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MAY 2014

PERSPECTIVES

TECHNICAL ANALYSIS

Cyclical slowdown should lead to a good buying opportunity

Jeff Hochman believes there are increasing technical signs of a cyclical correction taking hold over the next few months. Any consolidation is likely to be a temporary phenomenon, however, followed by a slow grind higher, and the market could even make new highs by the year-end. In this light, a correction should be seen as an attractive buying opportunity for investors. Investing remains challenging as market leadership among sectors is unclear. There are downward revisions on company valuations as company EPS growth has yet to materialise to match the recent rerating in share prices.

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Before he joined Fidelity in 1996, Jeff spent five years with Deutsche Bank as an equity analyst and strategist, and worked for Chase Manhattan Bank prior to that.

Jeff holds a Masters degree in International Management and a BA in Political Science and English Literature.

CURRENT MARKET OUTLOOK

Increasing signs of a cyclical slowdown coming

While a full-hearted 'sell in May and go away' type of summer may not be in store, there are sufficient signs of internal weakness building to suggest a correction happening in the next few months. The Cycle Composite suggests as much – a soft patch now, followed by a continued uptrend later. This would be a cyclical rather than a structural slowdown, followed by a very slow grind higher.

Although surprise macroeconomic policy announcements could of course create a melt-up, the market and technicals are not currently pricing in this possibility. The positive news is that any upcoming slowdown is likely to be temporary and the markets should at least regain lost ground and potentially finish higher by the year-end. A market correction caused by a cyclical slowdown will be a good buying opportunity.

EPS growth still falling short of expectations

EPS growth is still falling short of the expectations created by the market rerating over the past two years. There are still plenty of downgrades coming through to suggest growth might not be as solid as expected or maybe it is just too early. What we can see is that historic valuations on trailing PEs are somewhat high, while forward-looking PEs have returned to long-term averages.

Low volatility in the US and Europe reduces valuation dispersions

One of the key risks facing equities over the next year is that they remain flat or fall because analysts' consensus double-digit EPS growth forecasts are not realised. As equities have already rerated with higher PEs ranging from 'fair value' to 'expensive', any further multiple expansion will be minimal. Tactical sentiment is again on the high side, yet secular sentiment is nowhere near the previous market peaks.

Investing for income will be a good diversifier strategy

Although long interest rates are expected to gradually rise over the next two years as economies improve, the rate of increase will probably not be as fast as many expect. A more diversified approach to asset allocation would be desirable this year, by adding dividend growth and equity income strategies to capital-appreciation growth potential.

Investors continue searching for leading sectors

Despite investors searching for the market-leading sectors, there is very little evidence of any 'leadership' today apart from healthcare – although the sector retains its appeal, many companies are unlikely to reach former highs. Sector positioning is set to remain very challenging for the foreseeable future as investors, including many hedge funds and long-only investors, continue to zig-zag in and out of one-three month plays looking for the answers that still remain elusive.

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Risk assets continue to grind higher, making positive returns

