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the investor's choice

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Monthly Commentary 1st September 2014

August was kind to both equities and bonds, especially the latter. The only major asset class to fall was commodities, as oil fell almost 4%.

Fear factor

We have been receiving an increasing amount of communication from clients that they are reading many scary headlines in the media about a pending crash in financial markets.

Below is a typical email we received yesterday:

"There was a rather disturbing article in today's Telegraph warning of a ***market correction of up to 60%.*** *I pursued this a little more and found other commentators who are similarly bearish. The Fed's refusal to put up interest rates and new market highs appear to be adding to this sentiment."*

This is one of the classic FAQ's we've been getting lately.

Articles like this always attract attention and sell papers. In it, the founder of a research company is quoted as saying "you can see the entire bull market trend over the past 5 years has started to reverse". Even without looking at the charts or doing any analysis one might wonder how is it possible that the S&P is at all time highs and for the 5-year trend to have started to reverse? For something to reverse we need at least a medium term correction. Currently we don't even have a short-term correction.

Yes, there are many worries in the world, but markets have been climbing these walls of worry. It is actually very encouraging to see so many "experts" questioning the recent rally, and also calling for a major correction. It is a contrarian indicator. One may blame the internet for this state of investor anxiety. The deluge of Web warnings along with post-crash traumatic stress syndrome had investors obsessing over the next market meltdown and focus purely on the negatives.

As far as we are concerned, yes there are worries, but the fundamentals do not call for an imminent crash. The reasons:

- Liquidity is abundant. Even as the Fed ends its QE, it has telegraphed quite well that it will not begin to hike rates yet, and when it does, it will unlikely do so abruptly and meaningfully (really smart people like Bill Gross believe that the new "normal" neutral policy rate will be much lower than in previous cycles). At the same time, the ECB is about to embark on more monetary stimuli, and the Bank of Japan has its foot firmly on the "loosening" accelerator. Hardly conditions for a crash.

- Corporate earnings growth has improved markedly in the US, and it's at its best since 2011. This has been the missing ingredient in what has been a tepid recovery - the markets love strong growth. Top line growth has also been impressive lately.

- Companies are sitting on almost $5T worth of cash, which they can use for buybacks, capital

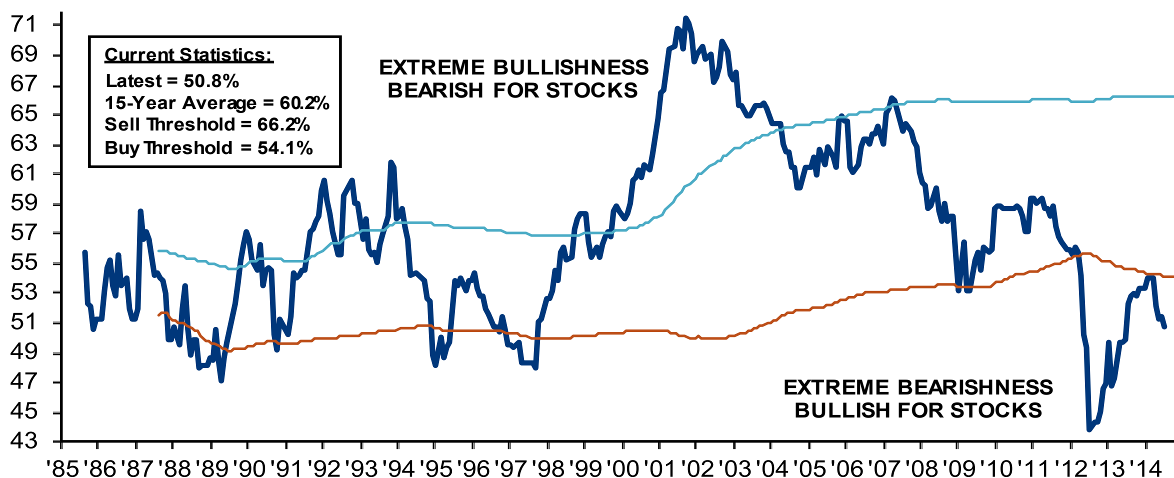
spending and acquisitions. All very healthy.

- Valuations are not unreasonable.

- Technically, the markets look fine - and completely at odds with what was quoted.

Finally sentiment, even among professional investors, is not that buoyant. We would start worrying when most turn bullish. Below is Merrill's proprietary Sell Side indicator, that tracks allocation to equities among Wall Street firms. Currently, the average firm is recommending the lowest allocation to equities in over a year, with a more bearish position than during the depth of the crisis. Historically, when the indicator was at or below current levels (has happened on 54 occasions), subsequent 12-month returns have been positive 100% of the time.

Merrill's Sell-side indicator



Source: BofAML Global Research US Equity & Quant Strategy
Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviations from the rolling 15-year mean. A reading above the blue line indicates a Sell signal and a reading below the red line indicates a Buy signal.

Many experts have been wrong before, and as Barry Ritholz of Bloomberg recently reminded us of this:

Strategists who have predicted weakening earnings growth would sink stocks have repeatedly been proven wrong since the bull market began. At the start of 2010, Marc Faber, publisher of the Gloom, Boom & Doom report, said the S&P 500 was at risk of ending that year with a loss amid economic and profit slowdowns. The equity gauge completed the year up 13 percent. Gina Martin Adams, an equity strategist at Wells Fargo & Co., echoed the same concern at the end of 2012, forecasting that "a trifecta of major macro drags," would hurt earnings and send stocks lower in 2013 (they rose more than 30%).

In summary, always question what sounds sensational, whether bullish or bearish.