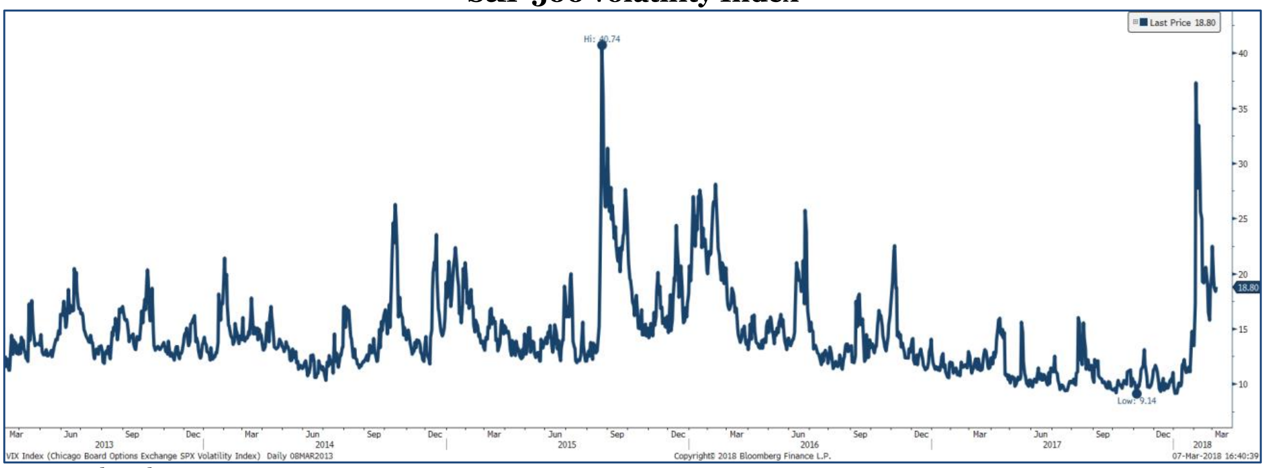
Market Review End of February 2018

Starting on January 29, the S&P 500 index began an 11.8% dip that took 10 trading days. It has then recovered most of the lost ground awfully fast, as the market was up 9 times out of 11 sessions. The Nasdaq has recovered almost the entirety of the decline that kicked off on February 1.

Volatility has returned in a big way. But does more volatility mean lower returns for stocks? Not necessarily. What's been weird about the markets is not the recent volatility, it's how absurdly low volatility has been previously (see chart below). According to DataTrek, since 1958 the S&P 500 has on average gained or lost one percent or more on a daily basis on 53 days. That's about 20 percent of the time, or about one day per week. In 2017, there were only eight days where the S&P moved one percent or more. Eight days, versus an average of 53 for the past 60 years. So far in 2018, there have been 15 down days (6 of which more than -1%) and 8 up-days of more than 1% in 9 weeks (at the end of February). Reversion to the mean? Sure looks like it. Time to sell equities? Just because US equities are more volatile does not mean negative price returns, at least when looking at the historical data.

S&P 500 volatility Index



Source: Bloomberg

All other asset classes corrected in February, there was no place to hide. As the cartoon reads, the wind has changed. Following months of “benign neglect”, investors have awoken to the new investment framework. The decade of falling interest rates is probably over as Central banks around the world start normalising their monetary policies. Synchronised economic growth is pushing central bankers to raise rates and shrink their balance sheet.

