September 2016

Recovery continues in defiance of investors' suspicions

- August passes without any major surprises
- High valuations are no reason to sell equities
- Risk appetite indicator: No sign of euphoria after price hikes

In the recent past, very few months have passed without a major geopolitical or monetary surprise occurring. But financial markets enjoyed quite a summery mood in August. On the one hand there were no nasty shocks from fundamental data, while on the other hand there were no upsets caused by central bankers. The nervousness of investors in the run-up to the meeting of the heads of central banks in Jackson Hole turned out to be unfounded, even though many had made the assumption – based on prior statements – that the Fed was preparing to raise interest rates earlier than the market expected. Many investors still do not really believe that share prices can continue to move higher, and treat recent rises with a suspicion. But this has not stopped the positive uptrend of stock markets since July. Many share indices continued to trend higher during August. The Swiss Performance Index advanced 1.0%, and the EuroStoxx 1.30%. After performing well over four consecutive months, the leading US index S&P 500 retreated slightly. Due to slightly less demand as a safe haven currency, the Swiss franc softened against the US dollar and the euro by around 1%. On top of that, the yields on fixed-income securities edged upwards, already factoring in an earlier than expected hike in interest rates by the Fed.

High valuations are no reason to sell equities

For some months now, many pundits have been warning of a major equity market correction, but share prices have still continued to rise, supported by purchases not only from institutional but also private investors. The reason repeatedly cited for this positive performance is that the US stock market is experiencing one of the longest bull runs in the post-war period and the high valuations are not warranted, given the subdued outlook for the global economy. Surprisingly, these are exactly the same people who do not consider bonds to be risky – despite negative interest rates – and who do not think that real estate prices are too expensive (despite their huge price increase in recent years) because of their real value. The problem is that they tend to forget that stock market performance does not depend exclusively on share valuations. More importantly, it is a mix of different components of the underlying environment, along with market sentiment, that determines how much investors are prepared to pay for equity holdings. Our fundamental model for the attractiveness of the equity market also determines that the US stock market valuation is too high and that the tentative recovery of the manufacturing sector in recent months is already losing momentum again. On the other hand, the monetary environment – which historically speaking has always been the most important driver for share price performance – continues to support the investment case for equities, reinforced by very robust global consumption. From a fundamental perspective, the positive stock market trend should continue for the time being (apart from some minor corrections), in defiance of all the gloomy predictions.

Monetary environment: A month ago we still expected the Fed might possibly raise interest rates as early as August. Despite all the speeches in Jackson Hole hinting at higher rates, we are picking up signals showing that the inflation risks for consumer goods are reducing slightly, still leaving the Fed still room for manoeuvre. This development is suitably positive for equities, which continue to be bolstered by monetary policy measures in the Eurozone and Japan.

Industry: The recovery had barely begun before it started to run out of steam again. In the USA, revenues in the manufacturing sector are not as high as expected, while in Europe the leading indicators point to a slightly weaker industry performance going forward. Both these developments trigger another fall in the model components. As a result, equities are once again facing strong headwinds on this front.

Consumption: There has hardly been any change in consumption. Within the separate components, however, the individual indicators shifted from the current performance towards expected consumer spending. While the effective level of consumer spending is slightly weaker, confidence in future US consumption now stands at its highest level since 2007. Consumption continues to be one of the major supports for global equity markets.

Valuation: Despite good quarterly results, the valuation of equities is becoming more expensive. In the USA especially, they are now significantly above an attractive level. Such a high valuation is definitely not good news for equities, even though equity markets can be overvalued for many months, or even many years in some cases. After US equities have outperformed their European counterparts for a long time, there are increasing signs that this trend could soon reverse.

Risk appetite indicator: No sign of euphoria after price hikes

Many investors are not particularly convinced by the current equity market recovery rally. This can also be seen in the risk appetite indicator used by our team. The level of hedging against equity market risks is increasing both over weekly, monthly, and quarterly periods. On the other hand, investors seem to be so optimistic that they are once again prepared to pay for higher valuations. This is echoed in the rising P/E ratios, which feed into the component "Market risk". Over a timeframe of one month, the inflow of relatively cyclical (i.e. riskier) investments is increasing as well. This in turn improves the market breadth. This component signals how many sectors and equities are participating in the stock market rally. After much of the performance since 2011 has been driven by defensive stocks, more recently it has increasingly been cyclical stocks that have contributed. Another positive aspect from a market psychology perspective is the impact of positive surprises. In most cases analysts' expectations are being beaten, which helps to boost investor confidence. Overall, four of the five components of the risk appetite indicator are now heading upwards, reflecting healthy investor sentiment, but without any sign of euphoria.

Risk appetite indicator: Investors have a healthy appetite

	Anzahl Indikatoren	Aktuelle Signale	1 Woche	1 Monat	3 Monate
MONEY FLOW	31	Buy	↗	↗	↗
SURPRISE EFFECT	17	Buy	↘	↗	↗
MARKET BREADTH	24	Buy	↘	↗	↗
HEDGING DEMAND	7	Sell	↘	↘	↘
MARKET RISK	37	Buy	↗	↗	↗
OVERBOUGHT / OVERSOLD		Neutral			
RISK APPETITE INDICATOR	**116**	**BUY**	↗	↗	↗

Your Contact at Amplia & Co. AG

Mikael Rosenius
Claridenstrasse 34
CH-8022 Zurich
Tel. +41 44 286 17 41
mikael.rosenius@amplia-co.com

Jennifer Erdin
Claridenstrasse 34
CH-8022 Zurich
Tel. +41 44 286 17 42
jenny.erdin@amplia-co.com