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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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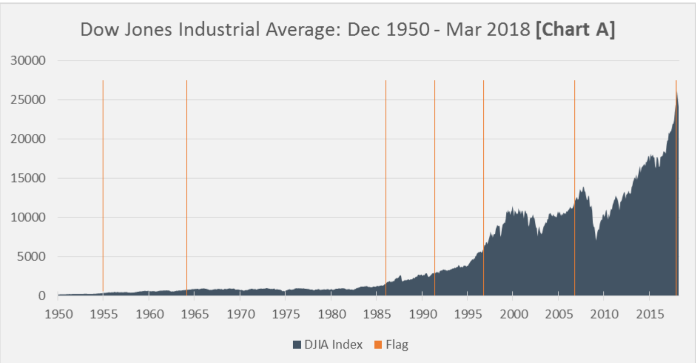
Putting It Into Perspective

After a fantastic few years of returns across equity markets, the numbers have moderated. Last month was red across the board, making it the first quarter since Q3 of 2015 that we have seen a decline. Following the pound's recovery, the S&P-500 is now up just 2% in sterling terms over the last 12 months, only slightly ahead of the UK FTSE All Share Index's 1.25%. Emerging markets were the place to be, but currency mattered. Although Brazilian shares are up over 30% year on year, the real has plummeted 20%. Fixed-income has not proven to be a source of good returns either and although gilts bounced back in March they are still only ahead by ½% over 12 months. Elsewhere, oil has continued to rally, now up 70% over two years. Gold has moved sideways, struggling to stay much over $1,350 per ounce for any extended period.

So is the bull market over? Plenty of investors seem to think so. Morgan Stanley's strategy team thinks that the US fiscal stimulus will disappoint investors, sending share prices lower. UK veteran fund manager Neil Woodford says that we "may be in the foothills of a profoundly different market environment". Billionaire hedge fund manager Crispin Odey claims that the current climate has similar characteristics to the 1970s and in a Bloomberg article here, one of his team says, "This particular phase is not over… longer term, I think we are starting a nasty bear market in bonds, equities and credit." It would be foolish to ignore these remarks, we know very well that the bull market *will* end. Timing it is a different matter and Odey has been calling it for most of the last three years, in which time his Swan fund has lost 40% in value, whilst world equities have risen 45%.

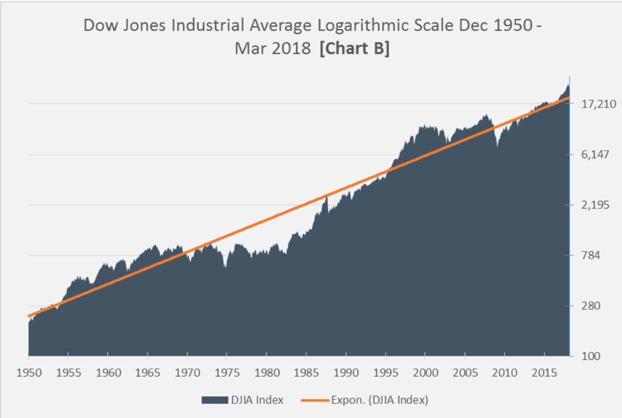
We simply think that these opinions come from the wrong perspective. We take the view that (a) stockmarkets haven't spiralled upwards out of control and (b) valuations are reasonable and that the current bull market still has legs.

These two statements however can be viewed very differently. For example, the chart below shows the Dow Jones Industrial Average since 1950. Typical observations could be along the lines of 'it must have been hard making money before the mid-1980s' or 'the rise since 2010 looks worse than the run up to 2008 … and look what happened then.' We face these comments a lot.



Source: Albert E Sharp, Bloomberg©

Chart B, below is exactly the same but has a logarithmic scale on the price axis. The reason for this is that it visually helps illustrate the magnitudes of change by compressing the higher values and stretching the lower values. For example, when the Dow Jones was trading at just over 200 at the beginning of 1950, it took five years to double in value to 400. However in Chart A, this is barely perceptible. Indeed the next doubling to 800 is difficult to spot, or the move to 1600 in 1986. In contrast, the move since 2006 seems enormous. The reality is however that over each period the same amount of 'work' was done. Nevertheless the perspective or the means of measurement in Chart A could easily scare off a potential investor, when the reality is that the movement is neatly in line with the orange trendline.



Source: Albert E Sharp, Bloomberg©

When it comes to looking at regional markets there are so many moving parts, it is useful to have a logic check in place. One metric that we look at is the expected return figures put out by the various banks and brokers. It certainly isn't the case that this will provide the answer, far from it, but we like to get a sense of what the others are thinking.

