Monthly Commentary 2nd June 2017

May was another good month for many markets. Global equities were up by more than 1%, with the UK market leading the way. Only some emerging market equity markets were weak, notably Russia and Brazil that fell by more than 4%. The former had more to do with commodity weakness that also negatively impacted the Australian market. The bond markets were also up while the euro was strongest among major currencies, following Macron's decisive victory in France.

In this commentary we shall stay with the equity markets theme, and ask again what is going to keep them strong, and conversely what are the contrarian arguments.

For answers, Merrill Lynch has written an informative research paper, which we refer to below. The paper is titled *"Exploring the Dark Side, He said, she said: the pros and cons of buying stocks today"*

With each pro and con, Merrill proceeds to counter-argue, thus making the process less biased than one would expect from a wealth manager, whose interest it might be to remain as bullish as possible. In any event, you can make up your own mind.

The bears say:

> **"Valuations are too darn high":** US equities are expensive on almost any metric, but valuation is a terrible short-term indicator. Today's levels suggest lower long-term returns, but even those returns generally stack up well vs. other asset classes.
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> **"Cycle is long in the tooth"**: More than eight years into the second-longest bull market in history, we see classic late cycle signs everywhere. But growth has been accelerating off, of several years of depressed levels. It rarely feels good to buy in a late-stage bull market, but it is dangerous to exit too early – think January of 1999.
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> **"The end of easy money"**: Central banks shifting to a tightening bias is new and scary, but the starting point and pace of this tightening cycle is benign vs. history.

"Leverage is high and the credit cycle is over": Corporate leverage is elevated at a time when delinquencies are just starting to rise, just as the Fed is accelerating hikes. But debt is mostly long-dated, and growth tends to solve most ills in the credit market, so with improving confidence, credit pressures may be delayed.

"Rising wages will crush margins": Building wage pressure is a big risk for labor sensitive-sectors like Discretionary, but broad-based wage increases usually come with stronger demand. It is usually not until growth starts to slow that wages (which are quite sticky) really pressure margins via negative operating leverage.

The bulls say:

"Finally, synchronized global growth": For the first time since early on in this cycle, growth is picking up across most major regions. Unfortunately, the second derivative may be in the process of inflecting lower.

"Stimulus will boost growth": Global stimulus has helped boost growth, but the likelihood for big incremental stimulus looks limited. The global purse strings have been wide open for a while, with restrained US fiscal spending more the exception.

"We're in an economic upswing": US economic surprises recently hit levels not seen in five years. However, it has been mostly driven by soft (survey) data rather than hard data. While the jury is still out on whether the soft data needs to come back down to earth or higher confidence levels will drive better growth, it is likely that we see a little of both.

"Low interest rates justify higher valuations": Lower interest rates imply lower discount rates and higher valuations. But equity valuations have less cushion to absorb higher interest rates at a time when rates could rise due to tightening central bank policy. Moreover, in a low interest rate world, the inverse relationship between rates and multiples becomes fuzzy.

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