Roses in the Vines

Whenever I visit Italy, one of my favourite things to do is to walk (or even run) through the vineyards. Nothing like being surrounded by the source of the reward that is coming later! I had often noticed rose bushes growing at the ends of rows of vines, but it wasn't until recently that I discovered that they served more than just a decorative purpose. I encountered someone trimming the vines, and he explained. Rose bushes and vines are susceptible to many of the same diseases, but the roses tend to succumb first, and certainly show earlier signs of stress. Signs of mildew will first appear on the roses, and they are also more attractive to aphids initially. So when the grower sees trouble on the rose bush, he knows it's time to start applying preventative substances to the vines. A floral early warning system. Clever.

We can't plant roses in portfolios, but we are always on the lookout for early warning signs that something is amiss. From my point of view as a strategist, there are several indicators worthy of scrutiny. These range across valuation, liquidity, economic growth, sentiment and technical factors, for example. Several of my peers are agreed that equity valuations and corporate indebtedness are the two greatest risks currently, but there is no special reason to expect either to be the catalyst for an imminent market collapse - at least not without help from something else, meaningfully higher interest rates and/or a recession being the main fears. Valuation is a notoriously poor predictor of short-term market performance. One of the most cited valuation measures is the Shiller PE, or Cyclically Adjusted Price Earnings Ratio. This measures the current share price against a rolling ten-year average of earnings per share with the intent of smoothing out cyclical peaks and troughs. It does appear to have a good record of predicting long-term returns, say on a ten year horizon, but its record of predicting on a one year view is not much better than tossing a coin. So although we might be able to say that returns on a ten year view are likely to be unexciting, that doesn't by any means rule out another shorter period of decent performance. And because many investors have already cashed out based on the CAPE analysis, it's not surprising that one can almost hear the groans around the City every time markets make new highs.

Another warning sign comes from corporate debt. Despite the fact that we hear much about the huge piles of cash that many US companies have trapped outside the US, overall corporate indebtedness is higher now than it was before the financial crisis. In 2007 the global corporate debt/GDP ratio was 72.6%, and at the end of 2016 it had risen to 87.6%. That needn't be a problem as long as growth continues and interest rates remain low, but you can see the risks inherent in the situation. It's one of the reasons that investors are so sensitive both to the pronouncements of central banks on interest rate policy and the overall growth outlook. We continue to believe that central banks are more worried by too little growth than by too much inflation, and so will err on the side of caution (i.e. too loose policy), while the growth outlook remains steady. For example, the Federal Reserve Bank of New York currently sees the probability of a recession in the US as being less than 10%.

One place that we would see concerns about corporate indebtedness being expressed is in the spread of corporate bond yields over those of government bonds. A low spread means that investors remain relaxed, a higher one that the risk of default is rising. Currently spreads remain low by historical standards. You might recall that they rose sharply towards the end of 2015 and into early 2016 amid heightened concerns about global growth and the health of the Energy sector in particular. As it happened, that turned out to be an exceptional buying opportunity, especially for High Yield bonds.

Investor sentiment can often by a good contrarian indicator, but, according to the latest Merrill Lynch survey, institutional clients continue to hold near record cash balances in portfolios. Inflows into equity funds have only recently started to pick up after several years during which investors have been piling into bonds at the expense of equities. No signs of euphoria here. Indeed euphoria is notably absent pretty much everywhere. Merger and acquisition activity is not overblown, Initial Public Offerings are subdued, and companies generally have not been splashing the cash on investment.

I rarely mention technical analysis (the use of charts), but it can be a powerful tool and is followed by enough people not to be ignored. As one might imagine, many investors are loath to commit new money to markets at all-time highs, fearing that they will be the mug who rings the bell at the top. However, chartists will tell you that "the trend is your friend", and the trend for equities remains positive. A loss of momentum would lead us to be more concerned. The collective wisdom of the market is remarkably good at sniffing out problems long before they are apparent to most individuals.

You might conclude from all this that we are super bullish, seeing no signs of blight on our roses. However, overall valuations and the view that markets are vulnerable, particularly over the summer, to unexpected bad news keep us on a neutral tack for now. But we are a long way from reaching for the tin helmets. Finally, the cartoon character originally called Oswald was Mickey Mouse. This week, who was the first artist to have a posthumous UK Number 1 album?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Ashtead Group	6.8%
Hargreaves Lansdown	5.8%
Micro Focus International	5.1%
Provident Financial	4.9%
ConvaTec Group	4.7%
Next	4.7%
Barratt Developments	4.6%

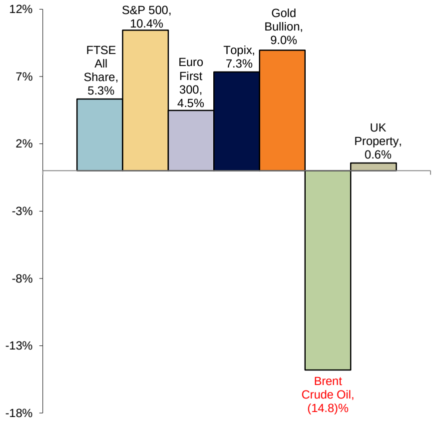
Source: FactSet

FTSE 100 Weekly Losers

EasyJet	-7.0%
International Airlines Group	-5.8%
Experian	-4.5%
Wolseley	-3.6%
Smiths Group	-3.5%
Rio Tinto	-2.8%
Paddy Power Betfair	-2.7%

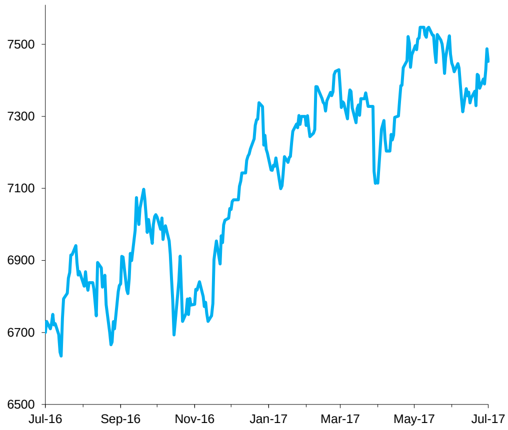
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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