

### Global Equity Observer

# The Bull-Bear Tug-of-War

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Given the recent violent moves in markets, even more caution than usual is required in any commentary at present. Indeed, the first draft of this monthly update, written in the last days of January, had to be jettisoned. Pointing out the possibility of both a melt-up and a melt-down, and the risks in absurdly low levels of volatility, now looks more than a little passé. As of the time of writing (February 7), it looks like the correction may have run its course, for now at least – so what is next?

The turbulence of early February has probably reduced the risk of a sharp move in either direction, while paradoxically increasing volatility, a healthy combination. The euphoria of January, and the associated retail frenzy, is unlikely to return with the same force, and on the downside the threat from low volatility trades, so profitable for participants in 2017 and so disastrous in 2018, seems to have been defused without severe direct damage to equity markets. The tug-of-war is likely to continue, between the bulls citing synchronised global growth and the bears pointing to normalisation of monetary policy and tail-risks from the Korean peninsula to Italian elections.

We have no clear view on the outcome for markets in 2018 but, in the longer term, we are distinctly cautious. One of our mantras is that there are only two ways to lose money with equities – either the earnings go away or the multiple goes away. Looking at markets today, we are worried about both risks. Multiples are still high. They have not been eased by the recent correction, which has only taken us back to December prices, and they are arguably dependent on both the very low risk-free rates, which are showing signs of normalising, and the assumption that earnings will continue to rise.

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“The tug-of-war is likely to continue...bulls citing synchronised global growth and bears pointing to normalisation of monetary policy and tail-risks from the Korean peninsula to Italian elections.”



However, it is earnings that are probably our larger concern, not so much in 2018, since growth and U.S. tax reform will help, but in the longer term. The recession, when it finally comes, probably on the back of monetary tightening, will have a severe cyclical effect on earnings, but there are also structural concerns. Forty years of pro-business policies, starting from the Reagan-Thatcher era, have provided a major tail-wind for corporates. In the U.S., the profit share of gross domestic product is at a high, and the natural corollary is that labour's share is at a low. This has driven a rise in inequality, and the associated populist anger. So far, this anger has been mainly

channelled by the Right, be it Trump in the U.S. or Brexit in the U.K., and aimed at immigrants and other 'out' groups. The risk to earnings is that populist anger shifts its aim to the corporate sector, whether through labour legislation, taxation or renationalisation. The collapse across the West of the centre-left, which supported the free market agenda over the last 30 years, makes this threat more real.

“...owning high-quality companies does seem a sensible place for capital”

In a world where there is little absolute margin of safety given high valuations, and risk still seems to be 'on' despite the beginning of February, owning high-quality companies does seem a sensible place for capital. These companies have a history of growing earnings across the cycle, reducing the earnings risk, and are trading at very reasonable valuations, in relative terms at least, with the Consumer Staples 12-month forward price/earnings ratio at its post-Financial Crisis lows versus the market as a whole. As we have said before, now is the time to be keeping the lights on, rather than shooting them out.

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