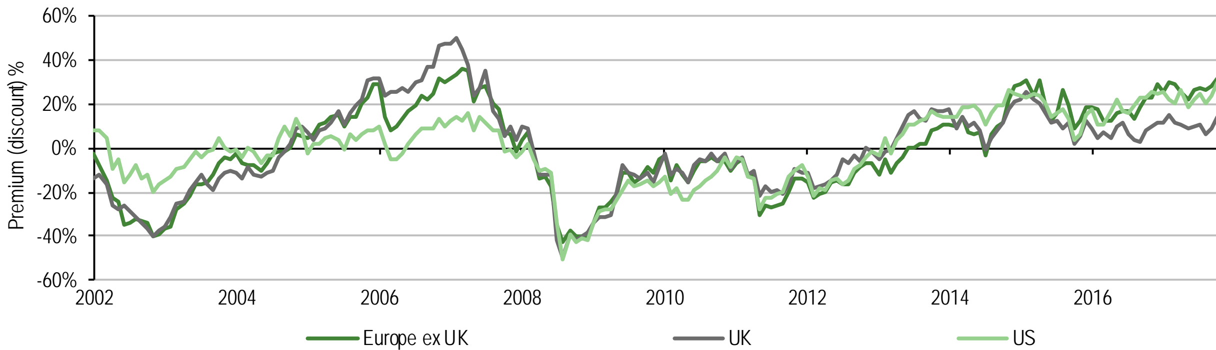
Source: Thomson Reuters Datastream

If unconventional monetary policy was associated with very low bond yields, low volatility, low interest rates and low equity and credit risk premia, the inference that is difficult to avoid is that in a renormalisation period the elephants in the room of very low equity and credit risk premia are as likely to be reset as the other investment parameters, which are now moving away from policy-depressed levels.

This reset of risk premia could in theory be as abrupt and shocking as in the case of market volatility – or more gradual. It is, of course, tempting to fear a 1987 scenario. For now, this appears less relevant, at least unless markets recover and make significant new highs later in 2018. One

helpful impact of the volatility spike has been to test the short-term resilience of markets, for the first time in over a year. With the rebound in markets since early February, market prices have proved more robust in the short-term than some observers might have assumed. Furthermore, contagion to other asset classes has been absent, at least to date.

Exhibit 3: Premium to 15-year average price/book

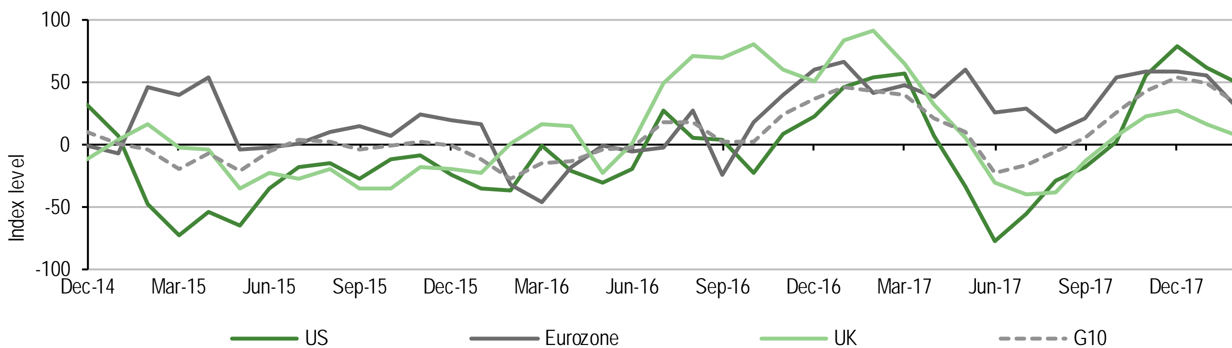


Source: Thomson Reuters Datastream. Data uses median I/B/E/S 12m forward book value

As a result, however, price/book valuations for US and continental European markets remain at the high end of historical ranges (Exhibit 3). Interestingly, the UK is now moving closer to its long-run average as investors become increasingly wary of Brexit. We believe asset-based measures of value remain relevant even as earnings-based measures may be emphasised by other commentators. As in 2015, earnings projections can easily evaporate with even a modest downgrade to world economic growth. Corporate profit margins are currently extraordinarily high - but a corollary of tighter labour markets and rising inflation pressure suggests that at least a gradual reversion to the mean should be embedded in investors' expectations, in our view.

We do not have a model for exactly how this process of renormalisation of equity valuations might unfold. Following the events of early February, we are now inclined to take as our base case that markets may move sideways in a more volatile trading range than that seen over the last few years. This may disappoint both those hoping for a day of reckoning with a view to capitalising on lower market prices and those who have added equity risk to portfolios with a view to enhancing returns. The correct equity strategy in the circumstances, in our view, remains to build a portfolio of company- or event-specific risks within the portfolio, while positioning the overall market exposure at a cautious level.

Exhibit 4: Economic surprises easing but still positive



Source: Thomson Reuters Datastream.

Economic and profits outlook remains positive

No evidence of spillover of market volatility into real economy

Several weeks after the outbreak of equity market volatility, we can see no sign of a meaningful slowdown in growth momentum or any downward revisions to profits forecasts. Median profits growth in each of the UK and continental Europe is forecast to be close to 10% in 2018 following a similar level of growth in 2017. In the US, median profits growth for 2018 is forecast to be 14% following a significant upward revision as a result of US tax reform.

In commodity markets, there are also for now few signs of a meaningful slowdown and key industrial commodities remain well above marginal cost. In China, credit measured by aggregate total social financing may have ebbed somewhat based on the rolling 12m average but it would be to early to draw any inference from this data alone.

Economic surprise data is also still positive, even if some of the stream may have come out of the data since the breakneck pace earlier in the year. On a seasonal basis, positive economic surprises tend to be concentrated at the start and end of each calendar year and the modest declines seen over the past month should not be of concern in their own right. Furthermore, it is still the case that G10 economies are showing positive economic surprise versus consensus.

We continue to believe, however, in line with our earlier notes, that investors should be focusing more of their attention on risks to growth rather than rising interest rates. A sudden drop in equity prices because growth is too strong is an unlikely scenario given all the attention that has already been given to the concept of rising bond yields and interest rates. What would be much more challenging would be a slowing of economic and/or profits growth at a time when inflationary pressures were still building. This is a risk scenario that would cause us to become very cautious, if equity markets were still as highly valued as today.

Conclusion

Renormalisation of monetary policy appears to be quickly moving through the market parameters of interest rates, bond yields and volatility but has not yet meaningfully affected equity or credit risk premia. In the context of a still strong economic and profits outlook, expectations for a sudden shift lower in equity markets appears overly pessimistic. Instead, our base case is for markets to trade sideways in a volatile trading range as equity valuation parameters move closer to long-term averages. We therefore maintain a cautious view on global equity markets.

Although global bond yields have continued to move higher, in our view this represents a continued correction towards the improving economic momentum, particularly in the US where the stimulus effect of tax reform intersects with an economy close to full capacity. We believe the risks to government bond yields remain to the upside and underweight duration risk.

On the other hand, short-term US interest rate expectations have now converged to the Fed's dot-plot outlook and now appear less of a risk factor for markets, absent further unanticipated US wage growth.

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