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Global Market Strategy – June 2018

Just another Italian storm in a teacup

Robert Shiller (he of the CAPE Shiller ratio to better determine company price earnings ratios by 'A'djusting the traditional measure of 'P'rice 'E'arnings by a 'C'yclical factor which takes into account inflation's impact on the [moving] average of ten years of earnings) is a renowned Nobel prize-winning economist, and he has been calling the equity bull market 'long in the tooth' for many months now, but he sees no sign of an imminent reversal in US indices.

Mr Shiller attributes much of the market's endurance and resilience to external events, to the US President. "There's something about how the world is reacting to the president - something about his self-confidence which is gradually lifting our spirits", he says, and he doesn't see anything deterring market sentiment or causing a setback to equities in the near future. Mr Shiller concedes political shenanigans in Italy are always a concern, particularly if populist parties manage successfully to extricate the country from the euro, but that appears a remote possibility, and it was far more likely that concessions and compromise would prevail. Indeed, investors should use current market turbulence to lighten up US equity positions and increase exposure to cheaper European equity valuations.

Europe may be cheaper than the US but without turbulence it is not, as evidenced by the rollercoaster chart of the German DAX since market volatility suddenly took off this year on January 26th. That was the date when markets reached their highs for the year so far and then suddenly began falling due to rising bond yields (lower bond prices) resulting from a higher than expected wage inflation report in the US, and rising oil prices.

Yet investors should not write off the US equity market. If Congress manages to pass an infrastructure bill, that, together with the repatriation to the US of an estimated $1trillion by major US exporters in response to the Trump administration's decision to offer a one-off tax discount on such moves, should result in increased corporate spending and a trickle down benefit to consumers. We have already seen record percentage earnings figures across the S&P during the first quarter, and although these are backward-looking numbers with no guarantee of continual improvement, fears of higher interest rates to spoil the party are overdone. Indeed, this is more talk now of a recession in 12-18 months than there is of rising inflation and higher interest rates.

In mid-May (17th), the US 10 year Treasury was at 3.12%, with Brent oil at $79.20, with West Texas Intermediate at $71.49. While Brent has moved back but a dollar a barrel, WTI is now (May 31st) $67.09. Neither is a major move in reverse but a more significant reversal has taken place in Treasuries, with the 10 year now 2.83%, following the latest wage growth data in the US showing a year on year rise of just 0.6%. If economic 'recovery' is this weak, buy bonds - that is the message the retreat in the 10 year yield is telling investors.

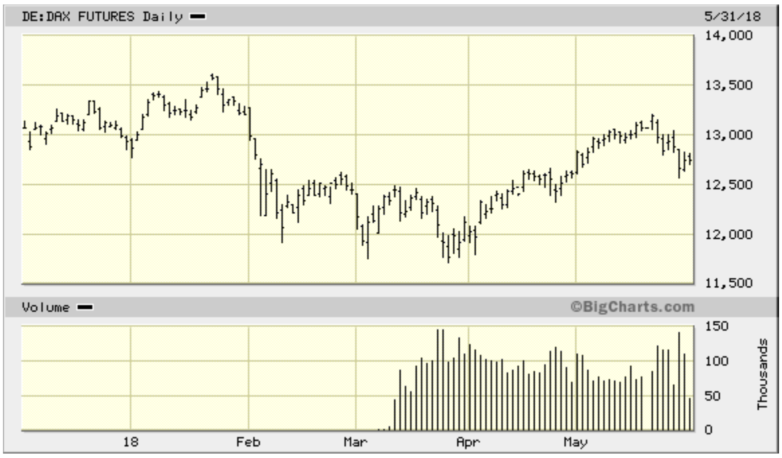
Two other worrying messages from the US market are the 2-10 year bond spread, and the job market's Participation Rate.

The 2-10 year spread (the difference in the yield on the 2 year bond against the 10 year) is a reliable indicator of a likely recession, and when it goes negative, ie when the yield on the 2 year is higher than that on the 10 year, a recession has followed 15 months later. The difference between the two now is now (May 31st) 41 basis points (2.83% v 2.42%) which is the smallest differential this year. If the differential gets as low as 15-20 basis points then that really would be a worry as the curve could easily invert from there, and that would doubtless bring about a large equity sell-off.

As important as the story from the bond market is that of the Participation Rate, where every 0.1% move is viewed microscopically each month. The current level of 62.9% is assuredly low yet that figure is of the whole population, taking account of retirees, those who are long-term unemployed and those yet to get to the workplace. The more concerning message is from the rate for the 24-54 year olds, those of prime working age. This measure fell from 82.2 precent in March to 82 percent in April and remains well below the 83.2 percent level in December 2007, the month the Great Recession of our lifetime began.

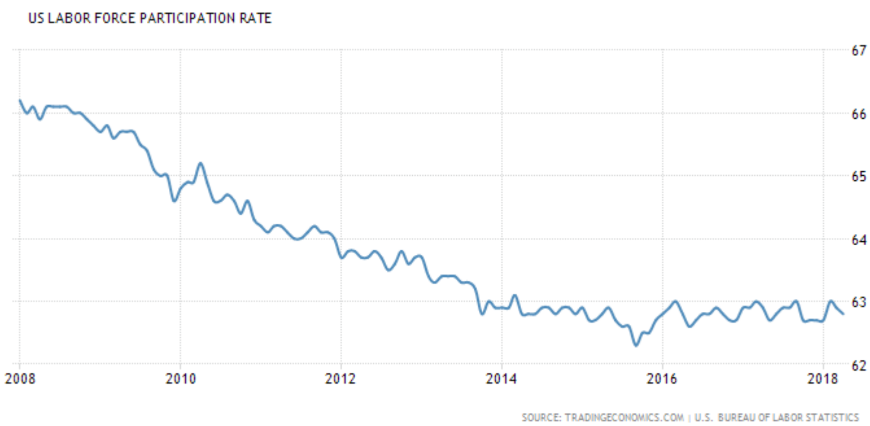
The participation rate for the prime working age group has not regained its pre-recession highs despite almost nine years of economic recovery.

The contradictory messages from the markets explain why they are having trouble making headway, and why fund managers have a neutral global equity position and are holding much larger cash positions now than for many months. It is not easy to determine where we go from here, and if the US catches a cold everyone else gets flu. However, optimists will point to healthy and higher corporate earnings across the world of late, the repatriation of US dollars to the US with a likely increase in share buy-backs, a forthcoming infrastructure bill ("It's going to be great!"), very reasonable equity valuations overseas (especially in the UK mid-cap sector, Europe, Asia and Japan), and the incredibly exciting-but-not-for-the-fainthearted market that is China, and they will remember that it is "time in the market and not timing the market" which counts in the long term.



Dax futures, 6 months to May 31st 2018 (Source: BigCharts.com)

Shanghai Composite Index, 12 months to May 31st 2018 (Source: BigCharts.com)



US Labour Force Participation Rate (Source: US Bureau of Labour Statistics

Favoured investment plays:

Nil risk:	Cash
Cautious risk:	AAA Corporate bonds
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	**UK, European equity**
Adventurous risk:	**Japan, Asia,** US equity, **UK/European/US mid & smaller company sector**
Speculative risk:	Water, **Technology, China,** India, Other EM

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (including new energy, all US) 31%, Global Equity 14%, US smaller cos 4%, (Other) US equity 6%, India 4%, (Other) Asia 13%, Pharmaceuticals 12%, Cash 16%

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