Exuberance and Gloom – Q1 2018

19/04/2018

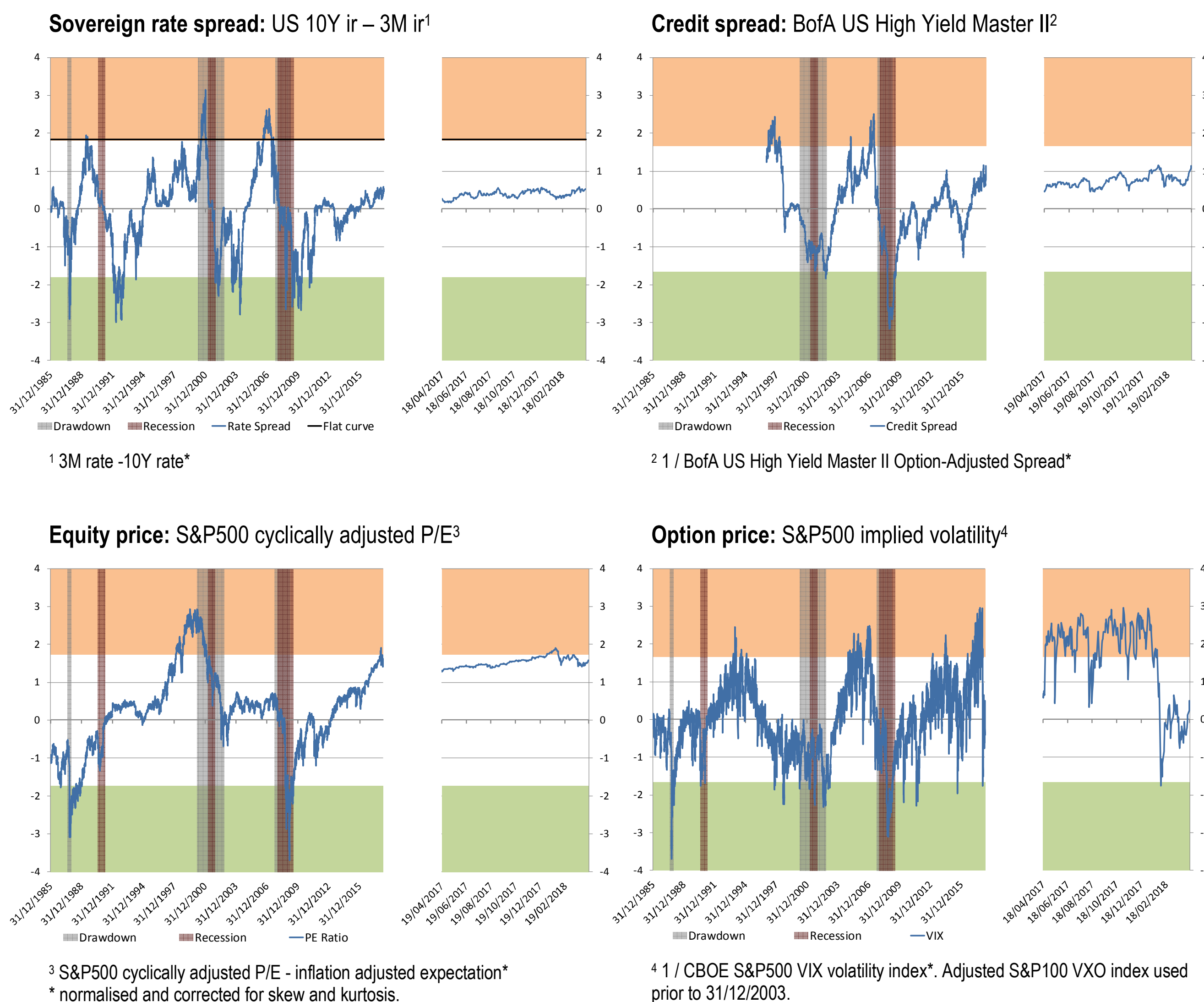
Summary of the quarter

After a strong 2017, investors lost their resolve in early February. Spooked by fears of higher inflation, fed rate hikes and trade wars they dumped their equity holdings resulting in a roller-coaster ride for US equity markets with the S&P500 experiencing a 10% intra-quarter drawdown.

In the first quarter, with the S&P500 up a paltry 0.2% and 10-year historical earnings rising, equity valuations were down and sentiment retreated from exuberant levels. The market turmoil drove implied volatility up to 33.5 at close of February 8th to finish the quarter at 20, resulting in sentiment swinging from exuberant to gloomy and back up to average levels. Credit spreads widening marginally pushing sentiment down towards its historical average. US sovereign short and long-term rates rose in parallel leaving the curve's slope unchanged and bond sentiment slightly above its historical average.

