Exuberance and Gloom – Q4 2019

16/01/2020

Summary of the quarter

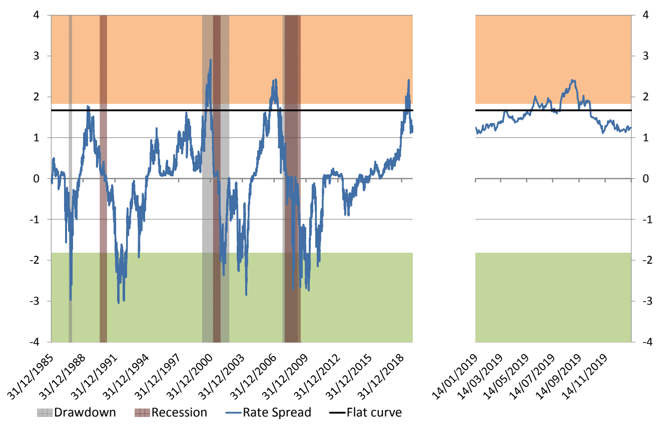
2019 finished on a high note with the S&P 500 rising 8.5% in Q4 to finish the year up 29%. A Fed rate cut in October, the dovish stance of Central Banks and a moderation of the US-China tariff war all contributed to a multiple expansion that drove-up equity valuations.

Over the quarter, the S&P 500 rose faster than its 10-year historical earnings resulting in higher equity valuations and leading sentiment back towards the exuberance zone. Implied volatility decreased from 16.2 to 13.8 driving sentiment up and away from its historical average. Credit spreads shrank from 4.02% to 3.60% pushing sentiment further above its historical average. The 0.25% US Fed rate cut reduced short-term rates while long-term rates rose, returning the US yield curve to normal and sentiment outside the exuberance zone.

In the corporate arena, initial claims remain at historical lows and employment sentiment exuberant. After a tax-cut boost, 12-month earnings growth remained below trend pushing sentiment down towards its historical average.

