Monthly Commentary 4th June 2018

May was a mixed month for markets, and more volatile than usual. Equities were strong in the US and very weak in Europe and Emerging Markets. Developed market bonds sold off strongly in the first half of May, only to rally even more so in the second half. The opposite happened for commodities, which were strong in the first three weeks of the month, only to sell off in the last week. The biggest story in the markets must have been renewed USD strength, that was up 2.3% on a trade-weighted basis and was strong for the whole month.

The Cassandras' are out in full voice

Italy was the latest focus of jitters in world markets as the fear of it crashing out of the Eurozone resurfaced in the last week of May. This drove many talking heads to forecast the beginning of the end of the European project. One of the prominent Euro bears is George Soros, and he made headlines (see below from the FT):

Global financial crisis

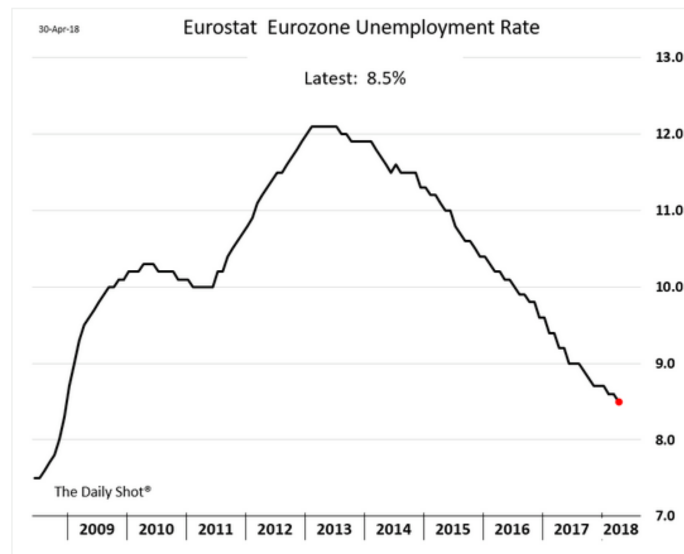
Soros warns of 'major' financial crisis

'Existential crisis' gripping EU, billionaire financier says

During a speech in Paris on May 29th, referring to the European Union, he said, "Everything that could go wrong has gone wrong".

Really Mr. Soros?

Our take is that unemployment is the Eurozone has come down massively in the last 5 years. See below.



This, in turn has spurred the European economy. In Germany, fundamentals such as consumer confidence, construction, and capital-expenditure plans remain robust. In France, more corporate investment and high confidence levels should ensure continued robust economic expansion.

Yes, some indicators this year have indicated a slowdown in growth and many short-term economic indicators have turned negative, relative to consensus estimates. This has stalled any progress in European equities. But growth is still robust and, according to Citi, in periods when European growth indicators have shown severe negative surprises, like now, equity returns have generally been well above average in the subsequent 12-months.

Additionally:

- Earnings per share should rise solidly this year as the economy keeps growing above trend.
- Global demand keeps supporting revenue growth of export-oriented companies even if the period of acceleration in economic activity seems to have passed.

- The ECB pares its bond-buying program this year. It is expected that this unwinding will be gradual and well communicated. As such the monetary policy backdrop should remain supportive.
- Eurozone equities are trading at valuations that are 8% below the long-term average. Valuations are attractive relative to government bonds.
- Unemployment, especially in peripheral Eurozone countries, may fall further. Any improvement should support domestic consumption and thereby revenue growth.

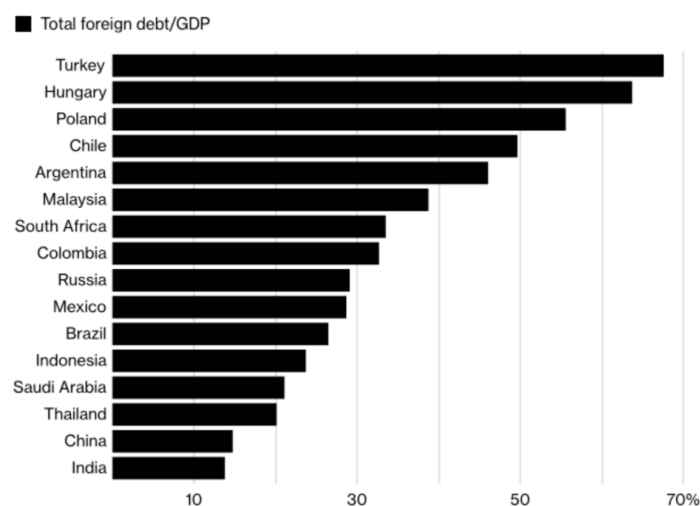
So, in 12 months it will be interesting to see if Mr. Soros proves correct and we end up eating humble pie.

On Emerging Markets (EM's)

EM's have had a rough time recently and both equities and bonds are down for the year, and this is against our expectations at the beginning of the year.

The strengthening USD is suggested by many as the main culprit. Other issues are potential trade wars and geopolitics.

With regards to the USD, the reasoning is that many countries have too much debt in USD and they will have a hard time paying it back as US interest rates rise and the dollar strengthens. The below chart from Bloomberg suggests that the bulk of the countries that make up EM equity indices (mostly Asia) are not facing huge foreign debts to GDP ratios:



In fact, none of the top 6 countries above have more than a 2.5% weighting in the MSCI EM Equity Index, while three of the five biggest (China, India and Brazil) are much lower down. The other two big ones – Korea and Taiwan - are even lower!

With regards to potential trade wars, times have changed. EM countries trade more with each other than they do with the US. Still, we are indeed concerned that a trade war will impact global equities most adversely - it will not be just an EM story.

In the case of geopolitical events, history shows that initial US equity market sell-offs have taken an average of just one month to reverse, with an average gain of 2.8% three months after the event!

EM equities are trading at a near record, massive valuation discount of 42% vs US markets. In our view, they are discounting a lot of bad news.

The Elgin Analysts' Team

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