The table overleaf shows the expected return over the next 12 months for nine key equity indices, with the emerging markets at the top showing an expected return of 20.8%. This seems to make sense, given the relatively high expected earnings growth rates over the next two years, the above average dividend yield and the current valuation, which is at a relative discount. One could say the same for Asia ex-Japan.

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Index Data

Index	Forecast Total Return	Est Dividend Yield	2018 P/E Ratio (X)	2018 EPS Growth	2019 EPS Growth	PEG
MSCI Emerging Markets	20.8%	2.8%	12.5x	24.1%	11.1%	0.7
MSCI Pacific ex-Japan	19.2%	3.1%	13.2x	22.3%	9.4%	0.8
FTSE All Share Index	16.7%	4.0%	14.1x	0.2%	6.6%	4.2
TOPIX (Japan)	16.2%	2.1%	13.9x	0.7%	9.5%	2.7
MSCI World	16.0%	2.5%	15.6x	20.4%	9.9%	1.0
S&P 500 (US Large Cap)	15.7%	2.0%	17.2x	26.8%	10.4%	0.9
MSCI Europe ex-UK	13.9%	3.4%	14.9x	7.1%	9.4%	1.8
S&P 600 (US Small Cap)	12.8%	1.3%	19.6x	51.5%	18.2%	0.6
FTSE 250 (UK Mid Cap)	11.8%	2.7%	15.4x	23.1%	9.0%	1.0
Average	*15.9%*	*2.6%*	*15.1x*	*19.6%*	*10.4%*	*1.5*

Source: Albert E Sharp, Bloomberg©

Interestingly, the FTSE All Share Index comes in third. Judging by the net outflows over the last 12 months or so the UK is clearly out of favour with international investors and the general tone from economists is hardly optimistic. In which case, something needs to happen to change the mood and earnings growth is not going to do it. In fact, expected earnings growth is the lowest in the group by a long way over the next two years.

Applying our modified PEG analysis puts this into perspective. This useful video explains the calculation in more detail with the slight difference that our analysis takes the PEG number to be the price earnings ratio divided by the average of the next two years of earnings growth. The same analysis works at a company level so if Firm A had a price/earnings ratio of 10x and was expected to grow earnings by 20% and Firm B also had a price/earnings ratio of 10x but was only expected to grow earnings by 2%, intuitively Firm A is more attractive. Same valuation in PE terms, but Firm A looks set to grow earnings much quicker. In other words Firm A has a PEG of 0.5 and Firm B has a PEG of 5. As a rule of thumb anything over 1 is thought expensive, anything below 1 cheap.

To be fair, there are countless ways of looking at this table; shift your perspective and you can easily come to a different conclusion. One thing that does concern us is that these forecast return numbers are way beyond the 8% long-term growth rate of most stock markets. Have analysts been influenced by the size of recent returns, illustrating availability bias and forgetting what is 'normal'? Or have they spotted something else, is history no longer a reasonable guide?

The words 'this time is different' are amongst the most dangerous in investing, but it is important to adjust one's view of the past based upon how the context has changed. So if an economist talks about average global income it is probably relevant to note that in the last ten years alone Chinese average wages have almost trebled. Or that if one considers borrowing levels, there are now 150 million more Indians with a bank account than there were in 2011. The size and shape of the world's economic engine has changed and it matters.

Which neatly leads us into next month's commentary that will look specifically at China and the Asian growth story, the structural shifts and the implications. We have repeatedly flagged the dangers of home bias and the article will reinforce that warning and go on to conclude that from every perspective, the investment case for Asia is irresistible.

