Monthly Commentary 2nd February 2017

Markets were "OK" in January. Equity markets rose in the US and Emerging Markets, while they fell slightly in the UK and Europe. Government bonds in the Euro area and the UK tanked, and in the US they continued to fall, but at a more modest pace. Commodities, ex-precious metals, fell modestly. The USD also took a breather and fell 1.7% (on a trade-weighted basis) in January.

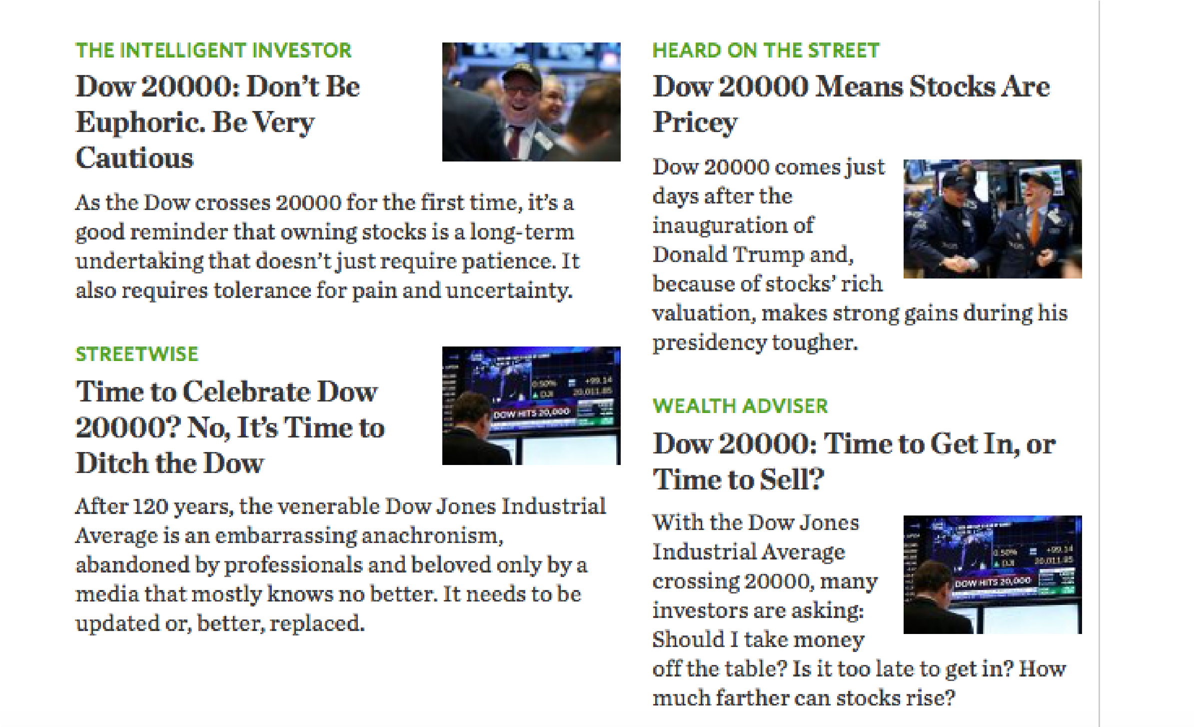
The "Trump Trade"

The above title has now joined the financial lexicon. A lot is being written on how the new US administration's policies will affect world markets.

Let's look at what is happening first before addressing the issue.
The Trump-trade euphoria has indeed mostly continued into 2017. What are the positives or near-positives?

- The corporate profit outlook is encouraging in the US, with an expected 10% earnings per share growth for this year. This had almost nothing to do with Trump as the beginning of his presidency coincided with a return (and also an uptick) in earnings growth. Should any tax cuts materialise, which are on his agenda, earnings growth could be even higher.
- The US trailing PE ratio is currently at 19.6, (only) 5% higher than the 20-year average (MSCI US). The forward earnings ratio is 17. High, but not excessive.
- It seems that the two stalled pipelines, which are huge infrastructure projects, will go ahead. If you add the "wall" on the southern border, then perhaps infrastructure spending will indeed boost GDP.
- Many new jobs are still being created, consumer spending is holding up very well, and housing is strong. It is highly unlikely that a recession will follow in the next 12 months. A pending recession is the most usual reason for a large fall in the markets.
- Europe is coming out of its funk and many indicators are pointing north. This includes a large drop in unemployment and good business and consumer numbers. For how long this lasts is anyone's guess, but valuations are far more reasonable and sentiment is still negative (mostly due to politics). It is the only equity market that Citi Private Bank has as "underweight" on. We would not be surprised if Europe delivers the best returns in the developed markets this year.

