IMPERIUM CAPITAL

momentum

Weekly Digest

Week ending **5 November 2017**

If investors are positioned for a crash, will one ever come?

A phrase the portfolio managers currently hear often is 'goldilocks period' – used to describe this period of reasonable growth, low inflation and low-interest rates which has led to excellent returns for equities and credit; i.e. 'not too hot, not too cold'. Since the market bottom in March 2009, equity markets are up somewhere between 350% in US and 200% in UK.

Despite these good returns, this recovery has been characterized as 'the most hated bull market in history'. Investors have been unusually cautious throughout this period and it is probably the reason why this is one of the longest bull markets on record. Looking at the valuation models today, nearly every asset class is trading close to peak valuations. Markets require a healthy pull back, i.e. a market correction, or risk a prolonged period of sub-par market returns.

In conversations with investment managers and reading the industry press, it appears that professional investors are becoming increasingly more cautious. The portfolio managers are also of that belief and over the recent months they have allowed cash to drift up, increased allocations to liquid alternatives, reduced exposure to credit and also bought some put options.

So say for the point of argument that intuition about increasing nervousness amongst market participants is correct. Let's then pose the question, 'If most professional investors are cautious, can we have a market crash?'

On the one hand, yes, but as investors are positioned to buy any dip, that would need to coincide with a meaningful change in expectations for real economic variables going forward, which would pressure the asset prices lower. What could cause such a change? Excluding a significant macro left tail event, one of the main risks today is a mishap in central bankers' policy. Removing liquidity and increasing rates too quickly can cause a significant economic slowdown and therefore a drop in asset prices. For now, the central bankers have been very cautious when it comes to raising rates. It also helps that policies among the key central banks (FED, ECB, BOE, and BOJ) are becoming less synchronised. While the FED is a lot further down the path of tighter policy, the policy in Europe and Japan is still very loose.

On the other hand, no. Crashes are characterised by a rush to the exit, which sees people accepting large discounts to fair values in order to get their cash back. If everyone is cautious and there is no exuberance, then it seems unlikely that we will see this redemption rush. Investors will continue buying the dips and this should support the case for markets to continue to grind ever higher. However, there are signs that investors are getting more and more complacent as would be suggested by the high market valuations and extremely low market volatilities. Also, there is some evidence that non-professional investors are becoming increasingly bullish. *Torsten Slok of Deutsche Bank has recently pointed out that US households have never been more optimistic about stock prices going up, behaviour more typical of a late-stage bull market. Eventually, as most investors who are 'worried today' capitulate and more fully invest in the market, the market crash becomes ever more likely.

If history is anything to go by, markets will continue to go through bull and bear cycles and it is highly probable that at some point in the future markets will trade much lower. As with any predictions, timing is everything and as such the portfolio managers do not try to make short-term market forecasts, but rather invest for the long term following a disciplined valuation-based investment process. For now, they continue to be invested in risky assets although with some increased caution. The portfolios' equity positions remain close to strategic weights, while the portfolio managers have been increasing allocations to the asset classes with either defensive characteristics or low correlations to risk assets.

** Financial Time, October 24, 2017 "Sign of a top? US households increasingly bullish on stock prices"*

The **Marketplace**

- Jerome Powell nominated as Federal Reserve chair
- The Bank of England votes to raise rates by 25 basis points
- US equities hit record highs
- Eurozone posts strong economic data
- US House presents initial draft tax bill

Market **Focus**

US

- President Donald Trump announced Jerome Powell as the successor to Federal Reserve chair Janet Yellen. Powell is expected to provide monetary policy continuity.
- US equities hit record highs, supported by a 2.6% rise in Apple following better than expected revenues.
- US non-farm payrolls for October were lower than expected (261k vs 313k consensus), but still took the unemployment rate to 17 year lows at 4.1%. Average earnings growth was lower than expected at 0.0% for the month versus 0.2% consensus.
- The House of Representatives presented their first draft tax bill, which included a corporate tax rate cut from 35% to 20%.
- Q3 non-farm productivity was above expectations at 3.0% annualised quarter-on-quarter versus 2.6% expected.
- The Chicago Mercantile Exchange announced it would offer Bitcoin futures by the end of the year.
- US equities rose 0.3% during the week while US Treasuries rose 0.5%.

UK

- The Bank of England Monetary Policy Committee voted 7-2 to hike the base rate by 25 basis points, taking the rate to 0.5%. The rise was perceived as dovish by the markets contributing to the 0.4% fall in Sterling versus the US Dollar and the 0.8% rise in UK gilts.
- Reports increasingly suggest that the UK may concede to EU financial settlement demands to progress negotiations, with previous reports indicating the UK had initially offered EUR 20 billion, while the EU has asked for EUR 60 billion.
- UK equities rose 0.7% in Sterling terms.

