Monthly Commentary 5th August 2021

July was more or less a flat month for world equities overall, with US equities doing better (up more than 2%) and emerging markets tanking (down more than 7%), mostly because of huge falls in China. Investment-grade bonds had a good month (up more than 1%) as yields generally fell, against expectations. Commodities were up 2% and the USD was down slightly. Bitcoin was up about 20% following its recent halving in price from its previous peak.

On expected returns and valuations

The future performance that clients can expect from their portfolios is probably the most frequently asked question we get. And of course, it's a very difficult one to answer. Not only does it assume that we can predict the future, but many believe that because we are "experts" this is part and parcel of our offering. How far from the truth. Like most serious financial professionals, we rely on ever-evolving models to offer some guidance on where markets might be headed. We feel more comfortable looking at a longer-term horizon. These models rely on a lot of historical data (known entities), current data (more nuanced) and future projections and extrapolations of more data (such as potential economic growth, corporate earnings growth, interest rates, inflation, political backdrop, global health, the environment, innovation, productivity, etc).

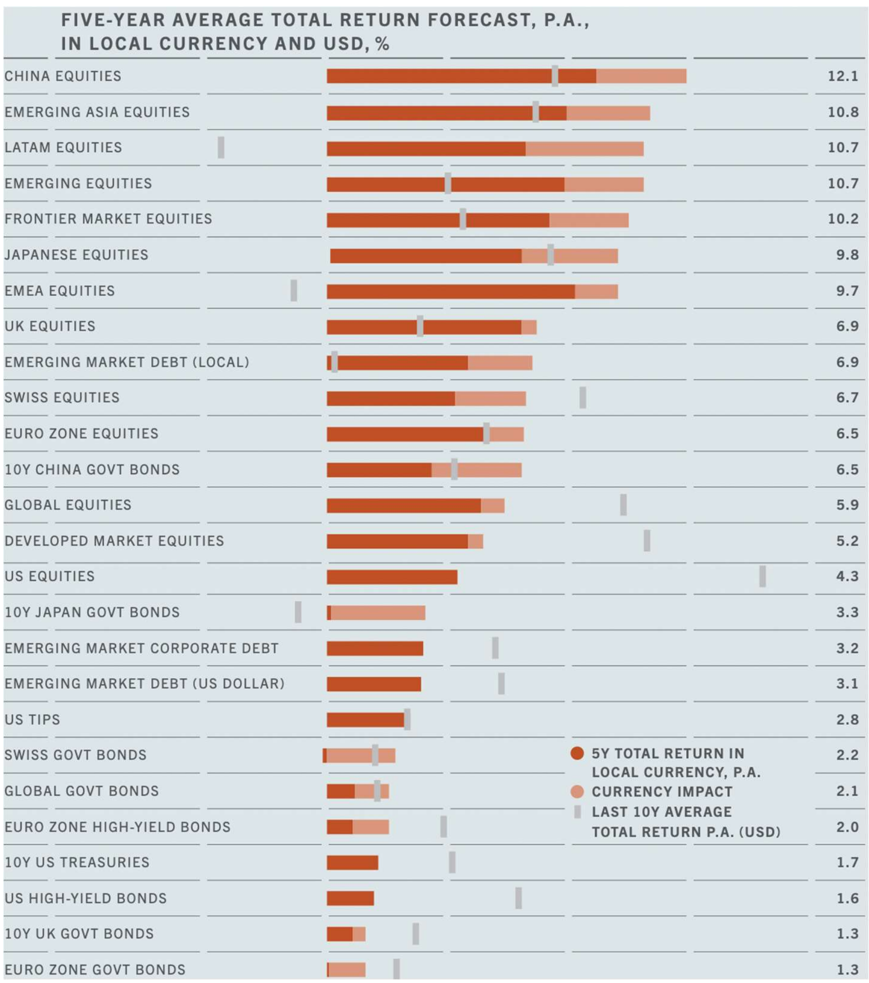
Every financial firm has an opinion about the future direction of markets. A lot of it is marketing. They want to be engaged, and "in your face". Keep those Twitter feeds busy, even if you have nothing material to say. Even if one makes a lot of predictions – big and small – most of them are wrong. Most are also forgotten long before they come due. That's because there are too many other predictions that come every day. Data. More data. Good luck interpreting it precisely.

