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MARKET COMMENTARY

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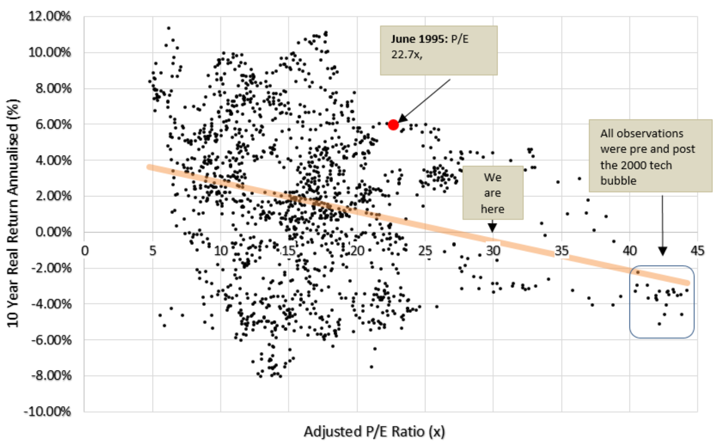
Jumping To Conclusions

Despite several major economic and political events in June, volatility remained extremely low across most financial markets. In the UK, another terrorist atrocity was followed by an unexpectedly damaging general election result for the Conservatives which was then followed by unusually hawkish comments from Mark Carney, yet the headline FTSE-100 index was only off 2.8%. Europe was also lower after the oil majors came under pressure as crude drifted back below $45 a barrel. The US markets were ahead marginally, notwithstanding a Fed rate hike and a pullback in technology late in the month. On the currency front, the pound climbed back over the $1.30 level with some suggesting this was due to an increased possibility that Brexit would not happen, given Theresa May's weakened position. We would argue that the prospect of higher UK interest rates, earlier than previously thought, is a better explanation and this is supported by the coincident sharp fall in gilts.

The first half of 2017 has nevertheless been another positive period for most UK investors, especially those retaining a decent exposure to overseas shares. A large part of the reason is due to a material improvement in US earnings so far this year and the next few weeks will be important for sentiment as the Q2 reporting season gets underway. Valuations are widely believed to be stretched and in this environment the received wisdom is that any companies missing earnings expectations or reducing forward guidance will likely see their share price punished more severely than usual. As measured by the forward price/earnings ratio, high growth superstars such as Amazon or Netflix both on nearly 150x are supposedly more vulnerable than the likes of Ford or Macy's, on 7.5x where the bar of expectations is set much lower. Of course with risk comes reward, and despite being 'handicapped' by being 20x more expensive, it still feels difficult to bet against Amazon beating Macy's in a straightforward share price race.

At an index level there are lots more moving parts, but as a generalisation there is evidence to suggest that the cheaper the valuation, the greater the scope for future returns, and this is illustrated in the CAPE (Cyclically Adjusted Price/Earnings) chart below, developed by Nobel Laureate Robert Shiller.

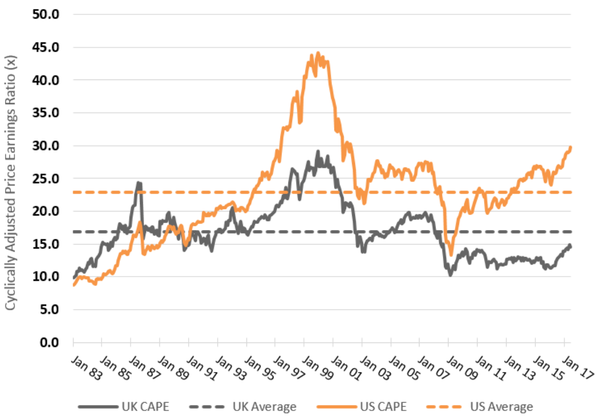


Source: Albert E Sharp, Bloomberg®

Using S&P-500 Index data, the scatter graph shows returns in the following 10 years from a P/E ratio at any month end point in time since January 1871, and adjusted for inflation. For example, the red dot represents June 1995 and shows that trading on 22.7x, the following ten years went on to return 5.9% each year. The conclusion that is usually drawn from this analysis is that the higher the index valuation, the lower the future returns and vice versa. At present, the market is trading on about 30x, in which case the regression line suggests that future returns will be negative.

But there is more to this story than meets the eye. All of the readings where the adjusted P/E ratio was 40 or over came during one of the most extreme periods in the stock market's history, namely the tech bubble. Is this helpful data? Ultimately, if you are worried about the performance of the index, then here's a suggestion - don't buy the index! Research on sideways markets by analysts at Fidelity shows that it is still possible to make decent returns when the broader market is going nowhere, if you know where to look. For example during the period early 2013 to the beginning of 2016, the UK was up by just 2.8%, however 178 companies out of the 605 in the index (nearly a third) returned 75% or more. In which case, look for an active manager who demonstrably doesn't track the index.