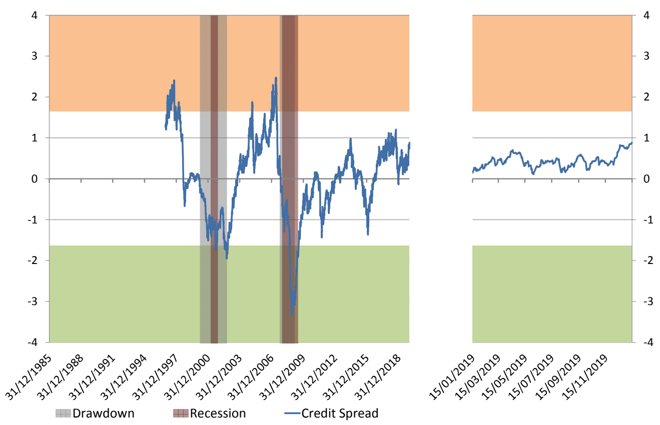
Market Sentiment – Dashboard

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



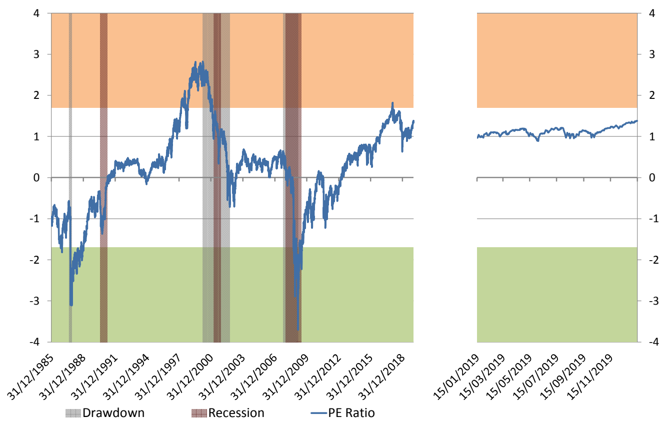
[1] 3M rate -10Y rate*

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



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

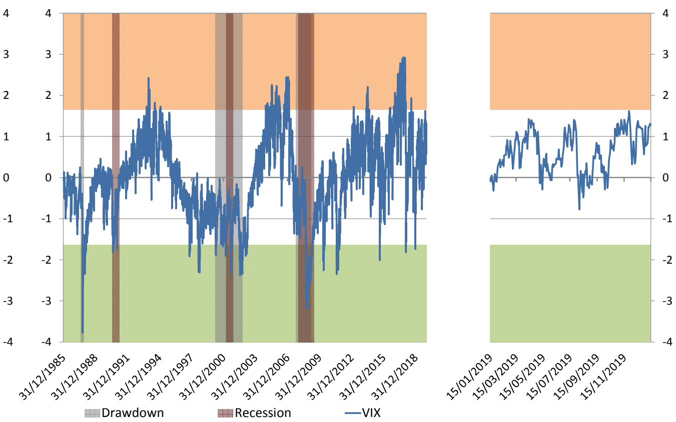
Equity price: S&P500 cyclically adjusted P/E[3]



[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

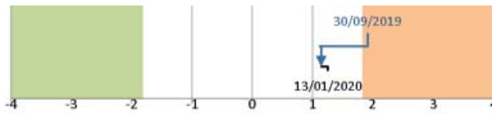
With S&P 500 prices rising 8.5% and 10-year earnings up 1.6%, the cyclically adjusted P/E ratio rose from 28.1 to 30.0, leading sentiment up towards the exuberance zone. After a quarterly drop of -0.3% in Q2, earnings are down by -2.7% in Q3. With a 7.8% increase expected in Q4, 2019 earnings are predicted 6.1% above 2018, below the 9.5% expected in September. 2020 earnings are anticipated 15.3% above 2019 earnings.

The VIX fell over the quarter from 16.2 to 13.8 leading sentiment higher above its historical average.

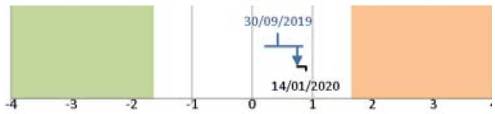
3-month rates fell from 1.84% to 1.52% while 10-year US bond yields rose from 1.68% to 1.92% returning the curve to normal and pushing sentiment out of the exuberance zone as investor confidence in holding duration rose. The BofA US High Yield Master II spreads fell from 4.02% to 3.60% driving credit sentiment higher above its historical average.

Market Sentiment – Quarter changes

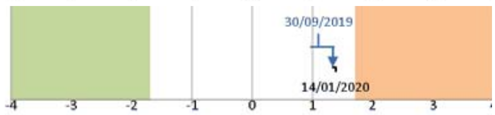
US sovereign yield curve 3-month to 10-year slope
steepened pushing sentiment away from the exuberance zone.



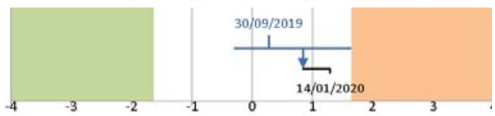
High yield corporate spreads
narrowed leading sentiment higher above its historical average.



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

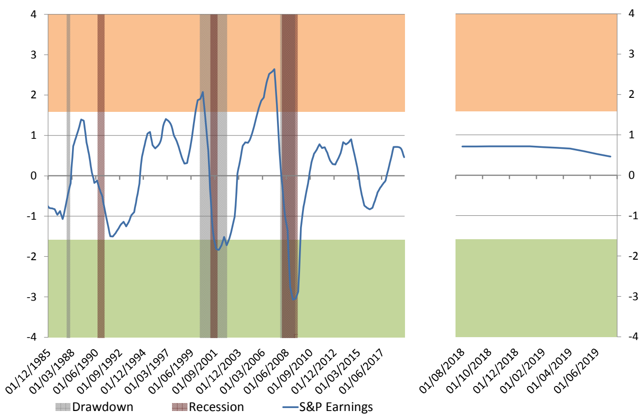


Implied volatility of S&P500 options (VIX)
fell driving sentiment higher above its historical average.



