Weekly Market Comment

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Yield-curve flattening: a bad omen?

After equity markets saw one of their longest winning streaks for quite some time, a bit of pushback from nervous traders and investors was probably inevitable. As if our lead article of last week had jinxed markets into action - sure enough - this week saw the longest streak of falling global equities since March. Before we get ahead of ourselves here, we should point out that this ‘losing’ streak means consecutive days of declining market value and not the actual amount that markets have lost – the actual decline has been a modest 1-2% across most regions. Still, no good mood goes unspoilt for too long, it seems.

Amid the worries we’ve seen about markets running too hot and valuation levels becoming unsustainably high, a market hiatus like this gives the bears (those expecting market declines or even recession) a chance to scout for evidence that all is not well. Unfortunately, it looks as though they’ve found some.

Over the past year, yields on two-year US Treasury bonds have risen around 0.7%, while yields on ten-year Treasuries have risen only 0.12%. In finance terms, this is called a flattening of the yield curve – a narrowing of the term spread (the yield difference) between short and long-term bond yields. Normal yield curves tend to slope upwards, as longer-term bonds come at a yield premium to those with shorter maturities, due to the longer lock-up until the bond matures. This ‘normal’ situation is supposed to indicate market confidence in a country’s short-term economic prospects (provided the yields aren’t just high across the entire curve). Conversely, a flattened or (especially) inverted yield curve – where long-term bonds yield the same or less than short-term ones – indicates a lack of confidence.

Why does this matter? The yield curve is usually one of the more reliable general indicators of economic prospects (in the US at least). An inversion of the treasury yield curve has preceded every US recession since the 1960s (and there have been no ‘false alarms’ – inversion but no recession – see the chart below - whenever the blue line has dropped below 0, recession soon followed). More than simply reflecting markets’ verdict on the economy, the yield curve also has a big effect on bank profitability. Banks make money off the spread between short and long-term yields, borrowing or taking deposits at the short end and lending at the long. When the spread tightens, a major source of profit dries up, and with it the banks’ lending ability. This cuts off financing to the real economy, choking opportunities for growth.

Blue line: Difference between 10 and 2 year US government bonds yields of = steepness of yield curve
Red line: Manufacturing PMIs as indicators of economic health;
Shaded areas: Recessions
Jan 1980 – Nov 2017; *Source:* Factset;

So, naturally the current flattening has many investors worried. Should they be? Short answer, not really. Long answer…

First of all, we should remind ourselves that this isn't a case of inversion or even complete flattening, the curve is just flatter than it was a year ago. And, while inversion may be a pretty reliable guide to growth prospects, relative flattenings aren't as much. At the beginning of 2016, the difference between 2 and 10 year treasuries fell to what was then its lowest in eight years. Much like now, many doomsayers gripped onto the news as proof of oncoming turmoil; unlike now, they had an almighty stock market wobble to back them up. But there was no disaster to be found. Both global growth and capital markets surged to extremely healthy returns in 2016, despite the yield curve continuing to flatten throughout most of the year.

We have to look at both the likely causes and effects of this particular flattening to see what it says about future growth prospects. Often yield curve movements are partly symptomatic of economic developments and partly influential on them – reflecting general economic expectations *and* causing actual changes through bank profitability.

We don't believe the flattening we're seeing at the moment is about markets expecting a downturn, but instead about the particular set up of the bond market at the moment. In Europe, the ECB's ongoing QE purchases have pinned the 10-year German government bonds (called bunds) down at around 0.4%. This, in turn, has a large effect on 10-year treasuries, as their subsequent price advantage over bunds (higher yields mean lower prices for those purchasing the bond) makes them more attractive. The same dynamic is also true in Japan, where their central bank has pinned 10-year government bonds at an even lower yield. This has effectively anchored the long end of the US yield curve down at its current level. Meanwhile, the Federal Reserve (Fed) is pushing up the short end of the yield curve through raising interest rates – with another rate hike expected in December. Like in many other areas, QE is somewhat of a game-changer for bond markets, and so we can't expect the same old indicators and dynamics to hold true.

That settles the question of cause, but what about effect? Even if the yield curve flattening isn't a vote of no confidence in the economy, it can still have a material impact through falling bank profitability. But again, QE could well have an effect here. As the Fed begins to unwind its own QE process and release its stockpile of assets, a tactical approach could help. Were they to disproportionately sell – or even just wind down purchases of – the bonds at the long end of the yield curve while maintaining their stock of short term bonds, this would effectively force a steepening, allowing banks to profit and thereby lend more credit to the real economy.

