Monthly Commentary 5th December 2017

November was a mixed month for equity markets, with US and Japanese equities doing very well (up more than 2%) and Euroland and UK equities losing more than 2%. Bonds did not move much and commodities were up slightly. Sterling and the euro strengthened versus the dollar.

It's this time of the year when every investment house, big and small, give their crystal ball views on the economy and markets. We read many reports. Not so that we can agree or disagree with what they write, but we think it is important to understand how they think of the future. Like every year, after reading thousands of pages, we shall conclude that there are so many moving parts that most predictions will be wide of their targets. So rather than bore you with what they are saying, this newsletter will have various tidbits that you may find interesting and/or amusing.

Potential US tax cuts – adding fuel to the fire

The US Senate passed a major overhaul of the US tax code. Should the House also pass something similar, it seems that the US will get their first major tax cuts in more than 30 years.

The markets in the US had been rising in anticipation of the legislation, as there will be a huge impact on companies' earnings growth. There are estimates of a one-off 10-15% increase in earnings per share for S&P 500 companies (small caps will probably benefit even more). There will possibly also be a recurring benefit of 8% in earnings growth in the future. This is massive.

Is it needed though? With unemployment close to 4%, a hot equity and housing market, very low interest rates and today's solid double-digit corporate earnings growth, is burdening the country with potentially over a trillion in more debt in the next 5-10 years a wise move?

Is it the case of "buy the rumour sell the fact"?

Elevated valuations?

By many measures, the US market is very expensive.

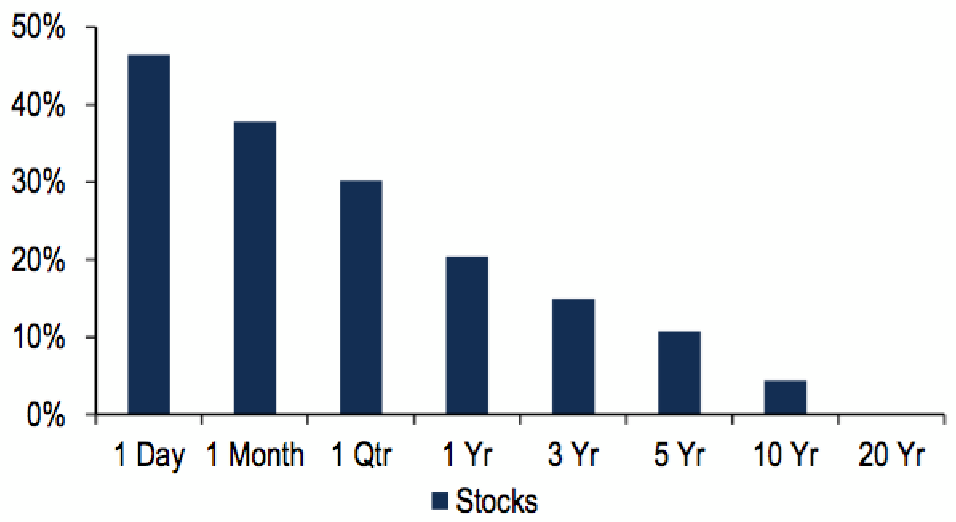
According to Merrill Lynch, valuation metrics are a lousy predictor of the near future, but over a longer time horizon they are quite prescient. "Price-to-normalised-earnings", Merrill's preferred valuation metric, has explained 80-90% of returns over the subsequent 10+ years. A regression analysis on current levels suggests compounded annual total returns of 7% over the next seven years with a 90% confidence interval of 3-10%. This is below average returns of 10% over the last 50 years, but asset allocation is a zero-sum game, and 7% gains still win in a low-return world. Assuming a 2% dividend yield, their model's implied price return of 5% per year indicates that the S&P 500 should reach 3500 within the next decade.

Not bad at all if it turns out as predictive as Merrill claim! But of course we could get a nasty correction or bear market in between.

Sentiment and long-term returns

With an increasing number of strategists being bullish on equities for 2018, we are rather worried that sentiment is becoming a bit too frothy. This is often a contrarian indicator and returns may not be as good as most predict. So while we can brace ourselves for a potentially meaningful correction, we should keep in mind that remaining invested has produced much better returns than trying to time the market. Below is an updated table from Merrill that makes a strong point for remaining invested.

