

Weekly Digest

Week ending 9 July 2017

PE lessons

In the portfolio manager's proprietary asset allocation models, the total returns of equity markets have four main components. These are: sales per share growth; change in margins; change in Price to Earnings (PE) ratio; and dividend yield. They model these inputs on a five year forward looking basis and use it as the foundation for generating their expected returns, they also analyse how these different elements have impacted total realised returns in the markets. It is instructive from time to time to look at how these different factors have contributed to markets returns.

A lot has been made of the movement in PE ratios in recent years as the trailing ratio has gone up from below 17 for global equities in 2011 to around 21 today. A major argument against the long term sustainability of equity returns comes from the premise that flows from government liquidity programmes such as Quantitative Easing (QE) have remained in financial markets rather than leaking into the 'real world' as this is reflected in increased valuations in global equity markets. There could well be some truth in this, but a decomposition of the global stock market's past twelve months returns paints a rather different picture. Over the past twelve months to the end of June 2017, developed equity markets have returned close to 19% in local currency terms. The income from dividends over that period was approximately 2.4%. Dividend yield is relatively stable and cannot be negative (the change in dividend yield could be but companies cannot actually take money back from you) whereas sales growth, change in margins and change in PE can all be negative contributors to returns. The change in PE contributed 2.1% to returns which is a relatively small amount given the double digit total return of the index as a whole. Sales growth was also relatively modest at 3.0% for the year meaning that the most substantial contributor to total returns from the global equity market over the past twelve months (by quite some way) was change in margins with a contribution of over 10%.

Margins are a measure of profitability i.e. they demonstrate a company's ability to convert sales revenue into profit. A positive change in margins of this sort can suggest a number of positive changes in companies. The managers undertake this analysis at an index rather than a company specific level so such changes

will be driven by a large number of businesses, but the sorts of underlying changes that may increase profit margin include, for example, focusing on product lines that have greater inbuilt profitability over lower margin ones, reducing costs which means that more revenue flows to the bottom line or improving inventory management. So while the past twelve months have been trying ones for consumers with large lumps of political uncertainty hitting much of the developed world, it is pleasing to note that sales growth remained a positive contributor to returns and that companies also made meaningful margin improvements.

Turning to the past three months the managers can observe an even more interesting trend with respect to PE ratios. Globally, over the three months to the end of June, the change in PE actually detracted close to 5% from developed equity market returns. This means that PE ratios fell (markets got a little cheaper on this measure) which is at odds with the broad trend since 2011. Despite this change in PE, equity markets provided a positive return of 2.7% in local currency terms. Dividend yield contributed 0.6% (which is consistent with a 12 month figure of 2.4%) but sales growth contributed 1.7% and change in margins contributed 5.7%. While three months is a short period and therefore only has limited merit for identifying longer term phenomena, this shows that markets can produce positive returns even if PE ratios contract as long as sales growth and change in margins make a positive contribution.

Turning to the forecasting work, this is essentially how the portfolio managers anticipate the next five years' 'base case' to play out. They believe that continued PE contraction will detract from developed market returns but this will be more than compensated for by sales growth and change in margins, with the latter in particular driving returns. So, while it is correct to observe that PEs are a touch on the high side compared to historical levels (and this may or may not be a direct consequence of QE), nevertheless, they believe that there is decent scope for sales and margin growth going forward and that paints a reasonable picture for global equity returns from here.

The Marketplace

- Oil prices declined just over 2.5% last week
- Drop in global government bonds accelerated
- G20 summit shows the divide between the US and others
- UN security council hold an emergency session in response to North Korea
- Global stocks jumped and are still at near record high

Market Focus

US

- ISM Non-manufacturing index picked up from 56.9 to 57.4, contrary to predictions of a decline to 56.5
- The S&P 500 Index was up +0.07% on the week
- The Dow Jones was up +0.3%
- Nasdaq was up +1%, leading US gains
- Federal Open Markets Committee (FOMC) minutes showed an overall tone of cautious optimism, though split on when to begin balance sheet normalisation
- Subdued wage growth belies strong headline payroll figures (+222K for June)
- Treasuries showed a sharp repricing in rate expectations over the course of June, yields sharply higher at 2.4%

UK

- Tuesday saw the 10th anniversary of the last interest rate rise
- Michel Barnier used an address at the EESC to warn that Britain will not enjoy 'frictionless trade' at the end of Brexit negotiations. British business leaders call for a 'pragmatic and flexible' approach to leaving the single market

- Service sector PMI expanded the least in four months in June standing at 53.4, though still reasonably solid
- UK Equities up 0.5% with the FTSE closing at 7312.7
- BoE continues to mull interest rate rise amid inflation fears, concern that economy not strong enough to absorb an interest rate hike as consumers come under pressure