Of course, the Fed might not want to pursue that policy of 'artificial' steepening. Indeed, a large part of unwinding QE is about removing central bank crutches and letting private credit creation take over. But, the point is that the central bank has these policy options available if it looks like their activity at the other end of the curve – through interest rates – is having a damaging effect.

Besides, the economy doesn't live or die by bank profitability. The entire reason why US rate rises are expected to lead a general global monetary tightening is because economic conditions *do* look favourable. Global economic resilience, a strong labour market (which should lead to wage growth) and good financial conditions could well pick up the slack where central bank support drops off.

The yield curve is a good tool for looking at economic developments, but we shouldn't think of it as an 'omen'. At the moment, we don't see too much reason for concern. But, things could well change if the flattening turns into inversion. In that case, we may have to take another deeper look and also consider widening junk bond yield spreads; their jump upwards over the past week was equally welcomed by the bears. However, just as with the yield curve, we have seen similar moves over the past 12 months.

As discussed at length last week, equity markets are overdue a bout of volatility, after having reached all-time highs while trading at exceptionally low volatility. However, for a near term correction or general market consolidation to turn into a full-blown bear phase it would require a significant deterioration of the general economic outlook around the world. Such a scenario is not currently anywhere on the horizon and, to the contrary – as we discuss in the third article – global growth looks more resilient than it has for a long time.

Q3 earnings wrap up: Europe and Japan shine

Now that 90% of companies have reported their Q3 earnings, we are in a good position to summarise the key highlights. Both profits (Earnings Per Share – EPS) and, importantly, top line sales growth printed better than expected, with Europe and Japan the clear standouts.

Global economic growth has remained robust and commodity prices have been generally stable, resulting in a favourable corporate backdrop. The real drivers of asset prices this year has been stronger and better than expected company profits, as well as improving business confidence.

However, doubts over the timing of US tax reform (which would boost EPS if corporate taxes were lowered), and a deceleration of growth from previous quarters, suggest that the fuel for further rises in equity prices is running low. This potentially might lead to more soggy markets into the year end, as investors seek to protect some of the strong gains made in 2017.

Summary of Q3

In absolute terms, growth rates in Q3 were lower than those seen in the stellar Q1 and Q2 periods. Q1 was the best earnings season in nearly seven years, while Q2 also proved to be healthy.

Admittedly though, those quarters' results might be a little skewed by the base effect of low earnings levels 12 months prior.

Regional performance - profits

Globally, Q3 EPS was slightly above analyst estimates. The period delivered a number of positive surprises, with a majority of companies beating expectations in all the main regions. There were some notable negatives, mainly General Electric and rising talk about 'value traps', but more on that later.

Japan was the clear standout, with EPS rising +16% year-on-year (YoY). Europe, meanwhile, posted +10% YoY and the US grew +6% YoY. Higher energy prices appeared to boost overall growth numbers. Excluding the energy sector, EPS rose +6% in Europe and +4% in the US.

Regional performance – sales (also called top line growth)

In sales terms, Japan again beat the rest, thanks to a sharp fall in the value of the Yen, which boosted exports. 62% of Japanese firms beat sales forecasts, with all sectors posting positive sales growth.

Top line growth was solid globally, with Japan up +8% and around a 5-6% increase in the US and Europe. We note that there was a higher than average number of companies beating sales forecasts in Japan and the US, but a lower than average number in Europe, suggesting firms struggled to combat a higher Euro. As further evidence of this, sales achieved by European firms were generally softer for exporters versus domestic players.

As with EPS, sales numbers overall were boosted by the rebounding energy sector. Ex-energy, sales grew +4% in the US and +3% in Europe. Investors often take more notice of higher sales than higher profits, because profits can be altered by cutting costs using share buybacks (which lower the number shares in circulation) to increase EPS. While cost cutting and share buy backs have limits, rising sales tend to imply that a firm is gaining market share or that the general economic backdrop is improving.

