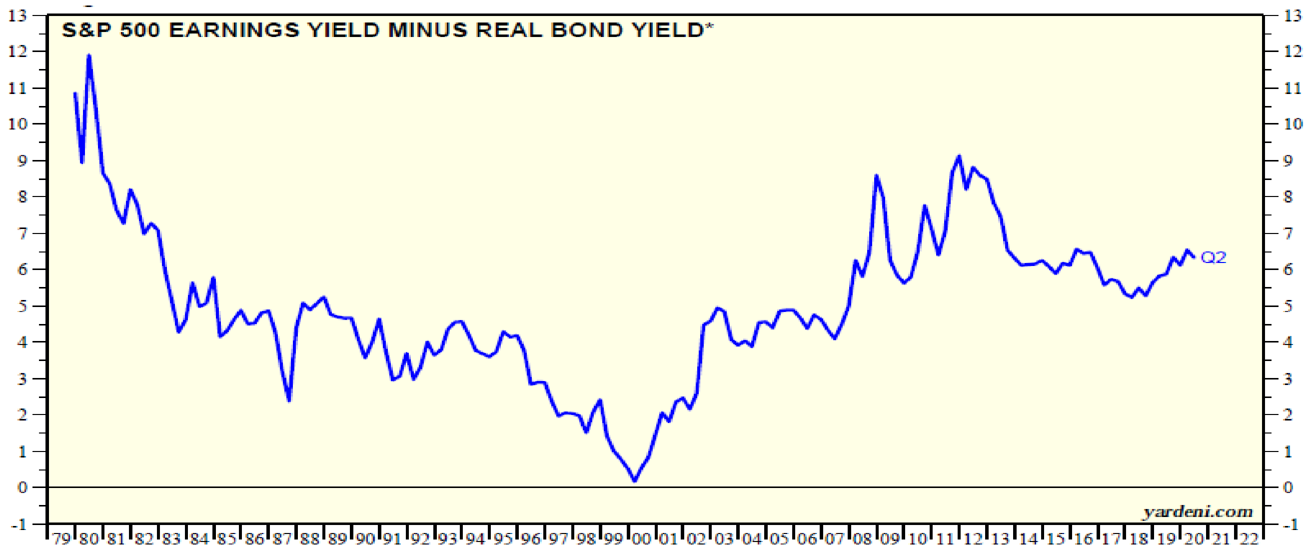
Investment Views

July 2020

The only way is up?

The equity risk premium (ERP) is the excess return that equities are forecast to deliver when compared to the risk-free rate; typically, the local government 10-year bond. Put simply, given current market prices and expectations, by how much are equities forecast to outperform bonds each year over the coming decade? For the US equity market, you take forecast earnings for the S&P500 and divide them by the index value; this gives you the earnings yield. You then subtract the real yield on a 10-year treasury to get the ERP.

As such, the ERP is not a measure of nominal valuation, rather a guage of the relative merits when allocating between stocks and bonds. If the ERP is high, one should favour equities, switching to bonds if the measure falls. Below is a chart of the ERP going back to 1979 (source: *Yardeni Research*). As you can see, at over 6%, current levels imply superior returns from stocks over bonds.



To be clear, this does not mean that US equities are cheap. A good part of the elevated ERP is due to the collapse in the risk-free rate (or US treasury yields). Furthermore, if forecast earnings prove too optimistic, this would reduce the earnings yield, in turn cutting the ERP and the relative attraction of equities.

So why share the ERP concept? Firstly, the measure became popular in the 1970s and 80s and remains a key allocation metric for large institutional investors. This suggests that large pools of long term capital will be shifting from bonds to equities, despite the latter being historically expensive. It is a fancy way of acknowledging that, when bond yields approach zero, investors have few other options than to buy equities. It is also one of the only fundamental measures we can find to support current US equity valuations; other nominal valuation metrics like price/book, price/sales and price/earnings are at or near over-valued extremes.

