Money, Macro & Markets Monitor

CANTILLON CONSULTING

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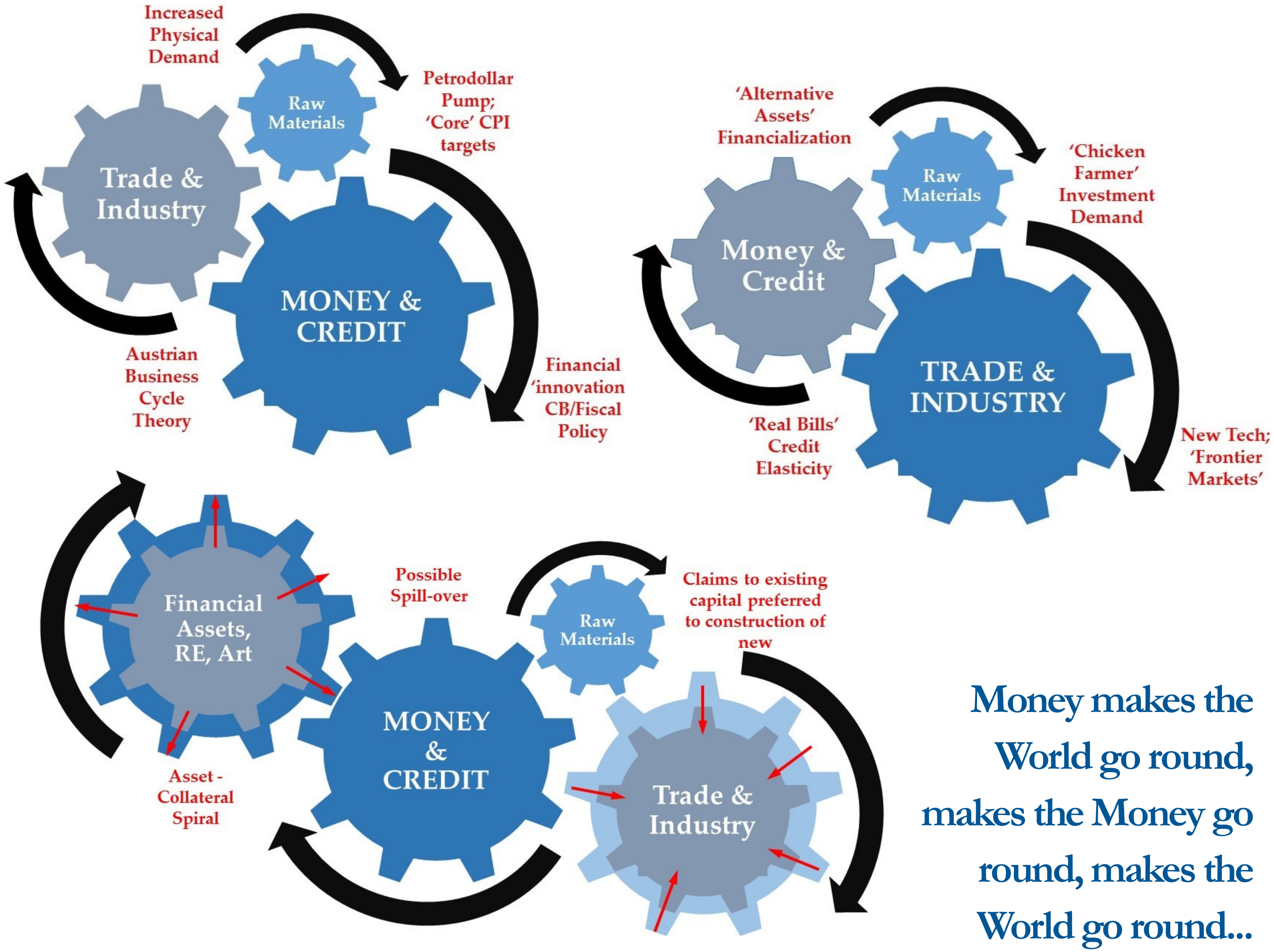
IN THIS ISSUE:-



Money makes the World go round, makes the Money go round, makes the World go round...

Volume II, Issue I

The CAPE of Good Hope

As the latest reporting season unfolds amid a further burst of rapid share-price appreciation, the Blue Skies Brigade has not been shy in linking the former to the latter, pointing out gleefully that the current blend of estimates and actual reporting for QIV shows earnings per share growth of around 12% for the S&P500, together with expected revenue growth of approaching 7% YOY. Creditable enough you might say and – indeed – an unmistakable sign of further progress out of the slough of the shale oil-induced 'Hidden Recession' of 2014/16.

There is, however, a dirty little secret within this ostensibly good performance – *viz*., that, despite the recent improvement, aggregate earnings (i.e., the actual dollars and cents accruing to company coffers once we allow for buyback-depleted share counts) are still no greater than they were four years ago.