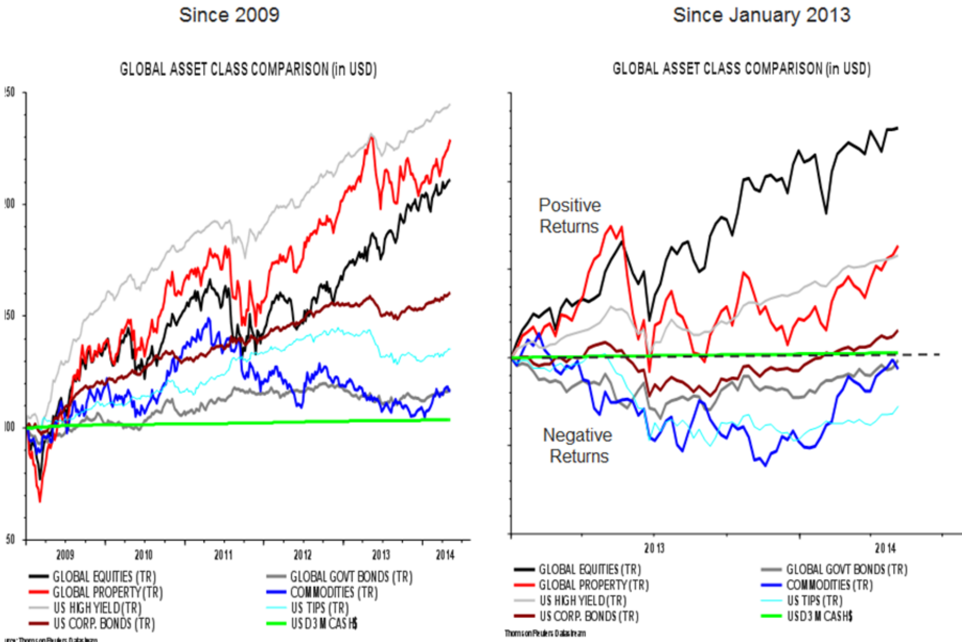


Chart 1. Source: Datastream, May 2014.

We can see from the charts above that most risk assets have delivered positive returns since 2009. The right-hand chart shows that global equities have performed strongly since the start of 2013, followed by global property and US high yield. These three asset classes have also led the field since 2009. However, commodities have been a noticeable laggard over the last two years, as investors have refocused on developed markets and intellectual property sectors like pharma and IT.

Volatility has dipped back to 2007-level lows

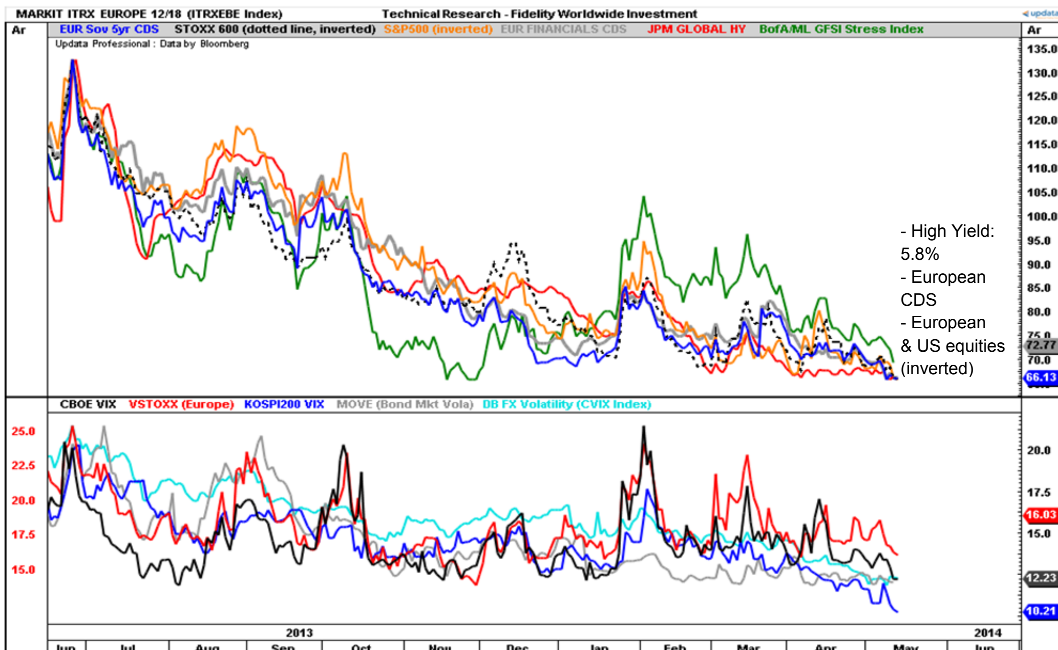


Chart 2. Source: Bloomberg; May 2014.

Volatility across the board is lower, and is now comparable with 2007 levels. Some notable examples are highlighted in the top chart (directly above) – global high yield (red line), European CDS (grey line), European equities (inverted) (black dotted line), and US equities (inverted) (orange line). Historically, volatility has tended to remain low for phases of five to seven years. Therefore, being about 18 months into the current low-volatility period, suggests we could have an even longer sustained run of low volatility in the markets to look forward to over the next few years at least. That said, at now sub-12 levels, the US VIX implied volatility index is at the very low end of the range albeit with a bias to remain within the general downtrend.

