Market Perspective

Normal service resumes | Are stocks too dear?

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Rothschild & Co
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Foreword

Ever since Professor Irving Fisher advised that “stock prices have reached what looks like a permanently high plateau” in mid-October 1929, economists have been wary of calling the stock market – or at least, they should have been.

As this October’s sell-off again shows, when we say market timing is difficult, it’s not false modesty. And ‘fundamentals’ only offer limited reassurance. Recessions and crises can fall from a seemingly clear sky – markets sometimes (not always!) smell the coffee first.

Nerves are understandable. Cyclical indicators have rolled over, and a sharp deceleration in corporate earnings lies ahead. The Federal Reserve (Fed) seems nonetheless likely to continue raising interest rates. The US–China trade skirmish continues; Italy’s budget has upset the EU; and a UK exit treaty has been elusive.

But these are familiar headwinds, not unexpected hurricanes. A slowdown in earnings is not a recessionary collapse. And as we suggest below, the major stock indices have not been especially expensive.

If, as we believe, the investment climate is still relatively benign, how should we respond? Profits won by selling now might prove short-lived if further falls are reversed as unpredictably as the onset of the decline.

There have been half a dozen such episodes since the Global Financial Crisis. If we step off the train now, it might leave without us. We advise sitting tight.

So what do we worry about most? A wider trade skirmish, perhaps. Central banks fighting the wrong battle (against an illusory deflation threat). And the looming departure of a grown-up politician who did something decent but unpopular. Chancellor Merkel’s confirmed retirement risks leaving the European project rudderless. Whatever you think about the economics of the EU, this is a sobering month in which to be reminded of its raison d’etre.

Kevin Gardiner

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Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin’s Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Normal service resumes

Risk is a fact of investment life

'October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.' – Mark Twain

Stock markets had been remarkably calm

Mark Twain's 'peculiarly dangerous months' have actually been few and far between of late. For much of the decade following the Global Financial Crisis, even as pundits proclaimed the imminent end of the world for all sorts of exciting and ingenious reasons, global capital markets were largely docile, quietly delivering some of the best sustained returns on record.

Since 2016, the lack of volatility itself became remarkable. Collectively, investors and advisers have perhaps needed reminding that markets can be noisy, and go down as well as up.

The latest reminder came in October. Most big stock market indices, and most sectors, fell markedly. The all-countries index fell by roughly 10% from its September peak.

Oil prices also fell sharply, but other commodity prices were more resilient. Most government bonds, gold and the yen – 'safe-haven' assets – rallied, but modestly. The US 10-year Treasury note yield has remained above 3%.

That recent stability aside, this latest stock market setback does not look unusual. There have been perhaps half a dozen similar episodes since 2009 (figure 1).

The jury is out on what caused it – if anything did, that is: we should be wary of over-analysis.

There are plenty of things to worry about...

Analysts who quickly tell us not to worry may be missing the point. There is always something to worry about. The very open-endedness that makes stocks good long-term investments can go scarily into reverse.

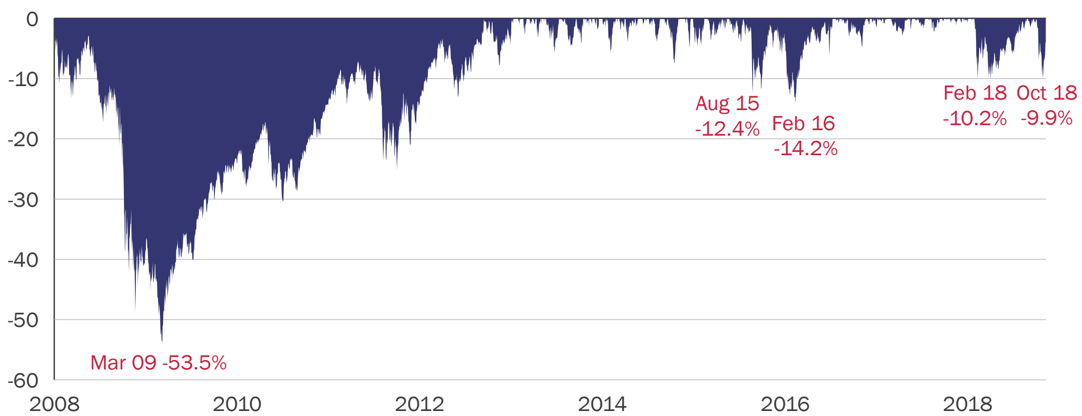
History shows that economic storms sometimes break from a seemingly clear sky. Corporate profits can evaporate with little warning. Big financial institutions can disappear. As investors in stocks, we own businesses, and face these unavoidable – and innumerable – risks. And as they say, the stock market indices go up on the escalator, but come down in the elevator. It is not possible to offer convincing reassurance.

