Not Quite Right

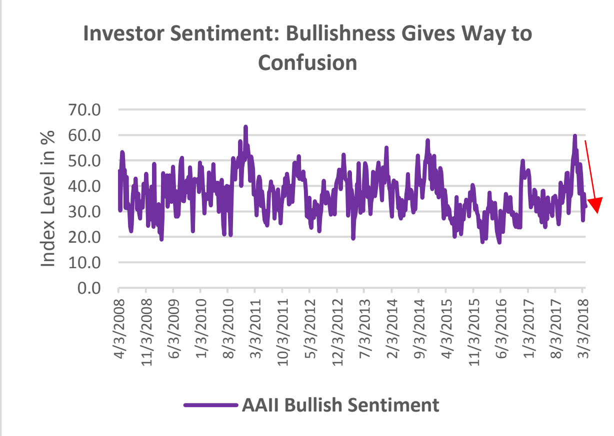
David F. Lafferty, CFA, SVP – Chief Market Strategist

March 2018

Trade War Fears Hit… and Then Disappear

Equity volatility returned in late March, if only for a few days. On fears of an impending trade war between the US and China, among other reasons, equities lost roughly 5% over eight days, shedding nearly $4 trillion in global market cap. Soon thereafter, markets reassessed the likelihood and impact of such a trade war and immediately bid up stocks with the S&P 500® regaining almost 3% in one day.

It's hard to know if these equity moves are inherently rational (reacting to quickly changing circumstances) or irrational (rising and falling by far more than the underlying fundamentals). What we do know is that these recent bouts of volatility have shaken retail investor sentiment. According to AAII data, investor bullishness hit a seven-year high in early January on the back of macro strength and the euphoria surrounding US tax cuts – only to collapse by early March. To underscore this investor confusion, the same survey noted a two-year high in "neutral sentiment" – with effectively half (45%) throwing up their hands.



Source: Bloomberg, Natixis Investment Strategies Group (4/3/08 – 3/29/18, weekly)

As always, there is no shortage of explanations for the current market action. This month we examine six prevailing equity market narratives – three bullish and three bearish. We find some validity in each of them, but none of them provide a complete picture. They just aren't quite right.

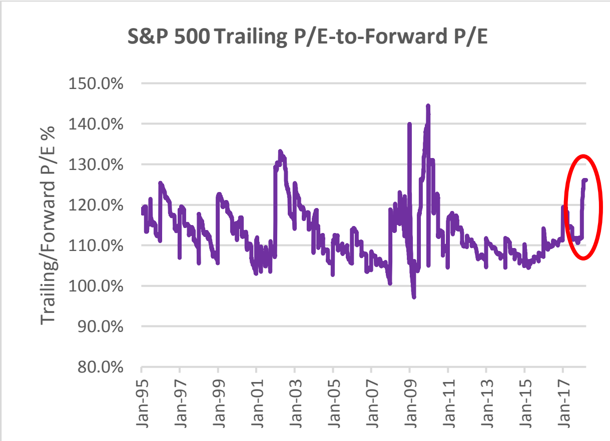
Six Equity Narratives

#1: The Macro Bulls believe in the fundamental strength of the global economy. The macro expansion that gathered steam in the summer of 2016 continues to roll, driving fantastic earnings growth estimates across global bourses for 2018, 2019, and beyond. This view, however, suffers in both its timeliness and ability to overcome expectations. First, the most recent macro data (February and March) has been decidedly mixed at best. It is too early to know if this is just more of the Q1 seasonal weakness seen in recent years or the beginning of a cyclical downshift – which we doubt so far. Second, even if the macro euphoria of December and January was justified, it has created a very high bar. Global equities already rallied hard from November through January, coincident with the peak in macro expectations.

#2: The Secular Bulls believe that the March '09 equity bottom (concluding two bear markets in eight years) was the beginning of a major up-cycle that could last many years, akin to the US equity run that lasted from 1982 to 1999. This is certainly plausible, but with two caveats: One, if this is a secular bull market, equity investors have already been paid handsomely. The S&P 500® returned +389%, over 19% annualized (total return with dividends reinvested) as of the ninth anniversary. Two, with stocks fully valued today, continued gains are likely to be driven largely by earnings growth. This can continue to push stocks somewhat higher, but without multiple expansion, it would be hard to call it a classic "bull market" going forward.