Sentiment in 2014 and beyond to remain bullish in developed markets

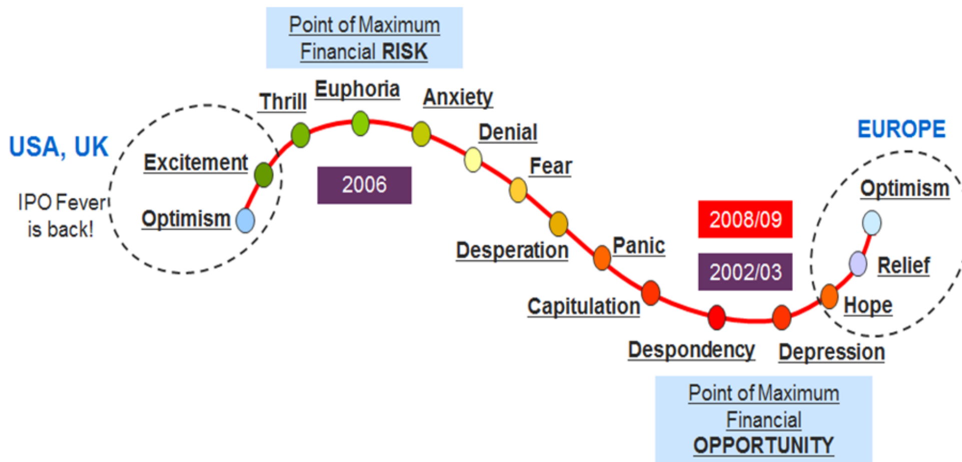


Chart 3. Source: Westcore Funds / Denver Investment Advisors LLC, 1998; FIL Limited.

As bull markets are said to mature on market 'optimism', this stage of market sentiment is well and truly escalating to 'excitement' levels in both the UK and the US where appetite for IPOs has once again increased. Europe lags somewhat as it moves through the 'relief' and 'hope' phases towards 'optimism'. All of the developed markets are likely to display positive sentiment this year and next as appetite for risk assets remains healthy.

Positive Advancer-Decliner data is masking some breadth deterioration

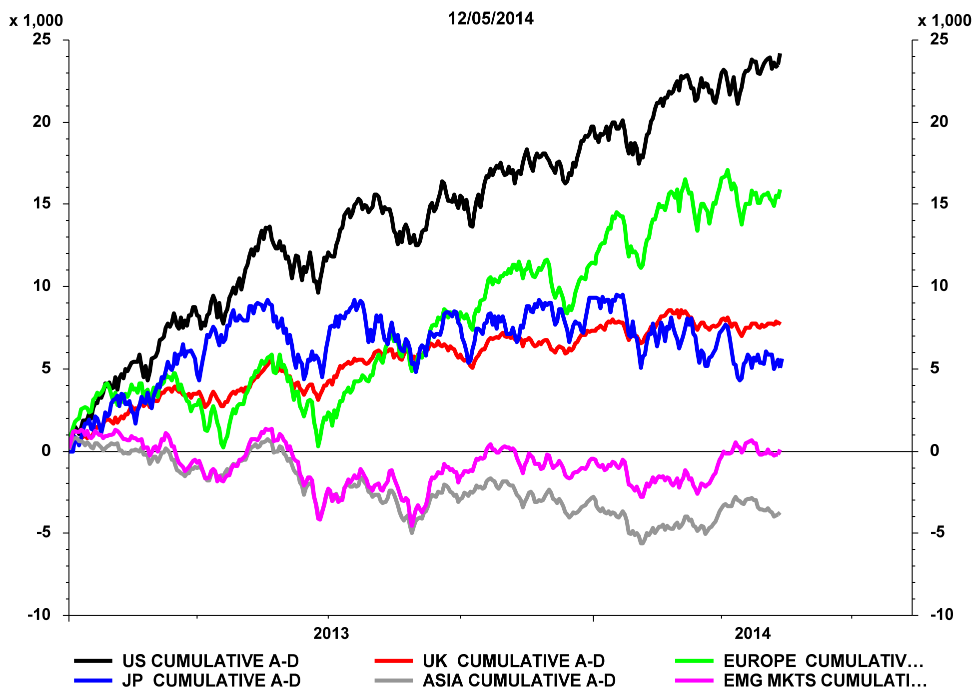


Chart 4. Source: Datastream, FIL Limited: May 2014.