Familiar market threats might include:

- Disappointing corporate profits, whether in isolation or because of:
  - an autonomous economic downturn
  - tighter monetary or fiscal policy, leading to slowdown
  - big trade protection, or a supply-driven surge in oil prices.
- Reckless borrowing – by Italy, Chinese corporates, or US home-buyers – leading to financial crisis, risk aversion and poor profits.

Figure 1: The latest setback for stocks is not unusual

S&P index drawdowns since October 2007 (%)



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

- Geopolitical stress and uncertainty – triggered by US insensitivity, Brexit or North Korea – which causes a flight to safe-haven assets.
- Excessive valuations.

...but they have not suddenly got worse

The market could be seeing something early – but as noted above, it doesn't always do that. The US economist James Tobin famously quipped that "the stock market has predicted nine of the last five recessions".

As yet, although business surveys are cooling (page 6), the next US recession still seems some way off. The Fed is in tightening mode, and likely to remain so, but US interest rates and bond yields are still historically subdued. Corporate results are robust – some high-profile misses notwithstanding. There have been no new escalations in political uncertainty of the sort that might affect markets.

For sure, US tariffs, Italy's budget and Brexit are all real concerns, but they have not become more pressing, and bad outcomes are far from guaranteed. Most recently, the US mid-term election results were widely expected.

With President Macron's reforms losing momentum, Chancellor Merkel's confirmation that she will not seek re-election in 2021 may rekindle scepticism regarding the leadership of the EU project. It feels like a background concern for now, however.

Meanwhile, the big picture remains one of healthy profitability alongside only gradual monetary normalisation. And as we note below, valuations have not been alarming.

The broadness of stocks' decline, and the failure of safe-haven assets to rally more substantially, hints perhaps at profit-taking by institutional investors – as in early 2016, maybe – rather than a more sinister macro cause.

Unknown unknowns?

In trying to see into the future, we are often unwitting prisoners of the past. All sorts of unprecedented and unimagined risks may be lurking ahead.

We can only keep an open mind, and hold some portfolio insurance. Some risks are simply uninsurable, the financial equivalent of an asteroid strike perhaps. For insurance to pay out, our insurers need to survive.

What next?

We do worry about a 'second derivative' effect: strong US growth and tax cuts have created such a boom for business in 2018 that it feels as if things are as good as they can possibly get.

A big profit slowdown in 2019 is possibly inevitable – alongside rising US interest rates – and this could lead to the earnings disappointment featured on our list. Is realisation dawning now?

If so, it may be a bearable burden for long-term investors. The likely level of earnings at which the inevitable slowdown will occur may yet be higher than expected. And slower growth, rather than an outright fall, will leave most valuation metrics intact.

We are not (we hope) gullible enough to believe in 'permanently high' plateaus. But we thought stocks were good long-term value before this slide, and think they still offer the best chance of inflation-beating returns for long-term investors.

Are stocks too dear?

'Nowadays people know the price of everything and the value of nothing'
– Oscar Wilde

Valuing stocks is not easy, and history can be cruel. Financial broadsheets and central bank commentaries have casually asserted that stocks are dear for several decades. Growth investors' models collapsed with government bond yields. Value investors thought they had Mozart's perfect pitch.

The clue is the word 'market'. Prices are ultimately decided subjectively: if there are no buyers, prices collapse. If there are no sellers, they soar.

We seek objectivity by comparing prices to earnings, book values, discount rates and the like, but those move around a lot. Even if they didn't, the way we view them would.