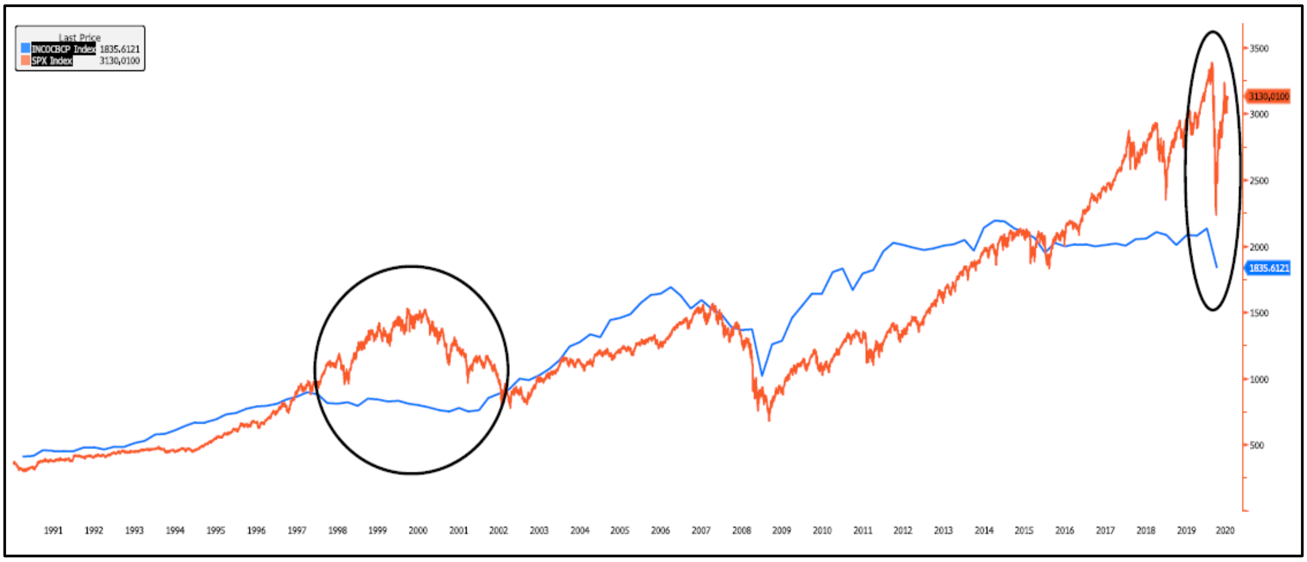
Furthermore, when momentum shifts in favour of equities, contemporary market dynamics can amplify and sustain the move. Trend following investment programs, a key part of marginal equity demand, simply follow whilst an army of retail traders has recently entered the markets. This is best illustrated by the growth of Robinhood, a zero-commission stock trading platform. The service allows clients to buy a fraction of a share, enabling them to invest (for example) $50 in Apple even though the stock trades at $364. It also allows them to amplify their bets using leverage and highly-geared option strategies. In the first 5 months of 2020, Robinhood reported a 30% increase in end users (to 13m) and a 600% surge in trades; Schwab, Ameritrade and ETrade saw account number rise by an average 125% in the 12 month to Q1 2020. Starved of sports betting, many of the 20m newly unemployed used their $1,200 government handouts to punt US stocks.

Can these dynamics sustain the current rally? Bulls argue that the ongoing monetary and fiscal support will continue, staving off mass unemployment and a wave of insolvencies. In such an environment, corporate and government indebtedness will weigh on future growth as both seek to repair their balance sheets; the former will not hire and invest, the latter will raise taxes and (eventually) cut spending. In the US, having slowed to 2%p.a. over the last twenty years, real growth will stall as productivity sinks. Growth stocks would continue to be favoured as investors buy "growth at any price"; utility type stocks, that deliver sustainable yields, would also be in demand.

Whilst we acknowledge this is possible, it is an incredibly fragile premise. Firstly, it implies that the costly monetary and fiscal props remain in place. Having become addicted to QE and the concomitant low rates, economies will shortly find out whether they are also dependent on the emergency fiscal measures. In the US, an unemployed person has seen their weekly benefit cheque swell from $378 to $978 during the crisis; as a result, unemployment insurance exceeds lost earnings for 2/3rds of recipients (source: *University of Chicago*). The extra $600 per week stops at the end of July. It will surely be replaced by some form of tapered support, but can aggregate demand continue to recover without the panicked largesse of late March? The story is similar in the UK, where over 9.3m jobs (nearly a quarter of the working population) are part or fully funded by the furlough scheme. As this gradually tapers to nil by end October, a second wave of redundancies is already unfolding. We fully expect support to continue but at what level and for how long? At some stage, markets will punish currencies and bond markets for profligate, over-indebted government.

"Growth at any price" will also create an ever greater gap between the stock market and underlying corporate profits. The 30-year chart on the next page (which we have shared before) shows total US corporate profits before one off adjustments and financial engineering (the blue line; NIPA profits).

