Market review

During a conversation with a client in October, the question was raised as to what MPL's current view of the market is.

In short, I explained that if we examine the global investment environment as we see it now, current PMI (Purchasing Manager Index – a reliable indicator of future levels of economic activity) surveys have given us some key pointers as to why financial markets are quite so resilient now: many companies are currently experiencing increasing rather than decreasing levels of new orders, which in turn has led to them increasing future output, business activity and employment projections. This ultimately and in the normal course of events should lead to increasing productivity and economic growth going forward.

We can take a closer look at several of the reginal and national areas, as follows;

In Asia

The monthly local company sector survey for September indicated that the greatest level of output and new order expansion was seen in the household & personal products sector. Moreover, growth in this segment was the highest since February 2015.

In Europe

Technology remained the fastest-growing European sector in terms of output and business activity – as this sector is more generally associated with the means of both current and future production, this bodes well for the Continental economy and its future output levels.

In the UK

UK manufacturing industry has continued to expand in the current environment, notwithstanding Brexit concerns and mainly due to rising intakes of new business in both domestic and overseas markets, the latter clearly benefitting from favourable currency rates for exporters. Growth rates in new export business remained among the best registered over the past six-and-a-half years, with reports of increased sales to Europe, the USA, China and Brazil.

Business activity also continued to increase in the much larger UK Services Sector, although somewhat subdued domestic demand – compared to what could otherwise have been expected - acted as a drag on the activity growth rate. It has been reported that concern over the business outlook has itself acted as a headwind to growth.

In the United States

Economic activity in the manufacturing sector had expanded for the 100th consecutive month in September as companies in the machinery and capital goods sectors reported strong business levels in a period which is more usually characterised by a seasonal downturn. Manufacturing companies are also forecasting strong ongoing demand for their products continuing into 2018.

Non-Manufacturing businesses likewise have recently reported growth for the 93rd consecutive month, with the Business Activity and Output, New orders and Employment survey components all continuing to expand. On a more macro level, this resilient global growth is reflected in the fact that all OECD nations (alongside numerous others) are currently experiencing synchronized growth.

We would point out however that we remain closely mindful of the fact that many financial market indices are currently at all-time highs, and that valuations of certain companies within these indices are perceived to be elevated at present.

Yet it is earnings growth that remains the primary factor driving these market valuations at present, and it needs to be noted also that these earnings growth levels are – as mentioned above - occurring within a relatively robust global economic environment. Indeed it is this revenue growth itself which is currently giving us a guide to as to whether earnings appreciation for certain companies and or sectors will continue.

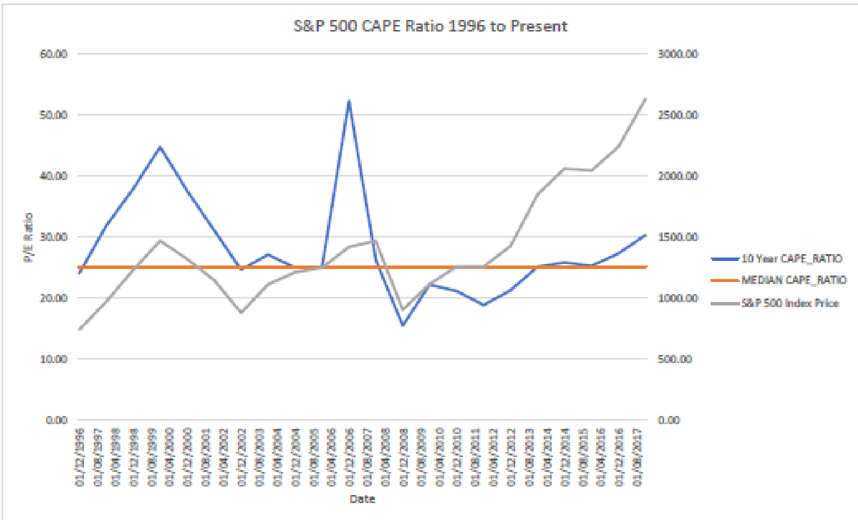
Hence, whilst certain commentators look at the higher level of market indices in isolation, it is the components of these indices (that is, the companies listed within them) which are providing us with guidance here.

