

## Exuberance and Gloom – Q2 2019

03/07/2019

### Summary of the quarter

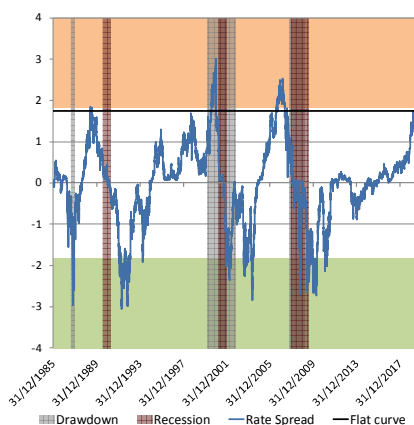
While Q2 was tumultuous, global markets continued to rebound with the S&P 500 rising 3.79% to reach new highs. The interplay of growing US-China trade tensions and the increasingly dovish stance of central banks resulted in a choppy Q2 with the S&P 500 dropping 6.6% intra quarter. In June, investors became increasingly certain the Fed would implement rate cuts, boosting both risky assets and safe assets.

In the quarter, with the S&P 500 rising faster than 10-year historical earnings, equity valuations rose pushing sentiment higher in the direction of the exuberance zone. Implied volatility increased from 13.7 to 15.8 driving sentiment down towards its historical average. Credit spreads were little changed leaving sentiment slightly above its historical average. US sovereign long-term rates fell more than short-term rates, inverting the curve and pushing bond sentiment into the exuberance zone.