It has flat-lined since 2012, taking a sharp leg lower in the first quarter. It will fall further as Q2 earnings are announced. The red line is the S&P500. The left hand circle shows a similar (but lesser) divergence during the dotcom bubble.



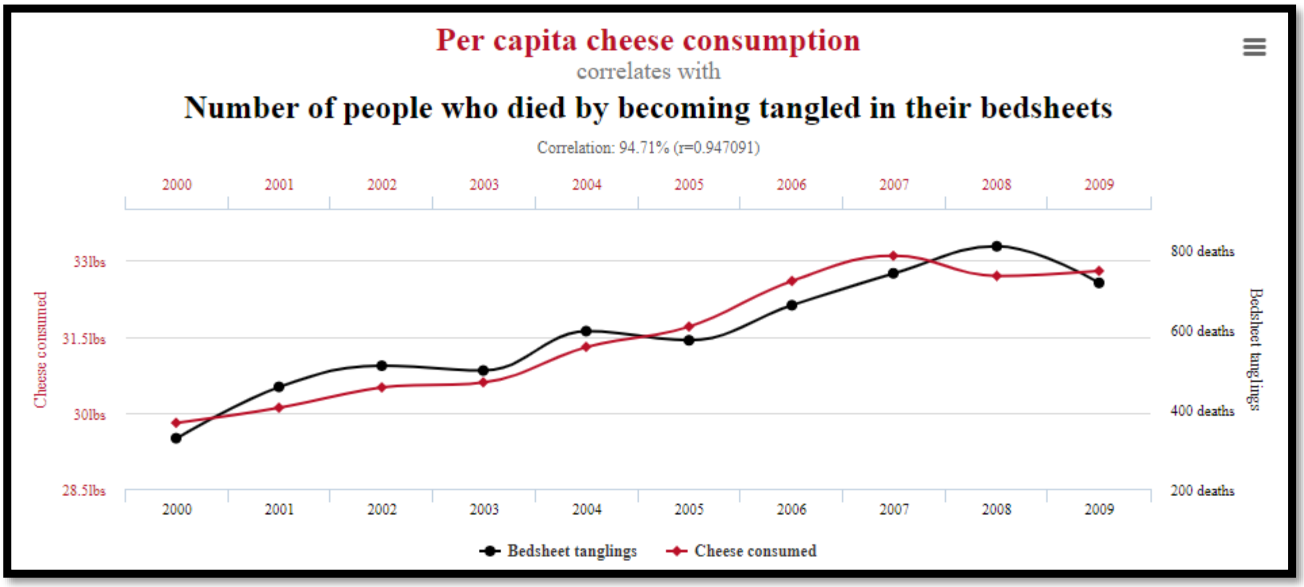
This yawning gap is before the damaging impact of a further acceleration of US Cov19 infection rates and/or a second wave of infections in other developed nations. The market will also lose a vital prop as companies are forced to cut shareholder payouts as reserves and borrowing capacity are exhausted. As the FT notes: "More than a quarter of UK listed companies and a third of large US (and EU) public companies spent more on dividends and buybacks in 2019 than they generated in net income".