Having dipped in the middle, it is, of course, an arithmetical inevitability that, if we are ever to move to new highs after a slump, there must be a point where we have only succeeded in scrambling far enough out of the valley to match the altitude of the previous peak. For example, such was the case in the aftermath of the two previous declines: aggregate earnings were no greater in QI'2011 than they had been in QII'2007 and ditto for QIV'03 and QIII'00.

Where the crucial difference lies is that, as that new highwater mark was reached after the Tech Bust, the S&P still stood almost a quarter below its previous peak; while the recovery from the Lehman-GFC seizure had them yet an eighth lower. Contrast the situation then with that of today - when we find that the index is now 50% ahead of 2013's closing score - and we can see that those who argue that the market is beginning to run on little more than fumes might just have a point in their favour.

In essence, what the past four years have seen is a one-third inflation of the outlay people are willing to make for each dollar of current earnings, the P/E ratio having expanded from 18.4 to 24.3 in the interim. Now it is true that we ourselves have argued that *some* of the secular expansion of multiples seen over the past 35 years can be justifiably attributed to falling bond yields (and hence to the greater NPV one might reasonably attach in one's estimations to the more deferred constituents of the firm's stream of earnings). But that can hardly be used as an excuse in this case, given that long-dated Treasuries, junk, and investment-grade yields are all broadly comparable at either end of our present horizon, while shorter yields are, of course, much higher now than they were before the Fed embarked upon its baby-step tightening programme.

Furthermore, if we *do* employ the NPV argument, we could also contend that whereas the past use of an outwardly identical discount factor might have been shaded to the side of optimism by the conditioning afforded by three, long decades of declining yields, the contemporary fear is that this benign trend is now, alas, behind us. Conversely, it would therefore be sensible to argue that a greater margin of safety needs to be incorporated into one's arithmetic henceforward in order to compensate for the prospect that interest rates indeed continue to increase, not dwindle further.

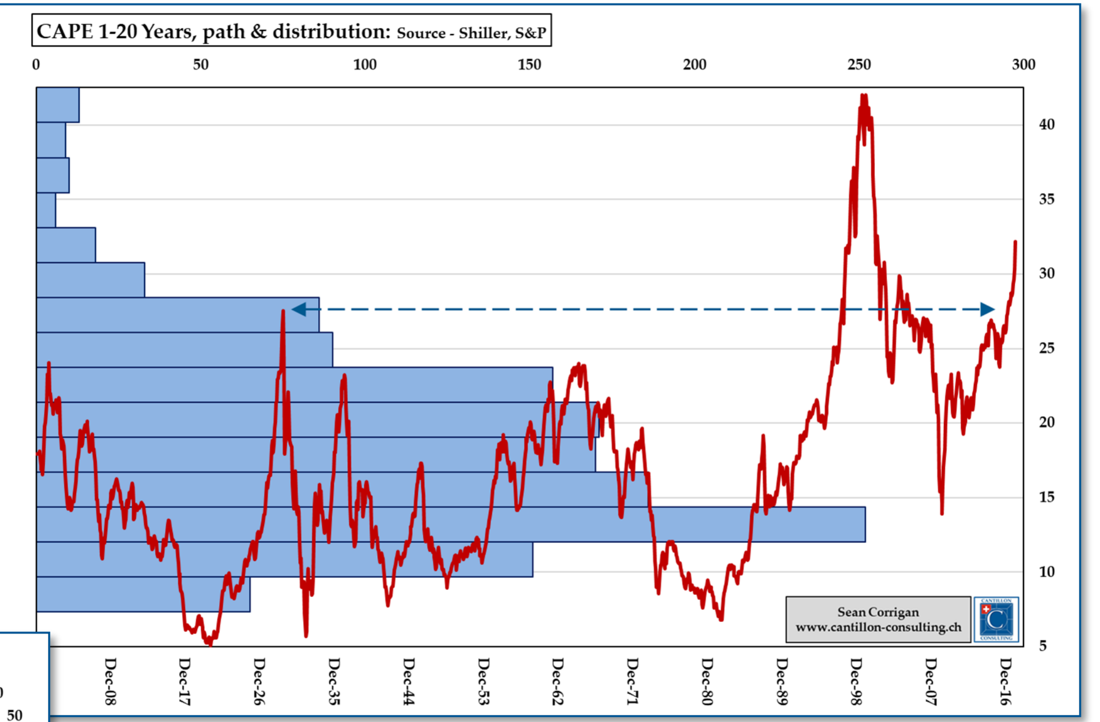
Rounding the Cape

Though we have come to look a little askance at the seemingly ubiquitous CAPE measure – not least because of its gratingly unnuanced adoption by the Permabears – we can still utilise it to derive some broad sense of the market's status once we attempt to adjust it for what we see as two of its bigger flaws: the seemingly arbitrary nature of the 10-year calculation period and its lack of regard for the effect of those wider asset valuations being expressed in the bond market that we have just touched on above.