When we suggest stocks are cheap or dear, we are expressing an opinion. Nowhere is financial precision more spurious than in the realm of valuation. There are no absolutes – no perfect pitch.

So what can we usefully say about stock valuations? Did October's setback happen because they were just too dear?

We think not. We try to keep an open mind, but we want our metrics to cover the whole market, not just some countries and sectors (or median companies) and to use credible data (which rules out 100-year comparisons).

The main reason we want to invest in stocks – to own businesses – is a wish to share in economic growth. If we're going to argue that stocks are good value, we have to be able to see some sort of link, however loose, to that growth. Most long-term gains in stock prices are traceable to corporate earnings (figure 2).

Momentum-based indicators

One minimalist approach simply compares stock prices with their trends. This is arguably not really a "valuation" per se, but if traders base their decisions on a stock index falling below (say) its 200-day moving average, it might prove self-fulfilling. We do not use these often – they are short term in focus, and ignore that growth.

Flow-based measures

The most common approaches compare prices with measures of income such as earnings, dividends, cashflow, sales or earnings before interest, tax and depreciation (EBITDA).

PE ratios – prices divided by earnings – can be viewed as the number of years of earnings your investment costs. Alternatively, they can be turned upside down, and seen as yields (which is how we usually view dividends).

Earnings are volatile. Profits are cyclical, and balance sheet write-downs can be big (see 2008 in figure 2). 'Cyclically adjusted' PE (CAPE) ratios use a 10-year moving average (often in real terms) to smooth earnings. But US earnings fell so sharply in 2008/9 that they affected the 10-year averages. As that fall drops out, the CAPE denominator will likely continue to grow – and valuations fall – for a while even if earnings now stagnate.

Price/sales and price/EBITDA ratios have become more popular, but are not useful for financial companies, a big sector.

Balance sheet-based measures

Usually, shareholders' funds or 'book values' are relatively stable – two high-profile exceptions being banks in 2008, and telecoms and media companies in 2002 – and so provide another useful valuation benchmark.

Debt or leverage ratios are also often used, but again the data can be difficult to interpret in the case of banks.

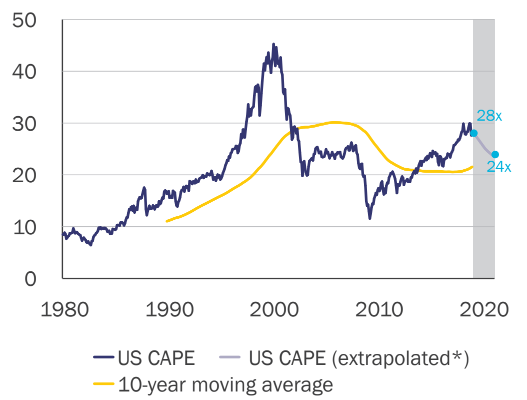
'Tobin's Q' compares stock prices to companies' alleged replacement values. It is supposed to be an absolute measure, but data are poor and hard to get, and the idea itself is misconceived.

Discounted cashflow (DCF) approaches

These use a riskless discount rate – usually government bond yields – often adjusted to take into account stocks' greater risk.

Figure 2: Stock valuations not extreme

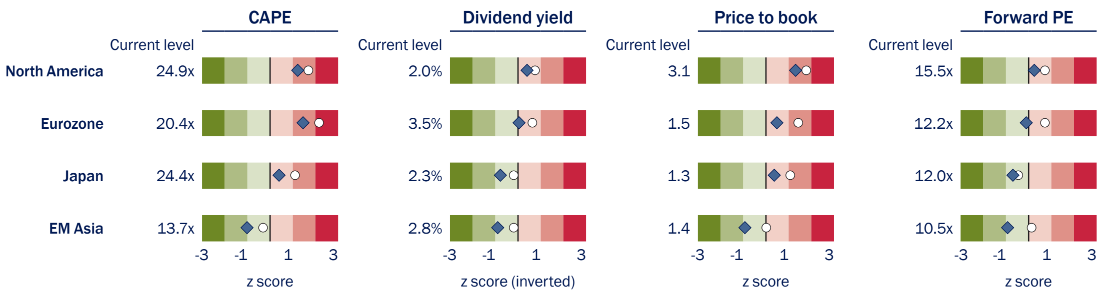
Developed world CAPE and trend



Source: MSCI, Rothschild & Co
**CAPE has been extrapolated to 31/12/20 and assumes no earnings growth or change in index level and 2% inflation per annum.*
Past performance should not be taken as a guide to future performance.

