Exuberance and Gloom – Q2 2018 20/08/2018

Summary of the quarter

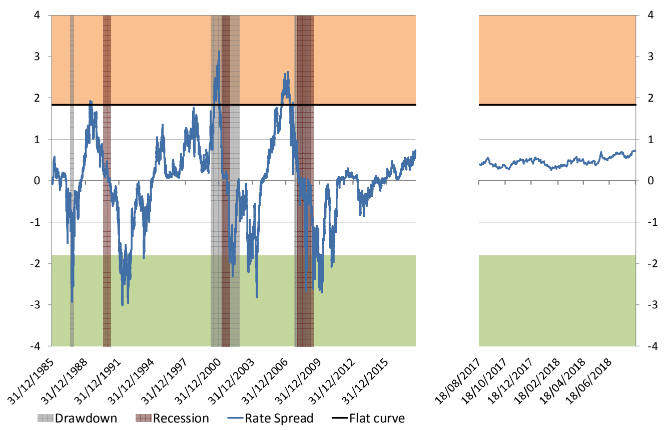
After an edgy first quarter, investors regained their composure in the second quarter resulting in a 2.9% rise of the S&P 500. Boosted by strong US economic growth and corporate tax cuts, S&P 500 first quarter earnings came in 22.5% higher than prior quarter earnings. The factors that spoked markets in the first quarter remain relevant however: fears of rising inflation, fed rate hikes, trade wars and an uncertain china outlook.

In the second quarter, the S&P 500 and 10-year historical earnings rose in tandem leaving equity valuations and sentiment little changed. Implied volatility, which had risen in the first quarter, declined to finish the second quarter at 16, pushing sentiment from below to above average levels. Credit spreads were unchanged over the quarter and sentiment therefore stable. US sovereign short-term rates rose slightly more than long-term rates thus flattening the curve and increasing bond sentiment further above its historical average.

In the corporate arena, initial claims again fell pushing employment sentiment further into the exuberance zone. With 12-month earnings edging higher sentiment rose towards average levels.

