Exuberance and Gloom – Q4 2018

24/01/2019

Summary of the quarter

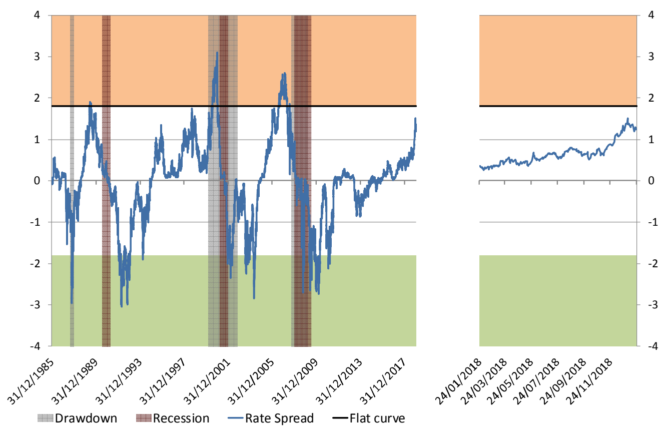
“May you live in interesting times” goes the curse and Q4 was certainly interesting. The S&P 500 tumbled 14% over the quarter to finish the year down 6%. This reversal was driven by the re-emergence of worries about a hawkish fed, European softness, trade barriers and slowing Chinese growth but also by declining US earning expectations. In Q4, the US markets joined other world markets in making 2018 a terrible year for investors.

In the quarter, the S&P 500 plummeted 14% while its 10-year historical earnings grew 4%, crushing equity valuations and driving sentiment away from the exuberance zone. Implied volatility more than doubled to finish the quarter at 25.4, leading sentiment well below its historical average. Credit spreads widened considerably pushing sentiment down to its historical average. US sovereign short-term rates rose while long-term rates fell, reducing slope of the curve to nearly flat and increasing bond sentiment further towards the exuberance zone.

In the corporate arena, initial claims rose but remained very low, keeping employment sentiment exuberant. With 12-month earnings rising, profitability sentiment was driven further above its historical average.