Market moves at the end of February

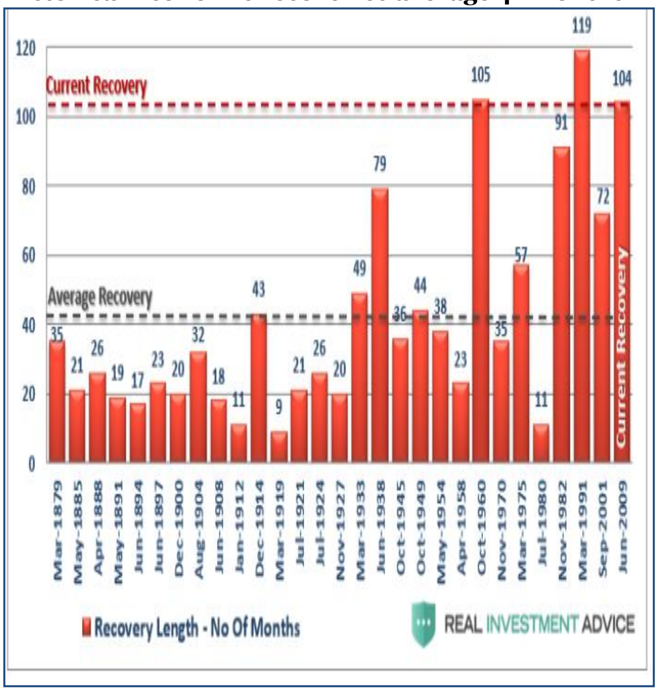
	Equities in Local Currencies							
End of February	**MSCI World**	**S&P 500**	**EuroStoxx**	**CAC**	**Spain**	**Switzerland**	**UK**	**Hong Kong**
Perf 1 Month	-4.30%	-3.89%	-4.72%	-2.94%	-5.85%	-4.60%	-4.00%	-6.21%
Perf 3 Month	1.96%	2.50%	-3.67%	-0.97%	-3.63%	-4.43%	-1.29%	5.71%
Perf YTD	0.69%	1.50%	-1.86%	0.15%	-2.03%	-5.07%	-5.93%	3.09%

	Commodities				Currencies vs EUR			
End of February	**WTI Oil**	**Gold**	**Copper**		**USD**	**JPY**	**GBP**	**CHF**
Perf 1 Month	-4.77%	-1.99%	-2.63%		1.68%	4.19%	-1.17%	0.45%
Perf 3 Month	7.39%	3.41%	2.50%		-2.60%	-2.61%	-0.61%	-1.50%
Perf YTD	2.02%	1.18%	-4.36%		-1.68%	3.81%	0.28%	1.51%

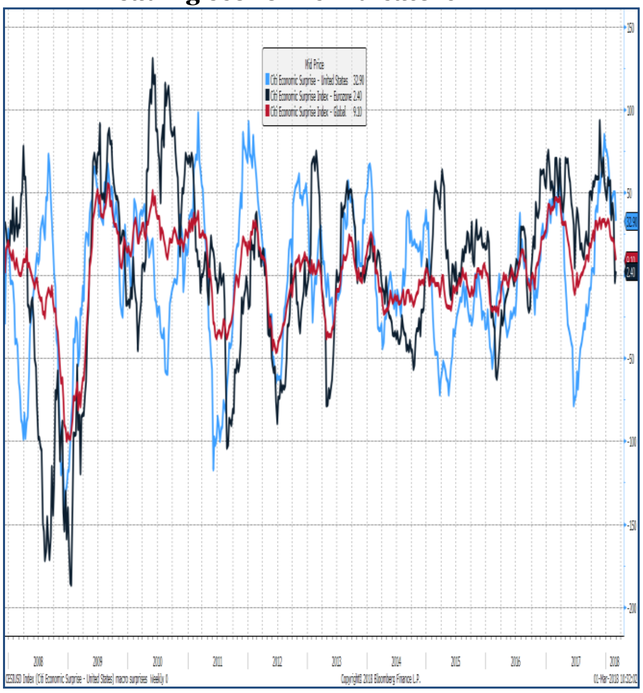
	Bloomberg Indices Bonds Total returns					
End of February	**Global Aggregate**	**US Aggregate**	**Euro Aggregate**	**US 10 Year**	**German 10 Year**	**Emerging Sovereign USD**
Perf 1 Month	-0.89%	-0.95%	0.12%	-0.95%	0.07%	-1.36%
Perf 3 Month	0.64%	-1.64%	-0.93%	-2.91%	-2.33%	-1.15%
Perf YTD	0.29%	-2.09%	-0.33%	-3.13%	-1.47%	-1.53%

We may reach the peak of this cycle’s economic expansion in 2018. We are now in the third longest economic recovery in history. Leading indicators are rolling over in Europe and correcting in USA and globally. It seems to be as good as it gets.