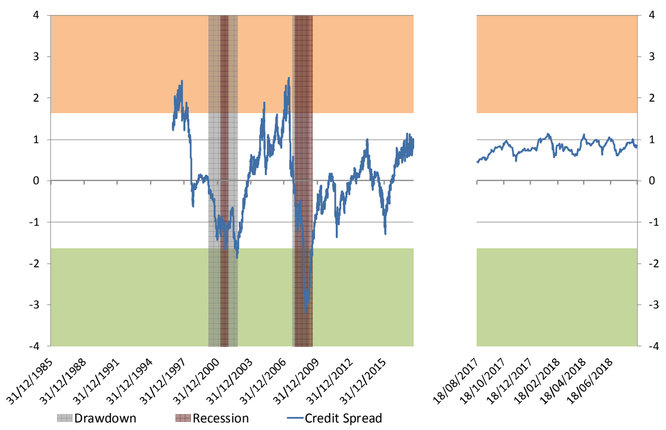
Market Sentiment – Dashboard

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



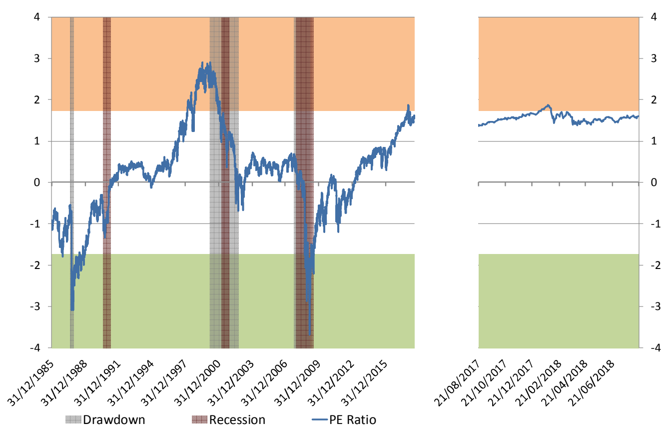
[1] 3M rate -10Y rate*

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



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

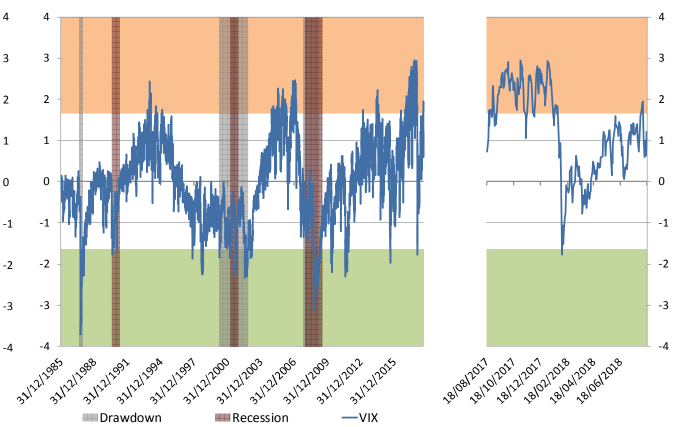
Equity price: S&P500 cyclically adjusted P/E[3]



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

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

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.

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Market Sentiment – Summary of the quarter

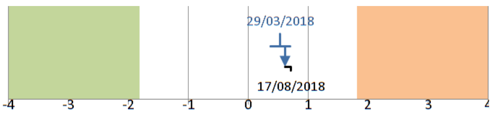
With S&P 500 prices and 10-year earnings rising in parallel, the cyclically adjusted P/E ratio remained at 30.4, leaving sentiment unchanged. The very strong Q1 2018 earnings came in 22.5% above prior quarter and 20.3% above Q1 2017. Earnings are to grow 3.5% in Q2 and a further 7.9% rise is forecasted for Q3.

The VIX fell over the quarter from 20 to 16 with a low of 11.6 on June 6th. This led sentiment from below historical average levels up to the edge of the exuberance zone and back down to above average levels.

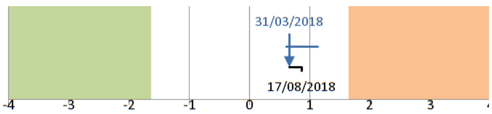
10-year US bond yields rose from 2.74% to 2.85% while 3-month rates rose slightly more from 1.7% to 1.89% resulting in a slight flattening of the curve and rise in sentiment as in investor confidence in holding duration increased. The BofA US High Yield Master II spreads were unchanged over the quarter at 3.7%, with a low of 3.2%, leaving credit sentiment stable.

Market Sentiment – Quarter changes

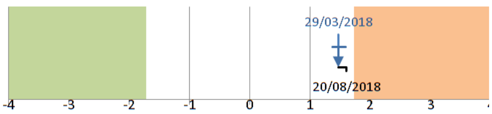
US sovereign yield curve 3-month to 10-year slope
flattened leading sentiment higher above its historical average.



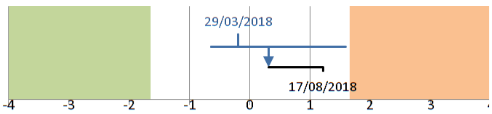
High yield corporate spreads
unchanged leaving sentiment above its historical average.



Cyclically adjusted S&P500 P/E ratio (caP/E)
unchanged leaving sentiment close to the exuberance zone.

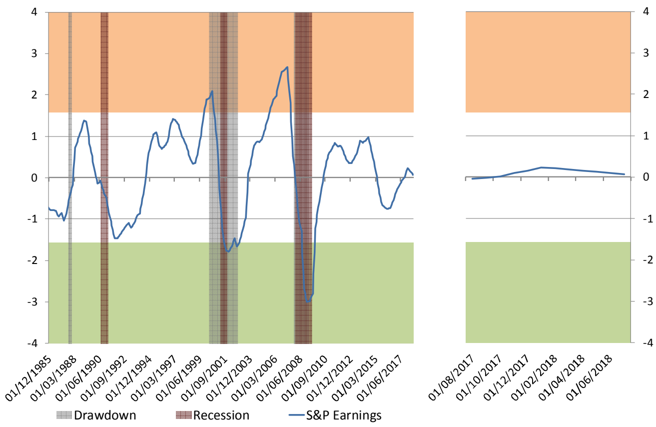


Implied volatility of S&P500 options (VIX)
fell driving sentiment higher to above historical average.