In the corporate arena, initial claims decreased maintaining employment sentiment in the exuberance zone. Earnings edge slightly higher but not sufficiently to keep sentiment rising.

Market Sentiment – Dashboard



Sovereign rate spread: US 10Y ir – 3M ir[1]

[1] 3M rate -10Y rate*

Credit spread: BofA US High Yield Master II[2]

[2] 1 / BofA US High Yield Master II Option-Adjusted Spread*

Equity price: S&P500 cyclically adjusted P/E[3]

[3] S&P500 cyclically adjusted P/E - inflation adjusted expectation*
* normalised and corrected for skew and kurtosis.

Option price: S&P500 implied volatility[4]

[4] 1 / CBOE S&P500 VIX volatility index*. Adjusted S&P100 VXO index used prior to 31/12/2003.

Sources: Federal Reserve Bank of St. Louis and Standard and Poor's

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Market Sentiment – Summary of the quarter

With S&P500 prices rising 0.2%. which is less than the increase in 10-year earnings, the cyclically adjusted P/E ratio fell from 31.5 to 30.4 and sentiment declined. While Q4 2017 earnings came in 5.2% below prior quarter they are 11.6% above Q4 2016. Earnings are forecasted to rise 28% in Q1 and a further 11.6% in Q2.

The VIX rose over the quarter from 11 to 20 with a high of 33.5 on February 8th. This led sentiment out of the exuberance zone down to the gloom zone before finishing close to its historical average.

10-year US bond yields rose from 2.4% to 2.74% while 3-month rates rose similarly from 1.37% to 1.7% leaving the curve's slope unchanged. Investor confidence in holding duration was thus unchanged over the quarter. The BofA US High Yield Master II spreads rose slightly from 3.63% to 3.7%, with a high of 3.8%, leading credit sentiment marginally lower.

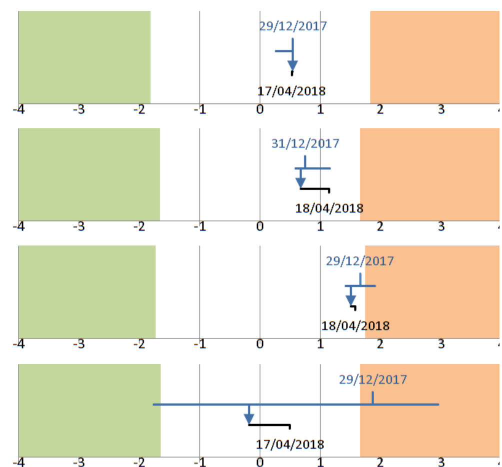
Market Sentiment – Quarter changes

US sovereign yield curve 3-month to 10-year slope
unchanged leaving sentiment above its historical average.

High yield corporate spreads
widened pushing sentiment lower towards its historical average.

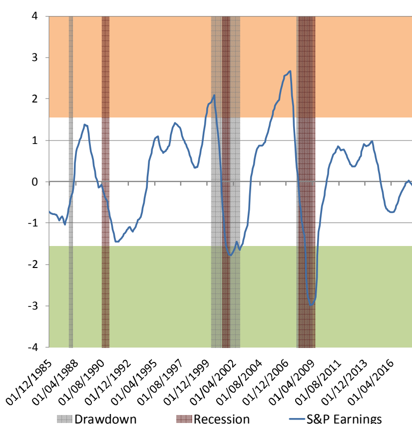
Cyclically adjusted S&P500 P/E ratio (caP/E)
fell pushing sentiment lower and out of the exuberance zone.

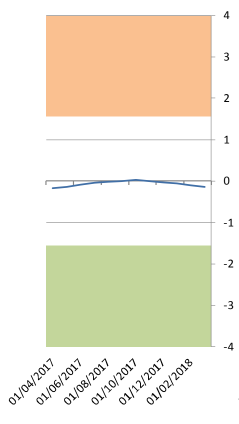
Implied volatility of S&P500 options (VIX)
rose driving sentiment much lower and out of the exuberance zone.



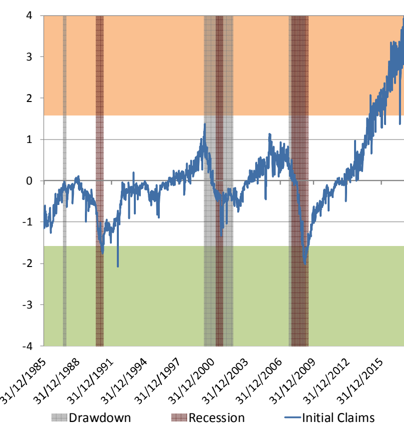
Corporate Sentiment – Dashboard

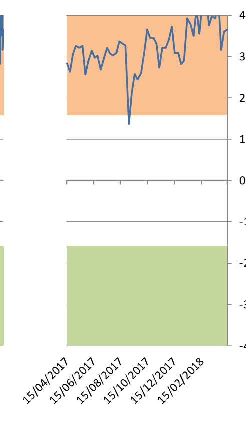
Corporate earnings: S&P500 earnings[5]





Employment: Initial claims[6]





[5] S&P500 12m rolling earnings versus long term trend*

[6] Civilian Labour Force Level / Initial Claims*

Sources: Federal Reserve Bank of St. Louis and Standard and Poor's.