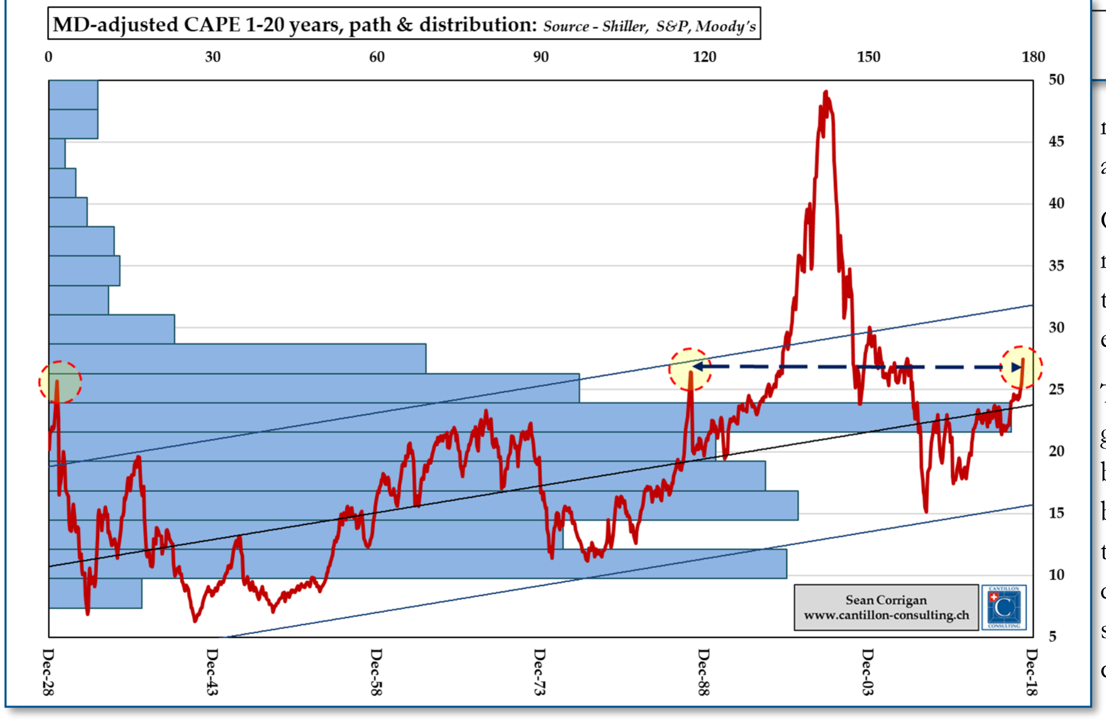
The first we accomplish by calculating the CAPE for *all* intervals from one to twenty years and then averaging them. The second via the shortcut of scaling the index earnings with respect to the contemporary duration of corporate bond yields (since higher durations mean successively deferred cashflows contribute more to today's valuations and vice versa).

Though we had hoped this would temper some of the wilder expositions of alarm to which the traditional measure has lately given rise, the first step still leaves what we might call CAPE1-20 pushing into what is historically very elevated territory - at more than double (circa 4 sigmas over) the 1900-1990 Average of 14.1, a mark where it was only ever exceeded during the height of the first great Tech Bubble.

With due account next being made for the change in long-term corporate yields, things are not quite as bad: the measure is now 'only' 2.4 sigmas over the simple mean of the six-and-a-half decade stretch between the Jazz Era and the age of Irrational Exuberance (1928-1994). Moreover, if we then allow for the steady - if modest - upward trend of 15bps per annum evident in the ratio (pausing briefly to note that this ascent's underlying causation ought really to be subject to further examination), we can further reduce the excess to just shy of 1 standard error from the central tendency.