Of course, being a small firm, we also rely on research from larger firms with more resources. And we try and read as much as possible but without getting lost in endless data. In the end, we keep it simple: Stick to quality funds and companies, diversify, accept that over the long-term markets go up, keep costs low and do not trade a lot.
Below we have two examples of 10-yr and 5-yr annualised forecasts for the US stock market (10yr), as well as many other markets (5yr).
The first is from a model at Bank of America Merrill Lynch. They say that the current (July 2021) "Price to Normalized earnings" ratio has a very strong relationship with

subsequent S&P 500 returns over the long haul and they predict price returns of 3% annually for the next 10 years, based on current Price/Normalized earnings ratio of 25X. **Add a circa 2% dividend yield and you get about 5% annually over the next 10 years.**

They have found that this long term valuation model has a high degree of accuracy for expected returns over a 10-year period.

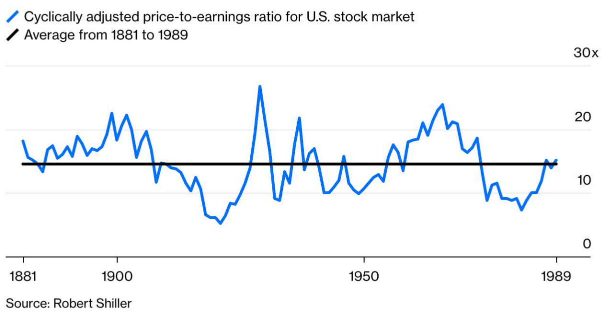
Pictet asset management, part of the Swiss private bank, **predicts 4.3% total annual returns from US markets in the next 5 years**. They are more bullish on emerging markets:



Frankly, we disagree with Pictet (and many others) in that emerging market equities are best placed to produce the largest returns over the next five years. We suspect that weak corporate governance, political interference, authoritarian regimes and nationalism will continue to create headwinds. The developed equity markets forecasts of annual returns of 4-7% are more in line with our expectations. As for fixed income, we seem to be running out of runway for reasonable historical returns and we shall generally be underweight.

On valuations

There is no doubt that equity valuations in the US seem rich. The most common multiple that is used for company valuations is the ubiquitous Price-to Earnings ratio, or P/E. Crudely speaking, the higher the P/E, the more "expensive" a stock is. The aggregate P/E of a market (say the US market) gives us a glimpse of how cheap or expensive it is relative to its history. Many financial analysts prefer to use the Cyclically Adjusted PE ratio (CAPE) as it uses the 10-yr average of company earnings, thus giving a more realistic picture of financial performance while isolating the impact of economic cycles.

