Exuberance and Gloom – Q3 2018

24/10/2018

Summary of the quarter

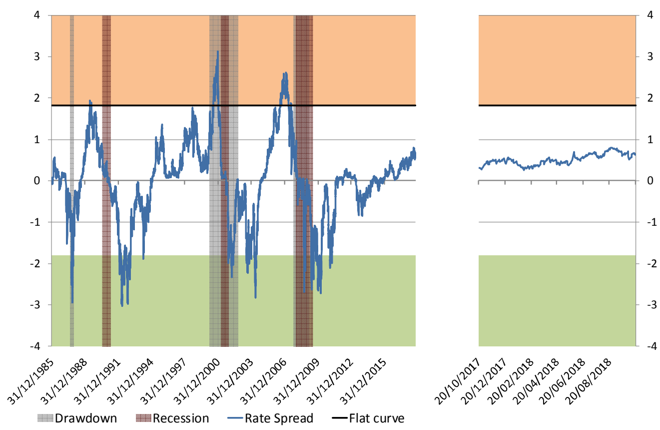
After regaining their composure in the second quarter, investors were emboldened in the third quarter as they drove the S&P 500 up 7.2%. This optimism is very US centric with the views on Europe, China and emerging markets being more subdued. While US economy data is strong the factors that spooked markets in the first quarter remain relevant: fears of fed hikes, trade wars, European softness and an uncertain China outlook.

In the quarter, the S&P 500 rose faster than its 10-year historical earnings lifting equity valuations and pushing sentiment towards the exuberance zone. Implied volatility continued to decline to finish the quarter at 12 which drove sentiment up to the exuberance zone. Credit spreads narrowed pushing sentiment higher towards the exuberance zone. US sovereign short-term rates rose more than long-term rates thus flattening the curve and increasing bond sentiment further above its historical average.

In the corporate arena, initial claims once again fell leading employment sentiment further into the exuberance zone. With 12-month earnings rising, profitability sentiment was driven further above its historical average.

