Allocation insight

10 September 2018

Records and risks under scrutiny

3,457 days. It's official: it is the longest bull market ever in the history of stock exchanges, during which US equities never fell by more than 20 per cent. The previous record from 1992–2000 was broken in August.

However, the equity market rally was not straightforward. Two market declines of more than 15 per cent and four of more than 10 per cent were seen during that period, plus several declines of more than 5 per cent. Despite stock price volatility, a patient investor, by investing in the S&P 500 index during the period in question, has achieved an annual return of 18 per cent in dollars (and in euros) with dividends reinvested.

Patient investors have achieved excellent returns

In Europe too, equity investors have been rewarded for risk-taking with a 12.5-per-cent annual appreciation, although the euro zone member states' coordination problems during the period in question have been far from easy. The period has also been favourable for corporate bond investors. In the US, corporate bonds with a higher credit rating have produced an average annual yield of 6.6 per cent from the cycle's trough in 2009. In Europe, the annual return on corporate bonds was 5.4 per cent during the same period.

When examining the above-mentioned return figures, it transpires that they clearly exceed the long-term average return in each asset class. The reasons behind the higher returns are, however, textbook examples. After the financial crisis, companies' ability to improve the efficiency of their operations, take advantage of the low interest rate environment and pay back capital and returns to both creditors and shareholders has been better than average. In addition, the return figures are embellished by the fact that the gap left by the financial crisis was exceptionally deep.

Although records are made to be broken, one cannot help but wonder if things have been too good to continue like this for much longer. This is a question that many market participants have posed recently. That is why we should revisit the three market risks that we pointed out in the beginning of the year and see how the investment environment has changed in light thereof.

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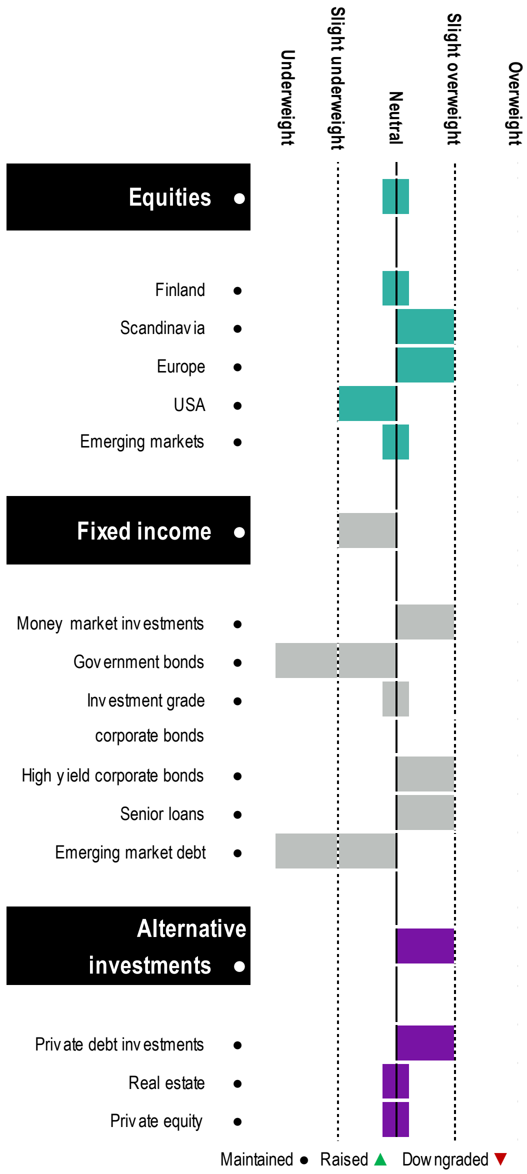

Direct and indirect impacts of tightening monetary policy

Global economic growth continues at a steady pace and the US economy has received a boost from an expansionary financial policy, the impacts of which are expected to become diluted by next year, however. Corporate and consumer confidence indicators have declined from their levels at the turn of the year but still predict continued growth. The tightening of the US labour market and slowly accelerating inflation, with the ensuing rise of the key interest rate, will continue to put pressure on the valuation levels of liquid asset classes worldwide, causing more turbulence in the capital markets than in past years.