In order to add some context, the chart below shows the direction of the PE ratio in the UK and US. Both are moving higher yet the UK remains below its 35 year average whereas the US is well above it. According to the concept of mean reversion (or regression to the mean theory) the conclusion would be that one should sell the US because it is expensive and buy the UK.



Source: Albert E Sharp, Bloomberg®

However, there are several caveats to this. 1. The composition of the two indices differs hugely, with the UK laden with banks, miners and oil companies, and the US more exposed to technology, consumer and general services. Could it be that these areas have greater growth potential and therefore justify higher valuations for long-term, structural reasons?

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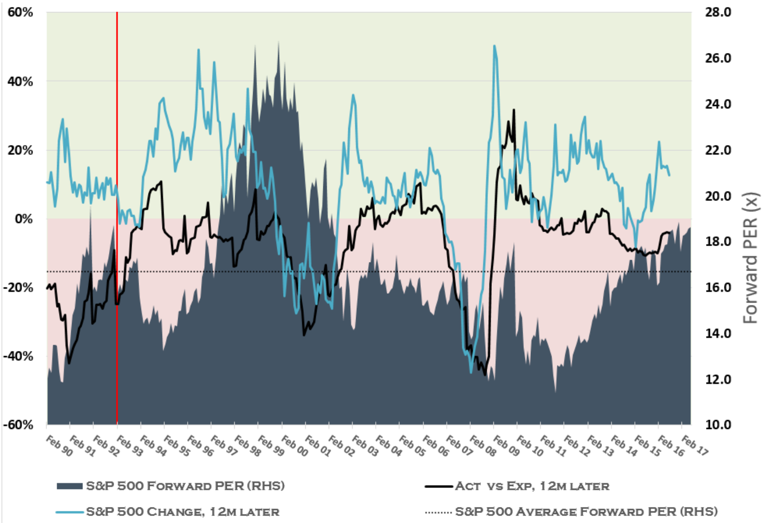
2. Future expectations of earnings are too pessimistic. After five years of anaemic earnings growth in the US, 2017 is seeing material improvement and this could continue well into 2018. The earnings part of the price/earnings ratio could be underestimated based on experience of the last five or six years, in which case the valuation will not prove to be as 'expensive' as some will currently think – especially if Trump injects a huge stimulus. 3. Technological progress through automation and robotics is preventing a tightening in the labour market, constraining inflation which is a long-term positive for many aspects of the economy. 4. Interest rates are at extreme low levels and will remain so for the foreseeable future, supporting equities.

The second point here could prove critical. Using data since 1990, we have tried to analyse how expectations and reality collide over a 12 month period and what happens to share prices. The chart shows that in February 1993, the forward price earnings ratio was around 15x (right hand scale) and 12 months later the market delivered earnings that ended up being about 22% lower than thought at that time (black line, left hand scale), yet the index went on to be some 10% higher (blue line, left hand scale). Interestingly, it shows how rarely earnings forecasts end up being above expectations 12 months after they were made; what is clear that when it does happen, it is very good for share prices. Simply meeting expectations definitely helps keep shares in positive territory and a rising trend seems to be an important and beneficial factor too. Having seen the equivalent of just 2% of earnings growth annually over the last 5 years, we now have the prospect of 20% in 2017 and 12% in 2018, according to Bloomberg® and if this is beaten, it could prove incredibly powerful for US equities. As we said, the impending earnings season will give us an idea as to how close expectations stand of being met.



Source: Albert E Sharp, Bloomberg®

So for investors, coming to the correct conclusion is a fraught task at the best of times and even if achieved, it is very possible to then put on the wrong trade. As billionaire investor Howard Marks put it, "'Prices are too high" is far from synonymous with "the next move will be downward." Things can be overpriced and stay that way for a long time … or become far more so.'"