The client however at this point stated he believed that the good news on earnings was already factored into markets, and remained concerned about market levels at that point.

Looking at markets in isolation, we believe that current valuations in certain markets could support that view.

Yet utilising the widely used relative valuation measure known as the Cyclically Adjusted Price Earnings (CAPE) Ratio, we have calculated 10 years of earnings for the various national and sectoral indices, adjusted for inflation, and compared each of these to its respective index at its current level. We have also indicated what the median CAPE Ratio for the period has been, which gives us an overall view as to whether the relative level of each index can or should now be considered as cheap, fair value, or expensive.

In the United States for example:



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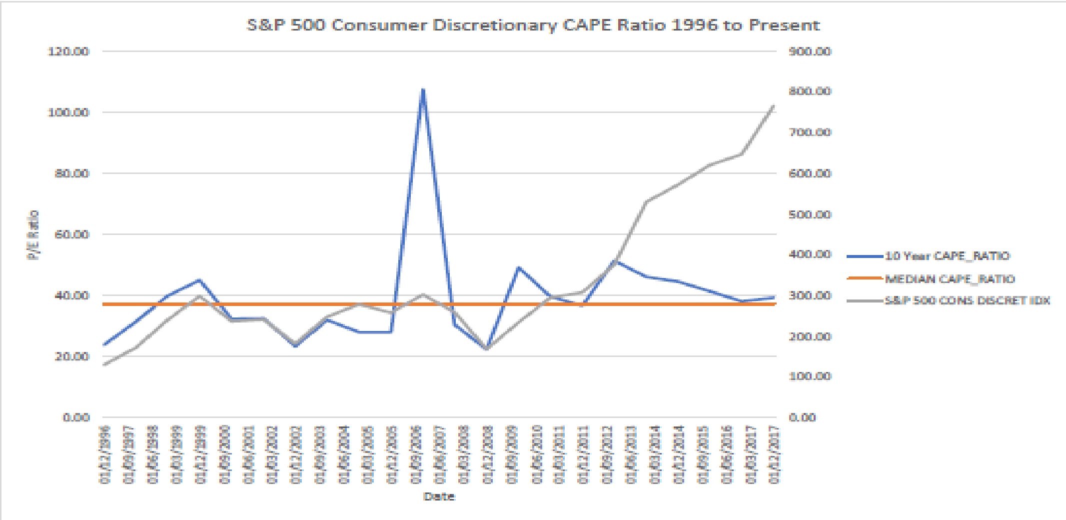
The median CAPE Ratio for the S&P500 Equity Index in the period from November 1996 to the present is 25.71 times earnings. At present the CAPE ratio for the S&P500 Index is 34.32 times earnings, hence at present the earnings of the S&P 500 Index are 33% more expensive to buy today, in comparison to the median annual earnings for this Index over the last twenty years.

A different picture emerges however, when you look at the constituent parts of the S&P 500 Index in the United States. At present, in respect of relative valuations compared to their long term median CAPE ratios some of the constituents of the S&P500 can be viewed as cheap, others are fair value, and yet others are considered expensive. For example…