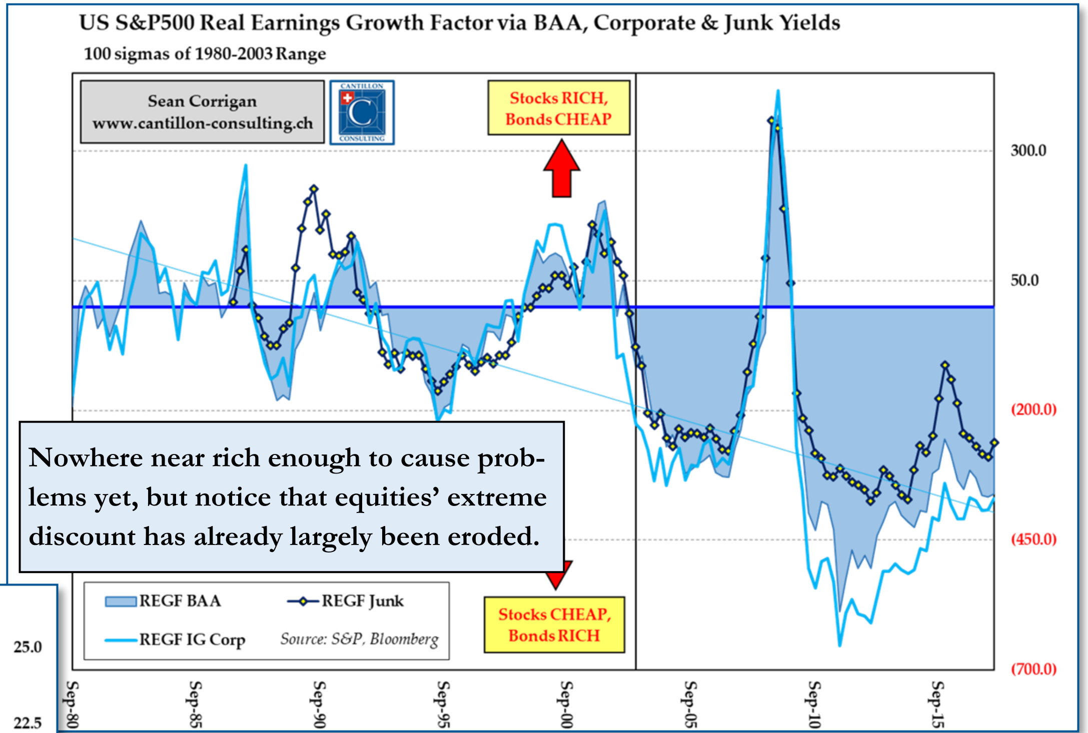


Even here, however, the ratio can be seen to have recently lurched higher so that it now clearly beats the 1929 peak (circled) and also edges out the 1987 spike (a feature brought into much greater prominence once the influence of the fixed income market is factored in). CAPE1-20 MD has thus only been surpassed – if hardly in the most trifling of manners – by the all-enveloping mania of the Dotcom Bubble. That latter extreme should warn us that it could still be very painful to be too short, too early from here but it nonetheless suggests that this is now a game of momentum, not business metrics, and that the 'sentimentals' are beginning to dominate the 'fundamentals', as we often say.



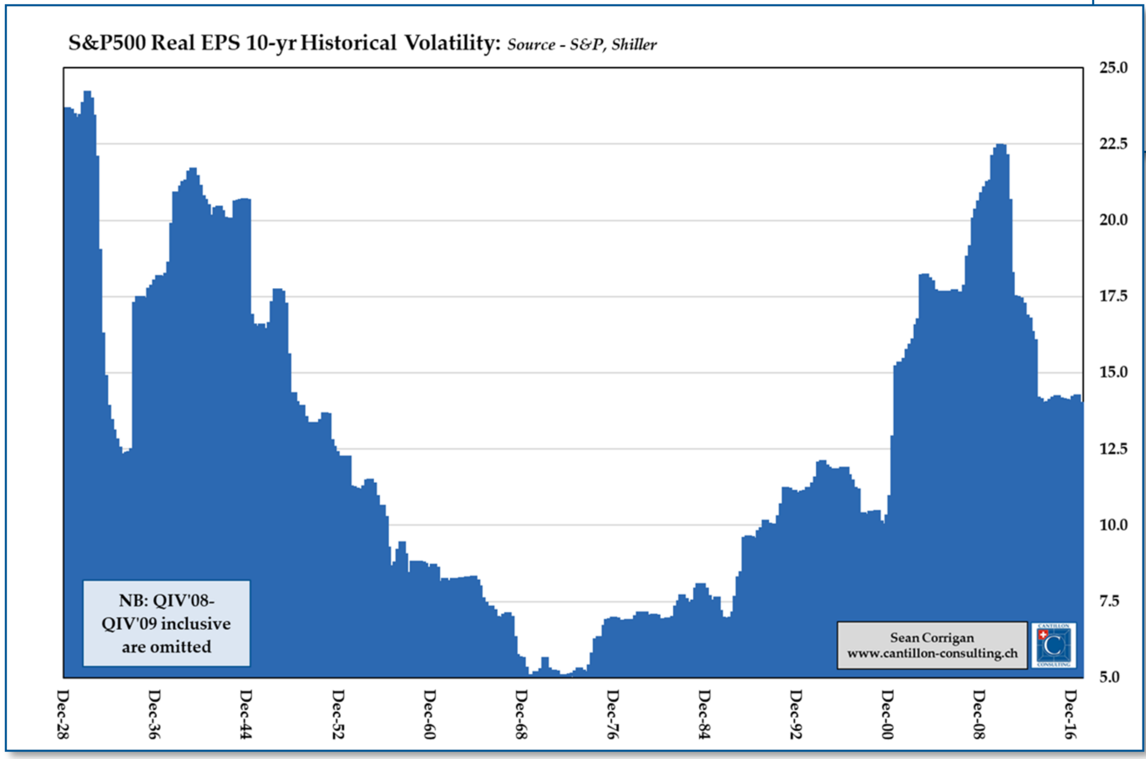
One final caution should be taken from the fact that the last 20-odd years of high-multiple pricing has coincided with levels of volatility of real earnings not seen since the turmoil of the Great Depression dropped out of the calculus (see over) – and that even if we excise the worst 15 months, centred on the disaster which was 2008/9.

