NEWS EXCHANGE

TOO FLUSH TO FAIL ?

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Are current central bank supported equities levels artificially inflated and what does this mean looking forward?

One needs to just look at the headlines in the financial news to see an apparent disconnect between global equity markets and the economic fundamentals and valuation metrics which theoretically should ultimately be driving them.

- Longest earnings recession since crisis looms for US shares (4 July 2016 – Financial Times)
- Not too late to reap gains after S&P 500 hits high (11 July 2016 - CNBC)
- Economy stutters as Brexit fallout takes hold (10 July 2016 – The Telegraph)
- The FTSE 100 just entered a bull market (11 July 2016 - Bloomberg)

While anxious investment eyes are focused firmly on the negative tone of catchphrases such as Brexit (Britain's pending EU exit); the Italian job (Italian banking failure contagion); Nenegate (the firing of ex finance minister Nhlanhla Nene) and China's hard landing (stalling Chinese growth figures), certain equity markets are flirting with all-time highs. In addition, global growth projections have been revised downwards four consecutive times by the IMF; corporate earnings across the board continue on a descending trajectory (revisited later in this article) and aforementioned market shocks lead to spikes in volatility and disruptions of hopes of stability. So the question begs asking – how are equity markets continuing to stay afloat in these choppy seas?

The answer lies in the actions of the global central bank heavyweights injecting liquidity into markets at a rate which may well have led to stretched equity market valuations and a potential threat of damaging reversions.

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With official policy rates at record lows (in some cases negative), alongside quantitative easing programs, currently active in Japan and Europe and previously in the U.S., equity markets have been propelled through a series of wild swings with investors continually twisting the metaphorical risk-on/risk off (RoRo) taps.

- Chinese growth data miss implying weaker demand for commodities – risk off.
- Negative U.S. employment data implying the Federal Reserve (Fed) won't raise rates – risk on.
- Initial concerns and confusion over the impact Brexit will have on future of the Eurozone and the UK – risk off.
- Subsequent realization of possible lower UK rates and further Japanese stimulus in the face of above confusion and concern – risk on.

All this volatility and near-constant retreat to safe assets, in particular gold and U.S.; Japanese and Swiss sovereign debt, in times of uncertainty has led to a compression in yield in these assets into unchartered territory. Globally, there is now approximately ten trillion dollars of negative yielding government bonds in the market, including securities with terms as far out as twenty years in Japan and fifty years in Switzerland.

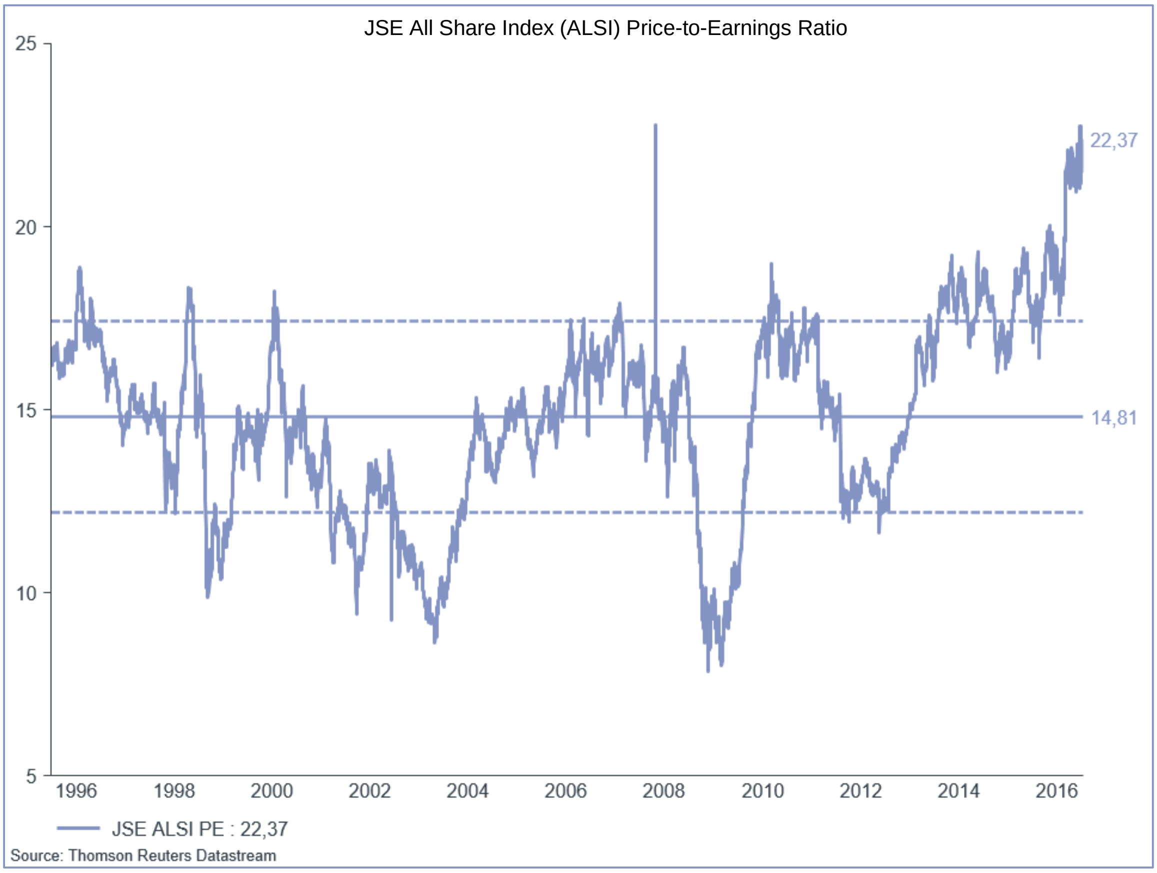
The Swiss now rewards investors with minus 0.012% for the luxury of a half-century debt instrument. While conservative investors scramble for anything resembling a positive yield and the promise of a 'safe asset,' the need for capital to be allocated to riskier assets such as equity and property opens up.