Historical Economic recoveries average 41 months



Leading economic indicators

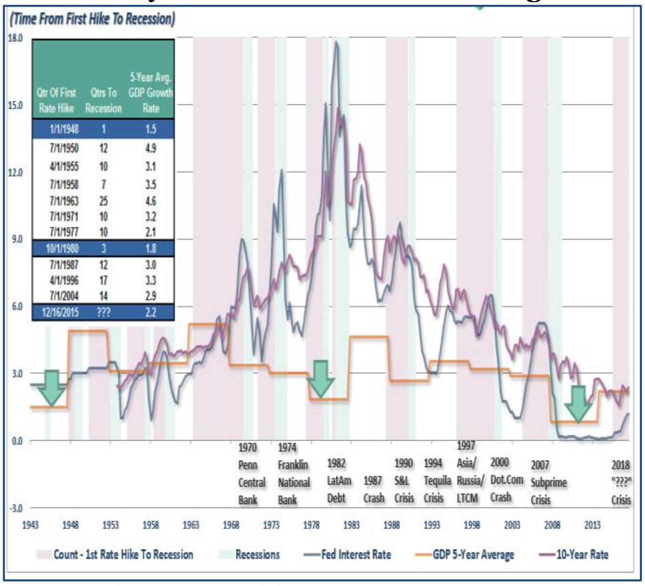


Source Real Investment Advice, Bloomberg.

Is it all over for this cycle? Not in our view. Markets may become more volatile and less complacent but the world economy is still growing at around 3.7% for 2018.

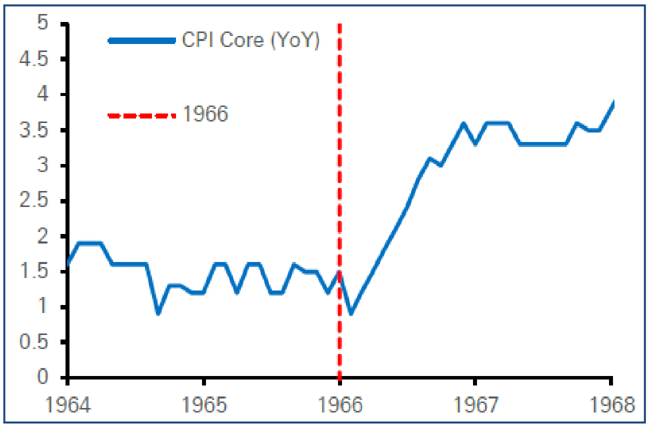
Are higher interest rates an issue? It is for bond holders and for highly leveraged businesses. Interest rates will continue moving higher in USA as the US Fed has indicated 4 rate hikes this year. But we will not see long term rates moving back to their pre-financial crisis levels as the long-term growth potential of the US economy does not seem within reach.

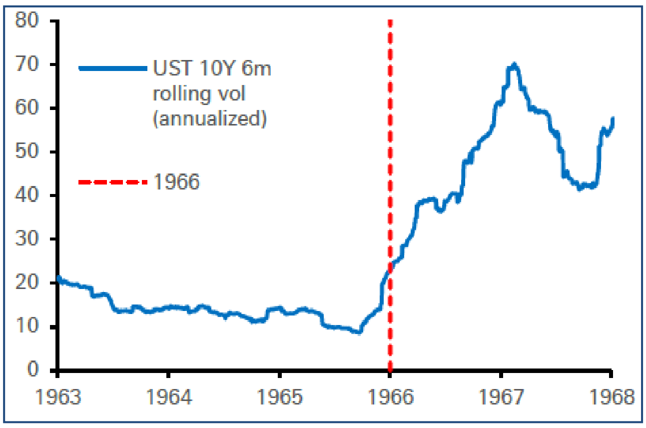
Fed & 10-year rates vs real economic growth



Source: Real Investment Advice.

