Weekly Digest
16 January 2018
The weekly insight into world stock markets

Investec
Wealth & Investment

A Deeper Dive into 7-Year Equity Market Performance

I spent the majority of last week contemplating the walls and ceiling of my bedroom while suffering from the latest flu bug. I have had flu three times previously – you don't forget flu, or mistake it for a cold – in 1977 (the "red flu"), 1990 and 2004. Technical analysts would have a field day with that information. On this trend I am next due a bout in 2032. Rather depressingly I note this to be around my seventy-first birthday, which is a) worrying close in flu cycle terms; and b) going to put me in the "at greater risk of complications, possibly death" category of patients. Great. Still, there are three US presidential elections between now and then, and a minimum of two UK general elections. If I spent the next fourteen years worrying about the outcomes of those I might never get anything productive done.

Luckily, I had already decided what I was going to write about this week, as my plan was to dig a bit deeper into last week's subject of the effects of Quantitative Easing. I was also planning to take a slightly longer perspective of seven years (half a flu cycle?) and look at different regions. At the global market level, the seven years to end 2017 have been very kind to investors, offering a dollar capital-only return of 59% and a total return of 92% (all data sourced from Bloomberg). We can never emphasise enough the contribution of compounded dividends to investment returns – a 33% return over this seven year period, or about 35% of the total return. Very important.

Various people have tried to calculate a scientific relationship or correlation between Quantitative Easing (QE) and the movement of equity markets. It certainly doesn't seem to be a dollar-for-dollar one. The total assets of the world's central banks have risen by around $10 trillion since the beginning of 2011, but the market capitalization of the MSCI All Countries World Index is up by a stonking $22 trillion. On a net basis, there has been minimal new equity issuance over the period, as rights issues and Initial Public Offerings have been offset by share buy backs and leveraged buyouts. Earnings per share are up (a rather puny) 17.3% in aggregate over the same period, which, I suggest, might only explain around $6 trillion or so of the rise in market value.

The rest is down to higher valuations. At the start of 2011, the Price/Earnings Ratio (PE) of the World equity market was 12.7x. Seven years later it was 16.7x, meaning that investors were willing to pay a third more for the earnings. Although few predicted this at the time, it is not difficult to post-rationalise. The discount rate, measured by the 10-year US Treasury Bond yield, fell from 3.33% to 2.45%, raising the present value of future earnings. The last piece of the valuation jigsaw is the Equity Risk Premium, or the extra return that investors demand to hold riskier assets. This fell from 4.6% to 3.55% over the period as the world appeared safer.

Looking regionally, the US, unsurprisingly, has been the best performer thanks to its remorseless growth path. It has achieved 73% eps growth (close to 8% compound annual growth). It suffered no further crises (despite opinions on the last election result), and has been home to the greatest concentration of world-beating technology companies. But there has also been a 37% re-rating of the S&P 500, which means it has delivered a capital return of 118%. Only Japan comes anywhere close to matching that, with a capital return of 98%, although the composition is quite different, with just a 6% rerating gilding 77% earnings growth. It's not as if Japan's equities were (or are) especially expensive, as the PE is still just

15.5x. This outcome also seems to suggest that QE tends not to "stay at home". The Bank of Japan's (BoJ) balance sheet has grown by some $3 trillion in the seven years, which is the biggest in terms of QE. Even with the BoJ buying directly into the equity market, a lot of those yen have fled the country.

Europe takes the re-rating crown, mainly because it started from such a low base. The forward PE has gone from 10.5x to 14x, for a 43% re-rating. At the peak of the euro zone crisis, the PE even fell as low as 8.5x, lest we forget just how scary that period was. It is testament to the lasting damage of that crisis (and its predecessor, the Great Financial Crisis), that forward earnings for European equities still remain more than 7% below where they were at the start of 2011, with the bulk of the shortfall coming in the Financial sectors. The UK's earnings are also yet to regain their 2011 levels, more on account of the commodity price collapse in 2015/16, so aggregate gains have come from a market re-rating, with safe growth stocks and overseas earners leading the way.

Bringing up the rear over this period are Emerging Markets, with commodity prices again doing a lot of the damage, but also a fair deal of political shenanigans, notably in South America. Emerging Markets were the best performer in 2017, but seven-year capital returns of only 4%, a re-rating of just 11% and earnings forecasts that remain below where they started suggest that one might not have completely missed the boat by not fully participating in last year's rally.

I know that just crunching numbers doesn't guarantee answers to investment questions, but I believe that taking a longer view provides a bit more perspective and a degree of greater objectivity when it comes to making investment decisions.

Finally, in Three Men in a Boat, Montmorency is a Fox Terrier who thinks he's a Great Dane. This week, in Scooby-Doo, what is Shaggy's real first name?

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Head of Investment Strategy

FTSE 100 Weekly Winners

GKN	28.7%
Anglo American	10.3%
Royal Bank of Scotland	9.4%
Smiths Group	6.9%
BHP Billiton	5.5%
Aviva	5.3%
Rio Tinto	5.3%

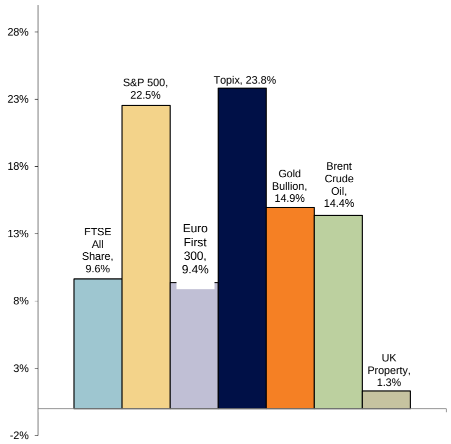
Source: FactSet

FTSE 100 Weekly Losers

Micro Focus International	-11.8%
Shire	-7.6%
United Utilities Group	-6.4%
Taylor Wimpey	-6.3%
Severn Trent	-5.8%
Barratt Development	-5.6%
Persimmon	-4.7%

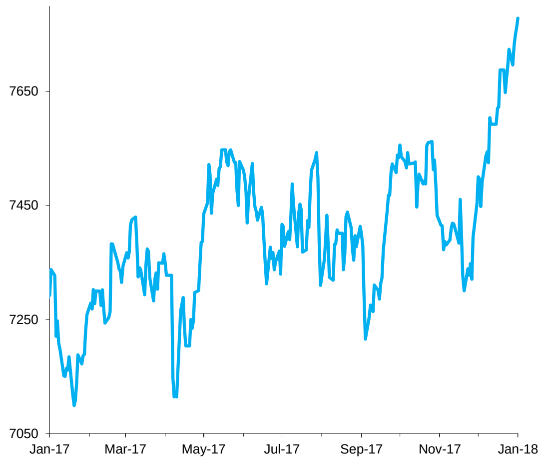
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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