In this instance what we have seen is that despite corporate earnings trending downwards or at the very best flat, equity markets have managed to hold steady and in some cases, including the U.S.; UK and South Africa, offer low-to-mid single digit returns over the past year. This all despite grey swan* events spiking volatility and leading to large scale short term sell offs, with the likes of Nenegate and Brexit being prime examples. What then emerges from such a situation is the abnormal notion of a bull market profit recession.

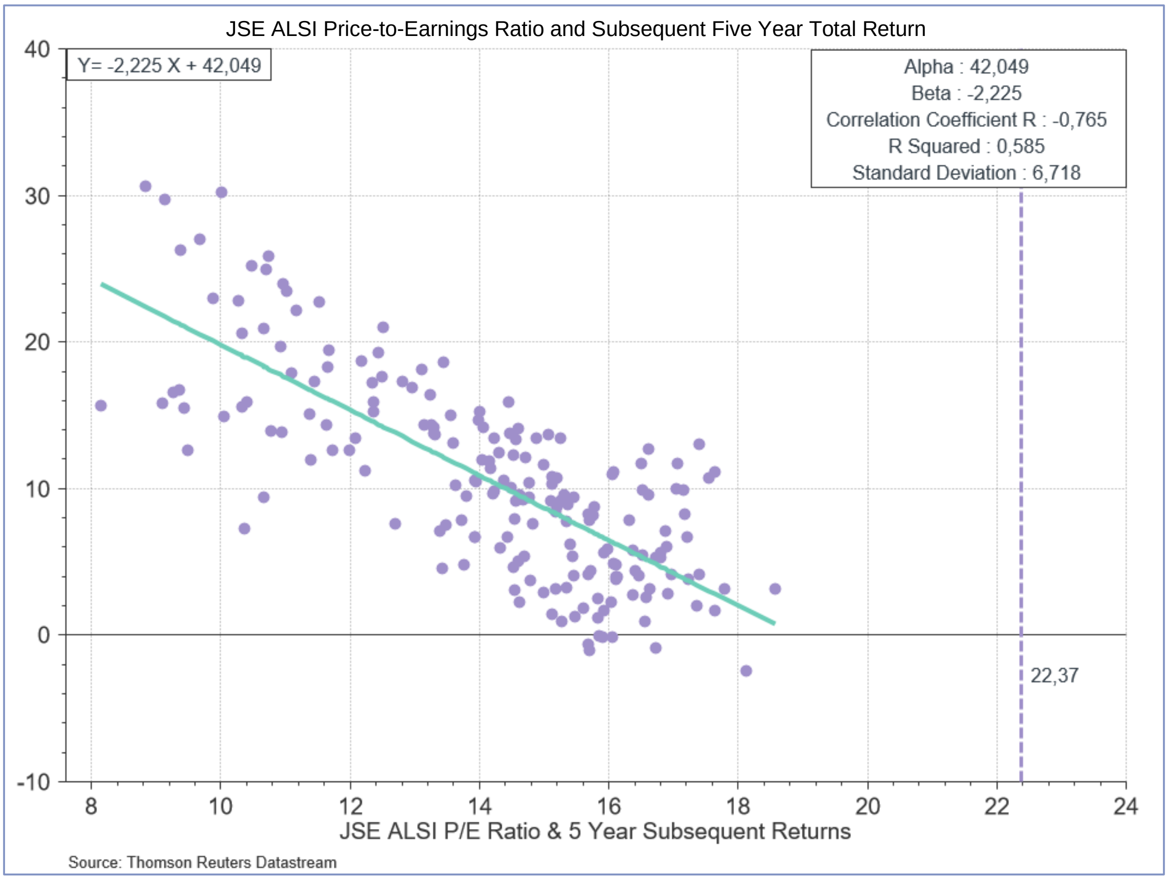
The table below shows what the effect has been on the price-to-earnings (P/E) ratio of these indices.

