MARKET INSIGHT

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2018: WALL OF WORRIES OR NOT?

The year is not over yet, but unless a serious shock, 2017 will be remembered as a year of superlatives by investors. All US equity indices printed all-time highs more than once during the year while credit spreads tightened to rock-bottom levels and volatility traded at an all-time low. Other notable moves include bitcoin soaring more than 700%, the market cap of the so-called FANG and their Chinese counterpart (Baidu, Baba and Tencent) grew $1.5trn, more than the entire German market cap, and Argentina, who defaulted 8 times in 200 years, was able to issue a 100-year bond… Bouts of stress were not sufficient to shift this über-bull mindset: the North Korea crisis appears, in hindsight, a complete non-event, while the constitutional crisis in Spain had virtually no impact outside of some Spanish names. Is this market really trading at unrealistic levels and what could derail (or not) this seemingly unstoppable market?

The MSCI All Country World (ACWI) surged more than 240% since its trough in 2009, topping by 55% its previous high of 2007. According to a number of strategists, this bull market will soon enter its ninth year, the second longest streak in history. The duration and magnitude of the ongoing cyclical advance is thus used as a major argument to claim that a down cycle is around the corner. Since the classic (and somewhat arbitrary) definition of a bear market is a drop of 20%, it should be noted that the rise that started in 2009 has already been interrupted twice by such a drop, in 2011 and 2015. Based on technical analysis, the MSCI ACWI really started its uptrend in 2014 when it surpassed the highs of 2007, negating the duration and magnitude arguments.

A number of investors and market observers are also calling for a coming correction based on across-the-board overvaluations. Although optically equities are trading at all-time highs and credit spreads are very tight, high valuations are neither necessary nor sufficient to trigger a bear market. In case of an exogenous shock, a correction can happen at any valuation level. Market pundits tend also to forget that period of high valuation can be sustained for a long period of time when supported by solid economic momentum, synchronized growth and earnings growth such as witnessed today. For 2018 consensus expects World GDP to growth grow by 3.7% and global EPS by 10%.

The case of US equities to justify (or not) excess valuation is quite self-explanatory. Most analysts are using current levels versus a long term median, but this simple technique does not take into account the current macroeconomic context (low inflation and low bond yields), does not adjust for extreme values (tech bubble, global financial crisis), and misses changes in the composition of the index. By looking at adjusted valuation ratios it appears that the US equity market is indeed not cheap, but not overly expensive. The PE to growth ratio (PEG) for the S&P500 stands at 1.3x, below its 2000 and 2007 level, while the cyclically adjusted PE ratio (CAPE) which accounts for earnings cyclicality is at 24x, above its long term median, but again below the peaks of 2000 (48x) and 2007 (30x). In addition, and maybe more important, the valuation of equities relative to bonds remains firmly in favor of equities. It will remain the case as long as the earnings yield and dividend yield are higher than bond yields.

Should investors fear central banks and the so-called quantitative tightening? The Fed should be the only key central bank to start tightening by hiking rates three times in 2018 and starting to reduce its balance sheet. Other key central banks – ECB, BoJ, PBoC – should continue to be quite accommodative, albeit at a reduced pace. Global financial conditions will thus remain broadly expansionary and support risk assets. Moreover, fiscal stimulus could partially offset some of the reduced monetary stimulus. Markets already priced-in this deceleration and only an inflation surprise could incentivize central banks to tighten more aggressively or more quickly than currently expected.

What makes this market interesting and challenging at the same time is that, despite the fact that the above-mentioned fundamental arguments are sound; the market is always subject to a number of exogenous factors such geopolitical events or a short-lived crisis adding uncertainty.

Year in year out Europe is bringing a new political crisis, being risky elections, referendums or constitutional changes; the region is always under the spotlights for a political issue. 2018 will unfortunately be no exception to this rule with the Italian General elections early 2018. The Italian banking system continues to be saddled with piles of non-performing assets; debt-to-GDP remains the second highest behind Greece and populism gains traction among voters. In such a context, the country has all the required characteristics to bring uncertainties in the European political landscape which usually translates with risk-off market movements. More precisely, the Populist Party "Cinque Stelle" would likely organize a referendum on the Euro membership, but technically there is a giant leap from a referendum to pulling the country out of the Euro. In any case, Italy should remain under the radar of every investor and is certainly not immune to a banking crisis.

“However, investors should always stay alert and not be carried away by complacency”

In the same vein, the White House has struggled this year to enact a number of reforms that have been promised during the campaign. After a number of failures, the market was eyeing the tax reform as the latest attempt from the Trump administration to score a significant reform during its first year in office. Although the ink is still wet, the Senate passed the Republican tax bill in early December. It appears now very likely that the bill will become law by year-end as the process is rather straightforward; House and Senate will most likely iron out detail in the Conference Committee so the law can end up on the desk of President Trump for signature. However, mid-term elections are coming in 2018 and it is unclear if the new tax law will be of any help for the GOP to maintain its majority as voters are not convinced the tax reform will be of any help to middle class. Moreover, some market and economy pundits already voiced that the current proposed bill is fiscally irresponsible as it is not deficit neutral and is partially based on the assumption of future growth to fund deficits. Even though the White House is currently celebrating this achievement, political noise in Washington will certainly continue to go on and add uncertainty.

All crises, or at least market corrections, come with their share of increased volatility. This time could be different though as volatility products have the potential to be the trigger of a correction, changing the causal relationship between stock prices going down leading to higher volatility. Low volatility feeds into much lower volatility through the channels of short volatility products and other strategies that see volatility as a yield input, adding to the compression trade. However, unlike other asset classes, volatility has the potential to reprice extremely aggressively as it is acting as a trigger for a number of products, which means that a few points of higher volatility unleashes deleveraging, which leads to more selling. The same negative feedback loop that has taken volatility to abnormally low levels can reverse and take it to abnormally high levels, wiping out strategies such as risky parity, volatility target, risk premia and other explicit short volatility strategies such as the infamous XIV. The trigger can materialize in different shapes and forms and remains highly uncertain; the only certainty is that repricing will be most likely very violent and unless adequately anticipated from a portfolio management point of view, there will be no place to hide.

2017 will most likely close as a very good year for most investors. However, they should always stay alert and not be carried away by complacency, even more so when performance is elevated. Portfolio construction should remain anchored to macroeconomic fundamentals and valuation; however tactical asset allocation should be as important in navigating these seemingly easy markets next year by focusing on agility and independent performance engines.

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