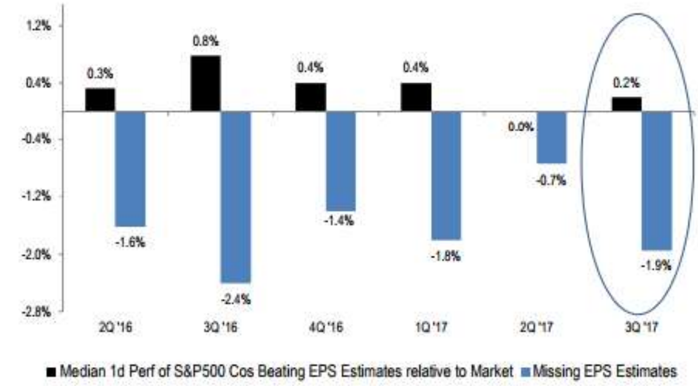
Sector performance

Cyclicals, as represented by technology, materials and energy, delivered much stronger EPS growth when compared against more defensive stocks like telecoms and utilities. It was a more mixed picture for industrials, consumer discretionary, financials, staples and pharmaceuticals.

It is worth noting that, in this quarter, US share prices (next page, left chart) and European share prices (right chart) behaved differently to each other when companies beat or missed expectations. In the US, the reaction was more asymmetric or negatively skewed if a firm missed compared to one that beat estimates. US companies saw a positive median gain of +0.2% when exceeding estimates, but a -1.9% median fall in reaction to a miss. The dynamic in Europe was more balanced at +0.3% to a beat and -0.5% to a miss.

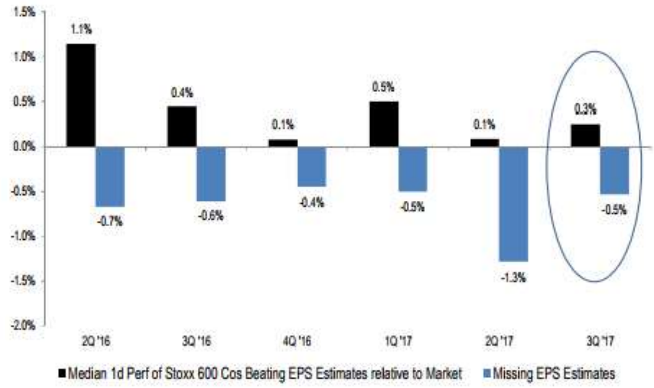
This would suggest that investors were more sensitive to a company missing estimates in the US than in Europe. This is likely a consequence of higher average market valuation levels and therefore more nervous investors in the US.

Figure 11: US Stock price reaction to quarterly EPS beats/miss



Source: Bloomberg, J.P.Morgan

Figure 12: European Stock price reaction to quarterly EPS beats/miss



Source: Bloomberg, J.P.Morgan

Summary and moving into Q4 17

EPS momentum remains more resilient relative to previous years. Positive earnings growth should continue to act as a tailwind for stocks as we head into 2018, but momentum is likely to reduce, given that comps (comparisons) will get more challenging (due to strong growth in previous quarters).

Looking at estimates for Q4, average EPS growth in Europe is projected at +9%, and +12% in the US. While at face value, these forecasts may look elevated, we note that the median Q4 estimates are lower, at +5% and +7% respectively. We see these as more realistic hurdles, given still healthy levels of global activity (PMIs) and higher energy prices.

One positive factor for investors is that nearly 60% of S&P 500 firms upgraded their guidance to the highest level in 5 years. This bodes well for the general economic outlook, as this should translate into higher levels of business investment, which contributes to GDP growth and has woefully lagged over the past decade and economic cycle.

As QE (quantitative monetary easing) programmes morph into QT (tightening), another source of upward market fuel is taken away, which reduces today's value of future earnings (higher discount factors in net present value calculations). So, there is the risk that stocks could become more vulnerable to concerns over slowing economic dynamics. Resilience in both profits and sales growth would constitute a valuable stabilising force. That is not to say we expect significant upside from today's levels, but rather suspect that further upside potential will be more closely tied to actual earnings growth instead of higher valuation multiples as is usually the case at this stage of the economic cycle.

It is somewhat ironic that post-financial crisis we saw good stock returns amid lacklustre economic progress, driven by strong profit growth and a premature expansion of valuation multiples as from QE. Now, we have the opposite scenario: better economic growth, but relatively softer profit growth and not much further upside to valuation multiples, leading to expectations of less dynamic equity market returns.

Economic and market cycles

Data and opinion often move in different directions. On the one hand, we continue to see (and forecast) solid upward trends in macro-economic data and corporate profits for most global regions. On the other, economists and market strategists are questioning the underlying data relative to the current trend – pointing markets in the other direction, or at least hinting that current trends are not sustainable.