The seeming paradox that higher P/E ratios (and hence lower earnings yields) have gone hand-in-hand with greater variability (i.e., with more elevated risk) can presumably only be explained by the fact that the investment income arising from within the business itself has been increasingly supplemented – as well as more closely concentrated – by that arising from debt-funded share repurchases. Nor should we entirely disregard the likelihood that the corrosive effect of such manipulation on the balance sheet of the company might be contributing to the self-same aggravation of commercial and macroeconomic volatility.



Bonds are teetering on the abyss – having attained the key technical level of which so much comment has been made – but have yet to overcome the fixed-income HODLers' understandable reluctance to commit apostasy by surrendering the worldview which has informed so many illustrious careers. In any case, as we saw in our last analysis, the divergence between bonds and stocks - while ultimately not to be ignored – may yet run on a while. At present, then, this is a 'cloud no bigger than a man's hand' at present, not a deluge fit to wash away the foundations of the entire bull market, but it behoves us to keep a weather eye open, nonetheless.

Similarly, the slide in the dollar – if past behaviour is any guide – could easily take on a life of its own and so could conceivably both aggravate the rise in yields *and* enforce upon the US' foreign sponsors the need to undertake what has generally been the costly, swollen basis-swap business of currency hedging. Either could well act decisively to diminish stocks' attractiveness but the timing, as ever, remains moot.



If history does teach us anything in this respect, it is that, for as long as Big Mo dominates the price action, few will give heed to either carry- or opportunity-costs in their frenzy to hold onto his coat-tails and ride the market with him to its climax.

As for commodities, there exists an intriguing parallel with the events of the 1990s when their long, post-Gulf War underperformance relative to stocks came to an end a good 18 months - and all of 25% - before the latter had finished their run (and as much as 85% short of the pinnacle in the case of the madness that was the Nasdaq). Superimposing the last decade's price history on that of this earlier era gives more than a glimmer of hope that a similar passing of the baton might be taking place today.

Bonds struggling, stocks expensive, dollar sliding, prices rising. Time to get real, perhaps?

Sean Corrigan

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'Silver alone is the True Sinews of the Circulation' - *Essai sur la Nature du Commerce en général*