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Corporate Sentiment – Summary of the quarter

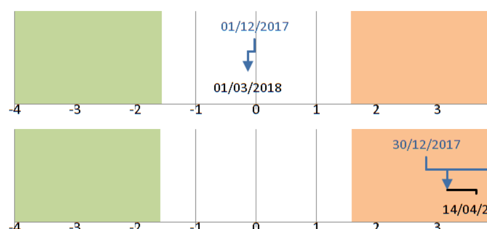
The earning uptrend initiated at the start of 2016 continued, with 2018 Q1 12-month rolling earnings coming in 2.6% above those of the prior quarter. However, this rise was smaller than that of the long-term trend and sentiment declined slightly. Earnings are above their historical trend and analysts expect the improvement to continue with forecasts of full year 2018 earnings 40% above 2017 earnings.

Initial claims (seasonally adjusted) declined from 248'000 to 242'000, with a low of 217'000, pushing sentiment higher, well within the exuberance zone. With the unemployment rate at 4.1% and the participation rate having stabilised, the employment market sentiment remains resolutely exuberant.

Corporate Sentiment – Quarter changes

S&P500 earnings
rose less than trend leading sentiment slightly lower and below historical average.

Initial claims
dropped driving sentiment higher in the exuberant zone.



Conclusion

In January market sentiment was very high with equity and volatility sentiments both in the exuberance zone. After a strong performance in 2017 markets were expensive and ripe for a correction. This was triggered by both political and monetary concerns that had been lurking in the background and which rose to the fore in February. Fear of an overly hawkish fed, erratic US trade policy and a weaker than expected Chinese growth drove investors to reassess their outlook. The ensuing correction, by deflating valuations, has provided some breathing room to markets. Investors would need to maintain a fair level of scepticism for some time for valuations to adjust sufficiently. If this is not the case, the excess number of poor capital allocation decisions will continue to rise ultimately decreasing economic growth prospects and increasing the risks of a strong correction. In the context of high earning growth expectations, fears of policy or monetary mishaps and a maturing business cycle, the coming months will be key in determining whether valuations will continue to rise, remain stable or decrease.

While equity and volatility sentiments retreated markedly during the quarter, bond and credit investors, who had been more cautious, reacted less forcefully.

On the corporate side, earnings are back at trend levels and sentiment is close to its historical average. Corporate management remains upbeat about these good results a fact that is highlighted by very low initial claims readings, which have led to a low unemployment rate and a stabilised participation rate.

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Objective

The aim of the analysis presented here is to identify phases during which investors and corporate management are feeling overly optimistic or overly pessimistic about future prospects. We postulate that in the presence of an overly optimistic outlook, which we label exuberant, the likelihood of a misallocation of capital by investors and corporate management increases substantially. The protracted accumulation of sub-optimally allocated capital will eventually lead to poor economic performance, a reassessment by investors of their holdings and ultimately a collapse in valuations. In the case of an excessively pessimistic outlook, which we label gloom, investment opportunities arise that will greatly benefit as investors reconsider their gloomy stance in the light of rebounding economic performance.

Methods

To estimate investors' sentiment, we observe the compensation they require to take on specific market risks. In the case of duration risk, we look at the yield pick-up between short and long-term bonds. Similarly, for credit risk we look up at the yield pick-up between sovereign and high-yield issues. For equity risk we look at the relationship between earnings and price and finally for option risk we look at implied volatility as a measure of premiums received. To render a clear as possible view of these indicators, their histories are smoothed and normalised as best as possible. Corporate management sentiment is assessed in a similar way by observing layoffs and earnings growth.

Galeo's Financial Analyst, Stephen Rufino:

Stephen joined Galeo, an independent wealth analysis and consolidation specialist, in 2012. He started his career in 1996 working within the Commodity Risk Management Group of UBS in Zurich. In 1998, he relocated to Geneva to join the fund of hedge fund manager Bucephale Investment Management as a quantitative analyst. At the end of 2002, he took charge of the growing hedge fund selection team at Anglo Irish Bank (Suisse) which later became Hyposwiss Private Bank Genève. In addition to his fund responsibilities, Stephen was chairman of the bank's investment committees, responsible for the redesign of the bank's investment guidelines and a member of the bank's management committee.

Stephen graduated from University of London with a PhD in Molecular Modelling and subsequently qualified as an investment analyst and wealth manager (CIIA & Analyste financier et gestionnaire de fortunes diplômé).

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