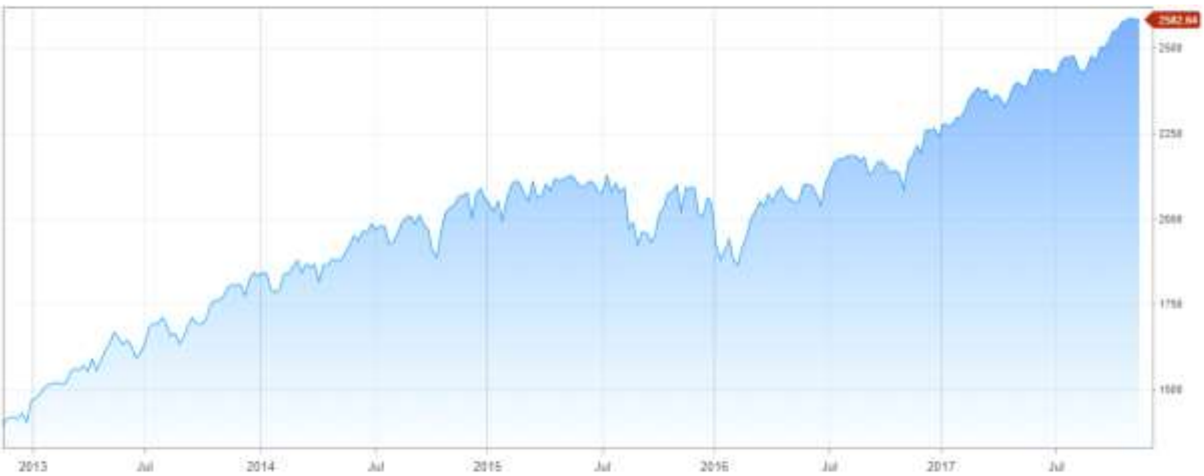
By way of example, late last month, the IMF's (International Monetary Fund) update on the global economy was less than "bullish". Even though there has been a global upswing in economic activity, with global growth projected to rise to 3.6% in 2017 and 3.7% in 2018, their report suggests that growth remains weak in many countries, and that the long-term outcome in many regions is uncertain.

Indeed, the rate of growth may be decelerating a little in the US, credit is beginning to tighten in China, and Brexit side effect slow the UK's growth. But, we have a less pessimistic view about future global economic conditions even if we remain vigilant about shock risk potential. Moreover, a generally pessimistic view would have contrasted with the record levels now being achieved in US (and other) equity markets, coupled with the lowest levels of market volatility for some time.

Indeed, many equity markets have never fared better. While the Dow Jones and S&P took marginal losses on the back of concerns over a flattening yield curve and rising junk bond yields, the Dow Jones Industrial Average reached a record high this month of 23,563, and the S&P 500 Index has been doing equally well (see graph below).

Of course, the more recent increases in US equity markets may have been partly driven by expectations of reform in the US tax system – president Trump's campaign to promote growth by cutting corporate and individual taxes. Elsewhere, however, the FTSE 100 Index reached an all-time high of 7,562 in November, while, earlier this month, the German DAX 30 Stock Market Index also reached a high of 13,478. Therefore, it is not just US investors driving the equity markets.

Record highs: S&P 500 Index (5 years to date)



Source: Bloomberg.com, November 2017

Against the backdrop of persistent and widespread scepticism – if not outright fear – over valuation levels, it is reasonable to assume that these conditions are not being driven by any form of *irrational exuberance*, but by the underlying data – whether economic, earnings related, valuations-based or some combination thereof. Clearly, identifying and isolating the underlying cause of multiple price movements, or the precise nature of certain valuations, is fiendishly difficult.

However, it is less difficult to apply some simple analysis to the aggregate (upward) movements in markets in order to "test" whether the trends appear rational and/or sustainable.

Firstly, the global economic data appears at least benign, if not wholly positive (is it ever?). For example, broad-based upward revisions by the IMF (and others) for the Eurozone (EZ), Japan, Asia, and even Russia all imply that the global baseline outlook continues to strengthen. As for the EZ, we have very recently written about the favourable conditions taking hold across there. year-on-year, the EZ economy grew 2.5%, beating the market consensus of 2.1%.

Turning to the US, we note the recent uptick in retail sales and (core) inflation, helping to maintain the positive US economic momentum. US economic growth is now running at an annualised rate of ~3%. As for unemployment, at just 4.1%, it is probably as low as it is ever going to be (give or take a margin of error). That said, US business may struggle to accelerate any further in the face of headwinds, like interest rate increases and labour shortages.

In China, according to latest reports, a cooling property market and tighter credit conditions point to an impending growth slowdown. However, China has achieved unexpectedly strong growth at 6.8% year-on-year in the first 3 quarters of 2017 and, as a result, the economy remains on course for its first annual acceleration since 2010.