Figure 3: Stock valuations unremarkable? Levels and z-scores (divergences from trend)

Selected valuation metrics (excluding interest rate-related measures). Z-scores calculated as standard deviations from trend.



Key: ◆ current z score ○ z score –3 months | 10-year average

Source: Datastream, MSCI, Rothschild & Co
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In their simplest form, they compare stocks' yield to that on bonds: the so-called 'Fed model' was based on the observation that for much of the '80s and '90s the two yields moved together.

More complex versions can in theory be used to construct absolute valuations – showing not just whether valuations are high or low relative to the past, but whether they are 'fair' or not. In reality, conclusions are hugely sensitive to small changes in input assumptions.

Conclusions

A few of the many valuation metrics that we watch most closely are summarised in figure 3 (page 4).

We do not include discounted cash flow-type measures here, though we routinely show stock and bond yields for reference on page 6. Bond yields have been so unusually low of late that such measures would probably have been too lenient.

Generally, most metrics before the sell-off were firmly above 10-year trends. The divergence was not unprecedented or alarming, however, and in a benign economic climate – in contrast to, say, the 1970s and early 1980s, when those trends were lower and 'normalised' interest rates much higher – deserved the benefit of the doubt (remember, this is not a precise exercise).

Valuations now are closer to those trends. Wherever markets go next, we doubt that they will be doing so for valuation-related reasons.

Investment conclusions

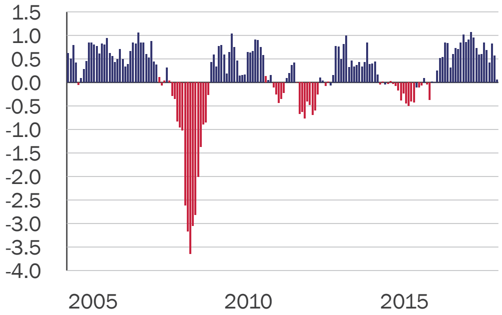
Our top-down views are unchanged. Our portfolio managers have been holding some specific protection in anticipation of volatile stock markets, but we have been wary of a more defensive restructuring that could leave us stranded if markets rally. The economic climate remains constructive, and stock valuations are close to trend again. US tax cuts and growth have added some real headroom in 2018; interest rate risk remains modest; and geopolitical risks may be manageable. Stocks can still deliver inflation-beating long-term returns.

- Inflation-adjusted, long-term US Treasury yields still looked low even after their recent rise. Other government bond markets remain still more expensive – most nominal yields remain below likely inflation rates. We still prefer high-quality corporate bonds to government bonds, but they are also expensive. The room for outperformance is falling – most visibly in the eurozone, where the European Central Bank's (ECB) buying will shortly cease and local credit concerns pose some limited risk to banks. We continue to view most bonds and cash currently as portfolio insurance.
- In the eurozone and UK, we continue to favour relatively low duration bonds. In the US we have been more neutral, and see some attraction in inflation-indexed bonds. Speculative-grade credit has run out of longer-term headroom – net of likely default and loss, returns may struggle to match inflation. We are not tempted to add emerging market bonds to multi-asset portfolios, even after their recent sell-off.
- We continue to prefer stocks to bonds in most places, even the UK (where the big indices are in any case driven by global trends). We have few regional convictions – though we think that emerging Asia's structural appeal remains intact, recent trade tension and volatility notwithstanding – and continue to favour a mix of cyclical and secular growth over more defensive bond-like sectors.
- Trading currencies does not systematically add value, and there are currently few obvious misalignments among the majors. Cyclical momentum and interest rate carry clearly favour the dollar, but it still has yet to break out of its recent trading range. The pound remains hostage to Brexit tensions, but the domestic policy mix continues to shift in its favour and it is competitive. Higher ECB rates remain some way off, and there are some local credit risks (Italy and Turkey-related bank stresses), but quantitative easing at least is almost finished, the euro is inexpensive and we remain sceptical of the euro disaster scenario. China's monetary policy has loosened preemptively, and the yuan has fallen back towards trend, but on a long-term purchasing power parity (PPP) basis it was highly competitive to begin with, and is now even more so. The yen is cheap, but its monetary policy remains the loosest. We still single out only the Swiss franc among the big currencies: we think its revived safe haven appeal will fade, and it remains expensive on a PPP basis. But the local economy appears in (even) better shape than we'd realised, and if this starts to matter the franc may yet stay stronger for longer.