Europe

- EU officials approve a rescue plan for Banca Monte dei Paschi di Siena, marking a positive reset for the troubled Italian banking sector
- Final PMI for June at 56.3, slightly down on 56.8 for May but still rounding off an upward momentum for Q2
- 10yr Bunds breakthrough 0.50% yield to 0.6% representing an 18 month high. Yields up ~30bps in France, Italy, Spain, UK and Germany
- CSPP(Corporate Sector Purchase program)/PSPP (Public Sector Purchase Program) ratio was 13.6% for June, above the average of 11.6% since QE was cut back in April
- Stoxx 600 closed the week at +0.2 ending four weeks of declines

Asia

- Nikkei closes -0.5% on the week
- Hang Seng closes the week down -1.6%
- North Korea fires its first intercontinental missile, drawing global condemnation but world leaders disagree on a way forward
- Samsung investing KRW20.4 trillion (USD18 billion) in efforts to expand semiconductor output in South Korea

James Klempster (CFA) & James Jones

Asset Class/Region	Currency	Currency returns			
		Week ending 7 July 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.1%	0.1%	9.1%	17.3%
United Kingdom	GBP	0.5%	0.5%	5.2%	16.8%
Continental Europe	EUR	0.4%	0.4%	9.1%	24.2%
Japan	JPY	-0.3%	-0.3%	7.0%	33.9%
Asia Pacific (ex Japan)	USD	-0.7%	-0.7%	18.9%	24.0%
Australia	AUD	-0.3%	-0.3%	2.8%	13.9%
Global	USD	-0.1%	-0.1%	10.5%	18.7%
Emerging Market Equities					
Emerging Europe	USD	-0.4%	-0.4%	3.4%	19.1%
Emerging Asia	USD	-0.6%	-0.6%	22.5%	27.3%
Emerging Latin America	USD	0.0%	0.0%	10.1%	18.5%
BRICs	USD	-0.1%	-0.1%	16.7%	26.1%
MENA countries	USD	-1.3%	-1.3%	2.7%	11.7%
South Africa	USD	-2.6%	-2.6%	5.2%	11.1%
India	USD	1.5%	1.5%	25.1%	22.5%
Global Emerging Markets	USD	-0.6%	-0.6%	17.7%	24.0%
Bonds					
US Treasuries	USD	-0.5%	-0.5%	1.5%	-3.7%
US Treasuries (inflation protected)	USD	-0.6%	-0.6%	0.3%	-2.5%
US Corporate (investment grade)	USD	-0.4%	-0.4%	3.4%	0.7%
US High Yield	USD	-0.2%	-0.2%	4.7%	11.4%
UK Gilts	GBP	-0.7%	-0.7%	-0.5%	-2.8%
UK Corporate (investment grade)	GBP	-0.4%	-0.4%	2.1%	4.4%
Euro Government Bonds	EUR	-0.8%	-0.8%	-1.8%	-4.4%
Euro Corporate (investment grade)	EUR	-0.1%	-0.1%	0.6%	0.6%
Euro High Yield	EUR	-0.2%	-0.2%	3.9%	9.2%
Japanese Government	JPY	-0.2%	-0.2%	-0.7%	-5.0%
Australian Government	AUD	-0.4%	-0.4%	2.0%	-2.0%
Global Government Bonds	USD	-0.9%	-0.9%	3.1%	-6.0%
Global Bonds	USD	-0.7%	-0.7%	3.6%	-3.1%
Global Convertible Bonds	USD	-0.5%	-0.5%	6.3%	7.3%
Emerging Market Bonds	USD	-1.1%	-1.1%	5.1%	1.6%

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Property					
US Property Securities	USD	-1.4%	-1.4%	0.6%	-4.0%
Australian Property Securities	AUD	-0.7%	-0.7%	-6.7%	-13.1%
Asia Property Securities	USD	-1.4%	-1.4%	14.1%	13.0%
Global Property Securities	USD	-1.3%	-1.3%	6.6%	3.3%
Currencies					
Euro	USD	0.0%	0.0%	8.4%	3.1%
UK Pound Sterling	USD	-0.9%	-0.9%	4.3%	-0.2%
Japanese Yen	USD	-1.5%	-1.5%	2.6%	-11.7%
Australian Dollar	USD	-1.0%	-1.0%	5.7%	1.7%
South African Rand	USD	-2.5%	-2.5%	2.2%	10.4%
Swiss Franc	USD	-0.5%	-0.5%	5.7%	1.4%
Chinese Yuan	USD	-0.4%	-0.4%	2.3%	-1.7%
Commodities & Alternatives					
Commodities	USD	-1.6%	-1.6%	-7.3%	-2.2%
Agricultural Commodities	USD	1.5%	1.5%	2.9%	3.1%
Oil	USD	-2.5%	-2.5%	-17.8%	0.7%
Gold	USD	-2.5%	-2.5%	5.2%	-10.9%
Hedge funds	USD	-0.1%	-0.1%	2.5%	5.6%

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