Some economists have argued, correctly in our view, that the current pace of Chinese growth cannot be sustained since it relied on significant credit-fuelled growth in property and infrastructure in 2016 (and before). However, the changes to credit policy in China should be viewed as helping to rebalance the economy, as opposed to a form of constraint on overall activity. In any event, given current data and momentum, it is difficult to envisage China's economy slowing to less than 6.5% growth.

So, what about valuations? Well, a recent Bank of America (Merill Lynch) survey states that 48% of the investors surveyed in November said that equities were "overvalued". It is important to note, however, that with many of the equity indices reaching record highs, investments will tend to be viewed as "riskier".

That is, the probable reward relative to the assumed risk may become lower and/or less certain. This does not necessarily mean stock markets are "overvalued". On average, underlying earnings yields continue to track at similar margins above the yields of less volatile forms of capital investments, as they have done historically. Moreover, the same survey found that 56% of investors surveyed assume there will be a continuation of so-called "Goldilocks" conditions (defined as high growth with low inflation).

In our view, the overall economic picture is not inconsistent with the recent and on-going developments in the various equity markets. We agree that economic conditions in the US and China may be set to moderate a little, but neither of these economies is likely to experience a material contraction or recession. The prospect of either would of course cause a contraction in equity markets.

Furthermore, equity valuations and any exuberance are as much a reflection of financial conditions as they are of individual price/earnings forecasts, asset valuations etc. For example, monetary policy in all advanced economies remains very loose, potentially even too loose. Therefore, absent a significant downturn in the economic data for the US, China, EZ and other regions, or policy errors in central bank monetary policy, the current record equity market levels may be better supported by the economic reality than many nervous market commentators would have it. However, as pointed out in the earlier article on Q3 earnings results, further upside in stock markets could increasingly be limited to actual earnings growth, while valuation multiples will be stress-tested by rising interest rates and yields.

Value traps

In our article on earnings, we mentioned talk about so-called value traps in relation to industrial powerhouse General Electric (GE). The term ‘value trap’ is one that seems to have been forgotten in recent years, but GE’s troubles above have sparked our collective memories.

Troubles at GE?

At their Q3 earnings announcement, GE’s CEO, John Flannery, said some troubling things for investors. This caused a whopping 8% fall in pre-market trading – one of the biggest single daily moves in the company’s history.

GE slashed its full-year 2017 profit forecasts by 30% to $1.05-1.10 a share, which is well below sell-side consensus of $1.54 a share. 2018 forecasts were also cut to $1.0-$1.11, which was below Wall St’s $1.18 a share. GE also shredded expectations by reporting a Q3 EPS of $0.29 – almost 50% lower than the $0.50 consensus estimate.

Below are some other ‘highlights’ that hit the newswires on the 13th November:

- *GE TO BORROW $6 BILLION FOR PENSION CONTRIBUTION, CEO SAYS
- *GE CEO: ALSTOM ACQUISITION PERFORMING BELOW EXPECTATIONS
- *GE CEO: GE POWER EXACERBATED ITS PROBLEMS W/POOR EXECUTION
- *GE CEO SEES `LIMITED' M&A IN THE NEAR TERM
- *GE CEO: NEW, SIMPLER EARNINGS METRICS TO FOCUS ON CASH

Ouch. But the pain did not stop there. GE announced a bigger than expected 50% cut to its dividend, from 24 cents to 12 cents a share, as the company saw a sharp drop in cash generation. Worryingly for investors, the troubles are not due to broader economic conditions, but more company-specific issues. We would not be surprised if GE announces significant corporate restructuring or more radical moves, like breaking up the 125-year-old company to unlock shareholder value.

Value traps

Essentially, a value trap is a stock that looks ‘cheap’ on valuation grounds – such as on a Price to Earnings (PE) or Price to Book (P/B) basis, but never really manages to grow profits and sales beyond a certain natural limit, excluding corporate actions like M&A. Typical examples are firms like utilities, fixed line telecoms or even large industrials like GE. Might Apple become the next value trap, absent its next big growth driver?

Such firms generally offer higher dividends to increase their attractiveness with investors to compensate for lower growth potential. They can act as shock absorbers when markets fall, relative to higher growth stocks.

However you look at it, investors appear to prefer growth (hence higher PE's – faster profits growth) over value, and not just in 2017 (see table below). Over the past 10-years, growth has outperformed value by around 2:1 – value investors seem to be patient people.

