Elgin
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investment commentary monthly

Monthly Commentary 2nd March 2015

Last month, we asked where asset prices were going for the rest of the year. Our conclusion was: *"Continuing, and massive stimulus in Japan and Europe, coupled with low oil prices, low inflation and low cost of capital is a strong tail wind for equities".*

The markets duly obliged as February was a very strong month for equities as they rallied more than 5%. Oil joined the party as Brent Crude was up by 18%. Bonds fell slightly and gold also retreated by more than 5%.

Time to buy energy shares again?

We are asked quite frequently about our thoughts on energy and whether it's time to buy again. Quite frankly we expect a lot more volatility and are far less bullish about oil's medium term prospects than we are for equities. Ironically the energy sector in the US underperformed the broader market in February, and that is worrisome. Additionally, the trading volume in energy equities kept falling throughout the month even as energy shares were rising, which might signal a lack of conviction in the oil rally. After falling by almost 60% with hardly a pause for 7 months, it is not surprising to see a strong bounce, but we would not bet that this mini-rally is the real thing.

Should we be worried that equities have risen too far?

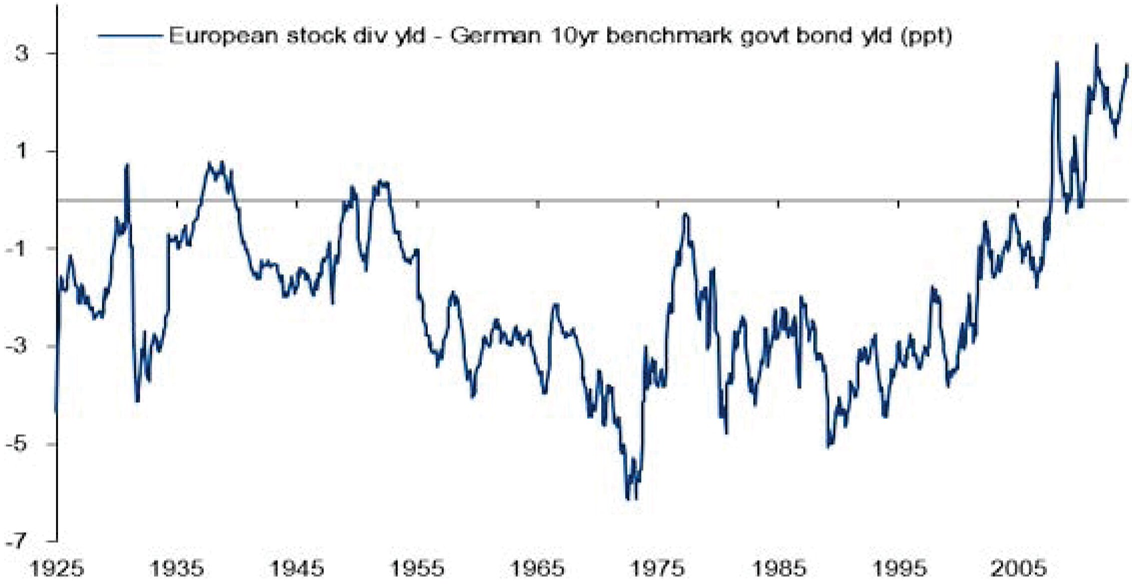
Even the (lagging) FTSE was in the news last week for finally having reached its all-time highs almost 16 years after the previous peak. Contrarians would argue that such headlines often signal the peak in markets.
And worries surely abound. Below we quote from Barry Ritholtz of Bloomberg:

The noise box in your den has been tallying a catalog of potential crises and hazards. That parade of "terribles" seems to be getting longer each day. Although none of them are new, it is as if all of them have suddenly risen in unison, a chorus of noise, funk and angst. Markets are expensive, the Federal Reserve's stimulus of quantitative easing and zero interest rates is ending, the euro is collapsing, deflation is a threat, rates are rising, residential real estate is a mess, biotech is a bubble, oil prices are plunging, Grexit will arrive any day.

We can name many more, like Russia-Ukraine, ISIS, uncertainty of UK elections, slowdown in China, more slowdown in Brazil etc etc… As we wrote in the previous monthly commentary, we certainly expect more volatility. We would not be at all surprised to see markets fall by 5% or even 10% without any warning. Yet, there are enough reasons to remain positive, with the main ones listed in the first paragraph of this commentary.

