NBAD

From West to East

Investment View
14 July 2016

The Return of FOMO (the Fear Of Missing Out)

The S&P500 rose another 0.13% last night, to a further new closing high, following those of the previous two sessions. The index closed at 2,152.43, up 5.3% for the YTD. The Dow Industrials index confirmed this move, itself reaching a new record closing high, and the Nasdaq Composite is back above the technically significant 5,000 level, which is encouraging for the rest of the complex. Investors will now be looking to see whether sector rotation evolves in a more bullish manner, i.e. away from staples and utilities, in favour of technology and consumer discretionary.

The current year P/E on the S&P500 now stands at 18.3x, falling to 16.1x for calendar 2017, based on the Bloomberg consensus earnings growth of 8.85% for this year, and 13.51% for 2017 (followed by 11.57% in 2018). With bond yields down at ultra-low levels, comparing current P/Es with historic averages becomes a deeper and more complex exercise. Investors are best advised to avoid paying multiples that are too high relative to an assessment of sustainable earnings growth, or aiming to buy stocks cheaply rated vs. assets or appraised 'fair value', depending on whether one subscribes to a growth, or value methodology.

The recent price action in the S&P500 has been very frustrating for many investors. They have been concerned about politics, earnings manipulation, an economic cycle that looks very elongated, and having to make decisions against the background of rampant bond markets. The average investor in US stocks is understood to have historically high percentages in cash, pending what was expected to be a difficult summer. Many fund managers will be on holiday, with their relaxation being interrupted while they are torn between hoping that the rally doesn't run away with itself, and wondering whether they should send instructions to increase equity exposure immediately.

Last week's NFP (Non-Farm Payroll) numbers led to a massive sigh of relief in the US markets, the effects of which rippled through other asset classes. Talk of Brexit is no longer trending, small reductions to estimates of global GDP growth rates have been made, and investors are factoring-in expectations of renewed central bank monetary easing - from the UK, and especially in terms of size, from Japan. Investors have piled further into quality sovereign government bonds, although prices for these have retreated from the highs during the last few days as sentiment has turned to more 'risk-on'. The yen has finally begun to weaken upon indications of extra QE, and Japanese stocks have taken heart from this, as they usually do from a weakening currency. Prime Minster Abe's victory in the upper house has been received very well.

Gold has traded down from its recent highs of $1,375. The markets have also been relieved to see that sterling has not continued to plumb new lows, but rather has rallied back towards $1.33, partly on the swift installation of Theresa May as the new PM. Within the UK itself, worries about the effects of Brexit on the economy are now being replaced by quite a steely 'we will get through this and prosper' attitude. Brexit will cause some localized difficulties, but the global implications will probably be well contained. We know that the ramifications for Europe could be insidious. Overall, though, the shift to more positive sentiment in the markets has become noticeably less subtle.

The fact that US equities have reached new highs is especially impressive given the run-up to the US Presidential Elections, and this month's party conventions. What the markets seem to be saying is that the Street now assumes Hillary Clinton will be the new President. She is not very popular, but at the end of the day that may not actually matter much, because the supportive machinery behind US government is in place. At least she is a known quantity.

Alcoa is always the first US company to announce figures each quarterly results season, and a few days ago they beat expectations both at the top and bottom line. However the real significance is that aluminum has a broad spread of modern-day applications (packaging, through to transportation) and is correctly perceived as an industrial bell-weather metal, reflecting conditions across a range of sectors.

The dollar, currently 96.209 on its index, has not really shown signs of strengthening for some months now. It has been trading in a range of 93-100 since early last year, so the effects of earlier dollar strength have washed through in terms of any adverse effect on US corporate earnings.

The yield on the US 10-year is currently 1.50%, after falling to 1.32% last week, and would have to solidly break above about 1.83% to suggest a trend reversal. The yield on the S&P is 2.13%, not a huge amount, but adequate to cover some dealing costs, and still above many quality bond yields.

Our TAA Committee is scheduled to meet next Monday (18th July). We have maintained a neutral weighting in global equities, tilted a few weeks ago to an overweight in US stocks, vs. being underweight in European stocks. In the last Weekly Investment View we wrote, "we have been mindful that short positions are under pressure, and that billions of dollars of corporate cash could be applied in M&A activity". The report finished by saying that "investment strategy remained essentially unchanged, pending more definitive signals from the markets". The Committee will discuss the extent to which a 'definitive signal' has been received with the S&P closing at new record highs, and whether any new Japanese monetary pump-priming represents significant risks to the markets which need to be acted upon.

Markets move with the 'weight of money' applied to them, even if that money is to an extent debased. The best markets are ones that appear to be climbing a 'wall of worry'. Perhaps above all, investors ignore new highs at their peril, as they only turn out to be bull traps occasionally. Earlier this year we used the phrase 'Fear Of Missing Out' (FOMO); that is what we are likely to see. If the markets - led by the S&P - do continue to climb, let's hope this doesn't presage a bubble. In the meantime, however, those overweight in cash will be getting more worried.

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