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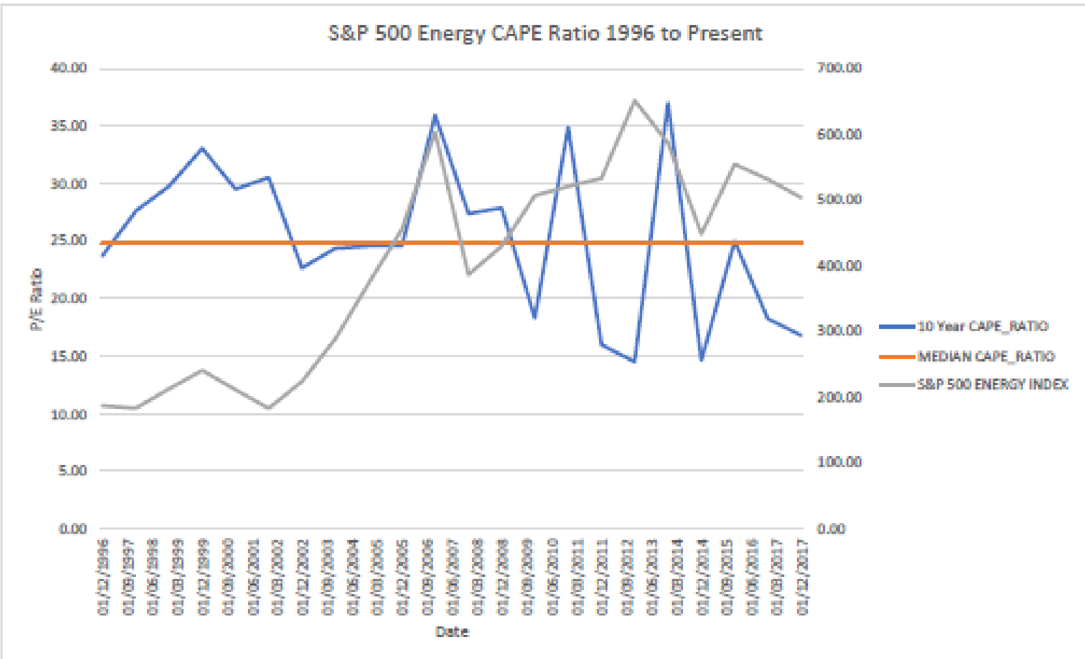
The S&P500 Consumer Discretionary constituent, chart above, which encompasses companies such as Ralph Lauren Corporation and Walt Disney Co, has been more expensive than the overall market in the period from 1996 to the present at a median CAPE of 36.63 times earnings, and is currently expensive at a CAPE ratio of 39.37 times earnings.

Whereas the S&P 500 Energy constituent – chart below - has a median CAPE ratio of 24.98 and a current CAPE valuation of 16.99 times earnings, which is perceived as inexpensive. Whilst some commentators could argue that this sector is cheap for a reason, the recent weakness in crude oil prices having been a major factor here, over 2018 some strength and relative price stability should be seen in this field.



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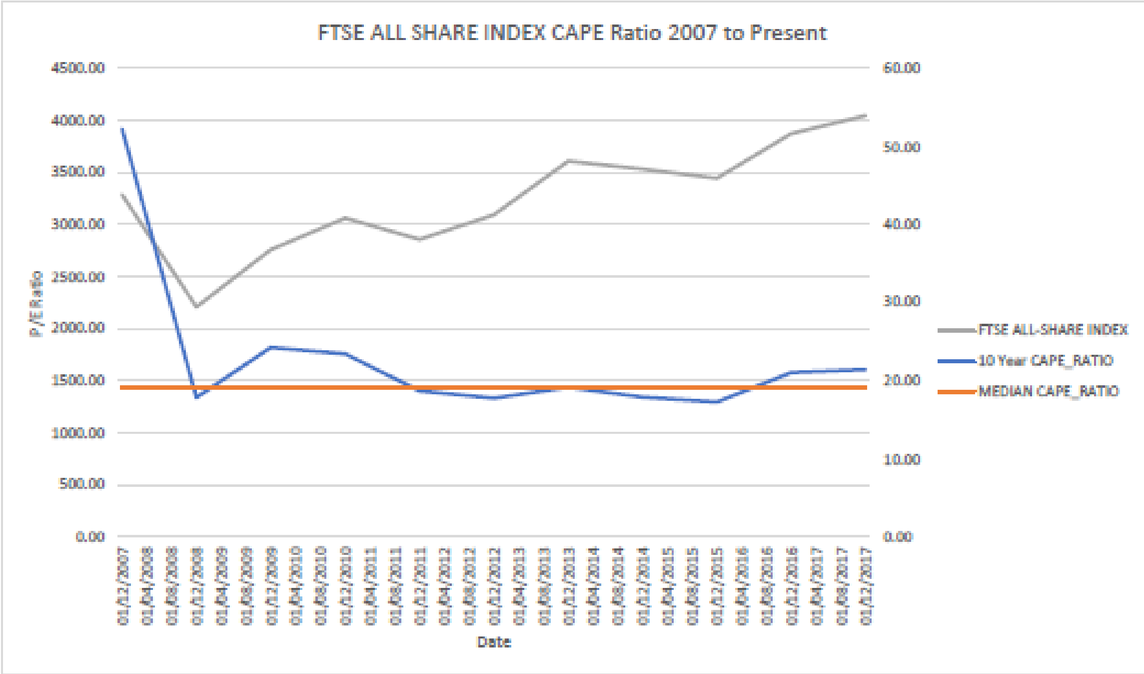
Hence, the earnings of energy companies such as Schlumberger, Exxon Mobil and Chevron Corp should benefit within this environment.