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

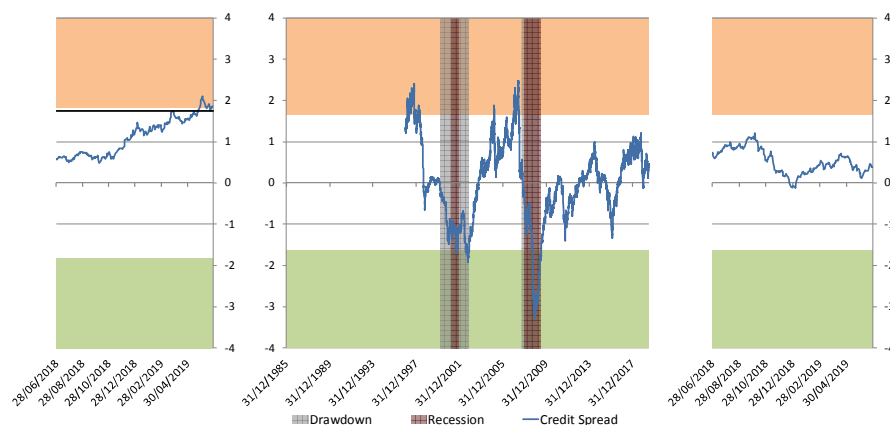
### Market Sentiment – Dashboard

**Sovereign rate spread: US 10Y ir – 3M ir<sup>1</sup>**



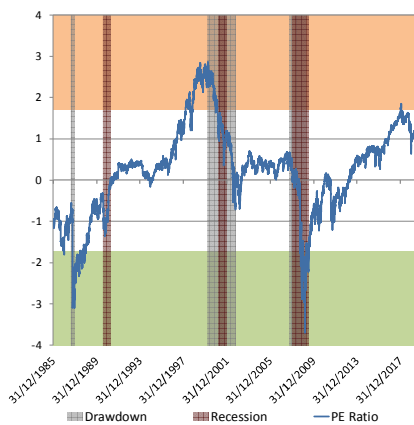
<sup>1</sup> 3M rate -10Y rate\*

**Credit spread: BofA US High Yield Master II<sup>2</sup>**



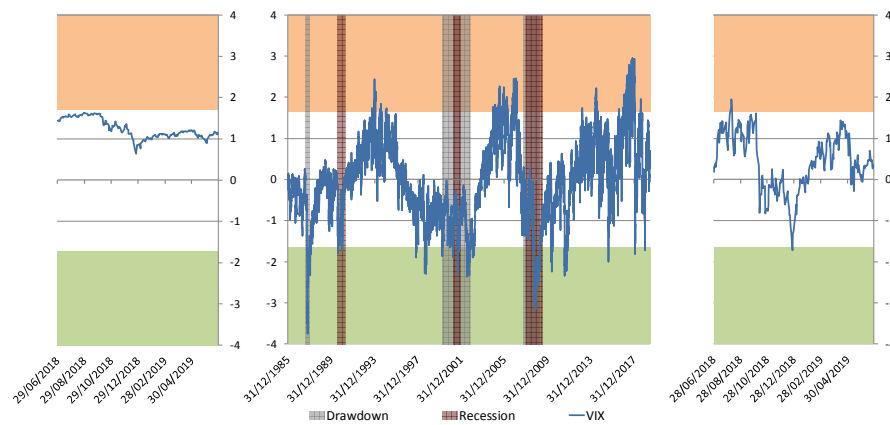
<sup>2</sup> 1 / BofA US High Yield Master II Option-Adjusted Spread\*

**Equity price: S&P500 cyclically adjusted P/E<sup>3</sup>**



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

**Option price: S&P500 implied volatility<sup>4</sup>**



<sup>4</sup> 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 3.79% and 10-year earnings up 2.41%, the cyclically adjusted P/E ratio rose from 28.1 to 28.4, leading sentiment into the exuberance zone. After a quarter over quarter drop of 20.9% in Q4, earnings are rising again with Q1 earnings up 20.9% with expectations of increases of 4.1% in Q2 and 13.3% for the full 2019 year.

The VIX rose over the quarter from 13.7 to 15.8 leading sentiment down towards its historical average.

10-year US bond yields fell from 2.41% to 2.01% while 3-month rates fell by less from 2.35% to 2.09% leading to a slight curve inversion of -0.08% and a rise of sentiment into the exuberance zone as investor confidence in holding duration increased further. The BofA US High Yield Master II spreads rose slightly from 4.05% to 4.09% leaving credit little changed and above its historical average.

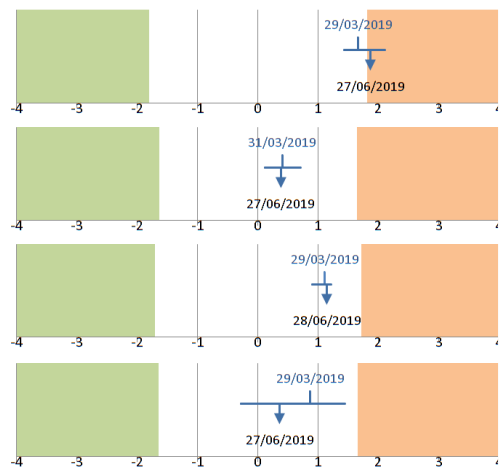
## Market Sentiment – Quarter changes

**US sovereign yield curve 3-month to 10-year slope** flattened driving sentiment into the exuberance zone.

**High yield corporate spreads** widened slightly leaving sentiment to above its historical average.

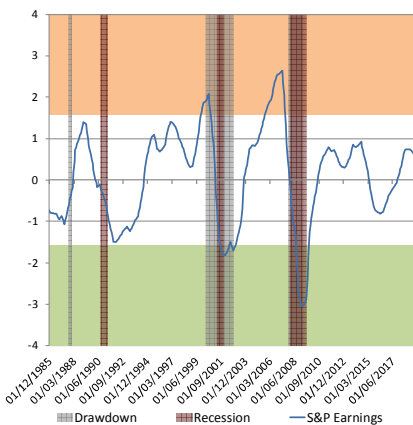
**Cyclically adjusted S&P500 P/E ratio (caP/E)** rose modestly pushing sentiment higher towards the exuberance zone.

**Implied volatility of S&P500 options (VIX)** rose significantly driving sentiment lower towards the historical average.