Consider the following:

	2017 YTD		2017 YTD	Difference
Russell 1000 Growth	24.8%	Russell 1000 Value	6.3%	+18.5%
Russell 2000 Growth	15.7%	Russell 2000 Value	2.1%	+13.6%
S&P500 Growth	22.5%	S&P500 Value	7.3%	+15.2%

How can we identify value traps?

We believe there are a number of factors that can help us to find and steer clear of such firms.

1. Peak earnings occur with peak in operating or business cycle
    - After 7 years of economy recovery, most firms should be close to peak earnings. If not, then there could be a problem (this excludes commodity firms like oil & gas)
2. Underperformance does not result in changes in CEO/board pay
    - Declining share prices should normally force changes in top levels of pay. Lack of this is an indicator that something is wrong.
3. Management composition and group thinking
    - Boards made up of similar people may lack diversity and the ability to bring about change.
4. Company continues to lose market share
    - Value traps often lose market share to new or more advanced competition. Until there are gains in market share, a stock will find it harder to move higher.
5. Entrenched or large powerful shareholders
    - The car industry is a good example, since union and government pressures can slow the pace of change. At Volkswagen (partially state owned), could the emissions problems have been resolved earlier? If the ROC (Return on Capital) has to battle against vested interests, then change is slow.
6. Capital allocation process is opaque
    - Value traps can still generate strong cash flows, but the 'trap' is how the business uses that capital to reinvest for growth. What new opportunities are there that will benefit shareholders?

7. “You will know them by their fruits”

    - Can the company change its operational DNA to improve the business so that even customers see a difference?

8. Are business goals achievable?

    - Value stocks ‘work’ when profits grow according to plan, allowing multiples to marginally rise.

9. Debt or leverage too high?

    - Is the debt load sustainable during a turnaround? High debts make value traps deadly, as interest expenses cripple management’s ability to turn a company round.

10. Value traps lack long term vision

11. CEO and Chairperson are one and the same

    - CEOs are estimated to spend about 25-40% of their time managing the board. A value trap, by its nature is a corporate turnaround, often requiring 100% of the attention of the senior management team.

12. Lack of involvement of shareholder activists

    - A firm with easily resolvable issues should attract the attention of activist shareholders. If they stay away, maybe you should too.

The list above is not exhaustive, but can provide some pointers for further research. As historic stock returns have shown, growth has had a strong run, but value has its place and usually takes the reins in terms of investment return towards the end of the cycle. Investors should therefore neither assume that growth stocks will forever remain the winners nor automatically assume that being ‘cheap’ in value terms automatically makes an attractive value stock.

Caveat emptor or buyer beware!

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	LATEST	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7383.7	-0.7	-49.3	↘
FTSE 250	19830.1	-1.0	-190.7	↘
FTSE AS	4054.3	-0.7	-29.7	↘
FTSE Small	5755.9	-1.1	-65.1	↘
CAC	5320.9	-1.1	-59.8	↘
DAX	13014.9	-0.9	-112.5	↘
Dow	23387.1	-0.2	-35.1	↘
S&P 500	2581.1	0.0	-1.2	↘
Nasdaq	6334.7	0.4	25.6	↗
Nikkei	22396.8	-1.3	-284.6	↘

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.32	0.02	OIL	62.1	-2.2
USD/EUR	1.18	1.00	GOLD	1286.2	0.9
JPY/USD	112.31	1.09	SILVER	17.1	1.3
GBP/EUR	0.89	-0.95	COPPER	308.1	-0.5
JPY/GBP	6.63	0.21	ALUMIN	2102.0	0.4

Fixed Income

GOVT BOND	%YIELD	1 W
UK 10-Yr	1.309	-0.03
US 10-Yr	2.351	-0.05
French 10-Yr	0.715	-0.06
German 10-Yr	0.369	-0.04
Japanese 10-Yr	0.036	-0.01

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PROVIDENT FINANCIAL	5.7	MEDICLINIC INTL.	-7.2
VODAFONE GROUP	5.6	BABCOCK INTL	-6.5
BRITISH LAND CO	5.6	GKN	-5.8
TESCO	4.4	CAPITA	-5.6
ROYAL MAIL	4.3	UNITED UTILITIES	-5.5

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.6
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.0
Standard Variable	4.3
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	23.5	Brazil	179.8
US	24.5	Russia	135.3
France	18.3	China	61.1
Germany	10.0	South Korea	68.9
Japan	32.5	South Africa	197.1

For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

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