BBGI GROUP Global Investments

7 may 2019

Return of uncertainty in equity markets – Time to sell ?

Donald Trump sows the wind and could reap the storm. The prospect of a trade agreement is moving away. Return of uncertainties. Beware of high valuations. Reduce the equity risk.

Key Points

- Euphoria may already be taking over from panic
- Trump stokes uncertainty
- Likelihood of trade agreement declines
- Uncertainty and higher valuations make for troublesome mix
- A price consolidation is on the cards
- S&P500 meets resistance at 2'950
- Likely correction in Europe
- Nikkei at risk
- Emerging markets unlikely to avoid profit taking
- More defensive strategy in Switzerland as well

Euphoria may already be taking over from panic

In January, we spoke of the more attractive equity valuation levels in the wake of huge, fast-paced corrections to prices in December 2018. At the time, we had stated that, in the absence of any marked slowdown in global growth in 2019, prospects were favourable for equities. We predicted a price recovery for those assets specifically affected by the apparently overstated forecast of a collapse in US and global growth. Four months on, the investment opportunities highlighted generally materialised thanks to almost systematic price rises of around +16.5% across all international markets and of +19.4% in Switzerland.

The bounce back in financial assets met our expectations, but it should be pointed out that this revaluation process happened very quickly, often completely offsetting year-end losses (Etats-Unis, Europe, Suisse, etc). As such, the investment climate went from panic to euphoria in just a few short weeks, which is not reassuring with regard to the risk/return ratio and the outlook for the market.

The American Association for Individual Investors was showing excessively pessimistic investor sentiment in mid-December. This indicator was almost at its lowest level of optimism for twenty years, at around just 20% bulls (positive contrary indicator), but has bounced back since then and headed very much north of the 40% threshold in April. Even if this situation could perhaps not qualify as euphoria, but confidence levels are nonetheless higher than the average of the past few years indicating an increasing risk of complacency.

A price consolidation is on the cards

The valuation of assets that depreciated particularly sharply in December have quickly bounced back, sometimes to the point of being generous and potentially risky today. The low PE in December are obviously no longer an issue after the impressive price rises of recent months. The SPI index posted new highs, with no considerable revaluation of profit growth forecasts for 2019, and is once again trading at 17.4x expected profits (13.9x at the end of December) and +6% higher than the peak reached in January 2018. In terms of evaluating risk, our models have been affected by "valuation, quantitative, technical and sentiment" risk factors to a greater degree in the last four months.

This once again suggests higher scores that place most equity markets in a potentially volatile zone. As such, valuation levels quickly became less attractive in the short term, in a context of modest economic growth for 2019, and in the absence of any significant upward profit revisions.

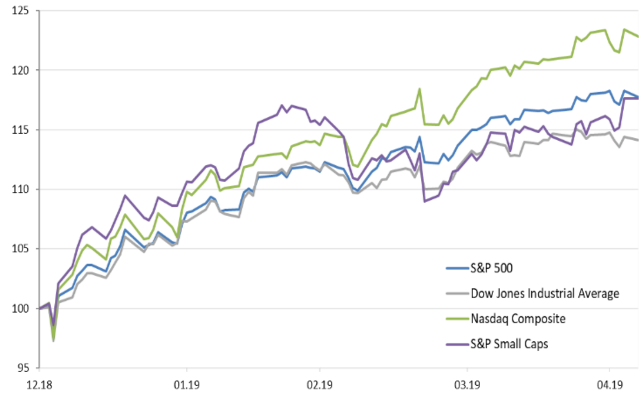
S&P500 meets resistance at 2'950

In our Strategy at the start of the year, we warned that a quick rise in equity prices, particularly if the S&P 500 headed back towards 2'900 points (September 2018), should trigger a careful risk evaluation. With the quarter having closed at 2'822 points, and at 2'950 in April, we believe that the time has already come to carry out this evaluation. Our analysis of yield/risk ratios now leads us to believe that the valuations of risky assets point to a profit-taking opportunity on most of the assets that underwent revaluation over the past few months. It is likely we will see fresh volatility in the short-term, especially since the US president has lost patience in the past few days and is threatening the negotiation process with China. Although a trade agreement had seemed increasingly likely over the past few months if not a done deal, it is now becoming less and less likely, raising doubts once again regarding the global growth outlook. Coincidentally, today the European Commission published its forecast for the euro area, slightly down from its previous forecast, which could set the tone regarding the next major source of uncertainty to weigh on equity markets in the immediate future.