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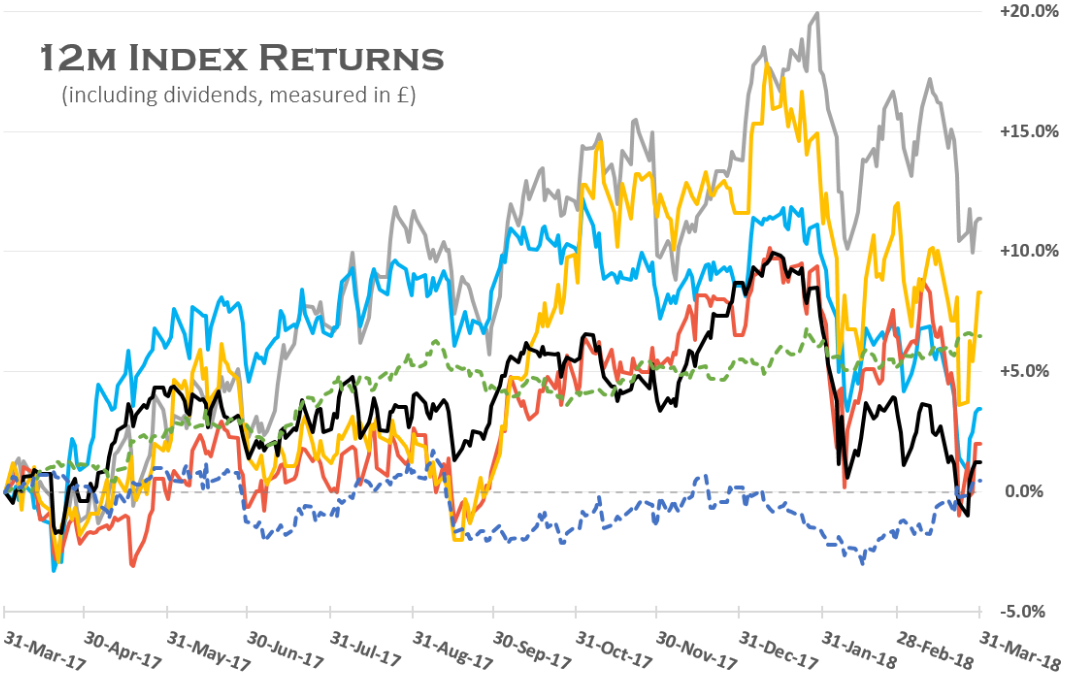
INDEX RETURNS

Index	Region/Asset Class	31 Mar 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,056.6	-2.4%	-3.6%	+14.3%
UK Mid Cap	UK	529.4	-3.1%	-2.8%	+6.1%
UK Small Cap	UK	5,593.1	-1.9%	+3.0%	+23.1%
Dow Jones Ind Avg	USA	24,103.1	-3.7%	+16.6%	+36.3%
S&P 500 Index	USA	2,640.9	-2.7%	+11.8%	+28.2%
NASDAQ Comp.	USA	7,063.4	-2.9%	+19.5%	+45.0%
Nikkei 225	Japan	21,454.3	-2.8%	+13.5%	+28.0%
Euro Stoxx 50	Europe	3,361.5	-2.3%	-4.0%	+11.9%
CAC 40 Index	France	5,167.3	-2.9%	+0.9%	+17.8%
DAX Index	Germany	12,096.7	-2.7%	-1.8%	+21.4%
Milan Index	Italy	22,411.2	-0.9%	+9.4%	+23.7%
MSCI Emg Mkts (£)	Emg Mkts	563.2	-3.6%	+11.4%	+50.0%
IBOVESPA Index	Brazil	85,365.6	+0.0%	+31.4%	+70.5%
MICEX Index	Russia	2,285.5	-0.5%	+14.5%	+22.1%
S&P BSE SENSEX	India	32,968.7	-3.6%	+11.3%	+30.1%
Shanghai SE Comp.	China	3,168.9	-2.8%	-1.7%	+5.5%
Hang Seng	Hong Kong	30,093.4	-2.4%	+24.8%	+44.8%
UK All Property	UK Property	132.6	+0.5%	+7.6%	+5.2%
UK Conv Gilts	UK Gilts	3,598.3	+2.0%	+0.5%	+7.1%
UK Index linked Gilts	UK IL Gilts	4,913.8	+2.5%	+0.5%	+20.5%
JPM Glob Agg. Bond ($)	Global Bonds	575.4	+1.2%	+6.5%	+4.4%
iBoxx Non-Gilt	UK Corp Bonds	336.5	+0.6%	+1.2%	+10.6%
WTI Crude ($/barrel)	Oil	64.9	+5.4%	+28.3%	+69.4%
LMEX	Base Metals	3,204.8	-4.0%	+12.1%	+41.1%
Gold Spot ($/oz)	Commodities	1,325.00	+0.5%	+6.1%	+7.5%
S&P Agri & Livestock	Agriculture	747.24	-4.1%	-5.9%	-11.3%
£1 = US$	Currencies	1.40	+1.9%	+11.7%	-2.4%
£1 = €	Currencies	1.14	+0.8%	-3.4%	-9.8%
£1 = Yen	Currencies	148.95	+1.5%	+6.5%	-7.9%



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