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Profit taking in equities

Flash note from Multi Asset Solutions | 5 December 2014

For professional investors only

SUMMARY

- Time to take profits in equities
- Equity markets have rallied by almost 10% since mid-October
- Many of the potential catalysts we highlighted to support higher equity markets have delivered

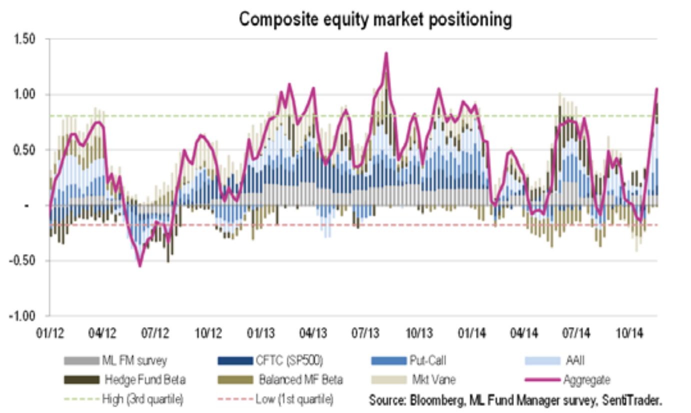
The past seven weeks have seen many positive events including positive surprises in corporate earnings, the continued fall in oil prices, investor appetite for equities, satisfactory results from the ECB's review of banks' asset quality and waning concern about the Ebola outbreak. In addition, major central banks have continued to prime the monetary pumps. On the last point, I would caveat that the US Federal Reserve is the odd man out. The Bank of Japan (BoJ), the ECB and the People's Bank of China (PBoC) have all positively surprised the market, while the Fed only reiterated its plans and provided no fresh clues.

US equities have continued to hit all-time highs. I have lost count of how many times the S&P 500 index has broken into virgin territory. Global equities are within a stone's throw of an all-time high, while the EuroSTOXX 50 is close to a five-year high.

SO WHY DECREASE LONG EQUITY NOW?

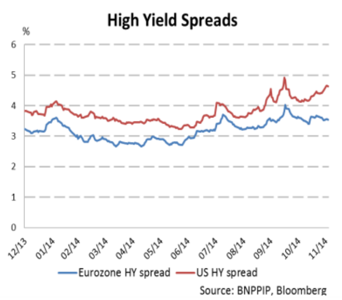
October's market turmoil allowed the MAS investment team to increase the equity weights in client portfolios. We were clear about the reasons why. We said the fundamental backdrop of valuations, corporate earnings, macroeconomics and the contrarian signal of investor positioning and oversold conditions should support equity prices.

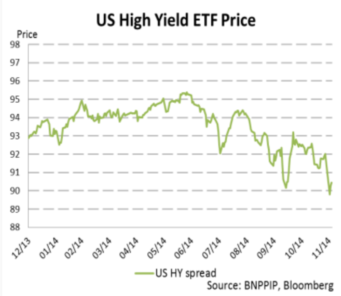
Shorter-term support for our long equity position has fallen away. The chart below show the change in investor positioning: this is currently near peak levels.



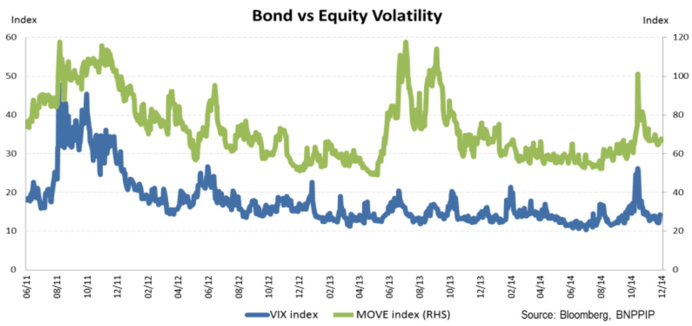
As mentioned above, central banks have been very active. The PBoC surprised investors by unexpectedly cutting interest rates; in the eurozone, ECB president Draghi gave the biggest hint yet that full blown quantitative easing (QE) was an option and he would not tolerate any threat to price stability (too-low inflation). The BoJ continued with QE and Prime Minister Abe called a snap election to gather support for the 'third arrow' (structural reform agenda) of his pro-growth Abenomics initiative.

However, the high-yield market continues to struggle despite the rally in other risk assets and ETF prices have fallen back to October lows. We should note that about 15% of US high-yield bonds relate to the energy sector, so cash flow uncertainties arising from an oil price of only USD 70/bbl are likely to weigh on the results of these companies.





Furthermore, we expect market volatility to rise next year as uncertainty around the outlook for interest rates in the US and the course of the economy is likely to be higher than in recent years.



Our expectations on growth rates for European and US corporate earnings exceeded the market consensus for Q3 2014 the charts below show the above-average EPS beats in the latest reporting season.

However, if we look ahead, the cross-currents of a stronger US dollar and lower oil prices are likely to render the earnings outlook more opaque. A rising dollar is intuitively good for EAFE corporate earnings, but the aggregate level of revenue hedging on balance sheets is not clear to us.

Moreover, the drop in crude oil and petroleum prices should benefit consumers through lower prices (resulting in an effective income increase). But from a stock market perspective, the energy sector is a large contributor to earnings at an index level. Pressure on this sector translates into pressure on the index.

WHAT ABOUT THE LONGER-TERM OUTLOOK?

Not much has changed in our outlook for the macroeconomic cycle. We continue to believe that the US economy is on a firm footing and should provide support to the rest of the world. Crude oil prices have fallen significantly and the US dollar has risen, allowing the US consumer to benefit from cheaper imported goods and lower petrol prices. However, we do recognise the risk of the eurozone slipping into a third recession without growth having reached escape velocity and of China suffering a 'hard landing'.

WHAT ARE THE RISKS?

While in the eurozone, low levels of inflation have intensified in the past few months, the margin of error for policymakers has fallen.

One additional scenario that has been incorporated into our outlook is a significantly stronger US economy driven by wage growth. This could force the Federal Reserve to raise rates sooner and more quickly than the market currently expects. We believe this could lead to a disorderly rise in bond yields and a sustained rise of volatility in equity markets. Our portfolios are currently not positioned for such an outcome.

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