While market sentiment helps to define a bull market, the real definition of a bull market is when there are more stocks advancing in value than declining in value. The chart above shows that the level of advancers versus decliners is hitting new all-time highs in the US, Europe, the UK and Japan.

But this positive news is masking some of the marginal breadth deterioration that investors should monitor closely. For example, the S&P 1500 continues ever higher, yet with more breadth divergences. Such divergence does not necessarily precede a market peak, but after a period of lengthy market advances, breadth divergence can be one useful tool in building conviction on a market reversal.

Are US small-cap stocks providing a warning sign to the broader markets?

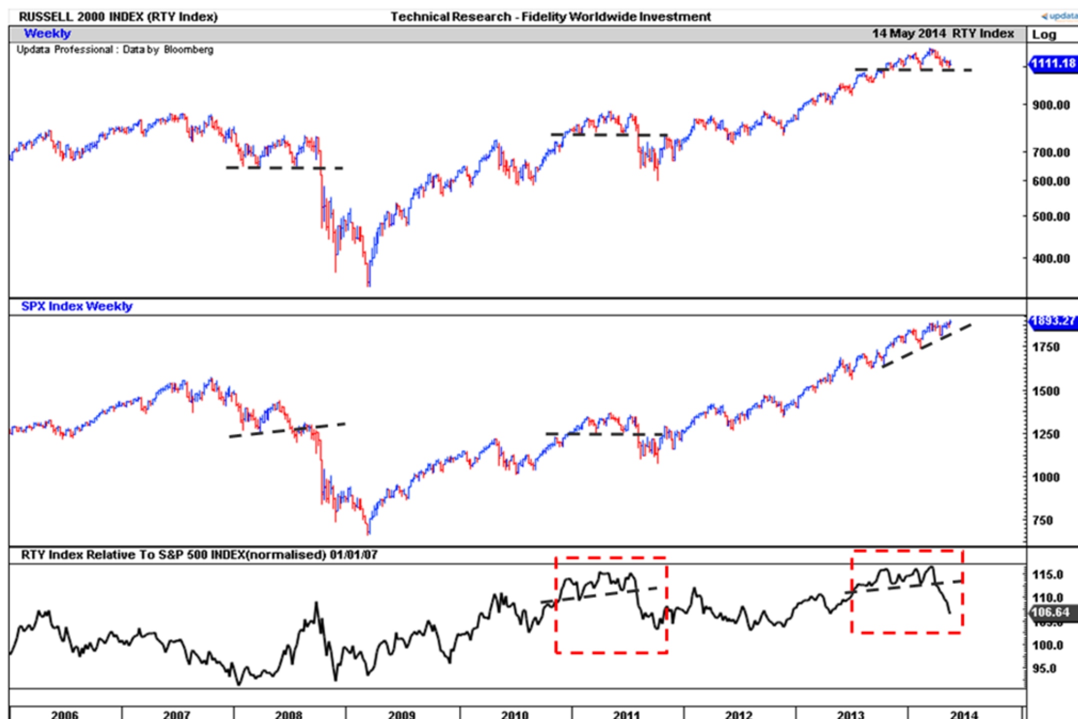


Chart 5. Source: Bloomberg; May 2014.

