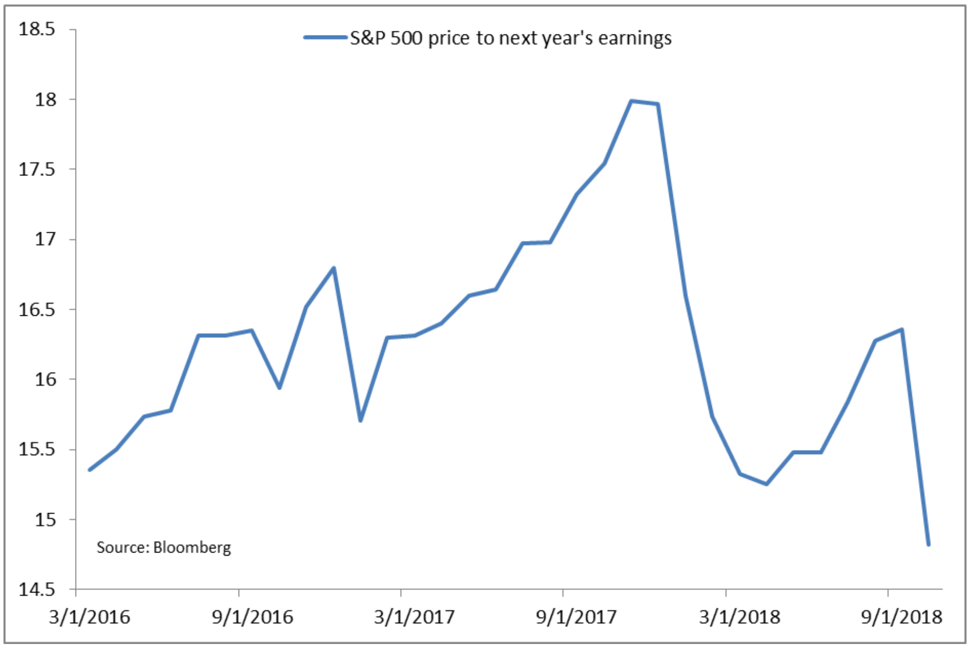
From West to East

Weekly Investment View
28th October, 2018

US stocks look ripe to resume the rally after this correction

October is coming to an end — good riddance. The month was particularly painful for stock investors as even US equities (until recently some of the best performing securities in the world), lost a lot of ground. The S&P 500 dropped 8.8% between 1st October and 26th October, leaving the index negative by 0.56% for the year-to-date. The correction, however, was likely just that - a correction. In the process, stocks have become a lot cheaper and compelling as an investment. Now, there is a good argument to see a rally going into year-end.

The S&P 500 companies now trade on average at 14.8 times their expected earnings for next year, the lowest they have been in terms of this metric in 2 ½ years (see chart). What is more, the underlying US economy is very strong, which could mean healthy earnings growth going forward. On Friday, the Bureau of Economic Analysis said that US GDP grew 3.5% in the third quarter, after 4.2% in the second quarter. Strong economic growth tends to translate into higher revenues and earnings for listed companies, and that is exactly what is happening. Three of every four companies that have reported third quarter results so far have beaten analyst estimates – even though analysts have recently started to revise their estimates higher.



"US stocks have become cheap after this correction, especially since the economy is very strong."

In such an environment it is hard to understand why stocks dropped so much, so fast. In fact, there have only been three other months of October that were this bad or worse for US stocks in the past 40 years: 1978, 1987 and 2008. Those who enjoy financial history will recognize the pattern – all of them were the beginning of major financial crises. In fact, two recent market crashes started in the month of Halloween; 1987's Black Monday and the Lehman Brothers bankruptcy filing were both in October. Does this mean the market drop this month is the signal of something bigger brewing? No, that seems very unlikely. In the previous instances of really-bad Octobers, the US economy had already been slowing for a while and there were clear indications that big problems were brewing. In 1978, the oil crisis had already started, in 1987, the savings and loans crisis had been simmering for months and the same is true about the sub-prime mortgage market in 2008. This time, instead, the US economy has been accelerating, with jobs and wages increasing. There also appears to be no clear bubble popping or immediately brewing economic issue. The move, therefore, may be much more related to how markets operate now instead of major underlying problems. Passive investors now are a very large part of the stock market, for one. In total, exchange-traded funds that focus on stocks have more than US$2.7 trillion of assets. While that is spread across an array of markets across the world, it is fair to say more than two-thirds of the amount focuses on US stocks. Considering the roughly US$23 trillion market capitalization of the New York Stock Exchange, ETFs could now make up more than 10% of stock ownership. It is a bit more complicated – ETF stock ownership is much more concentrated on a few companies, since they tend to follow indices and may have even more weight than that for those benchmarks. While ETFs are a great tool that allows individual investors to diversify their portfolios at a low-cost, they also could exacerbate moves in the indices they track. The S&P 500, for instance, is market-cap weighted. This means that as a stock price rises, it gains weight in the index. That has a deadly effect on passive investors, such as ETFs, which have to buy more of the stock as its price goes up and sell it as it drops. This causes feedback loops which make sharp moves in stock markets, particularly in the US, sharper. Add to that the growing number of hedge funds that trade based on momentum using computers. These hedge funds teach machines to see which way the market is going and to then follow. So if the computer programs suggest the market is going up, it starts buying, and it sells when the market reverses. Again, another feedback loop. These dynamics may have had a significant part in the sudden sell-offs in October and February. **It could also mean that the recovery and ensuing rally will be very strong, after all, the feedback loop works both ways.**