The appreciation of the dollar (Figure 1) resulting from a tightening monetary policy and the trade policy have increased pressure on emerging markets and many emerging market currencies have depreciated quite sharply against the dollar and the euro. The EM currency depreciation wave that started with the Turkish lira and the Argentinian peso has also hit Brazil, South Africa and Indonesia. The Chinese yuan also depreciated around eight per cent during summer, but the reasons behind this are likely to be found in trade policy. The depreciation of the currency does offset, at least partly, the negative impact of the import tariffs set by the US on Chinese exports, and is presumably perfectly in line with the Chinese central government's objectives. No progress was observed in the US-China trade relationship during summer and additional tariffs continue to be a threat.

Should the symptoms in EM currencies and on the capital markets spread or continue for a long time, the probability of a reaction from western central banks will increase. Uncontrolled deceleration of economic growth in Asia would clearly have negative impacts on both Europe and the United States. The asset manager PIMCO, the former employer of the newly appointed vice chair of the Federal Reserve, Richard Clarida, took a stance in favour of a quicker tapering of the central bank's balance sheet and, correspondingly, a slower interest rate hike path in its August market strategy. If it materialises, this scenario will probably ease both the appreciation pressure on the dollar and the emerging market symptoms. Markets will be keeping a close eye on the Fed's September meeting. We are maintaining equities at neutral weight, fixed income slightly underweight and interest rate risk, measured in duration, at a lower level than the market average.

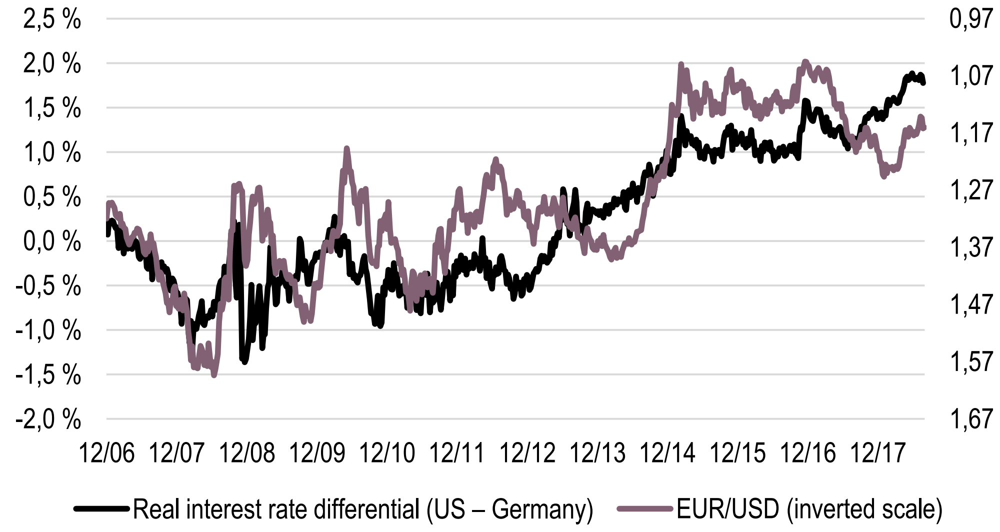

Figure 1. Development of the real interest rate differential between the US and Germany and the foreign exchange rate EUR/USD in 2006–2018.

US equity market performance increasingly dependent on a single sector

This year too, the technology sector has been the engine of the US equity market (Figure 2). The appreciation of technology companies accounts for close to half of this year's return on the S&P 500 index. Both Apple and Amazon have exceeded the thousand-billion-dollar mark in market value, setting new records.

However, the success experienced by emerging market technology companies in 2017 did not last. Whereas large technology companies accounted for about 25 per cent of last year's excellent equity market return, their contribution has been modest this year. The stock price of Tencent, China's largest internet company, has fallen by close to 30 per cent from the February peaks, due to earnings falling slightly short of expectations and a slower-than-expected rate of release of new mobile games. The company has lost more than a hundred billion dollars of its market value.