In the following pages there are a few interesting charts courtesy of Merrill Lynch that put matters in perspective - i.e over the very long term. In one of them, while the US markets are up more than 30% from their previous highs, this isn nominal terms. In real terms (inflation-adjusted), they are still 4% below their all time highs.

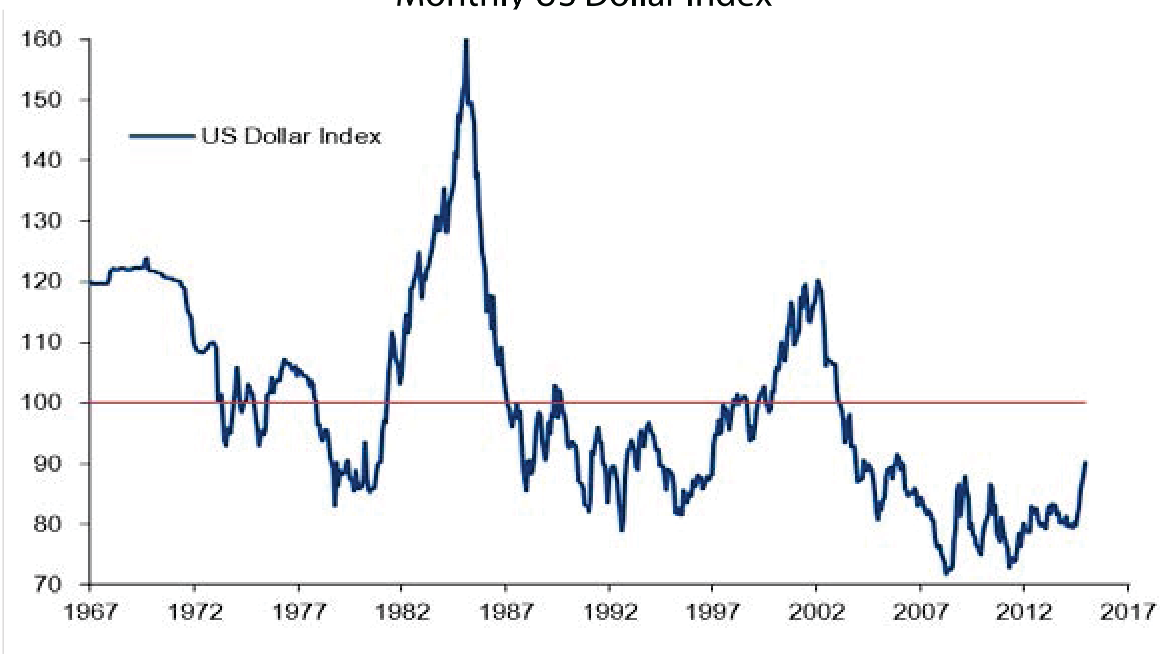
European Dividend Yield - German 10-Yr Bund



Monthly data. Dividend yields from Global Financial Data prior to December 1969, MSCI Europe thereafter. No German bund yield data available from August 1931 – March 1932 and December 1943 – December 1945
Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg, DataStream

The above clearly shows the decisive yield advantage of European stock dividends over German 10-year bonds. It is currently at an all-time high of about 3%. This is one of the reasons we favour European equities.

