Plus ça Change…

Happy New Year! Before writing this first Digest of 2018, I looked back at the opening editions of the last three years, and, not entirely to my surprise, found that there were very similar themes running through all of them. The most consistent theme has been the lack of value offered by sovereign bonds, particularly with respect to the yield. That remains the case. Our initial preference has been very much been for riskier assets over the last three years, with equities and corporate bonds (particularly High Yield credit at times) being favoured, although our enthusiasm has always been tempered by a combination of value considerations (notably in the US) and a long list of things that might upset the applecart. In retrospect, one of the key positives for risk assets has been the fact that many of the things that might have gone horribly wrong have not.

So how do things look at the start of 2018? Well, not dissimilar in many respects. The UK Gilt market offers little in the way of income, with the 10-year Gilt currently yielding just 1.23%. The yield on US 10-year Treasuries is beginning to look more attractive at 2.47%, and the US 2-year Treasury at 1.96% is beginning to look quite enticing as an alternative to cash. Even so, that hardly represents a bounty. Also, on current trends, the biggest threat to bond markets is deemed to be a pick-up in inflation, which would tend to push yields higher still.

As far as equities are concerned, we have been consistent for the last two years in our view that we could no longer rely on higher valuations for excess returns, and would depend increasingly on earnings growth. I must admit that we have been pleasantly surprised that equity valuations have made further progress, although also believe that this has effectively borrowed some performance from the future. According to data compiled by Citigroup, the forecast Price/Earnings ratio for the global equity market twelve months ahead at the beginning of 2015 was 14.4x. In 2016 it was 15.3x. A year ago it was 15.7x. The same figure is currently 16.3x (i.e. the forecast P/E ratio to the end of 2018), suggesting that global equities are 13% more "expensive" than they were three years ago. It is tempting to explain this away through the discount rate, but the truth is that key bond yields around the world are not notably lower now. In fact, the US 10-year yield has risen from 2.17% to 2.46%; Germany's 10-year Bund yield is effectively the same at around 0.5%. Yields are lower in the UK (1.73% down to 1.23%) and Japan (0.33% down to 0.06%).

There seem to be two main drivers to this ongoing equity re-rating. One is the persistent fall in credit spreads (the extra yield that corporate bond investors demand over safe government bond yields). Since the start of 2015 investment grade spreads have fallen 23 basis points in the US and 9 basis points in the UK. US High Yield spreads, probably a bigger driver of equity risk appetite, have fallen 38 basis points over the period. But those moves fail to explain everything. A lot of the applause (blame?) must be reserved for the liquidity provided by the world's central banks. The current total assets of major central banks stands just shy of $20 trillion, nearly $5 trillion higher than it was three years ago (driven almost entirely by the central banks of Europe and Japan). Although there has been gently increasing demand for capital in the real economy, much of this increased liquidity has found its way into financial assets.

So it looks as though equity markets have benefitted mainly from liquidity and an increased appetite for risk. We can infer this from the earnings growth relative to market performance. The forward earnings forecast for the global equity market has risen 12.2% over the last three years, while the MSCI World Index (in US dollars) is up 26.3% over the same period. Where does that leave us? With mixed feelings, to be honest. The good news is that the earnings element of equity performance continues to look supportive. The forecast for global growth in 2018 is 11.2%, followed by 9.9% in 2019 (so over 22% cumulatively). The bad news is that central banks are either slowly taking their foot off the accelerator pedal (Europe, Japan), or even dabbing the brakes (US, UK, Canada) and bond yields are edging higher. Indeed, consensus forecasts now suggest that the aggregate global central bank balance sheet will start to shrink in about twelve months' time.

That appears to set up a titanic struggle between growth and liquidity. Currently they are still working positively together, which is why equity markets continue to make almost daily new all-time highs. Talk of a stock market "melt-up" continues to gain traction, with even the grizzled veteran Jeremy Grantham suggesting such a possibility in his latest missive. Even some columnists in the Financial Times who have not been noted for their bullishness are suggesting that current market trends can be sustained. But even then there is more than a suspicion that a melt-up would only create the environment for a bigger setback in future.

Bearing all of this mind, we are reasonably happy to keep riding the tide for the present, but very wary of committing new funds to riskier assets purely to enjoy the "last hurrah". If markets do progress, we are minded to take profits into that strength.

Finally, the middle name of the author Jerome K Jerome was Klapka. This week, in Three Men in a Boat, what breed of dog is Montmorency?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

NMC Health	8.8%
Next	7.3%
Centrica	6.4%
Johnson Matthey	4.0%
CRH	4.0%
Just Eat	3.8%
Smiths Group	3.7%

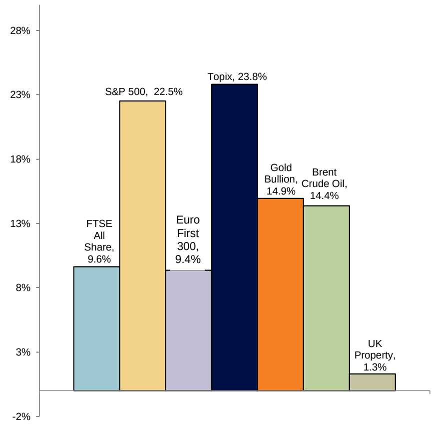
Source: FactSet

FTSE 100 Weekly Losers

Admiral Group	-6.5%
Mediclinic International	-3.6%
Direct Line Insurance Group	-3.1%
Old Mutual	-2.7%
British Land Company	-2.4%
Fresnillo	-2.4%
Antofagasta	-2.3%

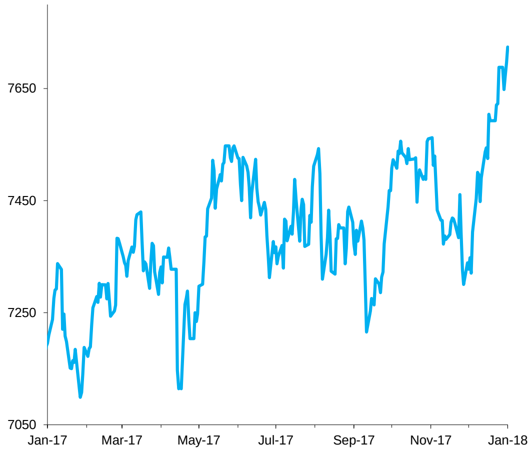
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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