In December, our quantitative risk analysis model was suggesting a drop in the risk level and an improvement in the likelihood of a rise on equities. Its reaction to the exceptional growth on equity markets in 2019 was sizable and quick. Risk scores rose and now place most regional markets in the "neutral" zone or in the zone with "significant risk of temporary consolidation" of prices. In the medium-term, risk seems to be reasonable, but the upward trend on indices is unlikely to continue in the immediate future. We believe that equity markets have already anticipated a positive resolution to the conflict between China and the USA and an upcoming improvement in economic prospects. They have also been buoyed up by central banks' change in attitude; banks have assured the markets that their rate normalisation policies are coming to an end but the current context seems favourable.

We believe that a temporary price consolidation is likely before we see any real economic progress that would revive the trends seen recently.

American equities YTD



Sources: Bloomberg, BBGI Group SA

Likely correction in Europe

Several months ago we noted that European equities would likely benefit from a probable decrease in international tensions at the beginning of 2019 and from favourable arbitraging by investors due to the European market's positive risk premium. Indeed, the performance of European equities was boosted by a more positive investment climate at the beginning of the year. The Euro Stoxx 50 index of the largest European blue chips is up +18.4% in four months. By climbing back to their 2018 July levels, European markets rapidly recouped losses posted in S2 2018. However, given the rise of other equity markets, its valuation remains attractive on a comparative basis. The valuation gap is holding at around 25%, a relatively significant risk premium, which has remained stable for several quarters. European shares maintain a valuation and yield advantage (3.7%), while the earnings outlook for 2019 is converging with that of US shares. In spite of these positive factors, European equities are currently burdened by an uncertain macroeconomic environment and a discouraging news flow. The uncertainty tied to the protectionist threats by the US are, however, likely to gradually subside once an agreement is reached between the parties. Nevertheless, the European economy will also have to offer better prospects to warrant real outperformance by Eurozone stocks. In this context, we recommend taking profits temporarily on European markets as a whole. European equities still have relatively good potential to catch up, but this should only happen gradually, and after a period of consolidation prior to any improvement in growth forecasts for the second half of the year.

European equities YTD

Sources: Bloomberg, BBGI Group SA

Japanese equities YTD

Sources: Bloomberg, BBGI Group SA

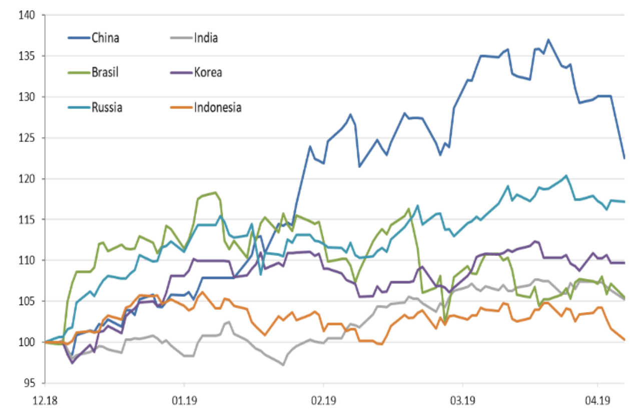
Nikkei at risk

Japanese corporate earnings ended up falling -7% yoy in Q4 2018, which was a brutal shock compared to the positive results posted in June (+17.9%). The volatility of Japan's economic performance and the fall in exports had a significant impact on corporate earnings in H2. An economic upturn is now necessary for Japanese corporate earnings growth to resume, but this seems unlikely without an upswing in the global business cycle. Yet Japanese firms invested significantly in physical capital, with capital expenditure growing by +5.7% yoy, likely in reaction more to the structurally low unemployment rate than to a positive economic outlook for the immediate future. The poor performance of Japanese firms could, however, be followed by a significant rally once an agreement is reached by China and the US with regard to their trade dispute. Chinese and Asian demand is then expected to recover and boost profit growth in 2019 and 2020. The worst may already be over for Japanese corporates, which could once again benefit from a change in international investors' risk perception, whose investments in Japanese securities have been broadly negative over the past several months. Investors' earnings expectations for 2019 are low. The Japanese market benefited less than other markets from the improving stock market climate, gaining just +12.3%, one of the poorest performances among developed markets in 2019. Further depreciation of the yen will thus likely sustain a further upswing of the Nikkei, provided that the investment climate improves and that the risks that are currently weighing on the global growth outlook recede. The outlook is positive for 2019, but we are maintaining a relatively neutral strategy with regard to Japanese equities.

