

## Exuberance and Gloom – Q3 2019

16/10/2019

### Summary of the quarter

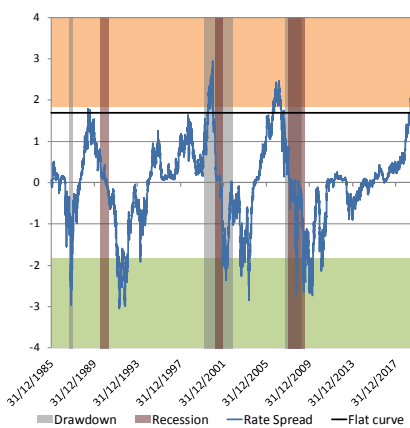
Despite a choppy Q2, global markets finished the quarter little changed with the S&P 500 rising 1.19%. The increasingly dovish stance of Central Banks counterbalanced the continuing drama of the US-China tariff war. The double Fed rate cuts have been a support for both risky assets and safe assets.

Over the quarter, the S&P 500 rose slower than its 10-year historical earnings resulting in lower equity valuations thus leading sentiment away from the exuberance zone. Implied volatility increased from 15.1 to 16.2 driving sentiment down towards its historical average. Credit spreads were little changed with sentiment remaining slightly above its historical average. The 0.5% cut of US Fed rates reduced short- and long-term rates, but with long rates falling more the US yield curve inverted further sustaining an exuberant sentiment.

In the corporate arena, initial claims remain at historical lows and employment sentiment exuberant. 12-month earnings growth, after a tax-cut boost, is now below trend while sentiment remains above historical average.

