

Exuberance and Gloom – Q1 2019

18/04/2019

Summary of the quarter

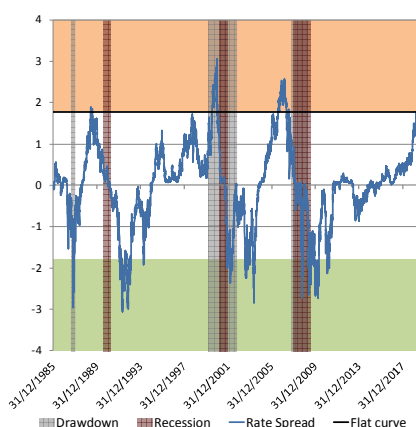
In Q1 global markets rebounded strongly with the S&P 500 rising 13% to recover most of its Q4 decline. Weakening economic momentum pushed the Fed to shift significantly from its announced tightening plan to a more dovish stance, dampened the risks of a US-China trade dispute and ensured continued Chinese economy stimulus. This emboldened investors to drive markets into a broad-based up move.

In the quarter, the S&P 500 rose 13% while 10-year historical earnings grew 4.7%, driving equity valuations up and sentiment back towards the exuberance zone. Implied volatility collapsed from 25.4 to 13.7 leading sentiment from well below to well above its historical average. Credit spreads declined pushing sentiment up to well above its historical average. US sovereign long-term rates fell more than short-term rates, decreasing the slope of the curve to nearly flat and increasing bond sentiment to the edge of the exuberance zone.

In the corporate arena, initial claims declined, maintaining employment sentiment exuberant. With 12-month earnings rising at trend level, profitability sentiment remained above its historical average.

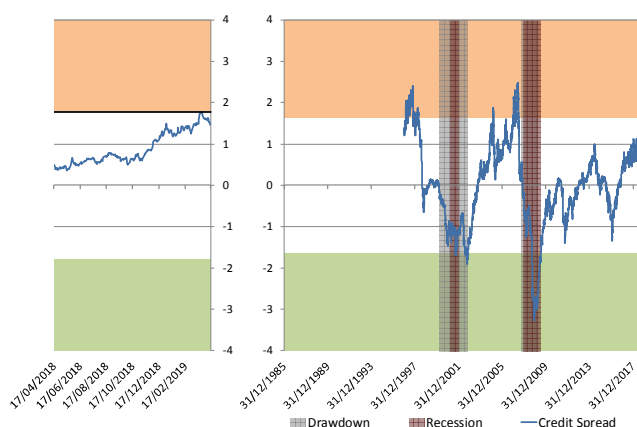
Market Sentiment – Dashboard

Sovereign rate spread: US 10Y ir – 3M ir¹



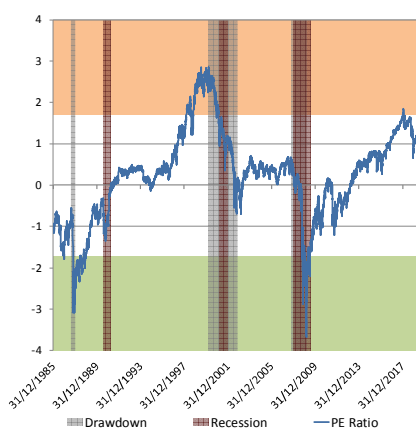
¹ 3M rate -10Y rate*

Credit spread: BofA US High Yield Master II²



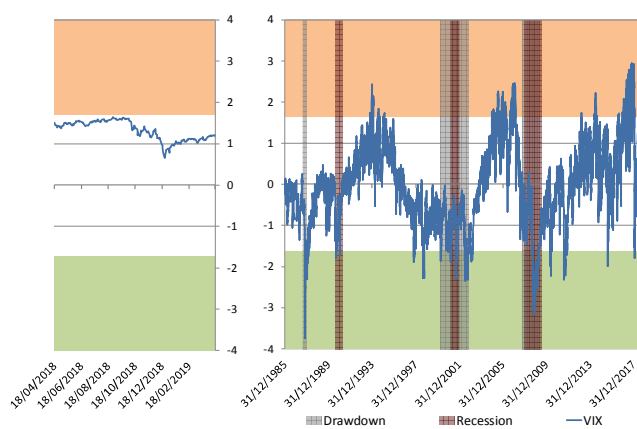
² 1 / BofA US High Yield Master II Option-Adjusted Spread*