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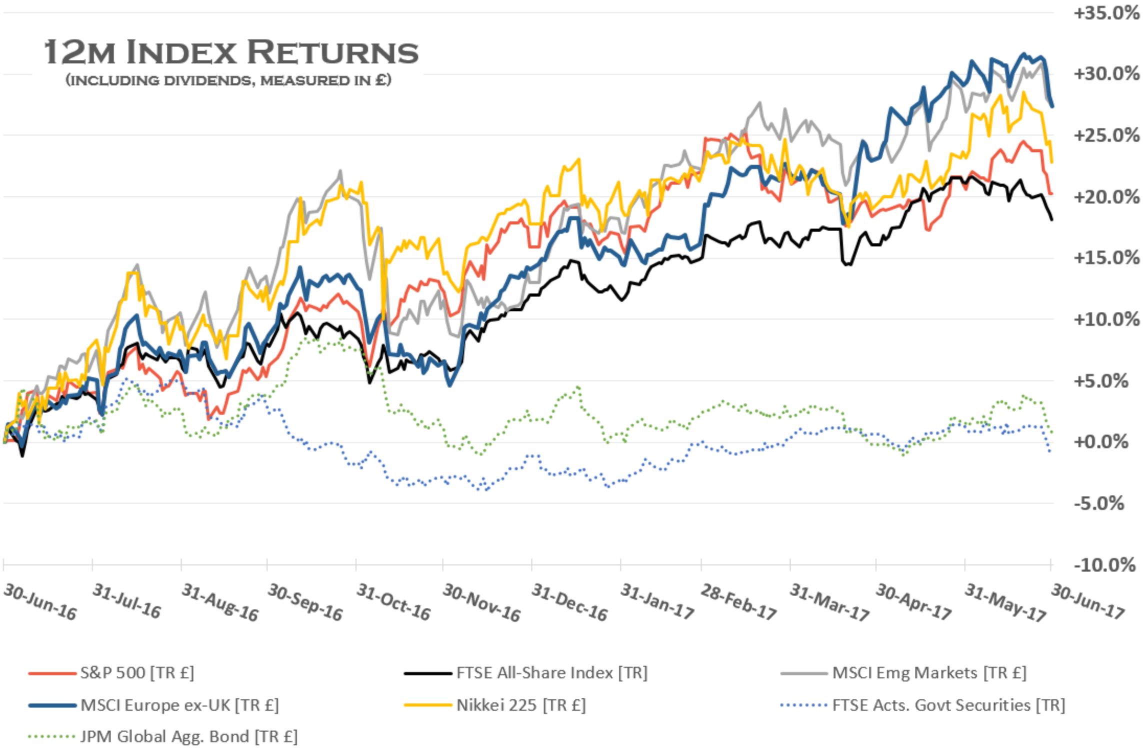
INDEX RETURNS

Index	Region/Asset Class	30 Jun 2017	1m Change	1 Yr Change	2 Yr Change
UK 100	UK	7,312.7	-2.8%	+12.4%	+12.1%
UK Mid Cap	UK	546.2	-4.1%	+13.5%	+7.9%
UK Small Cap	UK	5,585.0	-1.2%	+24.9%	+19.4%
Dow Jones Ind Avg	USA	21,349.6	+1.6%	+19.1%	+21.2%
S&P 500 Index	USA	2,423.4	+0.5%	+15.5%	+17.5%
NASDAQ Comp.	USA	6,140.4	-0.9%	+26.8%	+23.1%
Nikkei 225	Japan	20,033.4	+1.9%	+28.6%	-1.0%
Euro Stoxx 50	Europe	3,441.9	-3.2%	+20.1%	+0.5%
CAC 40 Index	France	5,120.7	-3.1%	+20.8%	+6.9%
DAX Index	Germany	12,325.1	-2.3%	+27.3%	+12.6%
Milan Index	Italy	20,584.2	-0.7%	+27.1%	-8.4%
MSCI Emg Mkts (£)	Emg Mkts	517.3	+0.4%	+27.3%	+31.8%
IBOVESPA Index	Brazil	62,900.0	+0.3%	+22.1%	+18.5%
MICEX Index	Russia	1,879.5	-1.1%	-0.6%	+13.6%
S&P BSE SENSEX	India	30,921.6	-0.7%	+14.5%	+11.3%
Shanghai SE Comp.	China	3,192.4	+2.4%	+9.0%	-25.4%
Hang Seng	Hong Kong	25,764.6	+0.4%	+23.9%	-1.8%
UK All Property	UK Property	6,897.2	+0.3%	+6.5%	+9.7%
UK Conv Gilts	UK Gilts	3,535.8	-2.0%	-0.9%	+12.5%
UK Index linked Gilts	UK IL Gilts	4,776.9	-3.0%	+6.7%	+22.6%
JPM Glob Agg. Bond	Global Bonds	805.2	-0.7%	+0.8%	+29.2%
iBoxx Non-Gilt	UK Corp Bonds	334.0	-1.2%	+5.3%	+14.7%
WTI Crude	Oil	46.0	-4.7%	-4.7%	-22.6%
LMEX	Base Metals	2,853.5	+3.4%	+20.4%	+9.7%
Gold Spot $/oz	Commodities	1,241.6	-2.2%	-6.1%	+5.9%
S&P Agri & Livestock	Agriculture	820.44	+1.6%	-6.6%	-17.1%
£1 = US$	Currencies	1.30	+1.0%	-2.1%	-17.1%
£1 = €	Currencies	1.14	-0.6%	-4.9%	-19.2%
£1 = Yen	Currencies	146.39	+2.5%	+6.6%	-23.9%



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