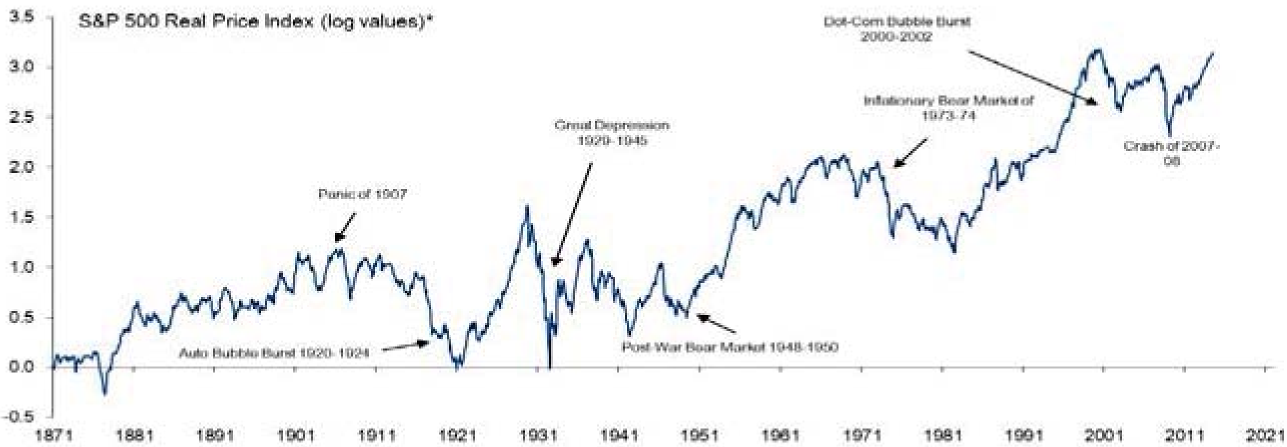
Monthly US Dollar Index



Monthly data
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

The above shows that the USD bull market may still be at its infancy. It reflects belief in US macro superiority. This has implications for all investment portfolios, but also for commodities.

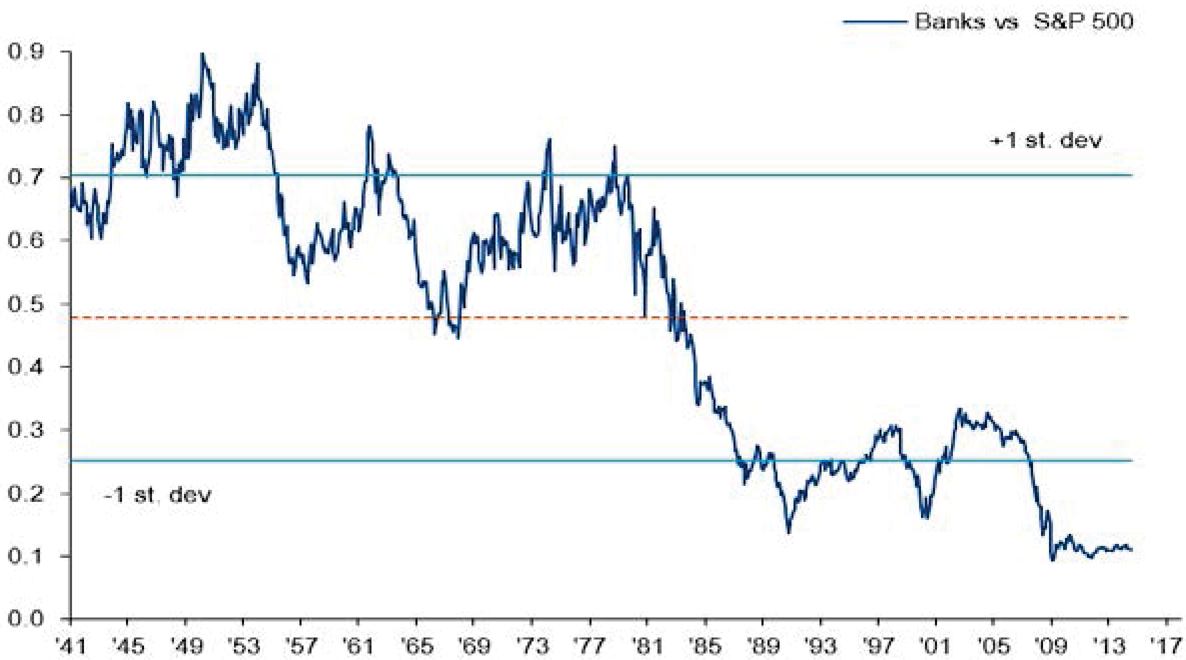
Real returns of US Equities Dollar Index



*U.S. large company stock market returns, logarithmic values of real monthly average price return
Source: BofA Merrill Lynch Global Investment Strategy, Robert Shiller, Ibbotson

Adjusted for inflation US equities are still 4% below their all time high.

Banks versus the S&P 500 Index



Monthly data
Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg

Banks in the US are currently at a 75-year low versus the index. Could (imminently) rising interest rates change this. Investing in banks today might be a profitable contrarian call.

Elgin Analysts Team