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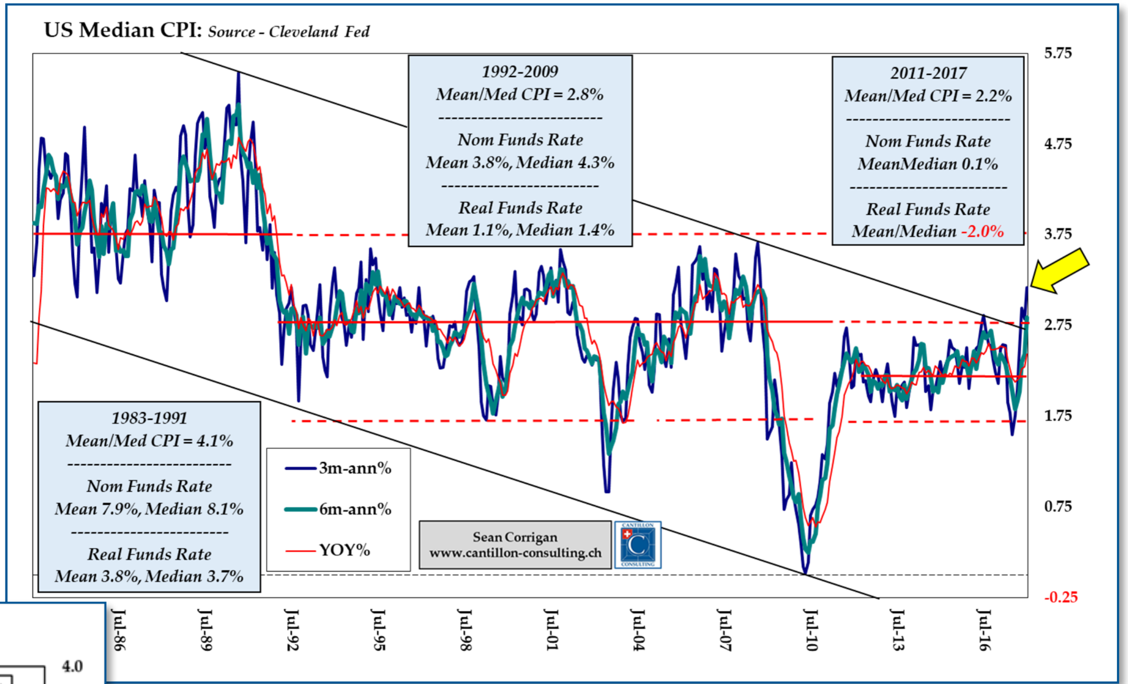
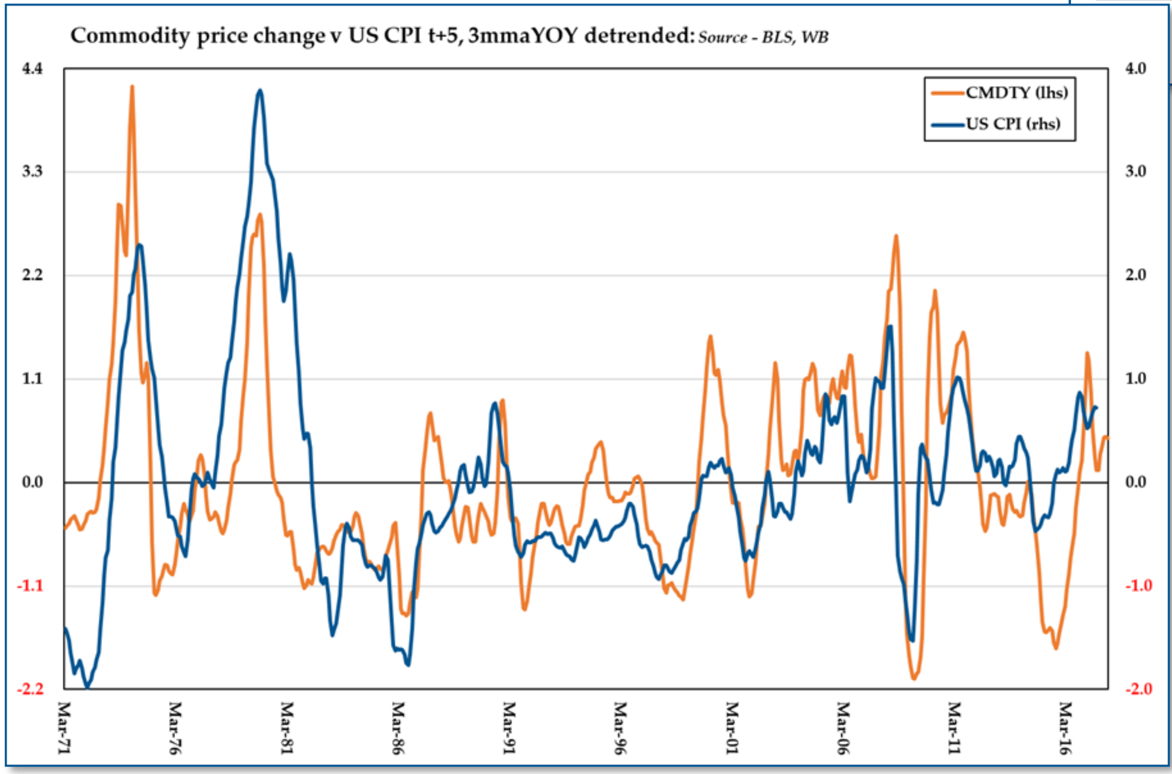
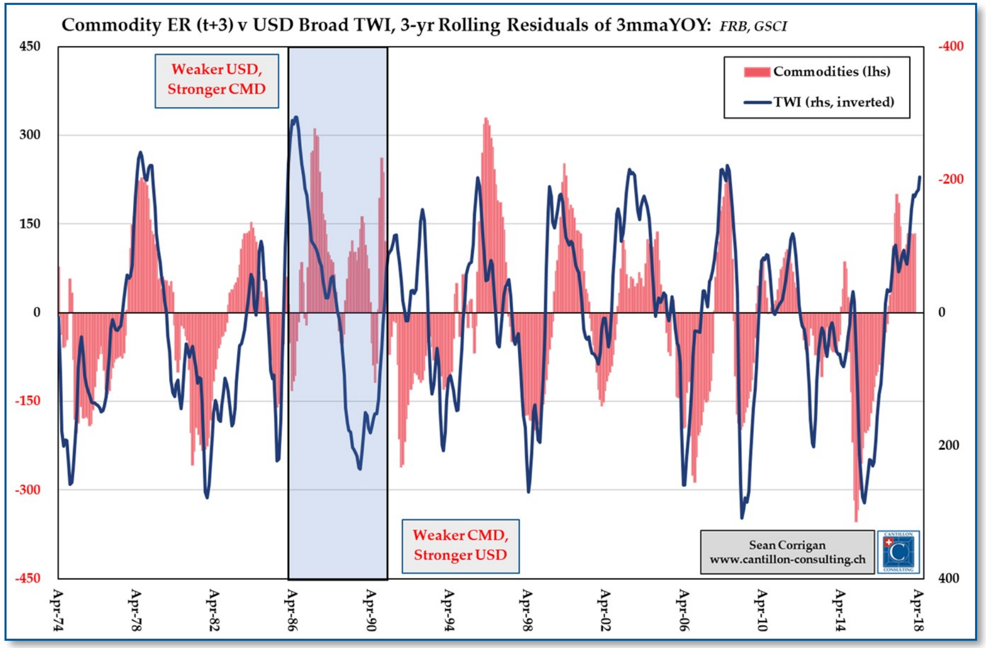
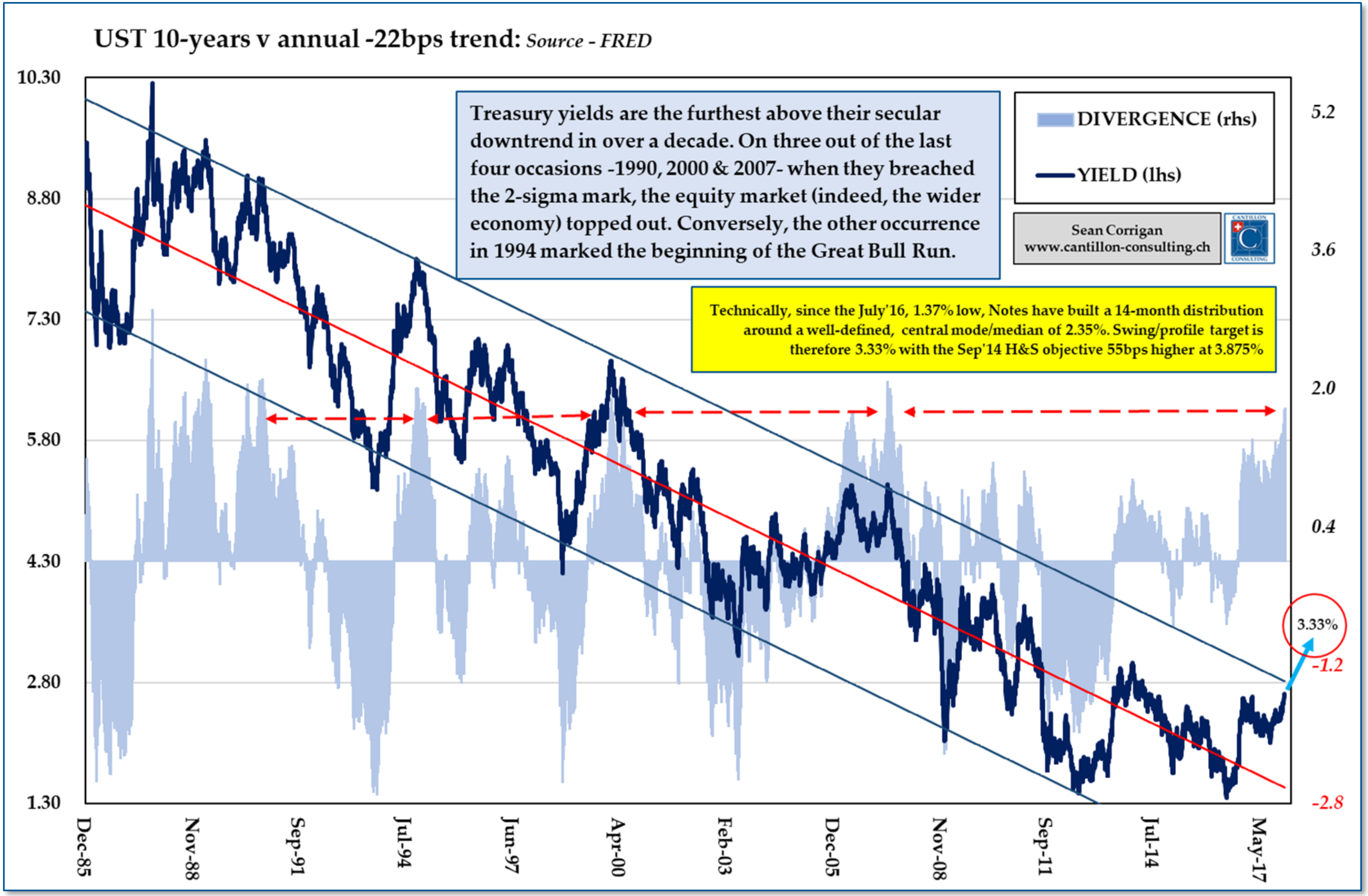
Recently, some FinTwit querulously remarked: 'It's ludicrous to suppose we have base our investment policy on two lines drawn on a yield graph.' To which we rejoined: 'It's even more ludicrous that we have to base our EVERY decision on two lines drawn on a central banker's CPI graph.'