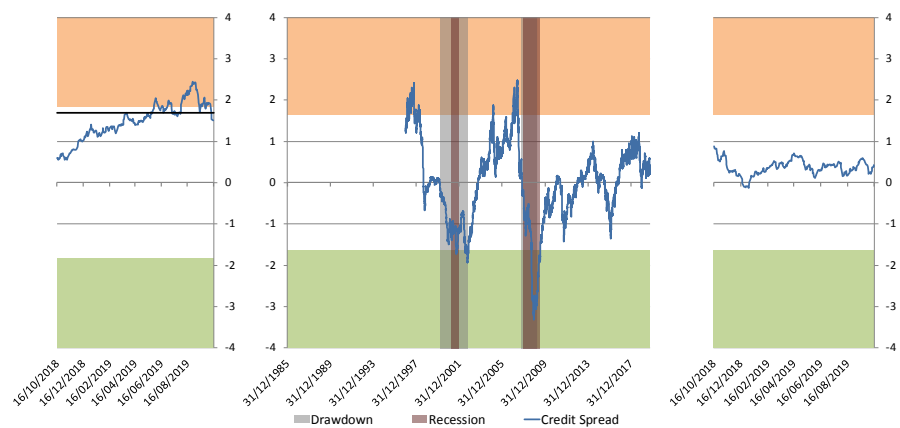
### Market Sentiment – Dashboard

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



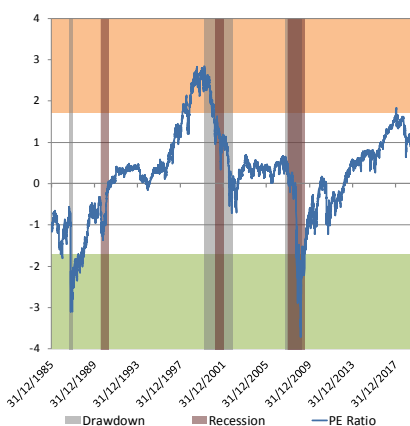
<sup>1</sup> 3M rate -10Y rate\*

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



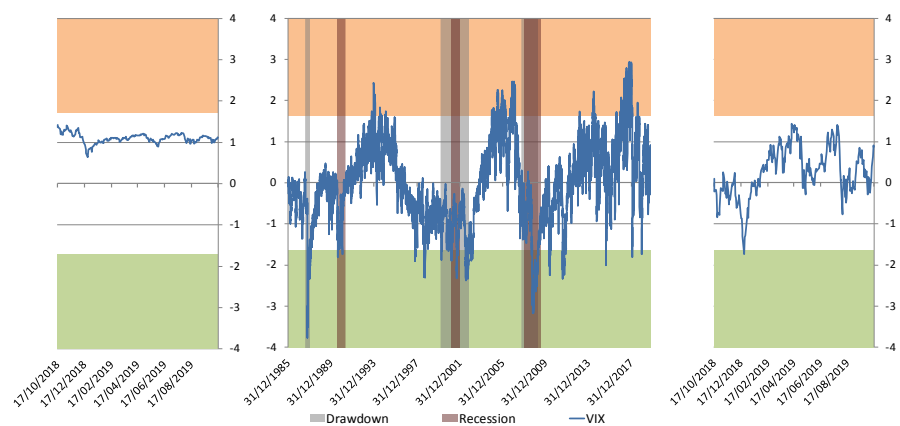
<sup>2</sup> 1 / BofA US High Yield Master II Option-Adjusted Spread\*

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 1.19% and 10-year earnings up 1.83%, the cyclically adjusted P/E ratio fell from 28.4 to 28.1, leading sentiment further away from the exuberance zone. After a quarter over quarter rise of 20.9% in Q1, earnings were down by -0.3% in Q2 with expectations of increases of 4.8% in Q3 and 9.5% for the full 2019 year. The latter is below the 13.3% expected in June for the full 2019 year.

The VIX rose over the quarter from 15.1 to 16.2 leading sentiment down towards its historical average.

10-year US bond yields fell from 2.00 % to 1.68% while 3-month rates fell by less from 2.08% to 1.84% increasing the curve's inversion to -0.16% and maintaining sentiment in the exuberance zone as investor confidence in holding duration increased further. The BofA US High Yield Master II spreads fell slightly from 4.07% to 4.02% leaving credit little changed and above its historical average.

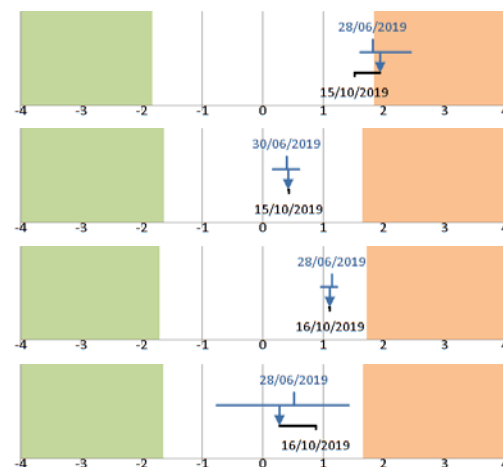
## Market Sentiment – Quarter changes

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

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

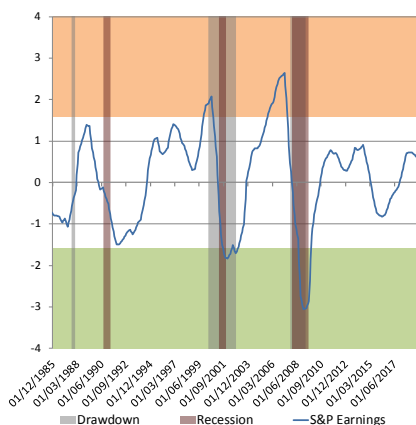
**Cyclically adjusted S&P500 P/E ratio (caP/E)**  
fell shifting sentiment away from the exuberance zone.

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

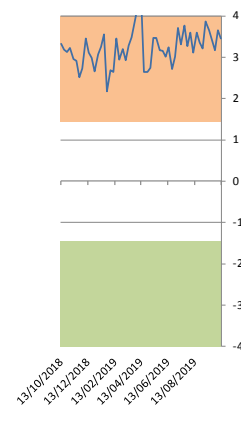
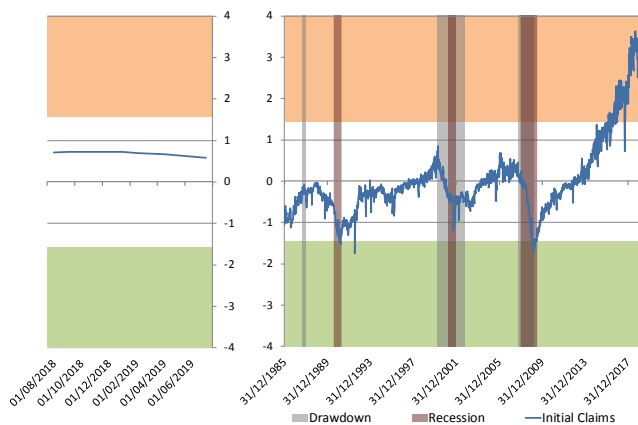


