wealth & asset management

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Global Market Strategy – March 2018

- ***Last legs of the bull market? Don't you believe it!***

The dramatic sell-off at the start of the February which produced the worst week since January 2016 (precipitated then by the Chinese property implosion), saw many global stocks in bear market territory (ie down at least 20%).

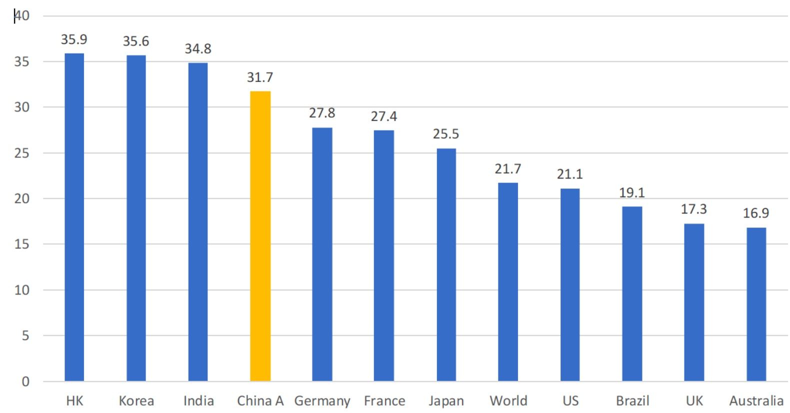
We saw 2500 points knocked off the Dow Jones index and $2.5 trillion value wiped off US stocks markets, and all this brought fear we were at the end of the bull market and the onset of another crash. It was indeed a crash that we experienced during the last 3 days of January and the first ten days of February, but it was a 'flash crash', a sell-off exacerbated and exaggerated by algorithmic trading which kicked in because those who had bought new-fangled exchange traded funds offering geared shorting of stockmarket volatility, suddenly needed to cover their short positions when volatility unexpectedly spiked. We had a scenario where some investors actually believed that because we had enjoyed 12 months of serenity in the equity markets, then it was ok to borrow money to continue to bet against volatility returning. When these highly speculative bets began to fall apart as volatility rose, mayhem ensued as traditional investments had to be sold quickly to meet margin calls (calls for collateral to paid to maintain gearing ratios) or to fully exit short positions.

Questions around whether the US Securities and Exchange Commission (SEC) should have actually allowed leveraged short-volatility ETFs to be sold in the first place are one thing, but unfortunately investors will have to expect to put up with this sort of domino-fall scenario in a world of ever more sophisticated, and ludicrous, trading instruments. Private investors need more than ever to have a professional advisor to counsel them to hold their nerve and not get panicked out of stocks at a time of low inflation, low interest rates, government infrastructure spending on global scale, and most importantly, higher and growing earnings and the prospect of increasing dividend payouts. If earnings are growing, consumers are spending. To keep a lid on inflation, rates have to rise, and economics reasons this should be to a level of 1.5% above the desired inflation rate.

What we experienced in early February was not the beginning of a bear market but volatility has returned. Having recovered to within 3% of all time highs on February 26th, the last two days of February brought a whipsaw retreat of up to 4%. Yet Ken Fisher, who manages on behalf of his clients nearly $80bn, expects the bull market to continue for some time. Although admittedly a 'Perma-Bull', he is a studier of detailed technical analysis and historical chart patterns. "Corrections are jarring", he says, "they come and go without warning but they are quite normal for bull markets". "Bear markets are born on euphoria, grow on grinding economics, mature on recession and die on panic." Because there is never any bell that sounds at the top or bottom of a market, those who suffer the effect of a market turn between bull and bear, are those who sell out of the market too late, believing they are taking action to avoid the worst of a sell-off but invariably staying out of the market during its recovery, thus underlining the importance of remaining invested through thick and thin, unless access to capital is needed in the short term (5 years or less).

Fisher claims to have struck upon an important '3 month rule' in deciding on whether a bear market is the real thing or not "because slow rolling tops precede the mayhem".

Since the start of 2017 **Emerging Markets** have been seen as representing value too good to miss. True to the expectation, they came good last year, China in particular.