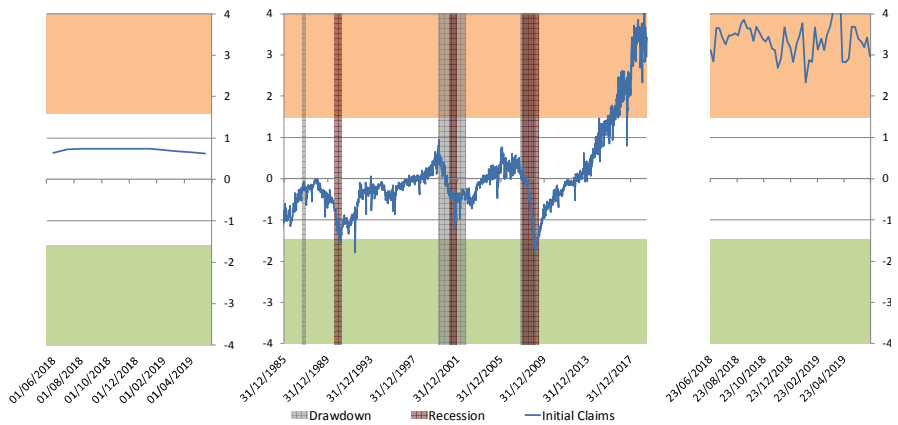


## Corporate Sentiment – Dashboard

**Corporate earnings: S&P500 earnings<sup>5</sup>**



**Employment: Initial claims<sup>6</sup>**



<sup>5</sup> S&P500 12m rolling earnings versus long term trend\*

<sup>6</sup> Civilian Labour Force Level / Initial Claims\*

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

## Corporate Sentiment – Summary of the quarter

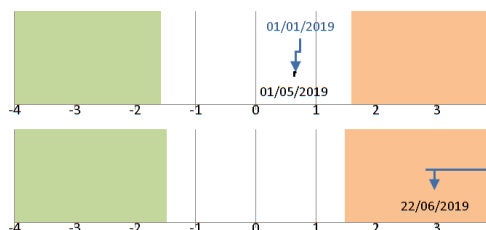
The earning uptrend initiated at the start of 2016 continued to slow in Q1 with 12-month rolling earnings just 1.5% above those of Q4, resulting in a slightly lower sentiment level. With Q1 earnings having recovered most of their Q4 decline, analysts expect growth to resume with full 2019 earnings predicted 13.3% above 2018 earnings.

Initial claims (seasonally adjusted) rose from 204'000 to 227'000 leading sentiment lower but still well within the exuberance zone. With the unemployment rate dropping to just 3.6% and the participation having stabilised, the employment market sentiment remains resolutely exuberant.

## Corporate Sentiment – Quarter changes

### S&P500 12-month earnings versus trend

declined slightly leading sentiment down towards its historical average.



### Initial claims

rose leading sentiment lower but still well within the exuberance zone.

## Conclusion

After a Q1 rebound fuelled by the Fed pausing rate hikes and shifting to a more accommodative posture, the second quarter saw a tweet triggered turbulent month of May. As the US/China trade dispute escalated investors took fright and the S&P dropped by 6.6%. And once again, the growing conviction that central banks would intervene to support the economy and markets triggered a rebound. With the Fed putting hikes on hold and opening the door to cuts and the ECB suggesting an expansion of its QE program, investors pushed the S&P 500 up 3.79% in Q2.

The US is growing at a good pace with Q4 2018 GDP 3% higher than Q4 2017 and Q1 2019 expanding at 3.2%. Earnings, which fell by 20.4% in Q4 versus Q3, grew 20.9% in Q1 and are predicted to grow in 2019 by 13.3% versus 2018. While the US economy is showing resilience, forecasts for the global economy have been cut back (World bank 2.6%, IMF 3.3%) due to the ongoing tariff war, China's slowdown and weakening Euro zone. China is fighting back with stimulus policies and by opening up of several sectors, including the financial sector, to foreign investment. In Europe, the ECB is pondering a reignition of QE.

Since the end of the Trump rally (26<sup>th</sup> of January 2018) the S&P 500 is up just 2.6% while 10-year earnings have grown by 17% in the same period, reducing the overextended valuations of US equities. This adjustment, which brings down by a notch the risk of an equity market crash and an ensuing recession, is a beneficial side-effect of the US's atypical approach to international and economic relations. During the same period however the US yield curve flattened and is now inverted. There has been a switch in exuberant overvaluations from equities to bonds. An inverted yield curve is a bad omen as it is a good predictor of a recession within two years, but a more prolonged inversion is necessary for this signal to be significant.

Suggestions of Fed rates cuts in the context of a still strong US economy and talks of ECB QE revival are a boost to the confidence of most investors while some do wonder about the ammunitions that will be left for central banks to fight the next recession.

The second quarter leaves us in a slightly perplexing situation as excessive optimism has gradually been reduced in many market indicators with the exception of the yield curve that is now inverted. Have expectations been sufficiently deflated to allow a further period of market expansion or are bond investors onto something?

## 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.

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### **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).*