Emerging markets unlikely to avoid profit taking

Despite the conspicuous absence of an agreement between China and the United States, optimism has made a come-back on Chinese equity markets. The forecast outperformance of this market turned out to be considerable thanks to the exceptional +37% growth achieved in fifteen weeks. Chinese assets had nosedived throughout 2018 (-28.5%), but have completely made up this fall, and are trading at just about 6% under their peak in January 2018. Our positive forecasts were quickly realised, despite the lack of any clear development in world trade. We expected some consolidation at the beginning of Q2 and recommended reducing exposure in April. Consolidation has to some extent been taking place since 22 April and will likely continue to given the current uncertainty with regard to the trade talks. The Chinese market will be affected by profit-taking to the greatest degree

Emerging equities YTD



Sources: Bloomberg, BBGI Group SA

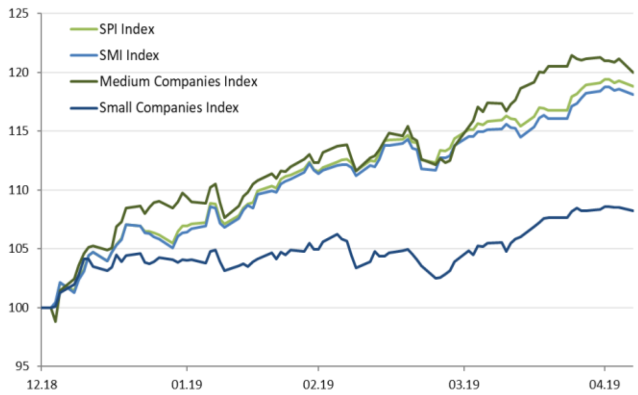
More defensive strategy in Switzerland as well

At the end of the year, after the sharp correction in Swiss equities, we noted that, barring a marked slowdown in global growth in 2019, we expected the outlook for Swiss equities to be favourable. The beginning of 2019 was as extraordinary as the end of 2018 for all equity markets, and for the Swiss market in particular. While the SPI corrected by close to -10%, reduced to -6.7% as at 31 December, it then shot up by +19.4% in four months. The SPI index thus exceeded the level it had reached prior to the brutal correction in December and even reached new heights topping its January 2018 highs. Investors seem to have very quickly given in to optimism or even euphoria at the beginning of the year, only a few weeks after a wave of panic had triggered a drop in Swiss share prices and caused general alarm.

The risk factors that drove the Swiss market down in December were essentially external and macroeconomic issues; the abrupt economic slowdown in Germany, which narrowly avoided a technical recession, the fear of a yield curve inversion in the US perceived as a leading indicator of a recession in 2019, and finally investors' shift in risk perception a few days before the end of the fiscal year caused a massive sell-off in a worldwide wave of asset allocation risk reduction. The sentiment at the beginning of the year was completely different, even though economic activity in Q1 is likely to remain weak overall including in Switzerland. Investors' optimism is thus for now based only on the expectation that global economic conditions will improve. The valuation levels of Swiss stocks, as mentioned in our year-end strategy note, offered particularly attractive investment opportunities in the medium term.

Valuation levels are presently once again rather generous by historical comparison. The Swiss market PE is once again close to 17x expected 2019 earnings, that is, significantly above its December level of around 13x. The SPI index is also trading at above 17x earnings, namely over 10% above its long-term average. With regard to yields, conditions are still attractive thanks to dividends that should allow SPI stocks to offer yields of close to 3% Caution is thus warranted with respect to these latest developments, which are perhaps too positive given the current context, after all uncertain again. We anticipate that the Swiss market could consolidate somewhat pending confirmation of the positive expectations that drove the market rally. Given the more fragile present context, we recommend adopting a more defensive strategy on the Swiss market.

Swiss equities YTD



Sources: Bloomberg, BBGI Group SA

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