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The Wall of Worry gets steeper - but the market cries out to be bought

Sentiment toward the equity markets has definitely got more worrisome over the last month.

After 8 years of a US bull market in equities, investors are very wary that the bull can continue. People want to sell out and bank profits; they don't want to lose them in a decline which they fear could be similar to 2008.

There's no question there has been a "Trump trade" since the US election last November, which has seen indices rise dramatically in the US, notably in the financial and commodity sectors. The broader sectors have risen thus: Dow up 14.32%, S&P500 up 11.49%, Nasdaq up 16.49%, Russell 2000 (small cap) up 17.50%. Understandably, investors do feel light-headed, especially if they have ridden the bull for many years.

However, in Asia, Emerging Markets and, especially, Europe, the bull is only just getting started. Yes, it would have been ideal to have had a presence in these markets 12-18 months ago but these areas are now only just beginning to see fund inflows from the US, and they should be expected to see a lot more, as US investors seek to diversify away from high valuations in the world's largest economy - but when will they do so?

During the busiest earnings reporting season of the year in the US, 74% of companies reported 'beats' (beating their or analysts' guidance for the quarter), 14% reported misses. Those are hardly figures which suggest a rush for the exits is imminent, and yet market reaction has been very subdued, largely due to greater geopolitical factors (Syria, Korea), doubts over what the Macron/Le Pen first round election result actually means (they are, after all, both running on an antiestablishment ticket), and frankly, doubts over exactly what the new US president is up to. (Trump has tried to appear very presidential by signing all kinds of executive orders but has backed away from threats to abolish NAFTA and ObamaCare; making Mexico pay for the border wall; a trade war with China; but has carried through with an expensive and somewhat revolutionary Reagan-esque tax plan, at a time when US debt is already huge.)

So if earnings figures were good, why is the market ambiance so downbeat? There are several reasons: data released in April showed that economic growth in the US had slowed to its weakest for nearly three years (outstanding earnings results have been propelled by those S&P 500 companies which generate more than half their revenue overseas, posting first quarter earnings growth of 19.9 percent, on average, double that of companies which conduct the majority of their business domestically); second, there is concern that Trump's tax reforms were rushed out to ensure the announcement was made within the first 100 days of his presidency, and that they will not be approved by Congress; third, Mario Draghi's rather downbeat outlook for the European economy at the end of last month; fourth, uncertainty over upcoming German, Greek and British elections; fifth, slowing UK economic growth, and so on. Yet these concerns are precisely why investors should remain bullish. There is no euphoria. In the first week of May, the Federal Reserve is likely to leave US interest rates unchanged; Mario Draghi if anything will step up the central bank's bond buying programme in order to ensure continued liquidity for both the corporate and private sectors; and the UK will not be tightening monetary or fiscal policy while there is much uncertainty over the outcome of Brexit.

History also counts in investors' favour. Ken Fisher of Fisher Investments has dug out the statistics for the performances of US and non-US markets during and immediately following the inaugural year of a US president. Granted, Fisher is a 'perma-bull', but his research is compelling: when the non-US markets (specifically Europe, Asia and EM) outperform the US in the first three months of the year (as this year) during a president's inaugural year of office, they then massively outperform in the second half of the year. US equities have hugely outperformed other areas since the financial crisis, until this year, despite the US election uncertainty last year. In 2017, we will see European electoral uncertainty abate as the months unfold, providing opportunity for European equities to rally strongly.

According to Fisher's research, in all inaugural years since 1929, non-US stocks have outperformed US stocks by a ratio of nearly 2-1. Excluding 1933 and 1973, the second half spread between US and non-US stockmarket performance averaged 10% in favour of non-US stocks. More powerfully still, when non-US stocks take the lead over US stocks in terms of performance, they retain it, for an average of just over 3 years, and the margin of outperformance ranges from 40% in the mid-90s to 379% in the 1980s. "The rest of this bull market… should last years longer", says Fisher, stating that the average duration of a bull market following the third increase in a tightening cycle (which is where we are now) is 36 months.

Mike Amey of PIMCO, sees bonds, the best forecasters of economic direction, beginning to finally lose their 30 year attraction because of a longer term rise in the yield curve (foreseeing inflation and rising rates). However, he says PIMCO, while being pro risk, "because that is where excess returns can be expected over time", is adopting a cautious stance toward stocks because of the leg up seen in equity valuations over the last 12-18 months. Disappointingly for UK investors, the FTSE indices correlate closely with the S&P500, usually. This does not bode well for investors who prefer or tend to have a bias toward UK companies in their portfolio; they should now consider wider geographical exposure.

Things do not look good for Japanese equities for the next year - at least from a technical perspective. The US dollar has been trapped in a sideways pattern between 93 and 100 for two years despite a 'strong dollar policy'. Yes, it moved briefly to 103 but has now given up two-thirds of Trump induced gains, and with a 'lower for longer' interest rate policy in the US, as in most jurisdictions, and no inflation momentum to speak of, the US dollar is likely to continue to trend sideways for at least another year, according to technical analyst Nicole Elliott of the Financial Times. With no strength in the dollar to make the yen weaker, it seems unlikely Japanese equities will make much headway. To give them their due, they've had a good run of late, see below, but until the dollar is assisted by a more steady stream of interest rate increases, it will be hard for Japan's stockmarket to continue the momentum.

Favoured investment plays:

Nil risk:	USD cash (in preference to Euro cash)
Cautious risk:	AAA Corporate
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	UK**,** European equity
Adventurous risk:	**Japan, Asia, Germany,** US equity, UK/European/US smaller company sector
Speculative risk:	Water, Technology, **China, India, Other EM, Natural Resources**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 20%, Global Equity 18%, US smaller cos 2%, (Other) US equity 8%, UK equity 5%, Germany 5%, (Other) European equity 9%, India 5%, (Other) Asia 18%, Pharmaceuticals 9%, Energy 1%