Here in the United Kingdom, the FTSE All-Share Index is just above its fair value number of 19.15 times earnings, at 21.68 times earnings when viewed on a ten-year basis using the CAPE valuation metric – chart below:



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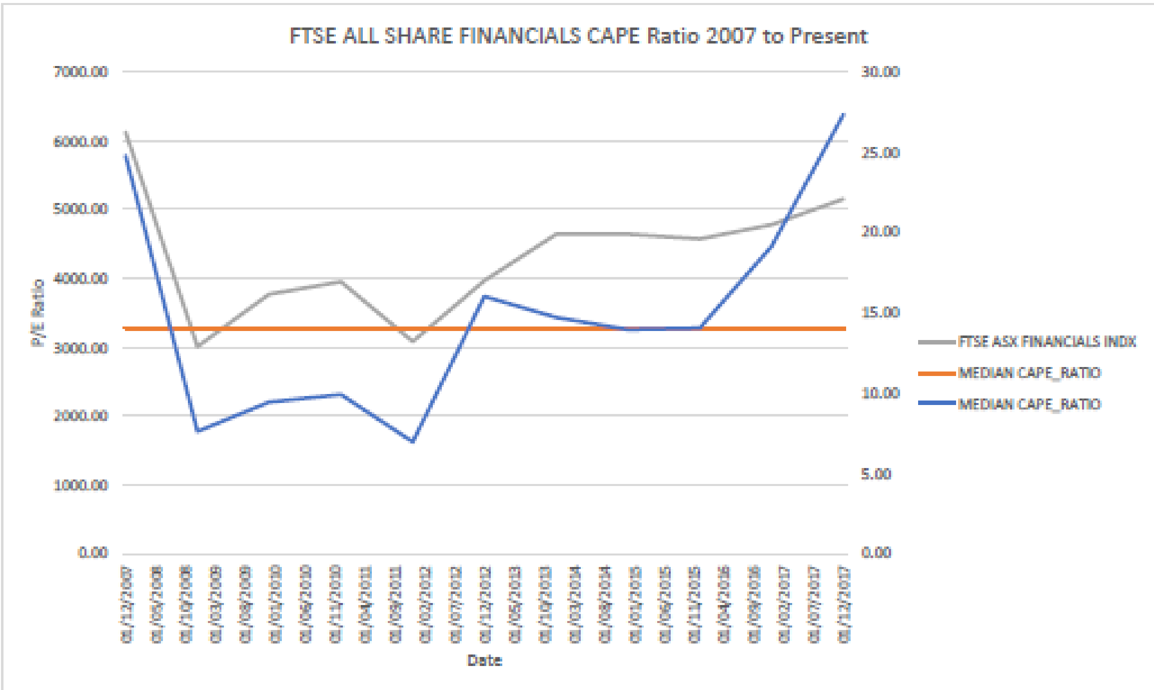
The Financials sector of the FTSE All-Share Index (chart below) now trades at levels far higher than its median 10-year CAPE ratio of 13.74x, at its current level of 27.66 times earnings, yet we do of course have to consider that the 10-year Financials CAPE ratio has itself been fundamentally biased downwards by the financial crisis which has lasted most if not all of that ten-year review period.