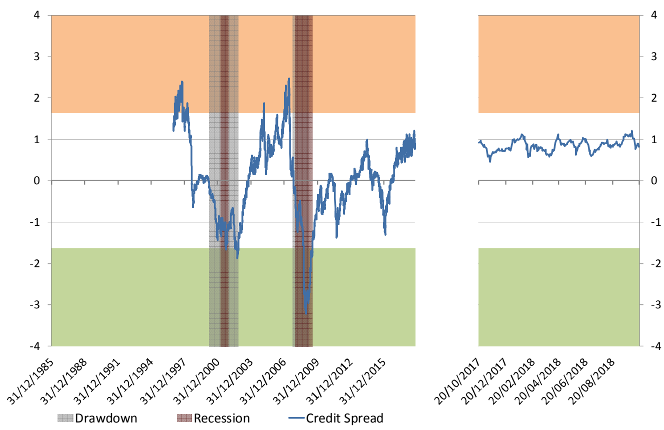
Market Sentiment – Dashboard

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



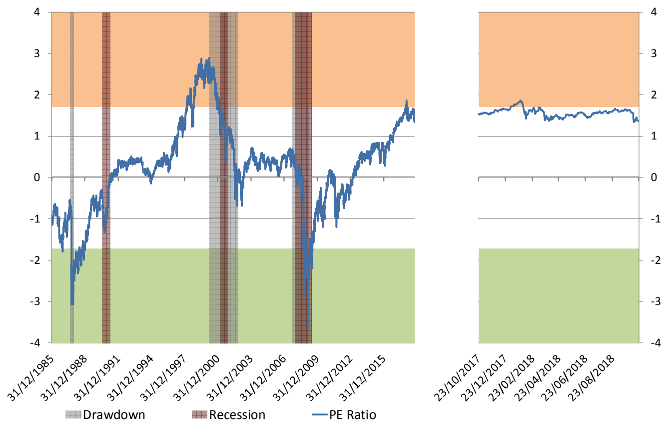
[1] 3M rate -10Y rate*

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



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

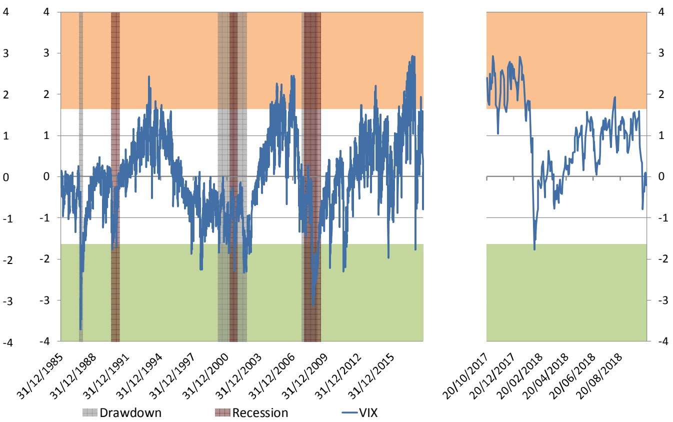
Equity price: S&P500 cyclically adjusted P/E[3]



[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

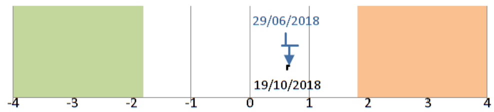
With S&P 500 prices rising 7.2% and 10-year earnings up a more modest 2.3%, the cyclically adjusted P/E ratio rose from 30.4 to 31.8, leading sentiment higher towards the limit of the exuberance zone. Q2 2018 earnings came in 3.1% above prior quarter and 26.1% above Q2 2017. Earnings are expected to grow 9% in Q3 and a further 5.6% rise is forecasted for Q4.

The VIX fell over the quarter from 16 to 12 with a low of 10.85 on August 8th. This led sentiment from above historical average levels up into the exuberance zone and back down to just below the exuberance zone.

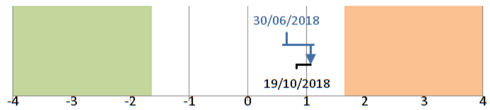
10-year US bond yields rose from 2.85% to 3.05% while 3-month rates rose slightly more from 1.89% to 2.15% resulting in a further flattening of the curve and a rise in sentiment as investor confidence in holding duration increased. The BofA US High Yield Master II spreads fell over the quarter from 3.71% to 3.28% driving credit sentiment higher towards the exuberance zone.

Market Sentiment – Quarter changes

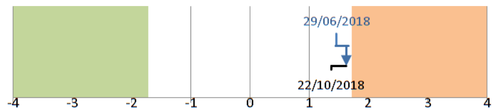
US sovereign yield curve 3-month to 10-year slope
flattened leading sentiment higher above its historical average.



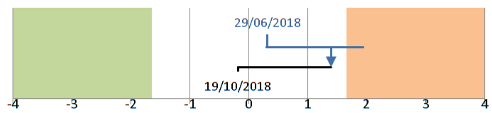
High yield corporate spreads
narrowed driving sentiment higher towards the exuberance zone.



Cyclically adjusted S&P500 P/E ratio (caP/E)
rose leading sentiment higher to the exuberance zone limit.

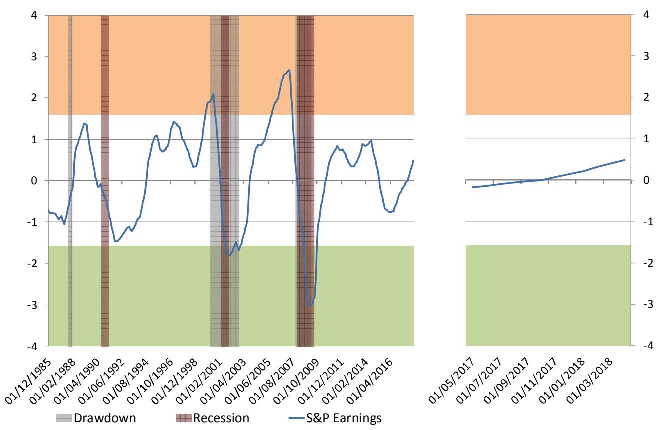


Implied volatility of S&P500 options (VIX)
fell driving sentiment higher towards the exuberance zone.

