

Taking Stock

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | AUGUST 2017

As has been the case so often in recent years, it was the overall swings in sentiment that drove markets in 2016. The year was very clearly delineated into a risk-off phase in the first half and a very strong risk-on rally in the second half, with relative sector performance to match.

To an extent, 2017 has reversed second-half (H2) 2016 sector trends, with some of the winners of H2 2016, such as Energy, Financials and Autos, finding themselves firmly in the back seat over the last eight months, while Health Care and Utilities have staged a comeback. Meanwhile, the relatively cyclical Information Technology, Materials and Industrials sectors managed to outperform in both periods. We also see some other long-standing risk-on/risk-off linkages breaking down, such as the link between the USD/yen exchange rate and the Topix.

We tend not to spend a lot of time trying to decipher what the market does or does not care about in the short term, as our time horizon is always much longer than the average market participant. But there are some major shifts in market sentiment that are hard to ignore:

- Central Banks and politics have dominated investor thinking over the last couple of years. Despite global politics being at a minimum “interesting” and the big U.S. quantitative easing unwind looming on the horizon, the market now hardly takes notice.

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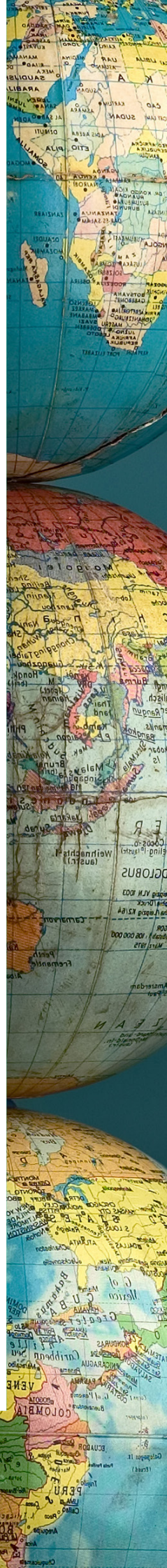
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“...our time horizon is always much longer than the average market participant”

¹ Source: FactSet, 31 August 2017.



- After five years of the U.S. economy and stock market outpacing Europe, a consensus has built that Europe might finally return to strong growth, outpacing the U.S. While in currency markets the euro has strengthened strongly versus the USD, the stock market outperformance in Europe has not yet fully materialised. We will see whether this will ultimately come to pass, but market perception has clearly changed.
- Disruptive change is moving to the forefront of investors' minds, trying to gauge the impact of the likes of Fintech, electric & autonomous cars, AI and e-commerce on their portfolios.

“...there is less valuation disparity in the market and multiples are high, which means that investment hopes rest more firmly on near-term improvement in the earnings outlook”

Playing the yin and yang of the risk-off/risk-on trade no longer seems to work. Investing for any of the major shifts is difficult and exceeds most people's time horizon. Instead, it seems the market gets very focused on near-term earnings beats and misses. We saw, even in our much more stable portfolios, how the market gets extremely excited about near-term good news, while being very harsh on mild misses or even just moderating near-term guidance. This has created the situation that overall stock market volatility, as expressed by the VIX, is at all-time lows, while individual stock volatility can be very pronounced.

Nervousness at the stock level may be driven by valuation. The median 12-month forward P/E of the MSCI World Index stands at 15.6x, well above the previous peaks in 2007 (13.4x) and 2000 (12.2x).¹ The higher multiples are now far more evenly dispersed than in previous peaks. In 2000, the top 40 stocks by market capitalisation accounted for 38% of the index but only 24% of the earnings of all the companies in the index overall, implying a 50%+ premium to the overall market. Today the ratio is 26% of market cap for 23% of earnings,¹ implying a negligible premium. In other words, there is less valuation disparity in the market and multiples are high, which means that investment hopes rest more firmly on near-term improvement in the earnings outlook. With many sectors at or above historic peak margins supported in turn by low wages and low interest rates,

“...short-term price volatility might present us with potential long-term opportunities”

these hopes are difficult to sustain across the whole market, unless we see some significant uptick in cyclical growth.

In this expensive and volatile world, we remain focused on long-term sustainable compounding, relying on steady earnings growth to protect us over the medium to long term. In the meantime, short-term price volatility might present us with potential long-term opportunities.

¹ Source: FactSet, 31 August 2017.

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