## Corporate Sentiment – Dashboard

**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

Earning growth deceleration continued in Q2 with 12-month rolling earnings just 1.5% above those of Q1 resulting in a slightly lower sentiment level. Analysts have moderated their growth expectations with full 2019 earnings predicted 9.5% above 2018 versus expectations of 13.3% in June.

Initial claims (seasonally adjusted) fell slightly from 222'000 to 220'000 maintaining sentiment in the exuberance zone. With the unemployment rate dropping to just 3.5% and the participation having stabilised, the employment market sentiment remains resolutely exuberant.

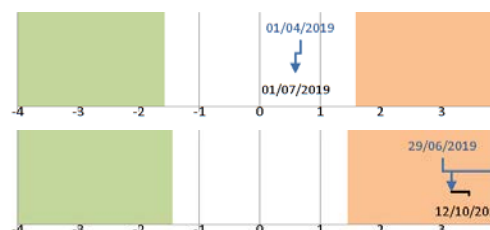
## Corporate Sentiment – Quarter changes

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

declined slightly leading sentiment down towards its historical average.

### Initial claims

fell slightly maintaining sentiment well within the exuberance zone.



## Conclusion

Market turbulence observed in Q2 was dampened in Q3 following the Fed's dovish turn and implementation of two 25bp rate cuts. The US central bank's more accommodative posture provided support for equities and drove up bond valuations. Global trade skirmishes and particularly the US/China tariff dispute continue to weigh on global growth. This led to US equity outperformance in Q3 with the S&P500 rising 1.19% while Asian markets in particular had a weak quarter.

The pace of US growth slowed from 3.1% in Q1 2019 (vs Q4; 2.7% yoy) to 2% in Q2 (vs Q1; 2.3% yoy). Similarly, earnings, which grew 20.9% in Q1 (vs Q4), shrunk by -0.3% in Q2 (vs Q1) and growths predictions for 2019 have been paired back to 9.4% (yoy) versus the 13.3% predicted 3 months ago. While the US consumer driven economy remains strong the global economy is being challenged by global trade deterioration. China, which has been in recent years a major driver of global growth, has not seen the anticipated impact from its stimulus actions. The global policy support deployed by the major economies has so far not been able to reaccelerated global growth. Europe, which is suffering from its own sluggish growth is also seeing its export power houses weakened by softness in global growth.

Since the end of the Trump rally (26<sup>th</sup> of January 2018) the S&P 500 is up 3.6% compared to a 20% growth of its 10-year earnings (trailing quarterly earnings up 30%), 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. On the other hand, the S&P500's cyclical adjusted PE remains elevated in historical terms and the US yield curve is now inverted which is a bad omen. An inverted US yield curve is a good predictor of a recession within a year or two of inception and as the current period of inversion is lengthening its significance is increasing.

It is of concern that the global stimulus initiatives have not, to date, revived global growth. Is this an indication that the leverage of central bank policy on growth has been weakened or that the circus in Washington trumps all? If the latter is correct, could it be that a bit of level headedness would be sufficient to put the global economy on the right tracks?

Volatility and credit spread sentiment indicators are at moderate levels but equity valuation sentiment is high and yield curve sentiment exuberant. So, while equity risk has been deflated, yield curve sentiment is flashing red. Will equity valuation deflation continue sufficiently to de-risk equity markets? For this the earnings growth needs to remain above price growth. Will the yield curve inversion then turn out to be a false alarm?

## 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).*