Europe

- In Spain, an arrest warrant was issued for expelled Catalan President Carles Puigdemont, citing he and several others promoted violent force. Puigdemont, currently located in Belgium, turned himself in to Belgium police on Sunday.
- Economic data continued to be strong with Q3 GDP growth at 0.6% versus 0.5% expected, and unemployment at 8.9% versus 9.0% expected. Core CPI was below expectations at 0.9% year-on-year versus 1.1% consensus.
- Eurozone manufacturing PMI was revised down 0.1 to a final reading of 58.5, a 0.4 increase from September and the highest level since February 2011.
- Continental European equities rose 0.9% while Brent crude oil rose 2.7% in US Dollar terms.

Europe

- Saudi Arabia's new anti-corruption committee, headed by Crown Prince Mohammed bin Salman, has ordered the arrest of eleven senior royal family members including Prince Al-Waleed bin Talal, the 50th richest person in the world.
- The Bank of Japan voted 8-1 to maintain its monetary stimulus policy.

Jernej Bukovec (CFA) & Oliver Cooper

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 3 Nov. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.3%	0.5%	16.9%	25.7%
United Kingdom	GBP	0.7%	0.9%	9.3%	15.5%
Continental Europe	EUR	0.9%	0.4%	14.8%	25.2%
Japan	JPY	1.3%	1.6%	20.5%	33.9%
Asia Pacific (ex Japan)	USD	1.8%	1.0%	33.4%	30.7%
Australia	AUD	1.0%	0.9%	9.0%	19.2%
Global	USD	0.6%	0.4%	18.7%	25.0%
Emerging markets equities					
Emerging Europe	USD	0.2%	-0.7%	13.6%	25.5%
Emerging Asia	USD	2.3%	1.1%	40.4%	35.9%
Emerging Latin America	USD	-2.7%	-1.3%	20.6%	15.2%
BRICs	USD	0.9%	0.7%	37.9%	35.0%
MENA countries	USD	0.2%	0.1%	-1.2%	10.3%
South Africa	USD	1.1%	0.3%	15.2%	12.6%
India	USD	1.9%	1.2%	35.9%	28.6%
Global Emerging Markets	USD	1.5%	0.6%	33.1%	30.1%
Bonds					
US Treasuries	USD	0.5%	0.2%	2.5%	-0.6%
US Treasuries (inflation protected)	USD	0.6%	0.3%	2.3%	0.3%
US Corporate (investment grade)	USD	0.5%	0.2%	5.8%	3.7%
US High Yield	USD	0.0%	0.0%	7.4%	9.7%
UK Gilts	GBP	0.8%	0.5%	0.6%	1.0%
UK Corporate (investment grade)	GBP	0.9%	0.6%	3.7%	4.7%
Euro Government Bonds	EUR	0.5%	0.0%	0.7%	-0.1%
Euro Corporate (investment grade)	EUR	0.3%	0.1%	3.0%	2.6%
Euro High Yield	EUR	0.5%	0.3%	7.6%	9.0%
Japanese Government	JPY	0.2%	0.1%	-0.1%	-1.7%
Australian Government	AUD	1.3%	0.6%	3.9%	1.4%
Global Government Bonds	USD	0.5%	-0.1%	5.2%	-1.1%
Global Bonds	USD	0.5%	-0.1%	5.9%	0.8%
Global Convertible Bonds	USD	0.7%	0.0%	10.0%	9.0%
Emerging Market Bonds	USD	-0.7%	-1.0%	7.4%	4.1%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 3 Nov. 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	1.0%	1.1%	2.7%	10.1%
Australian Property Securities	AUD	0.6%	0.3%	-2.9%	3.8%
Asia Property Securities	USD	1.1%	1.2%	25.0%	17.3%
Global Property Securities	USD	1.0%	0.8%	12.4%	14.2%
Currencies					
Euro	USD	0.1%	-0.4%	10.3%	4.5%
UK Pound Sterling	USD	-0.4%	-1.6%	5.7%	4.8%
Japanese Yen	USD	-0.2%	-0.5%	2.4%	-9.9%
Australian Dollar	USD	-0.1%	-0.2%	6.2%	-0.5%
South African Rand	USD	-0.4%	-0.6%	-3.8%	-5.4%
Swiss Franc	USD	-0.3%	-0.5%	1.7%	-2.8%
Chinese Yuan	USD	0.3%	0.0%	4.8%	1.9%
Commodities & Alternatives					
Commodities	USD	1.4%	1.1%	1.9%	8.3%
Agricultural Commodities	USD	0.1%	0.4%	-3.2%	-3.1%
Oil	USD	2.7%	1.1%	9.2%	33.9%
Gold	USD	-0.1%	-0.2%	10.1%	-2.6%
Hedge funds	USD	0.3%	0.0%	5.2%	7.9%

Source: Bloomberg. Past performance is not indicative of future returns

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