Monthly Commentary 3rd November 2018

Anyone "Hunting for Red October" only had to look at global financial markets to see the carnage. Even the mighty US market fell almost 7% and there was nowhere to hide as large losses reminded investors that markets do what they want to do and when the least number of market participants expect it.

What happened?

The numbers appear brutal. By the end of October, most indices logged **large falls from their most recent yearly highs.** In the equity world, these included: World -11.9%, US -7.8%, Euro area -13.8%, UK -9.8%, Japan -10.3%, Emerging -25%. Global bonds were not spared either, with investment-grade (supposedly safe) bonds down between 1.5% and 3.8% from their recent highs. Commodities fared worse, with oil falling almost 15% and gold 11% from this year's highs. Finally, currencies such as sterling, the euro and the yen all fell sharply (between 7% and 11%) versus the USD.

So, in summary, there was nowhere to hide other than cash.

Why did it happen?

All sorts of reasons have been cited: Rising US interest rates, trade tensions, the too-long duration of the current US economic expansion, high valuations in the US, weakening global growth ex-US, Italy's clash with the EU and a possibly messy Brexit.

Are these valid causes for the selloffs?

Perhaps. It is easy to make this argument as investors always seek explanations. The fact is that all of these reasons have been around for a long time and have been analysed to death. What is intriguing is why the market decided to fall at this juncture when all the posited reasons have been known for a while.

What is Elgin's take?

It actually does not matter, as our take, together with multiple others' assessments of the current situation is ignored by the markets. What matters to us is putting this selloff in the context of our investment philosophy (we shall explain this later). What we can present below are some arguments from some serious players in the world of finance.

Morgan Stanley analysed the last 65 years of the US market and the last 27 years of global markets. They found that sharp initial drops as the ones in October are hallmarks of run-of-the-mill corrections, defined by declines of between 10% and 20% in equity prices. On average, recovery follows within six months, and a rally within a year.

By contrast, bear markets typically start with deceptively gentle drops. From its last peak on Sept. 20 until the market close on October 25th, i.e. 35 days, the S&P 500 fell 7.8%. Judging by history, this looks like a correction. These have started with a median 6% fall over the same length of time, compared with 4% for bear markets.

In fact, following the 10 largest 35-day selloffs, stocks ended up bouncing back in nine cases. Only one eventually turned into a more-sinister bear market. The current rout falls in seventh place, whereas the 2007 selloff that heralded the global financial crisis—and a 36% stock- market loss within a year—doesn't even enter the ranking: It started with a 5% fall.

A likely explanation is that markets don't become smarter overnight: Useful information that shows the end of the economic cycle drips in over time. Sudden changes of heart on how to interpret the available data are more often just irrational. If history is any guide, the bear market, when it finally comes, will arrive with a whimper, not a roar.

Merril Lynch say that there has never been a bear market without a recession following soon after. Their economists argue that there is a good reason to expect a soft landing: economic fundamentals remain healthy. Households are in good shape. Consumer borrowing rates are still low, leaving the ratio of debt service to income near record lows. Business confidence remains very high, particularly among small businesses. Growth overseas has slowed, but is still above its long run trend. The dollar is slightly strong, but not enough to have much impact on exports. In other words, the economic recovery is old, but healthy. No recession seems imminent.

Additionally, Merrill's strategists argue that investor sentiment is too negative and institutional cash levels too high for the market to fall into a bear. Both of these signals are tried-and-tested contrarian indicators.

Valuations

One often-used fear is that valuations are expensive. In fact the US market (which is by far the most expensive), has an expected P/E (price to earnings) ratio of 16.6, a level not seen since 2013, and well below its 5-year average of 17.4.

Europe is even cheaper at a forward P/E of 13, well below the average of 14.5 of the last 5 years. The UK market is even cheaper than that, with the expected P/E ratio currently at 12.8, vs a 5-yr average of 15.3. This suggests that valuations are not the culprit.

Our investment philosophy

We have always used a three-pronged philosophy for investing:

1. Each client's mandate is based on their long-term investment objectives and their tolerance to risk. We are aware of both and implement accordingly.
2. We diversify as much as possible within the client's mandate.
3. We buy quality (and liquid) assets and do not speculate.

The worst thing an investor should do is panic and sell when markets are falling fast. Such trading is often counterproductive; from 1995 to 2015, investors earned about half of the market's return, on average, due to "greed and fear," or buying high and selling low.

Citigroup recently pointed out that for those with properly diversified global portfolios - set for a risk tolerance an investor can bear – there is much more to gain than fear from patient, long- term investing. For example, **a medium-risk globally diversified portfolio** lost as much as 12% in value in the year through mid-2016. But of course this was recovered. Even including the 2008-2009 period – the worst economic and financial crisis since World War II – such a portfolio shows no negative returns for a five-year or longer holding period.

We'll end with a quote from Patrick Palfrey, an equity strategist at Credit Suisse:

"*I'll be honest, I have a hard time explaining this. There isn't a single item that is the smoking gun behind the selloff. Concerns around trade or tariffs, concerns around valuations, concerns around peak earnings -- you name it, and I promise you I've heard a client trying to attribute it to that. I don't think any of them fit*."

This too shall pass.

The Elgin Analysts' Team

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