With regards to what the pundits are saying, it seems quite a consensus call that the markets will rise until the summer and then reverse when they realize that many of Trumps' promises might not be fulfilled. This scenario fits too well into a "box" and we are reluctant to embrace it. On the other hand, investor sentiment is not as giddy as recent market strength might justify. Anecdotally, the day the Dow crossed 20K, the Wall Street Journal had four major articles. Three of them were "negative" and one was "neutral". This can be counted as a contrarian indicator that the markets are nowhere near the top:



THE INTELLIGENT INVESTOR

Dow 20000: Don't Be Euphoric. Be Very Cautious

As the Dow crosses 20000 for the first time, it's a good reminder that owning stocks is a long-term undertaking that doesn't just require patience. It also requires tolerance for pain and uncertainty.

STREETWISE

Time to Celebrate Dow 20000? No, It's Time to Ditch the Dow

After 120 years, the venerable Dow Jones Industrial Average is an embarrassing anachronism, abandoned by professionals and beloved only by a media that mostly knows no better. It needs to be updated or, better, replaced.

HEARD ON THE STREET

Dow 20000 Means Stocks Are Pricey

Dow 20000 comes just days after the inauguration of Donald Trump and, because of stocks' rich valuation, makes strong gains during his presidency tougher.

WEALTH ADVISER

Dow 20000: Time to Get In, or Time to Sell?

With the Dow Jones Industrial Average crossing 20000, many investors are asking: Should I take money off the table? Is it too late to get in? How much farther can stocks rise?

Negatives also abound, but that's what makes markets:

- The adverse impact of a stronger dollar could crimp earnings prospects for U.S. multinationals and lower sales prospects for exporters.
- Inflation expectations are rising, so the Fed might act more aggressively. This can spook the markets.
- Trade policies can lead to protectionism and retaliation. Not good for markets.
- Geopolitics rarely affect markets in the medium term but any steep deterioration in US-China relations will be very negative for markets.

What to do – the case for staying in the markets

A sharp reversal can happen any time and one can argue that the markets need a breather and they will find any excuse to fall. Unless it is caused by very bad news, we suspect that investors will "buy the dips" as there are enough secular and cyclical forces to keep the economic expansion going for a while.

How does one protect portfolios in such instances of sudden drops? Gold is hardly a safe haven anymore. Buying volatility would be a good hedge, but it is difficult to implement in practice. Cash is probably the only defense, but there are risks, as we note below. And if one sells, when do they get back in?

It is well known that trying to time the market is almost impossible – both for professional and retail investors. Missing the best days in the markets can substantially affect returns. The table below from Merrill shows the well-known and oft-repeated statistic that if one had missed the best 10 days in the US markets each decade, the returns would be far worse than staying fully invested.

S&P 500 returns by decade excluding the 10 best days

Decade	Price Return	Excluding best 10 days per decade
1930s	-42%	-79%
1940s	35%	-14%
1950s	257%	167%
1960s	54%	14%
1970s	17%	-20%
1980s	227%	108%
1990s	316%	186%
2000s	-24%	-62%
2010s	95%	34%
Since 1930	10055%	31%

Source: S&P; BofA Merrill Lynch US Equity & Quant Strategy

This is because some of the best market returns come at the end of bull markets, when too many investors are "scared" and sell way too soon. It is also caused by those whose tolerance for pain decrease as markets drop and they tend to sell after large falls, whereby they crystallize their losses.

Another noteworthy statistic from Merrill is that the probability of losing money in the equity markets depends on how long one stays invested. The following chart is something investors need to be aware of when they consider their investment horizon.

As you can see, the longer one stays exposed to the equity markets, the smaller the chance of losses.

Probability of negative S&P 500 returns over different time horizons (1929-present)

Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

While we do not suggest that investors limit their opportunities to shift portfolios and respond to market events, we favour strategies that maintain a risk-appropriate allocation to equities as per each investor's investment objectives, rather than attempt to time the market.

If portfolios are well diversified, invested in high quality securities/funds, costs are maintained as low as possible, and rebalancing occurs when allocations become skewed, then an investor does not need to worry about when the next rally or decline in markets will come.

The Elgin Analyst Team

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