This is what the vulnerability of technology companies boils down to. The earnings expectations for technology companies in the US and elsewhere in the coming years have climbed very high. The valuation levels are clearly above market average and the technology sector's share of key equity market indices in both the US and the emerging markets has risen to nearly 30 per cent.

If US technology companies are not able to meet these high expectations, the US equity market may prove surprisingly vulnerable. We are keeping US equities at moderate underweight within the equity allocation. Europe's technology sector is substantially smaller. The sector's largest companies are SAP and Nokia, whose growth expectations are clearly more moderate.

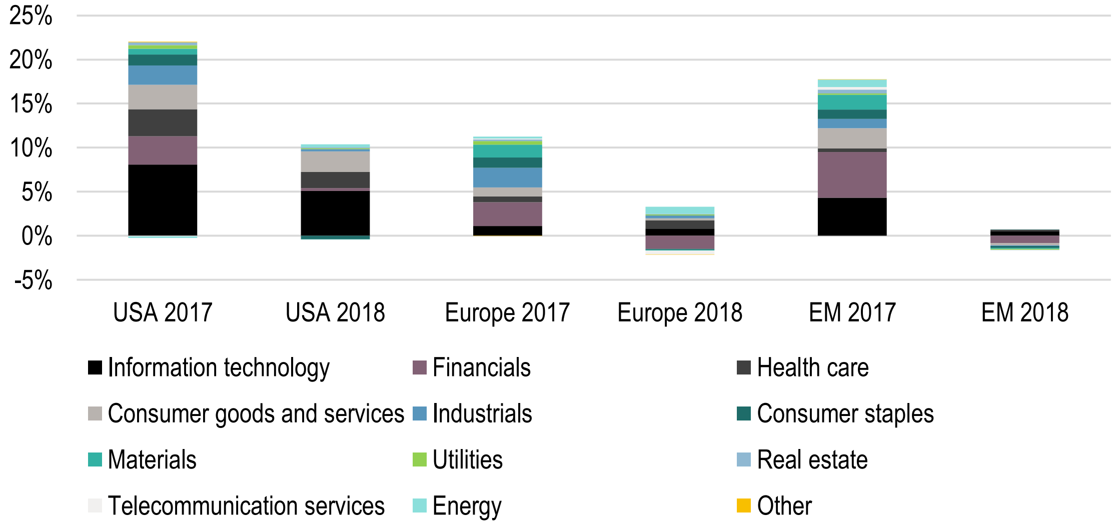

Figure 2. Total return breakdown by sector in 2017 and 2018. US return in dollars, Europe's and emerging markets' return in euros. Source: Bloomberg.

The length of the cycle may be a positive surprise while the portfolio return may be a negative one

In light of the above-mentioned record returns and risks, concerns about the economic cycle coming to an end are easily justifiable. However, it is good to remember that nearly all economic players are doing their utmost to ensure that economic activity remains on a good level. The actions of politicians, business leaders, employees, central bankers, consumers and other economic players are geared towards keeping the economy rolling. The materialisation of a systemic risk is in nobody's interest.

All economic players are doing their utmost to ensure continued good economic activity.

Paradoxically, the continuation of the economic cycle would probably entail challenging times for investors. It would probably be difficult to find attractive investments in liquid markets and the returns on fixed income investments in particular would be clearly lower than in the recent past, even negative. Most probably, equity investment return levels would also be lower than in the past years, considering the current valuation levels and the rising interest rate level. Money market or cash investments would generate losses in the form of lost purchase power.

Instead, in the scenario of continued growth, alternative investments would still offer attractive returns, in both absolute and relative terms, thanks to lower valuation levels and the liquidity premium. Investors should also prepare for this scenario by ensuring that the structure of their investment portfolio corresponds with the level of the targeted return expectation. In Mandatum Life's allocation solutions, alternative investments are slightly overweight.

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