Equity price: S&P500 cyclically adjusted P/E³



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

Option price: S&P500 implied volatility⁴



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

Market Sentiment – Summary of the quarter

With S&P 500 prices rising 13% and 10-year earnings up 4.7%, the cyclically adjusted P/E ratio rose from 26.4 to 28.2, leading sentiment towards the exuberance zone. While Q4 2018 earnings beat Q4 2017 by 7.4% they fell 20.4% versus Q3. They are however expected to rise by 13.5% in Q1 and a further 12% in Q2.

The VIX fell gradually over the quarter from 25.4 to 13.7 leading sentiment from well below its historical average to well above.

10-year US bond yields fell from 2.69% to 2.41% while 3-month rates fell by less from 2.4% to 2.35% resulting in a further flattening of the curve to only 0.06% and a substantial rise in sentiment as investor confidence in holding duration increased again. The BofA US High Yield Master II spreads fell significantly from 5.33% to 4.05% driving credit sentiment up above its historical average.

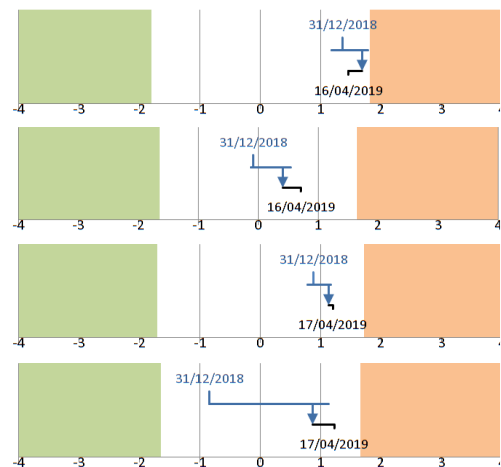
Market Sentiment – Quarter changes

US sovereign yield curve 3-month to 10-year slope
flattened significantly driving sentiment to the edge of the exuberance zone.

High yield corporate spreads
narrowed significantly driving sentiment to above its historical average.

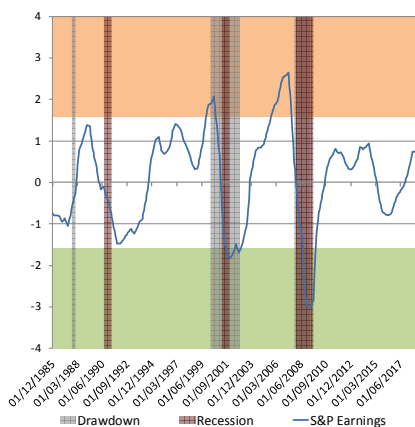
Cyclically adjusted S&P500 P/E ratio (caP/E)
rose significantly driving sentiment higher and back towards the the exuberance zone.

Implied volatility of S&P500 options (VIX)
fell significantly driving sentiment much higher.

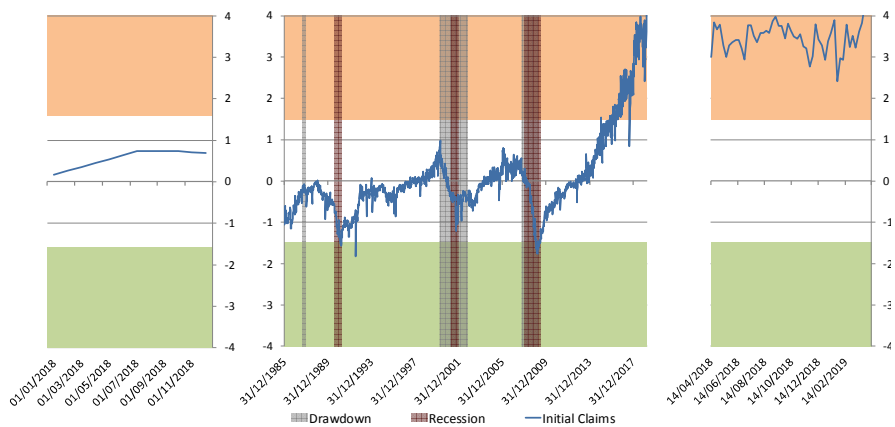


Corporate Sentiment – Dashboard

Corporate earnings: S&P500 earnings⁵



Employment: Initial claims⁶



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.