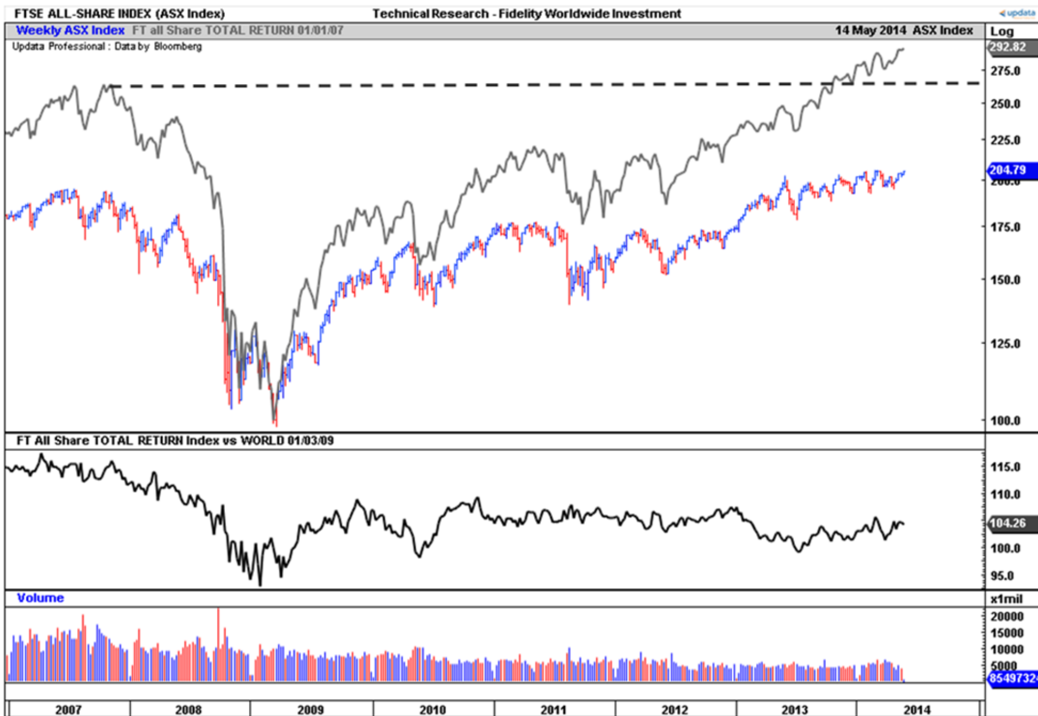
Although not an inevitable correlation, deterioration in the performance of small caps can be a precursor to underperformance of the broader market as it was in 2011 (see chart above). This poses the question about whether this could be repeated? In Germany, for example, large caps are outperforming the broader market, which seems overbought and prone to a reversal. In China, similar to the US, there has been a switch in favour of small and micro caps, demonstrated by their higher valuation compared with the composite index and large caps.

The former PIGS have morphed into PRINCES, but will it last?

Chart 6. Source: Datastream; May 2014.

Germany's DAX 30 index of leading stocks has performed consistently well compared with the rest of Europe since the 2009 downturn. But over the last 18 months, countries in the European periphery, notably Italy and Spain, have been leading regional performance. The strong flows into Italy and Spain leave them open to near-term profit-taking, since much has been priced into these markets and near-term momentum could fade. Does the recent pick up in sovereign yields (see black circled section in chart directly above) indicate these markets are starting to lose their shine? Time will tell.

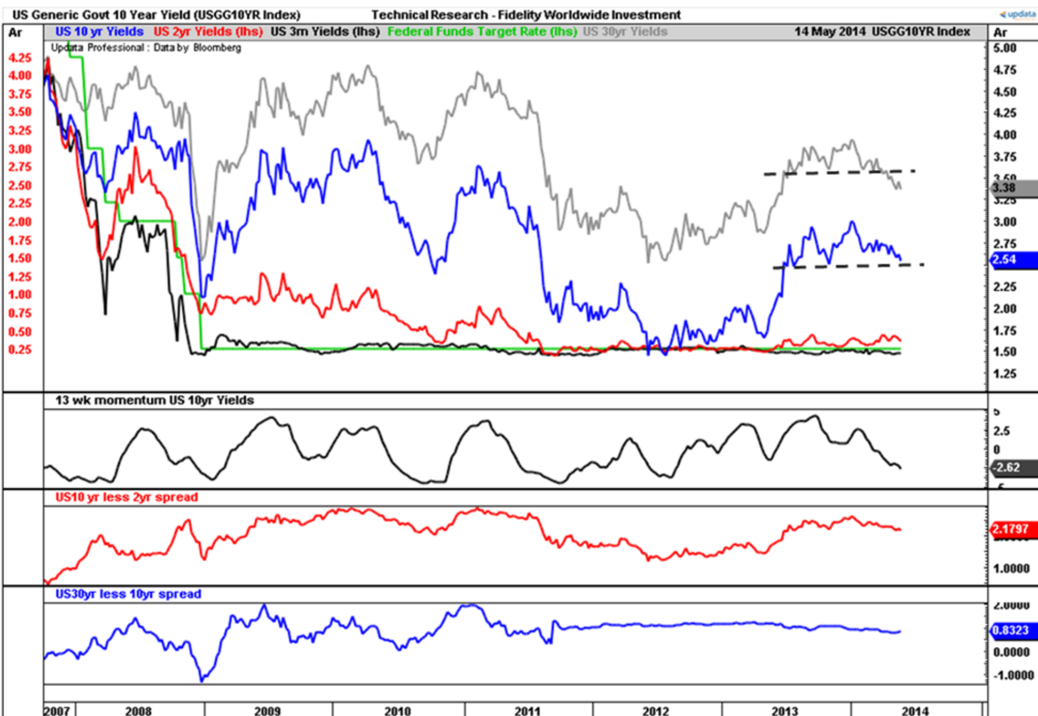
Dividends remain key to generating long-term total returns



