Market Review

Inflection Point

Oakwood Financial Advisors
Floor 2,
64 Mount Street Lower,
Dublin 2

01 652 3070
or
info@oakwoodfinancial.ie

Watershed Moment

Global Financial Crisis

This time ten years ago we were at the height of the Global Financial Crisis which threatened a systemic crash of the global banking system, brought down Lehman Brothers and triggered a widespread collapse in the prices of risk assets (equities and property).

Recovery

By March 2009 the Standard and Poor's US Equity index had finally slumped to its low of 677 (currently 2734 – **a 247% recovery**). The extent of the shock to the global system convinced many investors that we were in a "new normal" economic environment of low inflation and slow growth that in turn would result in an extended period of low investment returns.

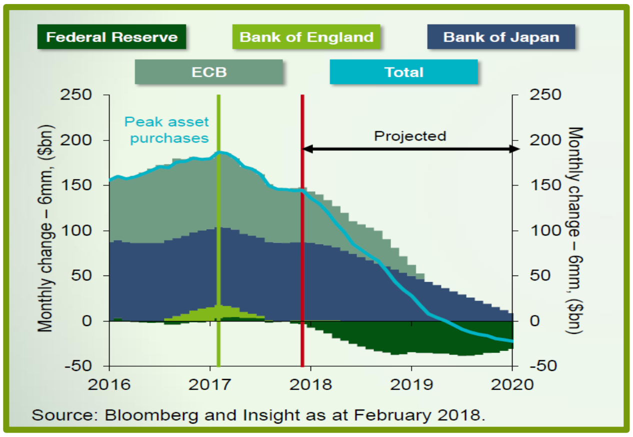
Ten years on inflation has remained low and asset returns have been very strong.

Quantitative Easing (the supply of new money into the money supply by a central bank QE) by the developed world central banks has been the dominant driver of this outcome. The low returns available on high quality assets have driven investors into riskier assets in the search for yield.

2017 Peak

Now however it is clear that the QE peaked in 2017. The Federal Reserve and the European Central Bank have both slowed their rates of purchasing with the latter expected to stop altogether from early 2019.

They are currently falling and are expected to reverse, i.e. dip into negative territory, in the middle part of next year.



Source: Bloomberg and Insight as at February 2018.

Bond markets (loans to both Governments and Corporates) benefited from low inflation and improving government finances whilst equity markets benefited from economic recovery.

Watershed Moment

Regardless by far the dominant influence on markets over the past nine years was QE. If that is indeed the case, the expected path of QE, as shown by the dotted line in Chart 2 below is a cause for concern.

The ending and eventual reversal of QE will mark a fundamental and negative watershed in the supply/demand balance in asset markets.

Causes for Concern

Causes for concern
On its own the ending of Quantitative Easing would constitute a significant hurdle for markets. Worryingly, its demise coincides with some other causes for concern.

US Economy
The long-running economic recovery, underway since mid-2009, is now nearing its peak. The US economy, still the engine room of the global economy, is operating close to full capacity with unemployment at 3.7% running at its lowest level for 39 years. The recent tax cuts driven by President Trump and the Republican party is increasing upward pressure on US wage rates.

Increased Interest Rates
The Federal Reserve has already increased interest rates to just over 2.0% (to "The Donald's" twitter ire) with more increases signalled to come. Equity markets do not react to but rather anticipate future events. The equity market typically peaks some six to twelve months before the economy reaches its peak.

Market Valuations
There is little support in market valuations. Bond yields, particularly in Europe, offer extraordinarily poor value to long term investors. Equity valuations this year have benefitted from strong corporate profits growth, helped by tax cuts, but still look extended on a longer term, cyclically adjusted, basis.

Negative Returns
International equity markets, already in negative territory year- to-date, don't look as expensive in valuation terms as the US but it is difficult to be positive on other equity market when the US market is in retreat.

World Stock Markets 2018 (18th October)	
	YTD
S&P 500 Index	4.1%
DOW Jones Industrial Average Index	3.3%
DJ Euro Stoxx 50 Index	-8.4%
Dow Jones Transportation Average Index	-1.3%
FTSE 100 Index	-8.3%
FTSE All Share Index	-8.4%
ISEQ Index	-14.8%
Nikkei 225 Index	-1.0%
Shanghai Composite Index	-22.9%
FTSE World Index ($)	-3.6%
FTSE All-World x-US ($)	-11.3%
FTSE Asia Pacific	-11.7%
FTSE Emerging Markets	-15.7%
Commodities	
Gold	-6.3%
Oil	20.2%

Market Indicators

Valuations & Returns

Market valuations do not normally act as a precise timing signal for market turns. However, they do provide a useful indication for long term expectations of investment returns. Typically, when valuations are low (i.e. yields are high) at the beginning of a period, subsequent long-term returns are high, e.g. in 1942 and 1983 in the table below.

Valuations & Subsequent Returns

Time Frame	Dividend Yield	Bond Yield	50/50		Dividend Yield	Bond Yield	50/50 Split
	Valuations				Returns		
1942 - 1965	8.1%	2.5%	5.3%		12.3%	-0.9%	9.3%
1966 - 1982	3.0%	4.6%	3.8%		0.7%	-0.2%	0.3%
1983 - 2000	4.9%	10.5%	7.7%		12.1%	7.6%	10.2%
2009 - 2017	3.2%	2.5%	2.9%		13.1%	1.9%	8.6%
31/12/2017	1.8%	2.4%	2.1%				

Anomaly

The current period 2009-2017 is the anomaly when low initial yields were followed by very strong returns, which in the main is attributable to the influence of QE. It is difficult to avoid the conclusion that we should have modest expectations for investment returns over the next ten years.

Market Indicators

Finally, there are several “indicators” which give an indication of the types of excesses that often emerge towards market peaks. Overall global debt levels are higher now than those prevailing before the Financial Crisis. There has been a particularly sharp pick-up in US Corporate debt.

Investor Leverage

Investor leverage (i.e. borrowing by investors to invest in the markets) is running significantly ahead of the levels which prevailed at the previous market peaks in 2000 and 2007.

Finally, Collateralized Loan Obligations (loans pooled together and sold) issuance are running at three times the 2007 level.

The tide is turning....

Oakwood
FINANCIAL ADVISORS

Expensive & Over-borrowed
To summarise, Q.E. can be seen as the life support which was switched on in 2009 for financial markets and is now coming to an end. Valuations are now expensive and many economies, corporates and investors are over-borrowed.

Inflection Point
It is difficult to forecast an inflection point for markets but it is even more difficult to avoid the conclusion that any realistic expectations for long term returns from current market levels should be modest, at best.

Principle Mistake
The principle mistake retail (private) investors make is that they start buying when markets are up and selling when markets have already dipped. With a well planned portfolio in place you can sit it out and wait for the recovery.

Great Opportunity
For investors, especially those who are investing on a regular basis (either through pension or savings) a dip in markets offers a **great opportunity to buy good companies at lower prices.**

A More Mature Disposition
For those of a more mature disposition (either close to or in retirement) that would prefer a less volatile outlook this may be time to increase focus on capital preservation and take a more cautious stance.

A timely quote from Ralph Wanger's (US fund manager) for times life this:

"'The stock market is a reliable indicator of where the economy is headed, but you'll get no help looking at it the other way around."

Ronan McGrath
Managing Director
Oakwood Financial Advisors
Floor 2,
64 Mount Street Lower,
Dublin 2

01 652 3070

or

info@oakwoodfinancial.ie