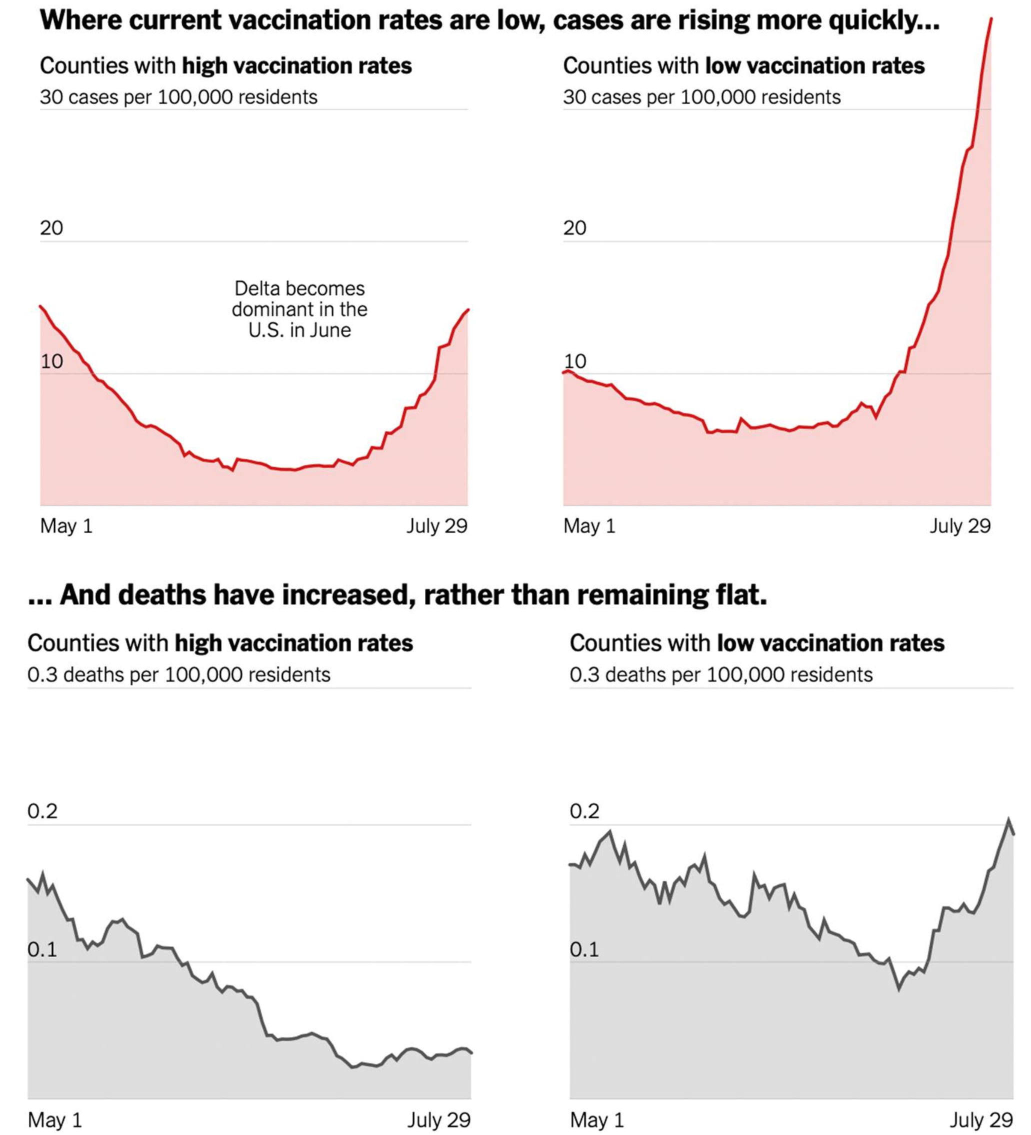


The graphic above shows the CAPE ratios from 1861 to 1989 (left) and from 1989 to mid 2021. Remarkably, in the first instance, it spent as much time over the average as it did below it, indicating periods of "over" and "under" valuation. Yet, in the last 30 years or so, it has spent almost the entire period seemingly being "overvalued". Is this a "new normal"? And can we project for the future that valuations have reached a much higher average level than in the past, and as such should we stop worrying about how "expensive" the market is, and that it might crash?

These are all valid questions but very difficult to answer. If anything, it points to the wise fact that markets are too complex to put into a neat box and to analyse them easily. Perhaps it is a new normal. Or maybe not.

On Covid and vaccinations

The two graphics below do not need explanation. Any reasonable person can see that vaccinations are by and large saving lives and preventing acute symptoms. We have no sympathy for anti-vaxxers, conspiracy theorists and those that are not driven by science on this issue.



Source: New York Times database of reports from state and local health agencies and hospitals ▪ Counties are considered to have high vaccination rates if at least 60 percent of the population is currently fully vaccinated. Counties with low vaccination rates are those where less 30 percent of the population is currently fully vaccinated.

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