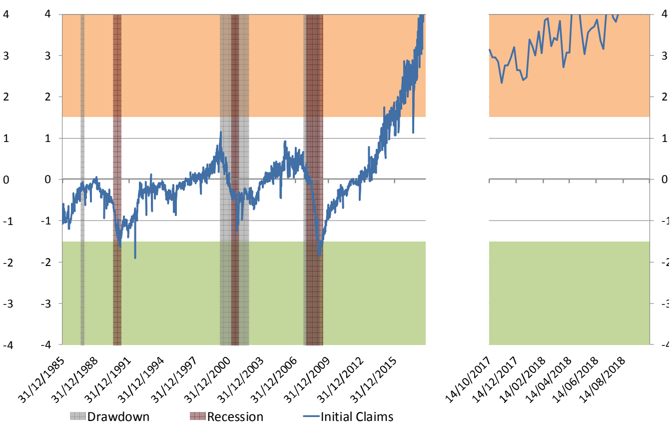


Corporate Sentiment – Dashboard

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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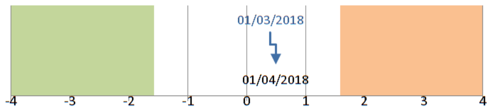
Corporate Sentiment – Summary of the quarter

The earning uptrend initiated at the start of 2016 continued, with 2018 Q2 12-month rolling earnings coming in 6.1% 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 30.5% above 2017 earnings.

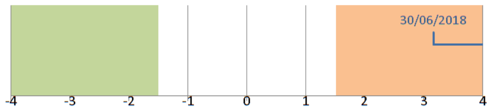
Initial claims (seasonally adjusted) declined from 232'000 to 207'000, with a low of 202'000, pushing sentiment higher, well within the exuberance zone. With the unemployment rate at 3.7% and the participation rate having stabilised, the employment market sentiment remains resolutely exuberant.

Corporate Sentiment – Quarter changes

S&P500 12-month earnings versus trend
rose leading sentiment higher away from the historical average.



Initial claims
dropped driving sentiment higher in the exuberance zone.



Fourth quarter 2018 so far

After a strong third quarter with rising sentiment indicators, October has seen a brisk reversal of sentiment with the S&P 500 down 9.2% to the 24th. While US equity investors remain very confident about future earnings prospects, the current high valuations make them very sensitive to potentially negative news flow. All market sentiment indicators have suffered in October with the exception of the US rate spread which has seen little change in the slope of the curve.

Conclusion

In September, the Fed hiked rates for the third time this year making the dollar more attractive and pushing up the required yield on other assets. As central banks reduce their liquidity support, higher volatility is expected and the attractivity of less liquid assets will drop. In this context emerging markets are viewed as being at risk and particularly those with significant USD liabilities and few USD denominated assets. The quarter saw a third round of US tariffs on Chinese imports which combined with a deceleration of the Chinese economy leaves the country in an uncomfortable situation. Globally the economic cycle is maturing and becoming less synchronised with the US, as other regions see weaker earning growth and market performance.

The US economy is vigorous: Q2 GDP up 4.2% at an annualised rate, unemployment at 3.7% and Q2 corporate earnings up 26% versus Q2 2017. High valuations reflect market participants' confidence in continued strong growth. Concerns of an overly hawkish fed, erratic US trade and foreign policy, weak spots in Europe and a slowing Chinese growth returned to the fore in early October leading market downwards.

Equity and volatility sentiments have both been hugging the limit of the exuberance zone this year but market participants don't seem willing to drive valuation much higher. Successive rate hikes are flattening the US yield curve and leading to rising bond sentiment. Credit sentiment, which had been lagging is now also in an uptrend. This broad enthusiasm is driven by growing US earnings due to strong economic growth, big corporate tax cuts and slow wage growth despite declining unemployment.

With market sentiment on the rise and both equity and volatility indicators close to the exuberance zone, asset prices are expensive. With the US yield curve flattening as the US economy moves from mid-cycle to late-cycle phases, investors are unlikely to be rewarded appropriately for the high valuations they are paying.

Corporate earnings grew above trend and pushed sentiment above its historical average. Management is upbeat about these good results, a fact that is highlighted by incredibly 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, 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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