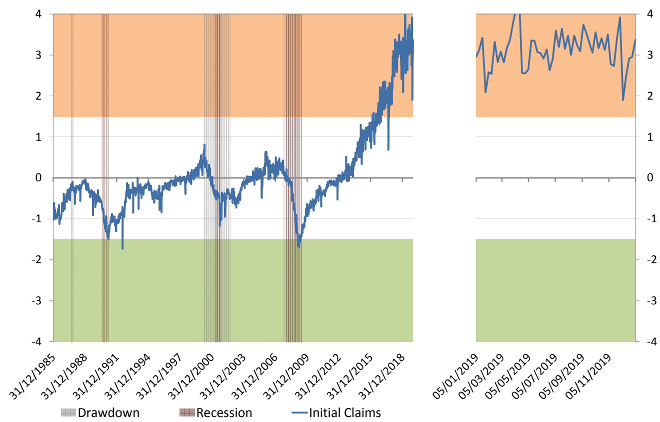
Corporate Sentiment – Dashboard

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

Earning growth deceleration continued in Q3 with 12-month rolling earnings 1.75% below those of Q2 resulting in a lower sentiment level. Analysts have again moderated their growth expectations with full 2019 earnings predicted 6.1% above 2018, versus expectations of 9.5% in September.

Initial claims (seasonally adjusted) rose slightly from 220'000 to 223'000 maintaining sentiment in the exuberance zone. With the unemployment rate at just 3.5% and the participation rising gradually (63.2%), 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 slightly maintaining sentiment well within the exuberance zone.

Conclusion

Q4 saw the third US Fed cut of 2019, a dampening of global trade tensions, particularly of the US/China tariff war, and increased clarity on the Brexit outcome. This has led to very strong performance for the S&P 500 whose price rose 29% over the year. At the same time 2019 S&P 500 earnings (Q4 being still an estimate) have seen a relatively modest growth of 6% versus 2018 earnings. And with current 2020 earnings expectations only 2% above 2019 expectations at the end of 2018, multiple expansion represents a large proportion of the S&P 500's performance. This excellent equity performance was not limited to the US as developed and emerging markets also showed strong results for Q4 and the year.

The pace of US growth continued to slow and while annualised quarter over quarter real GDP growth edged up from 2% in Q2 to 2.1% in Q3, year over year growth fell from 2.3% to 2.1%. Likewise, earnings, which fell by -0.3% in Q2 (vs Q1), shrank a further -2.7% in Q3 (vs Q2) with growths expectations for 2019 paired back to 6.1% (yoy) from the 9.4% predicted 3 months ago. However, the US consumer driven economy remains strong and the global economy is stabilising as the global trade deterioration moderates. China, which has been in recent years a major driver of global growth, is attempting to stimulate its economy sufficiently to maintain stability while avoiding the creation of credit or property bubbles. Globally, central banks are deploying policy support with the aim of reaccelerating global growth. This would provide a boost to corporate earnings which in the US are constrained by a tight labour market.

Since the end of the Trump rally (26th of January 2018) the S&P 500 is up 12.5% compared to a 21% growth of its 10-year earnings, reducing the overextended valuations of US equities seen in early 2018. This adjustment, which had brought down the risk of an equity market crash and an ensuing recession, is now reverting as the S&P 500 continues to rise and it's cyclical adjusted PE again approaches exuberant levels. In support of strong equity valuations are the steepening of the US yield curve and the narrowing of credit spreads which indicate that bond and credit markets are becoming more sanguine about the future prospects of the US economy.

At the start of 2020 all market sentiment indicators are at elevated level with equity price and volatility sentiment heading towards the exuberance zone.

It seems we are back where we stood at the end of 2017 with high equity valuations and weak earnings growth. To sustain the current equity valuations and avoid a market decline, a resurgence of global growth is required.

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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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