#3: The Technical Bulls believe the market is well supported by positive momentum trends (both on the economic front and within the capital markets) as well as supply/demand factors. Simply put, the trend is your friend. Moreover, with interest rates plummeting in recent years, equities have become "the only game in town" for many investors – particularly institutions that know they can't achieve their target returns by relying on paltry bond yields. In addition, business formation has been weak and abundant private capital has left a shrinking pool of public stocks to buy, while corporate buybacks are reducing the public equity share count. Little wonder that valuation metrics keep pushing higher. This theory, however, suffers from extrapolation. Markets change, and last month we highlighted several factors that aren't guaranteed to continue, including low inflation, low rates, and friendly central bankers. Excluding the effect of US tax reform, share buybacks were already slowing on higher rates and higher valuations (less bang for your buyback). The status quo is changing and we already see that in recent market volatility. Now for the bears…

#4: The Overvalued Bears believe that stocks are simply too expensive and that exorbitant multiples will result in terrible forward returns. In the long run, we agree that high valuations pressure returns. However, in the short run, valuation alone is a pretty poor forecaster of near-term market direction. Most bear markets have a catalyst that makes valuation relevant. Valuation generally speaks to the magnitude of a selloff, not its likelihood. Also, if you believe in the global growth and earnings story, stocks aren't necessarily overvalued. While trailing P/E metrics look expensive, expected earnings growth across most indexes make forward P/Es look downright average – especially in the US as the tax reform package gooses both consumers and corporate coffers.



Source: Bloomberg, Natixis Investment Strategies Group (January 1995 – March 2018, monthly)

#5: The Interest Rate Bears believe that some combination of inflation, higher rates, and more hawkish central banks will cause equity markets to buckle. Based on the simple arithmetic of discounting cash flows, this is a legitimate fear. Higher rates mean lower present values, which eventually comes through into prices (very directly for bonds, less directly for stocks). However, as noted above, the global economy may not be quite as strong as previously thought. Inflation and inflation expectations have been falling recently and sovereign bond yield yields peaked in early February. If bond yields stabilize at current levels, perhaps equities will remain "the only game in town."

#6: The Geopolitical Bears believe the world has become inherently more unstable, citing examples such as an existential threat to the Eurozone, Brexit, Trump, North Korea, and trade wars. While we agree the world continues to look scarier than ever, geopolitical forces are poor criteria for building portfolio allocations, much less guessing the direction of the stock market. Our general view is that geopolitical fears often cause short run volatility, but the worst fears often don't materialize and markets quickly rebound. The magnitude of that volatility and the duration of selloffs can be highly dependent on the underlying economic environment. Geopolitical fears fade quickly in the face of a strong global economy. They tend to carry more weight when the macro backdrop isn't as supportive.

So these are the narratives we've been hearing in the financial media and when we talk to clients. While they're not quite right, we do see strong arguments in each of them.

Equity Expectations

Picking and choosing the most compelling arguments from each, we offer the following thoughts:

It's still too early to get outright negative on equities. This is part basic probability (stocks go up more often than they go down) and part fundamental. For now, the global economy appears strong enough that a sustained downtrend would be unlikely.

Investors should restrain their upside expectations. Yes, earnings growth looks solid, but outsized equity gains are usually associated with strong earnings *and* multiple expansion – and we think the latter will be modest at best with growing signs of inflation and less accommodative monetary policy. We expect equity returns to be positive, but that alone doesn't create a classic "bull market."

The principal effect of higher rates will be on volatility, not returns. As we outlined last month, the growing debate about inflation and interest rates has the market more on edge than at any time in the last two years. However, at this point, rates do not look poised to rise high enough or fast enough to pull the rug out from under stocks. Given that markets are often driven by sentiment and not math, we think the *pace* of rising rates would be more important than the *level* of rates. While +0.50% over a year is hardly worrisome, +0.50% in a week is a problem.

We worry about valuations only within the context of the economic cycle. For now, solid global growth, excellent earnings trends, and still-low rates justify above-average valuations. However, when the global economy eventually falters, today's equity valuations would be exorbitant, unjustified, and unsustainable. This would produce an ugly double whammy for stocks, with sentiment pressuring P/Es while the Es (earnings) were falling.

In summary, we think ***global equities are bounded by strong fundamentals on the downside and elevated valuations on the upside.*** In this satisfactory environment for stocks, low beta participation remains our guidance. Alternative and non-correlated strategies (which have lagged in the bull run) continue to be attractive the later we get in the cycle.

David F. Lafferty, CFA®
Senior Vice President – Chief Market Strategist

2000858.6.1
CC283G-0318
Exp. 7/31/2018