What makes investors even more nervous is the uncharted territories we are entering. “Quantitative easing” was an experiment around the world, which was so far successful in saving the world from financial chaos. Unwinding this experiment may not be as easy.
On top of this monetary agenda, the US government is adding more fuel to the fire by injecting a fiscal stimulus into its economy.
A tax reform at this late stage of the cycle, could add a few more quarters of growth but also a lot more debt and worry bond holders. This explains the current bonds market reactions. We can draw a parallel with the late 1960’s when a fiscal stimulus at near full employment levels (similar to today’s) supported a shift towards higher inflation which led to an increased US-treasuries volatility.





Source: Deutsche Bank, BIS, Haver, Datastream, Bloomberg.

The positive effect of this tax reform is undeniably felt on the corporate side where earnings keep being revised higher. Valuations which were stretched at the end of 2017 (20x forward earnings) have corrected to more normal levels (17x 2018 EPS estimates).

S&P 500 earnings forecasts

S&P 500 Sector	2018 Estimated EPS Growth Current	on 12/31/2017	Change
Energy	69.8%	42.6%	27.2%
Telecom	15.4%	-0.5%	15.9%
Financials	27.2%	15.5%	11.7%
Industrials	17.5%	7.1%	10.4%
Cons. Discretionary	15.1%	7.0%	8.1%
S&P 500	***18.1%***	***10.3%***	***7.8%***
Materials	22.3%	16.6%	5.7%
Health Care	11.1%	5.5%	5.6%
Info. Technology	15.9%	11.0%	4.9%
Consumer Staples	11.2%	6.8%	4.4%
Utilities	5.8%	4.7%	1.1%
Real Estate	5.8%	6.5%	-0.7%

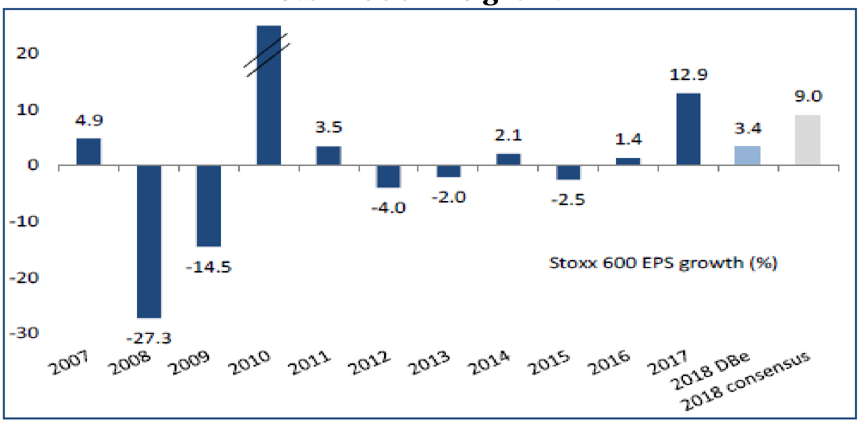
S&P 500 forward P/E

Source: Raymond James, Bloomberg.

In Europe, talks about higher interest rates are premature. In the face of the recent Italian election and the uncertainties about a future government, the ECB will remain very accommodative. Higher interest rates will bring back bad memories about the 2011 Euro crisis. The debt burden is still way too high in many European countries.

Corporate earnings are still growing at a healthy pace in Europe (around 9% estimates for 2018), although lower than in 2017. European companies do not benefit from a fiscal reform tail-wind similar to their US counterparts.

Stoxx 600 EPS growth



Source: Haver, Deutsche Bank.

One crucial element to monitor in the coming months and years will be currency adjustments. Interest rates, economic growth differential, reserve currency status were all long term supports of a strong USD.

But trade wars, military disengagement, weaker financial status could fore other alternatives. Euro is an alternative for the western world but emerging economies may choose closer economic ties with the emerging Chinese economic and military giant.

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