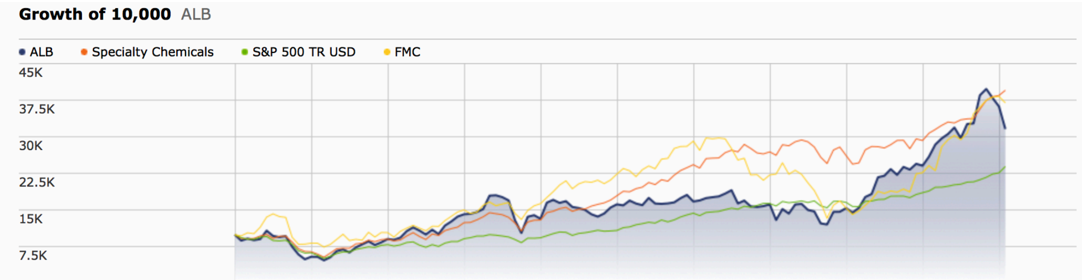


Equity market performances 2017 (Source: Bloomberg)

Despite their impressive rally last year, importantly, EM growth was not driven by growing PE ratios but by earnings, and both earnings and PE ratios are still at a heavy discount to those in developed markets. Brazil in particular is expected to see increasing dividend payout ratios as a result of improving corporate balance sheets. Asia generally also looks attractive, based on rising earnings but inexpensive valuations, and the key themes across Asia are China and South Korea by country, and technology and autos (specifically electric vehicles or ‘EVs’) by sector.

(Given the positive outlook for EVs in China first and foremost, it is interesting to note that Morgan Stanley have just come out with a downgrade of all lithium producers due to oversupply concerns, knocking heavily the share performance of Albemarle and FMC, the two big plays on the provision of lithium to the forthcoming EV market. This is all on the back of SQM, the state-owned Chilean miner of lithium, being granted a quadrupling of its licence from the Chilean government to produce the metal. Not only do Morgan Stanley see that single fact alone as a major threat but they also don’t see much demand for EVs until 2022. Morgan Stanley are out on a limb on this, as other finance houses take a very opposite view, but their report, issued on February 26th, has unsettled the market and created not only a wide divergence of opinion but also possibly an opportunity for investors to buy the current pull-back, though like all commodity investments, it is a speculative risk area.)

Fund managers are also positive on Japan and Europe. On a pure valuation basis they are both inexpensive but if, as seems likely, the ECB is going to deploy a ‘lower for longer policy’ and not raise rates at all during 2018, both to encourage some inflation and to suppress the euro, of the two areas, Europe seems the more favourable. Japan may be undervalued but Japanese equities are currently facing the twin headwinds of a stronger yen/dollar and a shrinking population. Shinzo Abe cannot do much about the latter but he may soon be given a helping hand with the former if the US raises rates by 1% during the course of 2018, which is what the markets are expecting. Equity investors may be pleasantly surprised however, by the Fed’s comparative inactivity. If the Fed raises rates only three times, or even only twice, all markets, except the UK, should again have a very good year.



History (01/31/2018)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD
ALB	-44.78	65.34	54.91	-6.45	22.15	3.59	-3.41	-4.92	55.87	50.06	-12.75
Specialty Chemicals	-34.88	39.54	36.91	4.31	38.18	35.33	10.75	-2.83	11.79	31.48	2.74
S&P 500 TR USD	-37.00	26.46	15.06	2.11	16.00	32.39	13.69	1.38	11.96	21.83	5.73
FMC	-17.12	25.78	44.17	8.45	36.97	29.87	-23.63	-30.23	46.23	68.53	-3.52
+/- Specialty Chemicals	-9.89	25.80	18.00	-10.77	-16.03	-31.74	-14.16	-2.09	44.07	18.58	-15.49
+/- S&P 500 TR USD	-7.78	38.87	39.84	-8.57	6.15	-28.80	-17.10	-6.31	43.91	28.23	-18.47
+/- FMC	-27.65	39.56	10.74	-14.90	-14.82	-26.28	20.22	25.31	9.63	-18.47	-9.23
Dividend Yield %	2.15	1.37	1.00	1.30	1.29	1.51	1.83	2.07	1.42	1.00	1.15
Market Cap USD Mil	2,041	3,329	5,109	4,572	5,522	5,075	4,692	6,285	9,682	14,131	12,330

Growth of Albemarle and FMC shares, ten years to close of business February 26th 2018 (Source: Morningstar)

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**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (including new energy, all US) 33%, Global Equity 18%, US smaller cos 2%, (Other) US equity 8%, Germany 5%, India 4%, (Other) Asia 13%, Pharmaceuticals 13%, China 4%

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