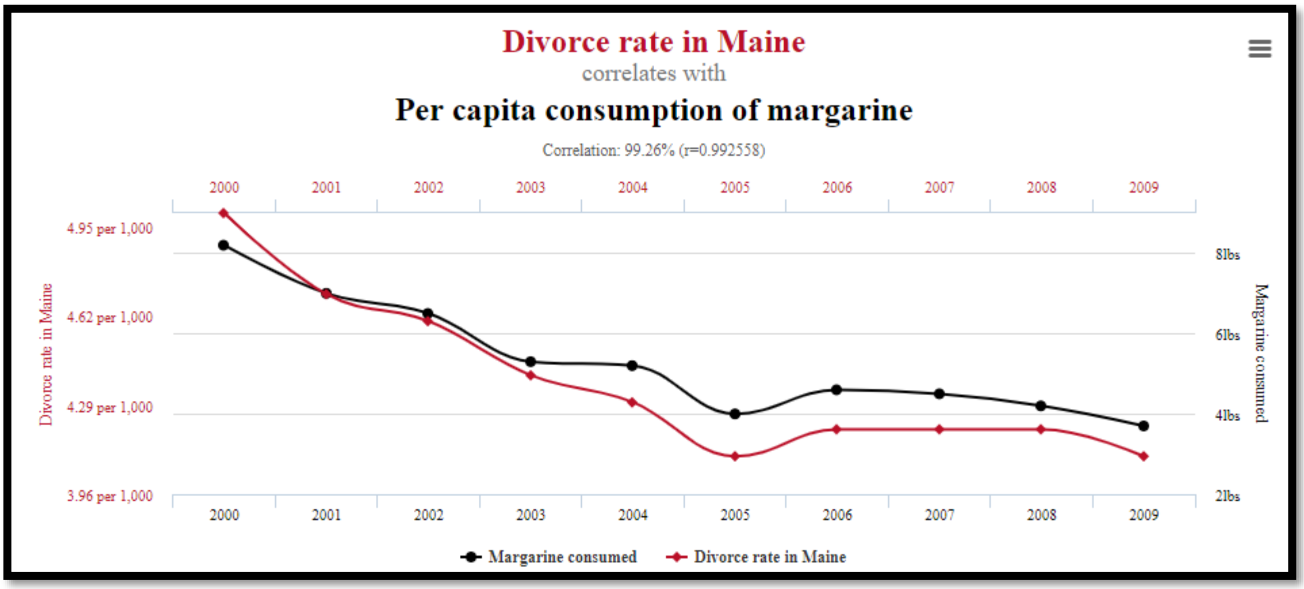
Finally, we have a US Presidential election in November. Although it is too early to call the winner, the Democratic nominee, Joe Biden, is now polling 59% versus 36% for 'The Donald' (source: *RealClearPolitics*). If Biden wins, we can expect to see him roll back a good part of Trump's corporate tax cut (from 35% to 21%). Biden is also an advocate of a $15/hour minimum wage; it is currently $7.25. Finally, with anti-trust firebrands like Democratic Senator Warren waiting in the wings, the backlash against the oligopolistic powers of 'big tech' would surely accelerate. With the top 5 tech companies now accounting for 22% of the US index, this has wider implications for the market as a whole.

We are not blind to the possibility of further equity upside; the nifty 50 of the late 1960s/early 70's and the dotcom melt-up of 1998/99 are instructive. Indeed, we have a list of equity sectors and themes we would like to own if the opportunity arises; we recently initiated exposure to the unloved energy sector, as WTI oil prices went negative. However, as this US rally becomes increasingly narrow and stimulus dependent, a growing list of fragilities continues to argue for caution as we head into the summer.

Spurious Correlations

One of the pillars of our investment approach is the study of inter-asset correlations, looking for patterns or variables that explain (and predict) one another. Recently, on sharing some of this research with a client, he wryly noted that correlations can often be spurious; seemingly close but almost certainly coincidental. He referred to the work of a Harvard student, Tyler Vigen, and his eponymous website that ably illustrates the point. We share a couple of his examples (for the statisticians amongst our readers, you will note the high correlation and 'r' coefficients).





Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Gold Miners China A Shares Sustainable yield Japan Energy sector	Inflation-linked, Emerging Market	Gold
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	30 June 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2401	0.5%	-0.2%	-2.3%
CHF	1.0556	1.5%	1.5%	3.0%
AUD	0.6903	3.5%	12.6%	-1.7%
JPY	107.9300	0.1%	0.4%	0.1%
EUR	1.1234	1.2%	1.8%	-1.2%
BOND YIELDS (10 yr)				
UK	0.17	-0.01	-0.18	-0.66
US	0.66	0.00	-0.01	-1.35
Germany	-0.46	-0.01	0.02	-0.13
Australia	0.87	-0.02	0.11	-0.45
Japan	0.02	0.02	0.01	0.18
EQUITIES				
US. S&P 500 (USD)	3,100.29	1.8%	20.0%	5.4%
UK. FTSE 100 (GBP)	6,169.74	1.5%	8.8%	-16.9%
FTSE Europe Ex UK (local)	257.35	3.4%	14.3%	-3.8%
Japan. Topix (JPY)	1,558.77	-0.3%	11.1%	0.5%
China. Shanghai Comp (RMB)	2,984.67	4.6%	8.5%	0.2%
HK. Hang Seng (HKD)	24,427.19	6.4%	3.5%	-14.4%
Australia. All Ords (AUD)	6,001.35	2.2%	17.4%	-10.4%
FTSE Asia Pac ex Japan	527.77	7.7%	18.4%	-2.9%
FTSE World (USD)	615.53	2.7%	18.8%	0.4%
FTSE World (GBP)	738.56	2.8%	19.2%	3.4%
COMMODITIES				
Oil (WTI)	39.27	9.6%	31.8%	-29.6%
Gold	1780.96	2.9%	12.9%	26.3%

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