Probability of negative returns over different time horizons (1971-present) – stocks (S&P 500)

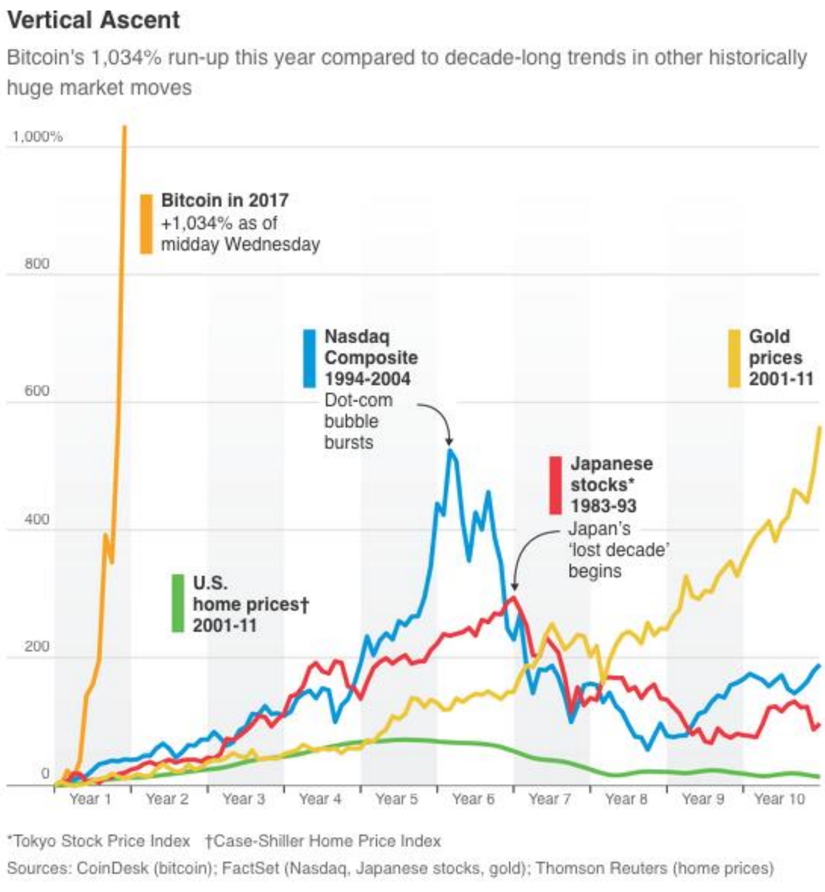


Source: BofA Merrill Lynch US Equity & Quant Strategy, S&P,

Smells & looks like a bubble. Is it a bubble?

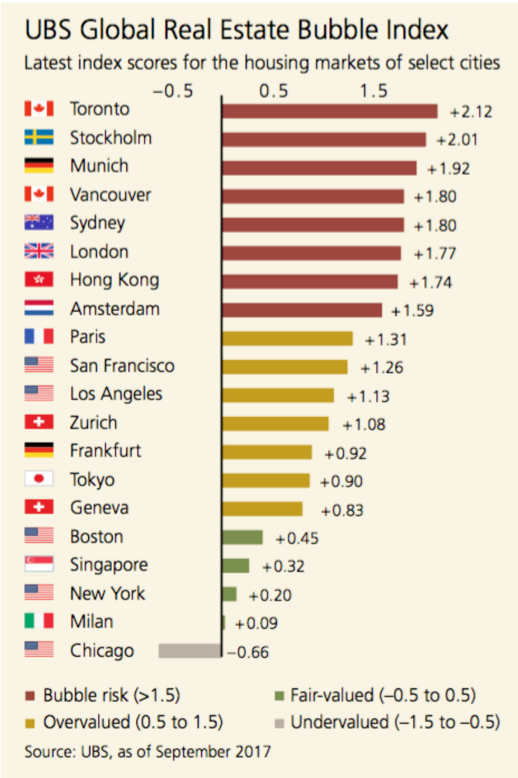
In September, when it was around $3500, we wrote a piece about how to buy Bitcoins. We are not sure if any of our clients acted on this. Since then, much as it has been doing all year, Bitcoin is flying.

Is it a bubble? See below from the Economist and make your own mind.



Real estate anyone?

Finally, with both equities and bonds being expensive, one might consider real estate. The graphic from UBS below will help you decide if you want to buy in a major city. No comments



We wish you all the best for the New Year.

The Elgin Analyst Team

Disclaimer