Charts 7. Source: Bloomberg; May 2014.

It's a message that is especially important to remember in a year like this one when we might see markets consolidate – investing in dividend-paying stocks is a vital component of an equity portfolio; dividends deliver a defensive boost to total returns that compounds over the long term. The chart above shows that the total returns (top grey line) of the FTSE All Share Index surpassed 2007 levels in 2013 and are continuing to reach new highs.

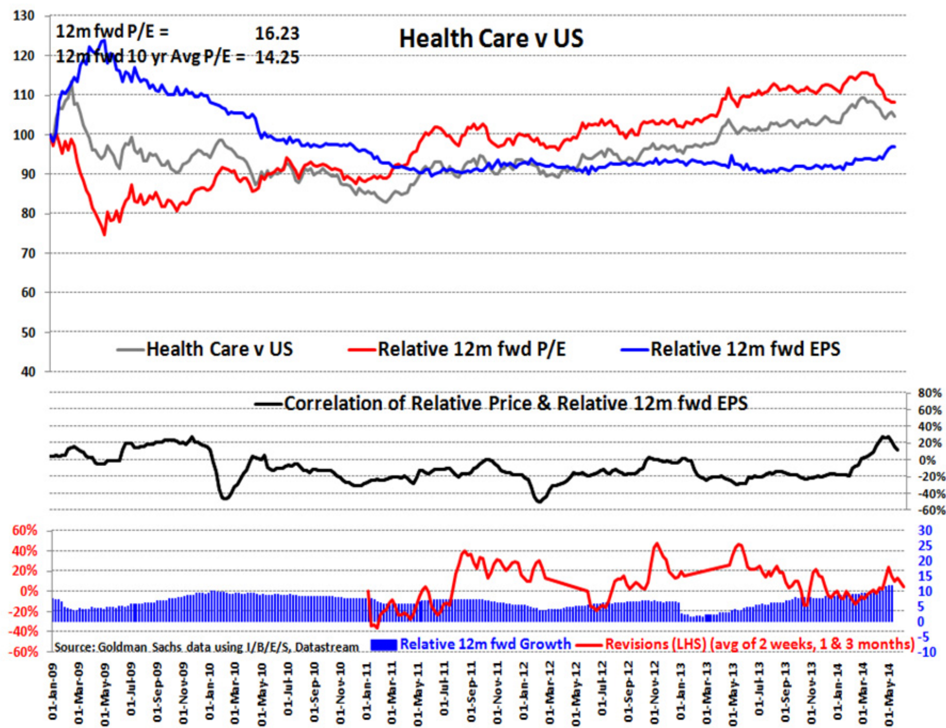
Bond market consensus on long rates was wrong



Charts 8. Source: Bloomberg; May 2014.

Long rates have been falling and not rising as the consensus had previously believed. A lack of maturities greater than 10 years has created a big supply-demand imbalance which has in turn resulted in a near-20 bps spread contraction over 10-year Treasuries since January. A break below 2.5% in 10-year Treasuries (see top dark blue line) would suggest a risk of another drop of 25-50 bps.

Healthcare maintains leadership but stock selection highly advised



Charts 9. Source: Bloomberg, Datastream, GS, FIL Limited; May 2014.

Healthcare's uptrend is still intact, particularly in the US (see chart above) but investing in the sector requires good stock selection to succeed. Elsewhere though there are very few standout sectors at present. Global financials is losing its leadership role; global consumer discretionary appears oversold with a turnaround sceptical. One to watch is stock-specific global industrials which could be trending higher.

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