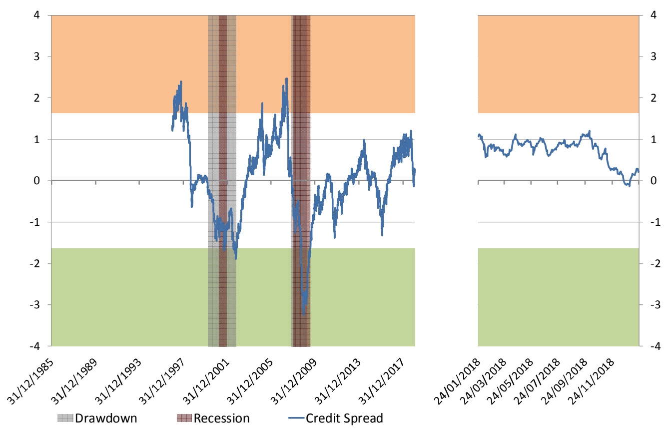
Market Sentiment – Dashboard

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



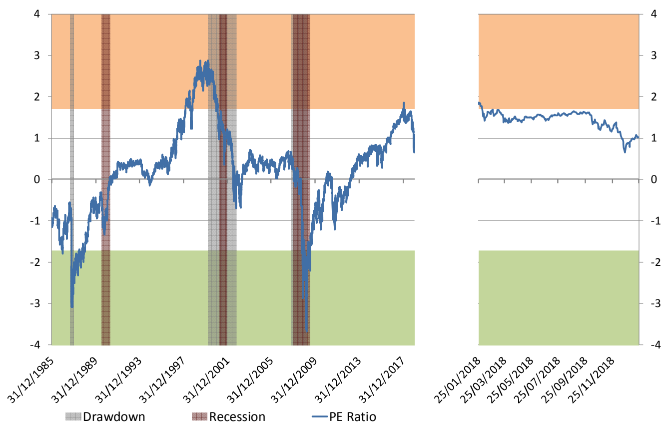
[1] 3M rate -10Y rate*

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



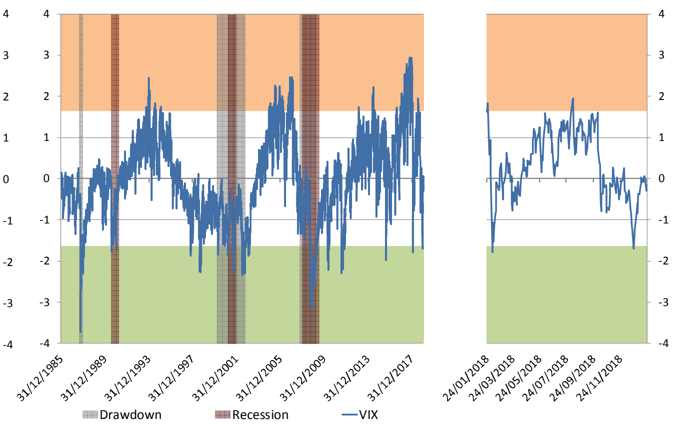
[2] 1 / BofA US High Yield Master II Option-Adjusted Spread*

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.

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.

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

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Market Sentiment – Summary of the quarter

With S&P 500 prices falling 14% and 10-year earnings up 3.9%, the cyclically adjusted P/E ratio fell from 31.8 to 26.4, leading sentiment away from the exuberance zone. Q3 2018 earnings came in 6.8% above prior quarter and 27.8% above Q3 2017. But earnings are expected to shrink by 0.8% in Q4 and a further 3.9% decline is forecasted for Q1 2019.

The VIX rose over the quarter from 12.1 to 25.4 with a high of 36.1 on December 24th. This led sentiment from just below the exuberance zone down to the gloom zone and back up halfway towards the historical average.

10-year US bond yields fell from 3.05% to 2.69% while 3-month rates rose from 2.15% to 2.4% resulting in a further flattening of the curve to only 0.29% and a significant rise in sentiment as investor confidence in holding duration increased. The BofA US High Yield Master II spreads rose significantly from 3.28% to 5.33% driving credit sentiment down to its historical average.

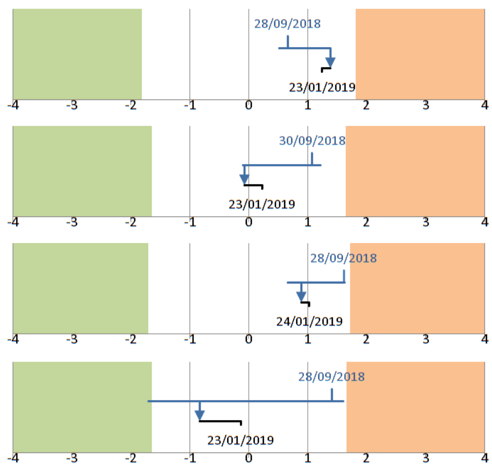
Market Sentiment – Quarter changes

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

High yield corporate spreads
widened significantly driving sentiment to historical averages.

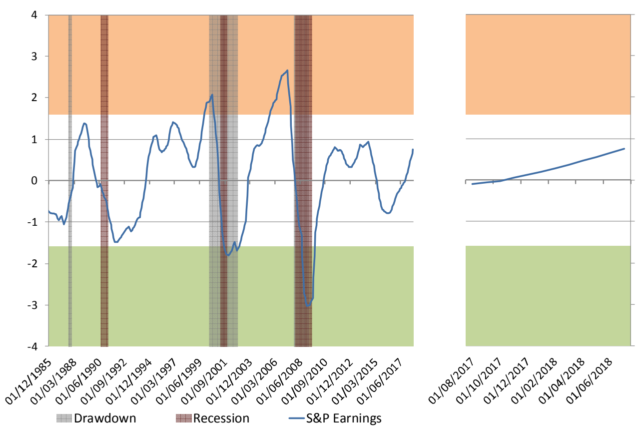
Cyclically adjusted S&P500 P/E ratio (caP/E)
fell significantly driving sentiment lower, away from the exuberance zone.

Implied volatility of S&P500 options (VIX)
rose significantly driving sentiment higher to below historical averages.