Economy and markets: background

Growth: major economies

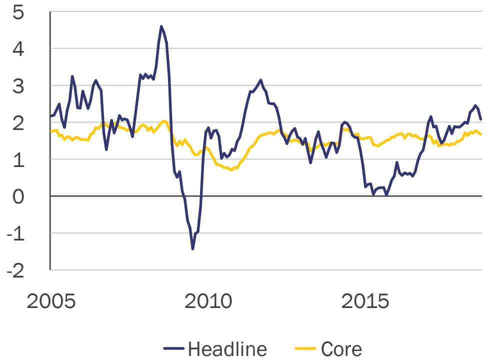
Business optimism: standard deviations from trend



Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

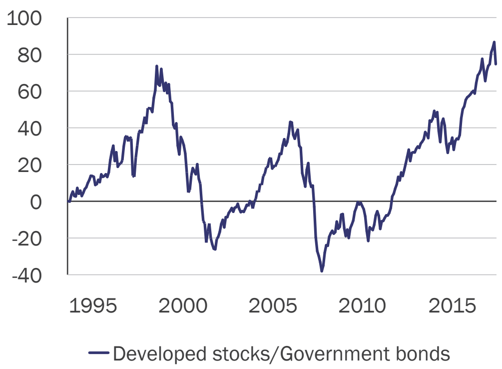
G7 inflation

%, year-on-year



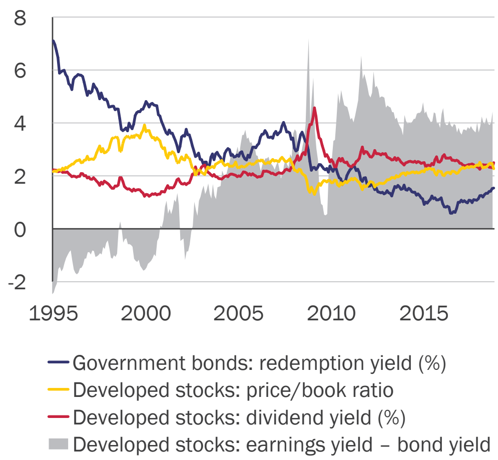
Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	3.1	-3.2	-0.5
10-yr UK Gilt	1.4	1.2	9.7
10-yr German bund	0.4	0.8	4.4
10-yr Swiss Govt. bond	-0.0	-0.2	-1.2
10-yr Japanese Govt. bond	0.1	0.0	2.2
Global credit: investment grade (USD)	2.2	0.2	6.7
Global credit: high yield (USD)	6.8	-1.0	19.9
Emerging (USD)	6.0	-3.4	12.6

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.6	0.7	26.0
Developed	2.5	2.1	26.4
Emerging	3.0	-8.9	23.5
US	1.9	6.6	35.7
Eurozone	3.5	-9.2	6.6
UK	4.4	-0.9	25.8
Switzerland	3.2	0.2	11.4
Japan	2.3	-4.2	9.6

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	110	4.4	6.0
Euro (EUR)	126	2.0	9.5
Yen (JPY)	91	3.9	11.1
Pound Sterling (GBP)	78	0.1	-15.7
Swiss Franc (CHF)	156	2.9	-0.0
Chinese Yuan (CNY)	130	-1.9	-8.4

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	191	1.8	-2.4
Brent crude oil ($/b)	75.5	23.0	52.3
Gold ($/oz.)	1,215	-4.4	6.4
Industrial metals (1991 = 100)	236	-12.8	22.0
Implied stock volatility: VIX (%)	21.2	108.5	40.9
Implied bond volatility: MOVE (bps)	60.1	17.6	-17.7

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st October 2018.

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Notes

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