There is, however, a third potential element which probably worsened the drop, and which has also been hitting emerging markets: interest rates. **The cost of leverage has gone up and that may have caused some investors to reassess their positions.** The best example of that dynamic is the cost of Libor. The benchmark rate borrowers use for almost everything, from commercial mortgages to margin loans, started this year at 1.7%, and closed at 2.52% on Friday. That means that a leveraged investment in, say, a bond with a 3% coupon now offers a very small profit – if any at all, once transaction costs are factored in. This has helped push down emerging markets, where there was a large amount of leveraged investments, particularly high-yielding government bonds such as those of Argentina, Brazil, India, South Africa and Turkey.

It may have finally made its way into US stock markets in the past two months, when the Libor increase was particularly violent – the measure has increased 20 basis points since 29th August. It is probably not a coincidence that the two corrections in the stock market this year happened after a sudden rise in Libor. The benchmark has also been rising faster than even US Treasury yields, and continued to go up last week even as Treasury yields retreated. The divergence has to do with the increase in the US fiscal deficit and the relative safety of US bonds. The US budget deficit has increased 50% since Donald Trump took over the White House, and much of that cash shortfall is being covered with short-term bonds. With more government bonds available at a higher yield, investors and banks are now requiring an even higher return to lend to each other instead. **The US deficit is expected to continue to rise and the Federal Reserve is likely to hike its benchmark rate at least a couple more times in the next year, so Libor is likely to rise further from here.**

That should not be a problem as long as the move is not too fast. And after a quick correction, benchmark rates seem to be stabilizing, and settling into a new range. That augurs well for stock markets and risky assets as well, and adds to the argument for increasing exposure to equities, in particular in the US.

"Benchmark rates are settling into a new range after a volatile period, providing another sign that risky assets could gain into year-end."

If volatility does indeed subside, gold and silver could resume their downtrends. The precious metals have been in a bear market for most of the year as the US dollar rose. Gold had risen for the past four weeks, having increased 3.6% since the start of October. It is, however, still 5.3% down in the year after having dropped almost all of the other months of 2018 so far. Silver has it even worse, given that it had started rising only two weeks ago, but could now resume the drop which has pushed its price down by 13.5% in 2018 to date. Among precious metals, platinum is perhaps the only one which has something going for it. The metal is used to make catalytic converters, which reduce car pollution. The parts can also be produced with palladium, which saw its price hit a record US$ 1,144.2 last week. As a result, catalyst factories could shift to platinum, which sells at US$ 832, and increase demand for the metal.

Overall, however, the outlook for commodities is hardly promising. Particularly given that the US dollar has continued to strengthen and there are few fundamental reasons to expect the currency to shift direction. The three currencies that most influence the value of the dollar, the British pound, the euro and the Japanese yen are all weakening. The European currencies are unlikely to strengthen at least until there is clarity on how the UK's exit from the EU is determined. And last week saw yet another sign that the UK could reach the March deadline to leave the bloc without a final agreement to smoothen the exit as Prime Minister Theresa May faced a rebellious cabinet in a meeting last Tuesday, just to answer uncomfortable questions in Parliament on Wednesday.

"A hard Brexit could push the euro and the pound down and boost the dollar."

That is bad news for emerging markets, amongst the worst-performing assets for the year-to-date. A stronger dollar and rising US interest rates have already helped push the MSCI Emerging Markets Index down 21% this year. Yet there is reason to also believe the turning point for the asset class could be near. While the Chinese economy grew less than expected in the third quarter, new loans in the Eastern side of the economy grew more than forecast. That suggests the Chinese reflation is well under way and should eventually start to translate into stock market gains. Furthermore, Brazil is expected to elect a market-friendly candidate in an election being held today. The Brazilian real has rallied 14.2% since the start of September, when it became clear that Jair Bolsonaro would be the likely winner of the presidential election. If he carries out his promised market-friendly policies, the excitement about Brazilian assets could even reignite the appetite for other emerging markets.

INVESTMENT SUMMARY: The NASDAQ Index dropped 3.7% last week, pacing losses for other US stock indices. It was its fourth consecutive negative week. Some of the best performing stocks until September were the biggest losers in the past five weeks, suggesting investors are revising their exposure to stocks with stretched valuations. Most technology companies, however, have beaten analyst estimates in the third quarter, suggesting growth remains strong.

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