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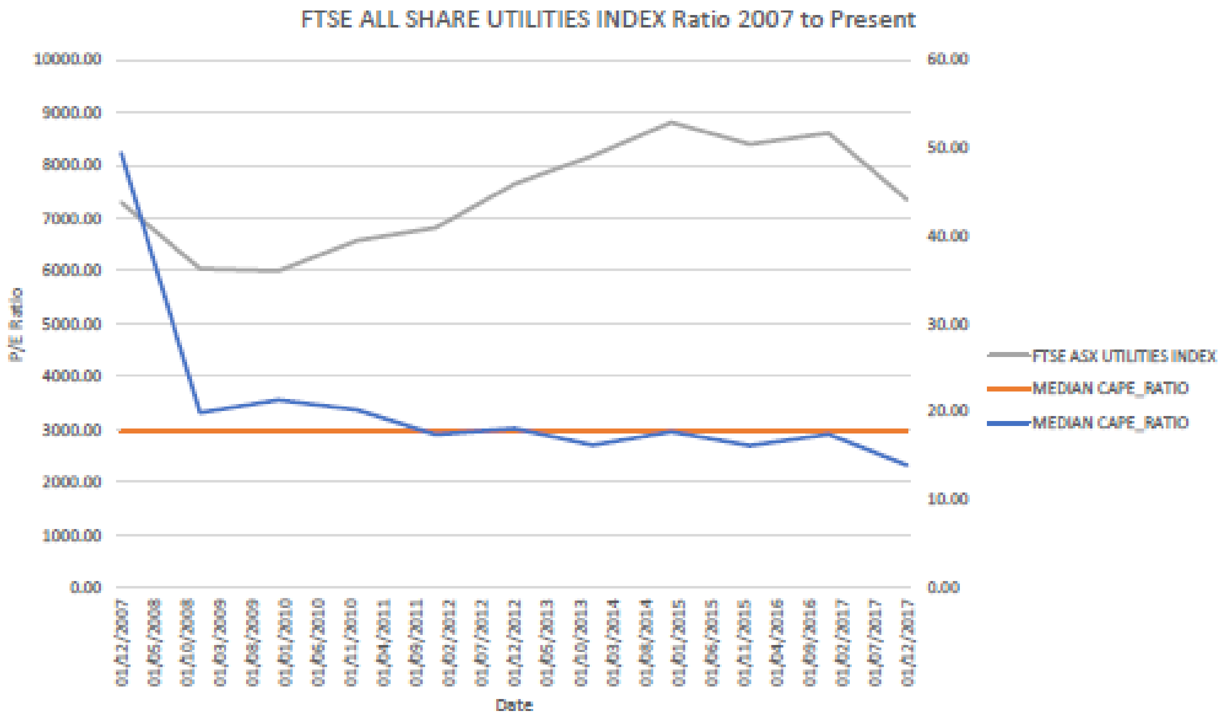
The more defensive Utilities Index (chart below) meanwhile is presently on a CAPE ratio of 13.91 times earnings, versus its median CAPE ratio over 10 years of 17.65 times earnings.



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Thus the over-riding point being made here is that whilst one picture points to a relatively expensive equity market valuation overall, a closer analysis of the underlying index constituents reveals a rather different picture. The key here is that in the current environment, investments can and should be made into those areas of the wider markets which still represent reasonable value.

Whilst it is undoubted that the enormous levels of liquidity which have been poured into the global economy by central banks over the past nine or so years have bolstered financial markets and served to inflate asset prices, passively buying the entire market will most likely not work as an investment thesis going forward. Whilst to a limited extent this has worked in recent years, 2018 will herald a change and an increased need for careful sector and asset selection within the wider equities arena.

With kind regards

*figures courtesy of Bloomberg & MPL

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