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M investment commentary monthly

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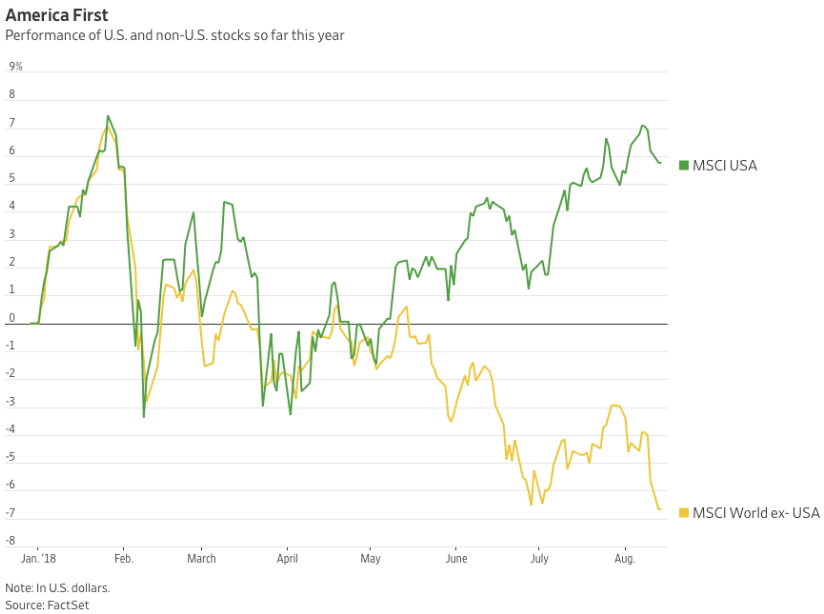
For equities, August told a tale of two different worlds separated by the Atlantic Ocean. On one side, the US market steamrolled ahead by 3% while Europe and the UK were down between 3% and 4%. Developed Market bonds were slightly up, paced once again by high yield in the US, while Emerging Market bonds suffered heavy losses. Commodities were down, with precious metals leading the declines. The USD continued its upward move.

Two worlds - the US and the rest

The graphic below shows how global equity markets have performed this year.



"America first" is certainly what has happened.

So is Europe "Done" for this equity cycle? SW Mitchell, a London-based European equity manager with a strong track record had the following thoughts:

"As the US enters its late cycle phase, it's time to take a close look at Europe

- *Current stretch of European underperformance is unprecedented both in length and magnitude.*

- *The US outperformed by 175% since the bottom of the crisis but Europe is now well positioned for an overdue catch-up.*
- *Earnings recovery is coming back strongly and Europe's operational leverage is vastly underappreciated.*
- *There is always a valuation discount to the US, but it has never been this wide (39% vs 24% average) and we struggle to see what justifies it.*
- *Macro data is still near two-decade highs and indicates robust economic growth.*
- *CAPEX boom expected: Europe running close to peak capacity after a decade of underinvestment.*
- *Support for the euro remains very strong and it's actually increasing in Italy. Politics is mostly noise: we focus on the business cycle, earnings and valuations, all of which are positive.*
- *Significant outflows from the region tend to be a good contrarian indicator".*

So not all seems to be doom and gloom on our side of the Atlantic.

Is the US market peaking? There is so much to worry about.
Good question. In fact it would not be outrageous to suggest that if the US market starts to fall, it will likely take the rest of the world's markets with it.

Short term, and even medium term, we have no idea what will happen. So, do we bail out now and hope to buy the market after it falls meaningfully?

Merrill Lynch argues that in the long term, "valuations are all that matter for future returns". In doing research, on "current-market prices-to-normalised-earnings" they conclude that for the next 10 years, the average annual gains from the US market will be about 5%. This is lower than the historical returns, but a great deal higher than most other asset classes have to offer.

So why try and time when to sell and when to get back in, especially if one has a 10-year horizon? A much-used graphic, in this instance also provided by Merrill Lynch, suggests that one should not try and time the markets.

The table on the next page shows what happens if one was not in the markets for the 10 best days in each decade. The total return would have been 72% versus 13,189% if one stayed in the market!

Panic-selling and pullback-timing result in missing the best days

S&P 500 returns by decade excluding the best and worst days

Decade	Price return	Excluding best 10d per decade	Excluding worst 10d per decade
1930	-42%	-79%	39%
1940	35%	-14%	136%
1950	257%	167%	425%
1960	54%	14%	107%
1970	17%	-20%	59%
1980	227%	108%	572%
1990	316%	186%	526%
2000	-24%	-62%	57%
2010	156%	75%	298%
Since 1930	**13,189%**	**72%**	**1,490,212%**

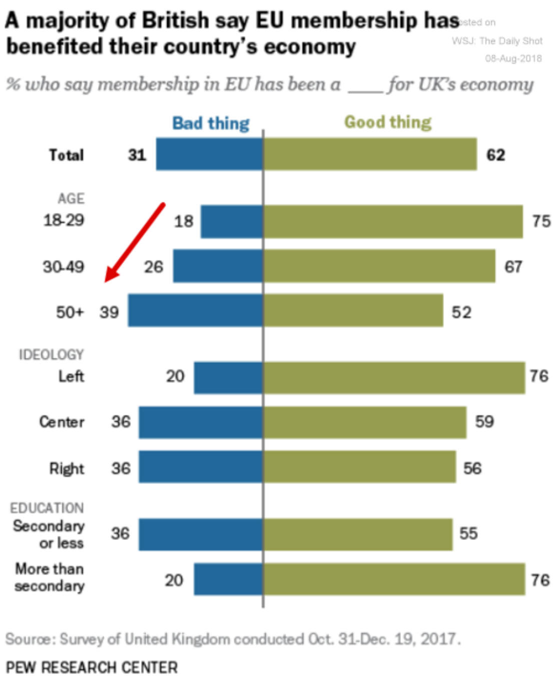
Note: Latest decade as of 8/6/2018

Source: S&P, BofA Merrill Lynch US Equity & Quant Strategy

Indeed, since 1930, pullbacks of 5% have occurred three times a year, and falls of 10% have occurred once a year. This is normal market behavior and not reason to sell.

The Brits and the EU

Below is a poll by the Pew Research Centre, arguably a serious and non-partisan organization.



It's telling that the "young" and "educated" overwhelmingly believe that the EU has benefitted the British economy. It seems that John Stuart Mill, arguably the most influential English-speaking economist of the 19th century would agree with them…

The Elgin Analysts' Team

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