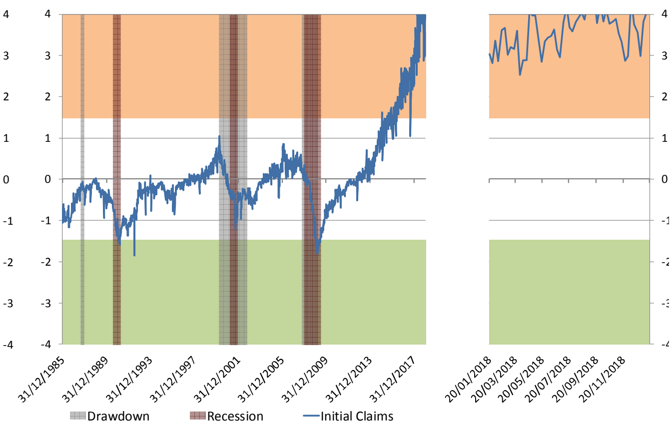


Corporate Sentiment – Dashboard

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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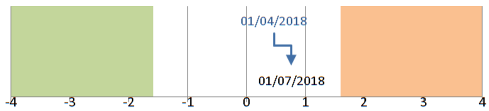
Corporate Sentiment – Summary of the quarter

The earning uptrend initiated at the start of 2016 continued albeit at a slower pace, with 2018 Q3 12-month rolling earnings coming in 6.5% above those of the prior quarter. This resulted in a higher sentiment level. However, analysts expect the improvement to moderate considerably with forecasts of full year 2019 earnings only 9.9% above 2018 earnings.

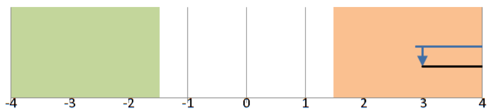
Initial claims (seasonally adjusted) rose from 207'000 to 233'000 leading sentiment lower, but still well within the exuberance zone. With the unemployment rate at just 3.9% and the participation rate having stabilised, the employment market sentiment remains resolutely exuberant.

Corporate Sentiment – Quarter changes

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



Initial claims
rose driving sentiment lower but still well within the exuberance zone.



First quarter 2019 so far

After the turmoil of the fourth quarter, January has seen sentiment regain some colour with the S&P 500 up 5.4% to the 24th. After having taken a beating at the end of last year, US investor confidence has rebounded slightly but their assurance in strong future earnings growth has declined as reflected by valuations that have retracted from 2018's exuberant levels. All market sentiment indicators have risen in January with the exception of the US rate spread which has seen the slope of the curve steepen slightly.

Conclusion

Following the fourth quarter market turmoil the main question is whether the drawdown was just a healthy correction or does it presage of a further significant market drop? Regardless of a pause in Fed rate hikes suggested by the US Fed Chairman's possibly dovish "just below … neutral" statement, the normalisation of monetary policy will continue as the cumulative balance sheet of major central banks are starting to shrink. Until now Europe and China had been showing weakness while the US continued to grow strongly. But there are now also early signs of growth moderation in the US as reflected by reduced earnings growth expectations. The US is facing the typical challenges of a late cycle economic expansion with a tight labour market, rising rates and earnings growth deceleration. The world economy is highly integrated and the US cannot indefinitely maintain a strong growth while the other regions struggle. China for example is in the uncomfortable situation of having to stimulate its economy in the face of a long-term slowing growth trend, a trade war with the US and an already high levels of private sector credit.

The US economy is still looking vigorous: Q3 GDP grew at an annualised rate of 3.4% versus Q2 and 3% versus Q3 2017, unemployment at 3.9% and Q3 corporate earnings up 27.8% versus Q3 2017. However, Q4 earnings are expected to come in 0.8% lower than Q3 and Q1 a further 3.9% lower showing a clear deceleration in earning expectations. This decline has pushed market participants, who were willing in the summer to trade equities at valuations bordering on exuberance, to be far less enthusiastic.

In our view the key factor that will determine whether the Q4 drawdown was a healthy correction or a sign of worse to come is the level of capital misallocation in these past years. If a sufficient fraction of investors and companies feel the necessity to offload their overpriced holdings the market fall will spill into the real world pushing a late phase economy to the brink and triggering a negative feedback loop. In prior crises technology and housing had concentrated much of the excesses but this time round the focus isn't as clear.

The flattening of the US curve is to be watched as an inversion is a good predictor of market drawdowns.

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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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