ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

August 2016

Climbing The Wall

July proved to be another strong month for the UK stock market with the 100 index getting closer to the magic 7,000 level and small and mid caps making up lost ground. In the US, the S&P-500, NASDAQ and Dow Jones closed the month at or near all-time highs as did many emerging markets, especially in Asia. Elsewhere, the oil price eased, sterling weakened and bonds rallied to new highs, forcing yields to new lows.

The change in sentiment over the last six months has been incredible. The 10%+ fall across markets from January to mid-February was getting close to being on a par with the slump during the 2008 Lehman crisis and many feared that worse was to come. On 18th February, market historian Professor Russell Napier warned in the *Daily Telegraph* that "shares could go on to halve from here" citing extended valuations, especially in the US, as a key reason. The article narrowly missed the market bottom by just a few days which went on to rally 20%. For UK investors, given the weakness in sterling, this translated to a 33% return. Napier won much acclaim for his book *Anatomy Of The Bear* which, according to the backcover blurb, "offers investors a financial field guide to making the best provisions for the future". Some of these books should have huge risk warnings on the front page.

What Napier failed to recognise was the impact of low and falling interest rates on the effectiveness of conventional valuation techniques. Furthermore, he misread the impact on investor sentiment. One of the central tenets of valuation methodology is the concept of the 'risk-free rate', usually taken to be the yield on three-month government bonds. At a very basic level this is easy to understand when comparing yields. If gilts are providing 3% and shares are offering 5%, you can try and figure out what should be the appropriate reward for the risk taken and then come to a conclusion what to buy.

This is the essence of the Capital Asset Pricing Model, one of the cornerstones of investment theory. What we have seen in recent months is that when the risk-free rate goes below a certain level, the relationships start to break down and when it goes below zero, the whole concept seems to disintegrate.

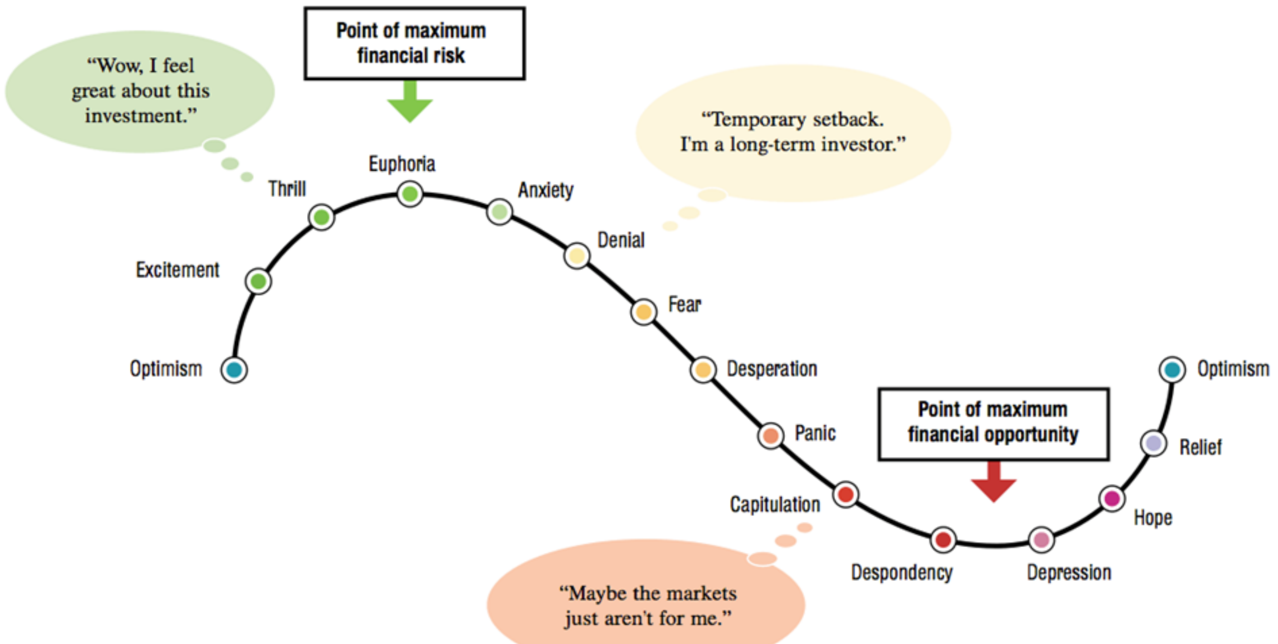
A concept much easier to grasp is the simple substitution effect. If you get zero at the bank, the allure of yields around 5-7% from Vodafone or BP start to become stronger, even with the risk to capital and shareprices get pushed up further. It is arguably the nominal *spread* between bond and equity yields that should be the main consideration, not so much whether metrics such as P/E ratios look high by historic standards. Indeed, with interest rates becoming negative for the first time recently, could it be that that valuation tools requiring the input of a risk free rate are now simply redundant? To be fair, Napier could still be right at some point, but not necessarily for the reasons he lays out. We suspect that it will ultimately be higher rates that trigger a sell -off, but that could still be long time hence.

With the failings of conventional models, investors and academics are increasingly focusing on behavioural factors as a guide to reading market tops and bottoms. The chart above attempts this, showing the supposed 14 stages of investor emotion, also neatly summarised in this YouTube video.

The challenge is in identifying where we are now and if we aren't at the top, how near are we? For what it's worth, somewhere between relief and optimism seems like a reasonable suggestion. What has been so noticeable about when new highs have been reached over the last few years is the total absence of euphoria, and we certainly are not feeling that now. So, based on this analysis, equities have further to go.

