Market Review - Prudence

An effective landslide UK election victory for Boris Johnson's Conservative Party; the just signed "Phase-One" of the US-China Trade Deal, which will end years of intense bilateral negotiations and promises billions of dollars of agricultural purchases by China and the beginning of reforms to China's longstanding practice of forced technology transfer; continued accommodative monetary policy from the key central banks, with four members of the Bank of England's rate-setting committee including Governor Mark Carney hinting that the British economy could require support from lower borrowing costs within months; a strong US consumer in a strong but slower US economy; the US Federal Reserve remaining on the side lines, as confirmed Wednesday 29th when Fed Funds rates were left on hold; and the swift dissipation of the potential threat of conflict between the US and Iran – these have all been factors which capped off an exceptional year for equity markets in 2019, and have led markets to new highs so far in 2020.

We are currently in the midst of the US fourth quarter earnings reporting season, where investors have been looking to see if there has been a pick-up in corporate earnings (which had been rather tepid through 2019) in the fourth quarter of last year, and which would indicate whether or not companies have turned a growth corner: so far investors have not been disappointed.

Casting our minds back to the fall in markets in Q4 2018, stocks fell while earnings grew, leading to a large multiple contraction (which refers to price-to-earnings, or P/E's - a ratio used as a way of valuing equities, which is derived by dividing the price of the stock by one year of per-share earnings). This is explained by investors selling stocks into the trough in Q4 2018, betting that there would be a recession which ultimately did not occur, hence stocks became very cheap at the end of 2018 as share valuations reflected a high degree of selling amidst investor pessimism whereas earnings estimates were still rising. This then led to a considerable dichotomy and then a sharp rebound in share prices into the early part of 2019 as it became apparent that the economy was in far better shape than many had believed.

A lot of the P/E multiple expansion which occurred in 2019 made up for and reversed the contraction in P/E multiples experienced in late 2018. As mentioned above, this was however in the absence of earnings growth, which was rather tepid in 2019, and this makes the forthcoming earnings season so important, where it appears for now that earnings are continuing to grow at a healthy pace.

According to researchers at Goldman Sachs, the stock markets' historic run in 2019 was driven almost entirely by a vigorous rise in price, rather than steady earnings growth. Since 2009, earnings growth has been the primary driver of increasing equity values, accounting for 67% of S&P 500 returns over that period. However, in 2019 earnings growth explained only 8% of the S&P 500 return in that year.

This multiple expansion seen in 2019 was supported largely by low interest rates and stimulus from the US Federal Reserve. In the absence of any further concerted stimulus measures this year, the baton will have to be passed back to earnings growth as a market driver in 2020, if the gains experienced in 2019 are to be sustained this year.

With little to no expectation of a US recession in 2020, earnings growth for the S&P 500 is expected to be in the range of 5% to 10% this year. If these targets are priced into market index levels relatively quickly in the first half of 2020, we will have cause to scale back our equity exposure. At this point, political risk will be on the rise in advance of November's US Presidential Election, the result of which will have wide reaching implications, not only for the US but for global financial markets as a whole.

Portfolio Allocation

In the immediate aftermath of the UK General Election, the MPL investment team increased portfolio exposure to the UK equity market. As speed was of the essence in this situation, our exposure to the iShares Exchange Traded Funds (ETFs) covering the FTSE-100 and FTSE-250 indices was increased to take advantage of the ‘Boris Bounce’ in UK markets following the election result. In the coming weeks, we will reduce our exposure to these securities, in favour of UK equity funds focused upon companies which will prosper in a post Brexit economic environment.

On the whole global equity markets have rallied significantly so far this year. This has resulted in many of the global equity positions (such as Technology, US Equity Income, and European Equity) within MPL client investment portfolios exceeding their weightings within our in-house allocations. With an eye to prudence and given the fairly full valuation of the market currently, these weightings will shortly be rebalanced back to our base portfolio allocations, taking advantage of current market strength to do so.

The current health of the consumer in the US and indeed to a certain extent globally, leads us to believe that overall reported corporate earnings will probably beat forward expectations and be strong enough to generate ongoing equity market strength, although we do not expect returns in 2020 to prove as significant as last year.

As markets have already had an excellent start this year, we may have to be a little more active through the remainder of 2020, given the prospect of the US presidential election cycle beginning in earnest in March, and the transitional phase of Brexit here in the UK to contend with. These known factors and other ‘unknown factors’ such as the Coronavirus outbreak will likely increase levels of volatility seen in financial markets. This could in turn could create opportunities for the MPL investment team to take advantage of, if client portfolios are correctly positioned.