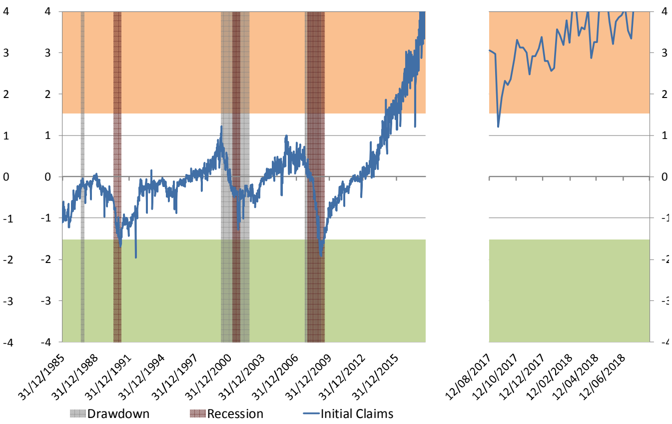
Corporate Sentiment – Dashboard

Corporate earnings: S&P500 earnings[5]



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

Employment: Initial claims[6]



[6] Civilian Labour Force Level / Initial Claims*

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

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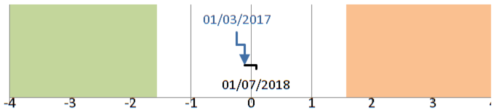
Corporate Sentiment – Summary of the quarter

The earning uptrend initiated at the start of 2016 continued, with 2018 Q1 12-month rolling earnings coming in 5.06% above those of the prior quarter. This resulted in a higher sentiment level. Analysts expect the improvement to continue with forecasts of full year 2018 earnings 30.4% above 2017 earnings.

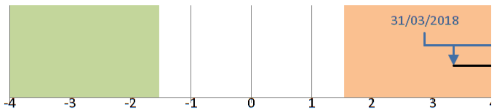
Initial claims (seasonally adjusted) declined from 242'000 to 232'000, with a low of 209'000, pushing sentiment higher, well within the exuberance zone. With the unemployment rate at 4% and the participation rate having stabilised (increasing for 25 to 54-year olds), the employment market sentiment remains resolutely exuberant.

Corporate Sentiment – Quarter changes

S&P500 12-month earnings
rose leading sentiment higher towards the historical average.



Initial claims
dropped driving sentiment higher in the exuberant zone.



Third quarter 2018 so far

After a second quarter with stable or rising sentiment indicators, the summer has so far seen a 5% rise in the S&P500 and a broad improvement in all sentiment indicators. While stock market performance has been generally good, emerging markets and particularly major exporting countries have not fared as well.

Conclusion

Markets participants have pushed to the back of their mind the fears that triggered the February correction. The concerns of an overly hawkish fed, erratic US trade and foreign policy and a weaker than expected Chinese growth are still pertinent but they have been overshadowed by the strong performance of the US economy which grew at a 4.1% annualised rate in the second quarter. Globally the economic cycle is maturing and becoming less synchronised with the US, as other regions see weaker earning growth and market performance.

Prior to the February correction equity and volatility sentiments had both been in the exuberance zone. They currently seem to be heading back to these elevated levels. After a multi year period of very loose fed policy, successive rate hikes are flattening the US yield curve and leading to a trend of increasing bond sentiment. This leaves credit sentiment as the only market sentiment indicator not in an uptrend. This broad enthusiasm is driven by a positive environment for US earnings due to strong economic growth, big corporate tax cut and slow wage growth despite declining unemployment. In contrast the global news flow is more mixed suggesting a certain decoupling with the US.

With market sentiment on the rise and both equity and volatility indicators close to the exuberance zone, asset prices are expensive. In the context of a flattening of US yield curve, which suggest that the US economy is moving from mid-cycle to late-cycle phases, this leaves little room for investors to be rewarded appropriately for the high valuations they are currently paying. Currently there is a contrast between strong US economy and concerns about global trade. Economic data flow will reveal which of these two forces in currently dominating.

On the corporate side, earnings saw growth and sentiment is above historical average. Corporate management is 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 to growing 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, 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).

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