One of the hackneyed industry sayings is that for markets to rise, they need to climb a wall of worry, but over the last 12 months at very least, the phrase has been very fitting. Fears over the Brexit vote have come and gone (seemingly), terrorist atrocities were shrugged off, a Continental European sovereign debt crisis was averted and China hasn't crashed. Looking forward, we have the worries of isolationism and de-globalisation led by Donald Trump, the impact of negative interest rates, political change across Europe and conflict in the South China Seas, to name but a few. The point to note is that when the list of things to worry about starts to get short, it's probably time to think about getting out of the market; but for now, thankfully, there is plenty to keep us awake at night.

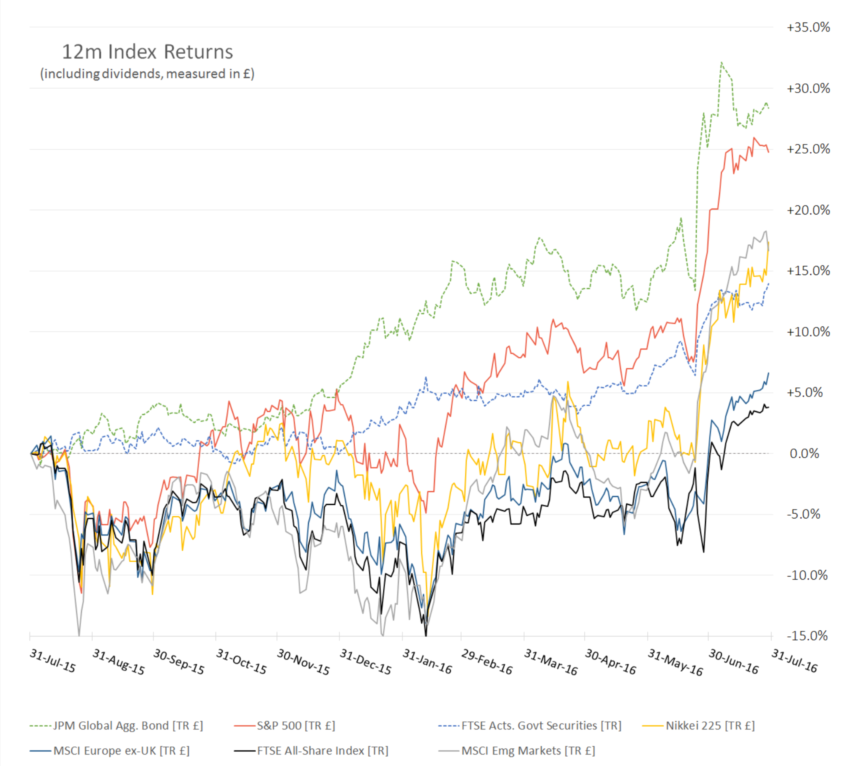
Click on blue links for more explanation online



Source: OptionAlpha.com

INDEX RETURNS

Index	Region/Asset Class	31 July 2016	Monthly Change	1 Year Change	2 Year Change
UK 100	UK	6,724.4	+3.4%	+0.4%	-0.1%
UK Mid Cap	UK	514.1	+6.8%	-0.7%	+13.5%
UK Small Cap	UK	4,774.9	+6.8%	+1.4%	+8.3%
Dow Jones Ind Avg	USA	18,432.2	+2.8%	+4.2%	+11.3%
S&P 500 Index	USA	2,173.6	+3.6%	+3.3%	+12.6%
NASDAQ Comp.	USA	5,162.1	+6.6%	+0.7%	+18.1%
Nikkei 225	Japan	16,569.3	+6.4%	-19.5%	+6.1%
Euro Stoxx 50	Europe	2,990.8	+4.4%	-16.9%	-4.0%
CAC 40 Index	France	4,439.8	+4.8%	-12.6%	+4.6%
DAX Index	Germany	10,337.5	+6.8%	-8.6%	+9.9%
Milan Index	Italy	16,846.9	+4.0%	-28.4%	-18.1%
MSCI Emg Mkts (£)	Emg Mkts	429.6	+5.8%	+16.7%	+9.3%
IBOVESPA Index	Brazil	57,308.2	+11.2%	+12.7%	+2.6%
MICEX Index	Russia	1,944.6	+2.8%	+16.5%	+41.0%
S&P BSE SENSEX	India	28,051.9	+3.9%	-0.2%	+8.3%
Shanghai SE Comp.	China	2,979.3	+1.7%	-18.7%	+35.3%
Hang Seng	Hong Kong	21,891.4	+5.3%	-11.1%	-11.6%
Conventional Gilts	UK Gilts	3,638.8	+2.0%	+14.0%	+24.8%
JPM Glob Agg. Bond (£)	Global Bonds	809.7	+1.4%	+28.4%	+32.0%
WTI Crude	Oil	41.6	-13.9%	-11.7%	-57.6%
Gold Spot $/Oz	Commodities	1,351.0	+2.2%	+23.3%	+5.3%
£1 = US$	Currencies	1.32	-0.6%	-15.3%	-21.7%
£1 = €	Currencies	1.18	-1.2%	-16.7%	-6.1%
£1 = Yen	Currencies	134.97	-1.7%	-30.3%	-22.2%



ALBERT E SHARP
INVESTMENT MANAGEMENT & STOCKBROKING
WWW.ALBERTESHARP.COM
7 Elm Court
Arden Street
Stratford Upon Avon
Warwickshire
CV37 7LN
☎ 01789 404000