Corporate Sentiment – Summary of the quarter

The earning uptrend initiated at the start of 2016 slowed in Q4 with 12-month rolling earnings just 1.5% above those of Q3, resulting in a slightly lower sentiment level. Once the impact of the poor Q4 earnings is absorbed, analysts expect growth to pick-up with full 2019 earnings predicted 13.1% above 2018 earnings.

Initial claims (seasonally adjusted) fell from 231'000 to 204'000 leading sentiment higher into the exuberance zone. With the unemployment rate at just 3.8% and the participation rate starting to rise, the employment market sentiment remains resolutely exuberant.

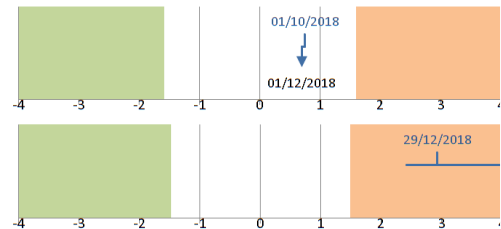
Corporate Sentiment – Quarter changes

S&P500 12-month earnings versus trend

declined slightly leaving sentiment little changed and above historical average.

Initial claims

fell driving sentiment higher and well into the exuberance zone.



Second quarter 2019 so far

After a strong first quarter, April has seen further improvements with the S&P 500 up 2.3% to the 17th. Market confidence has continued to improve except for US rate spread which declined as the slope of the curve steepen slightly.

Conclusion

Coerced by the fourth quarter market turmoil, the Fed paused its tightening plans and shifted to a more accommodative posture. This insured a return of market participant enthusiasm, with the Q1 experiencing a broad-based global recovery of markets. The longer-term impact of the Fed's change of heart is still to be determined but the fact remains that the US is facing the challenges of a late cycle economic expansion with a tight labour market, flattening yield curve and earnings growth deceleration while facing a monetary policy less supportive than in recent years. The US is nevertheless growing at a decent pace with 2019 showing improvement versus end 2018. GDP growth, which decelerated in Q4 to an annualised rate of 2.2%, is expected to grow over 3% in Q2. And earnings, which fell by 20.4% in Q4 versus Q3, are predicted to grow in 2019 by 13.1% versus 2018. Globally growth has been moderating, but there have been indications in 2019 of improving fundamentals. China, which is in the contraction phase, is showing signs stimulus policies are having an economic impact. The task remains challenging in the face of the trade scuffle with the US and an already high levels of private sector credit which will hamper the diffusion of stimulus measures.

Our sentiment indicators suggest that both market participants and corporate management are very optimistic. Valuations therefore remain extended and sensitive to a change in sentiment. In our previous newsletter we suggested watching out for a US yield curve inversion as an indicator of increased downturn risk. In Q1 the US curve inverted but only slightly and briefly. Only a more prolonged inversion would be a reliable predictor of a coming recession, usually within less than two years. It remains to be seen if the Q1 rebound is a relief rally triggered by the change in US monetary policy or if it signals a more profound upturn of the global economy.

An open question is that of where in the markets has investor exuberance been particularly excessive. The obvious possibilities are the high net leverage of BBB rated investment grade companies, the valuations of the FAANGs and that of the Unicorns. Neither of these cases is clear cut: other debt metrics don't look as bad, rate hikes are halted and the curve is flat; FAANGs may be highly valued but they differ from the dot-coms in that they are highly profitable and developed companies; Unicorns are not quoted and the transmission mechanism of issues to the quoted markets is unclear.

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, undervalued 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 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).