Index	Index Return 1 Year	Earnings Growth	Resultant P/E Ratio Growth
S&P 500	4%	1%	4%
JSE ALSI	2%	-20%	28%

What becomes clear then is that certain P/E ratios are beginning to get out of line with historical norms. The JSE All Share Index now trades at a P/E of over 22, well above one standard deviation of the long term average of 14.8. These levels are unprecedented in terms of our twenty-year data set and thus offer cause for concern. The three ways of normalizing a P/E ratio are 1) a retraction in prices or 2) earnings growth or 3) a combination of both, and with somewhat pedestrian growth in the price of the index it's fair to say the majority of this surge in the ratio has been on the back of a drop in earnings – a drop in excess of 20% that is.



In order to find empirical evidence to perhaps provide some solace or to confirm such concerns, we ran a model to test if there was a significant relationship between the starting P/E level and the subsequent five-year total return of that index, which we did for a number of global markets. What we found was a moderately strong relationship between a high P/E ratio and lower subsequent five year returns for the JSE ALSI.



At the current level of 22.37 (marked by means of the dashed, vertical line), which has never been captured by the model, one would expect that returns are more likely than not to be muted in the coming years. If we assume that inflation is likely to average around 6% per annum over the next five years; then the above chart implies negative real returns from South African equities, i.e. that those who invest now are likely to go backwards in inflation-adjusted terms over the next five years.

"…should a point be reached where the taps are turned off, these unrealistic debt-fuelled valuations may well need re-evaluation."

Note that the rather alarming message in the earlier paragraph is only for South African equities in general. There may be certain sectors of the market (either in terms of market capitalisation (i.e. size of company) or in terms of industry sector (financials versus industrials for example) that may perform very well in the economic environment we set out in this article. This is where the benefits of active management shine through.

Marry the high valuations of South African securities supported by a developed world awash with cheap money through a series of expansionary monetary policy programs globally, with an already low and decreasing global, and to a worse effect South African, growth environment, placing further pressure on already weak earnings and you have a situation where something simply has to give. The normalization of the P/E is realized through a turnaround in earnings in the current macro-economic state of play is difficult to fathom, which leaves weakness or simply flat (assuming earnings growth) in the price of the index.

This is not to say that this situation is imminent, as central bankers continue to find new and exciting methods to keep economies and asset prices afloat, all the while investors search for yield, be it in near or sub-zero bonds or riskier equities. However, should a point be reached where the taps are turned off, these unrealistic debt-fuelled valuations may well need re-evaluation.

Perhaps the most suitable sensationalist news headline we love to live off of late which speaks testament to the above goes as follows – Don't fight the central banker gang that might hand us Dow 20,000 (Market Watch.)

*Grey swan – a termed coined by renowned author Nassim Taleb which means a volatile event likely to have a sizable impact on a security or market which, unlike an unforeseen black swan event, can be anticipated through superior analysis and macro-economic foresight.

KNOWLEDGE INTO **WEALTH**