Easy to see (right) that the Fed has more work to do and hence that bonds will remain pressured.
Also evident from the charts below that the impetus from stronger commodity prices (which a weaker dollar will do little to restrain) is likely to feed through and force its way into the Fed's consciousness.








UST 10-years v annual -22bps trend: Source - FRED
Treasury yields are the furthest above their secular downtrend in over a decade. On three out of the last four occasions -1990, 2000 & 2007- when they breached the 2-sigma mark, the equity market (indeed, the wider economy) topped out. Conversely, the other occurrence in 1994 marked the beginning of the Great Bull Run.
DIVERGENCE (rhs)
YIELD (lhs)
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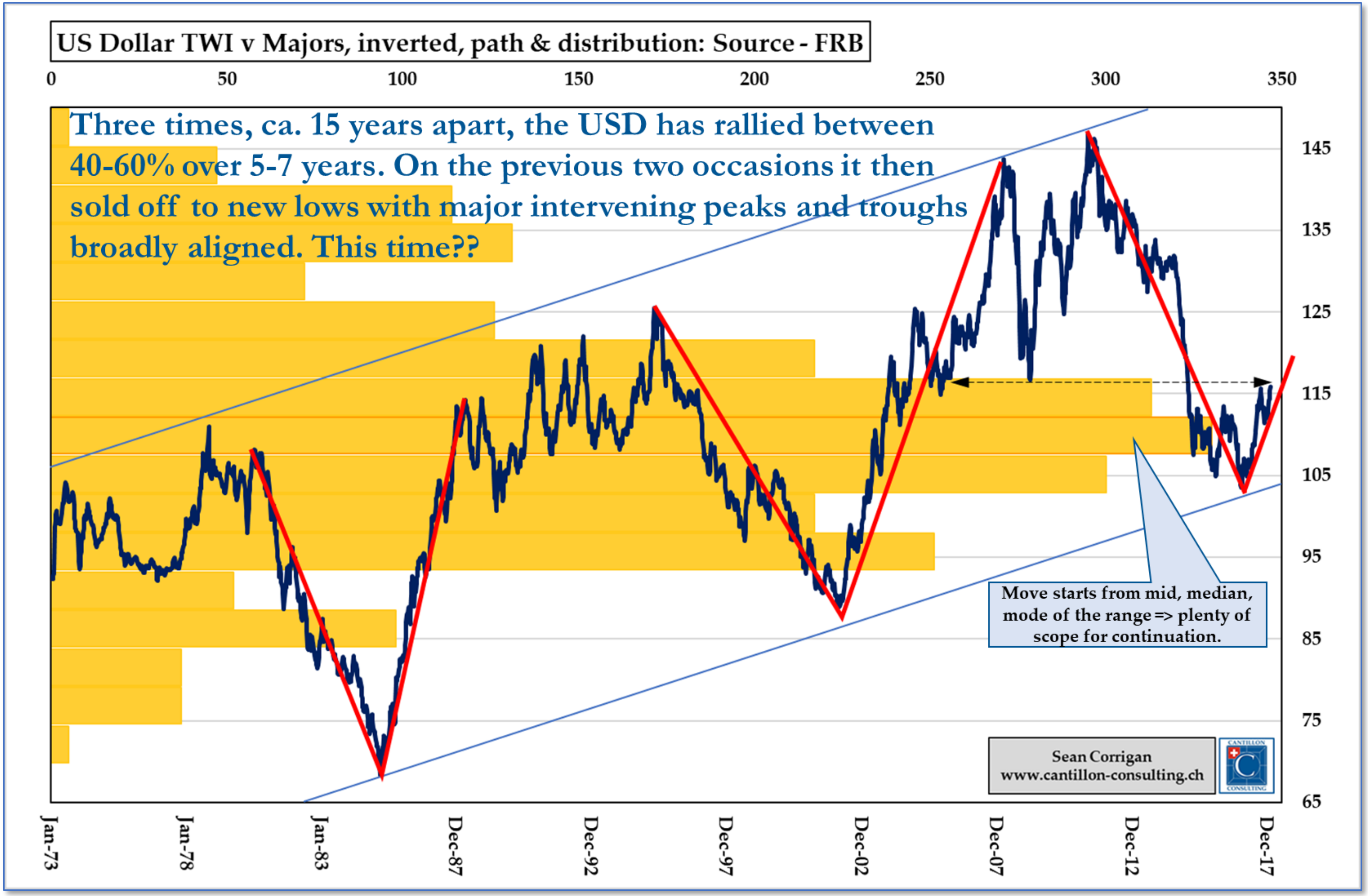
Technically, since the July'16, 1.37% low, Notes have built a 14-month distribution around a well-defined, central mode/median of 2.35%. Swing/profile target is therefore 3.33% with the Sep'14 H&S objective 55bps higher at 3.875%
3.33%
10.30
8.80
7.30
5.80
4.30
2.80
1.30
5.2
3.6
2.0
0.4
-1.2
-2.8
Dec-85
Nov-88
Sep-91
Jul-94
Jun-97
Apr-00
Feb-03
Dec-05
Nov-08
Sep-11
Jul-14
May-17


US Dollar TWI v Majors, inverted, path & distribution: Source - FRB
0
50
100
150
200
250
300
350
Three times, ca. 15 years apart, the USD has rallied between 40-60% over 5-7 years. On the previous two occasions it then sold off to new lows with major intervening peaks and troughs broadly aligned. This time??
145
135
125
115
105
95
85
75
65
Move starts from mid, median, mode of the range => plenty of scope for continuation.
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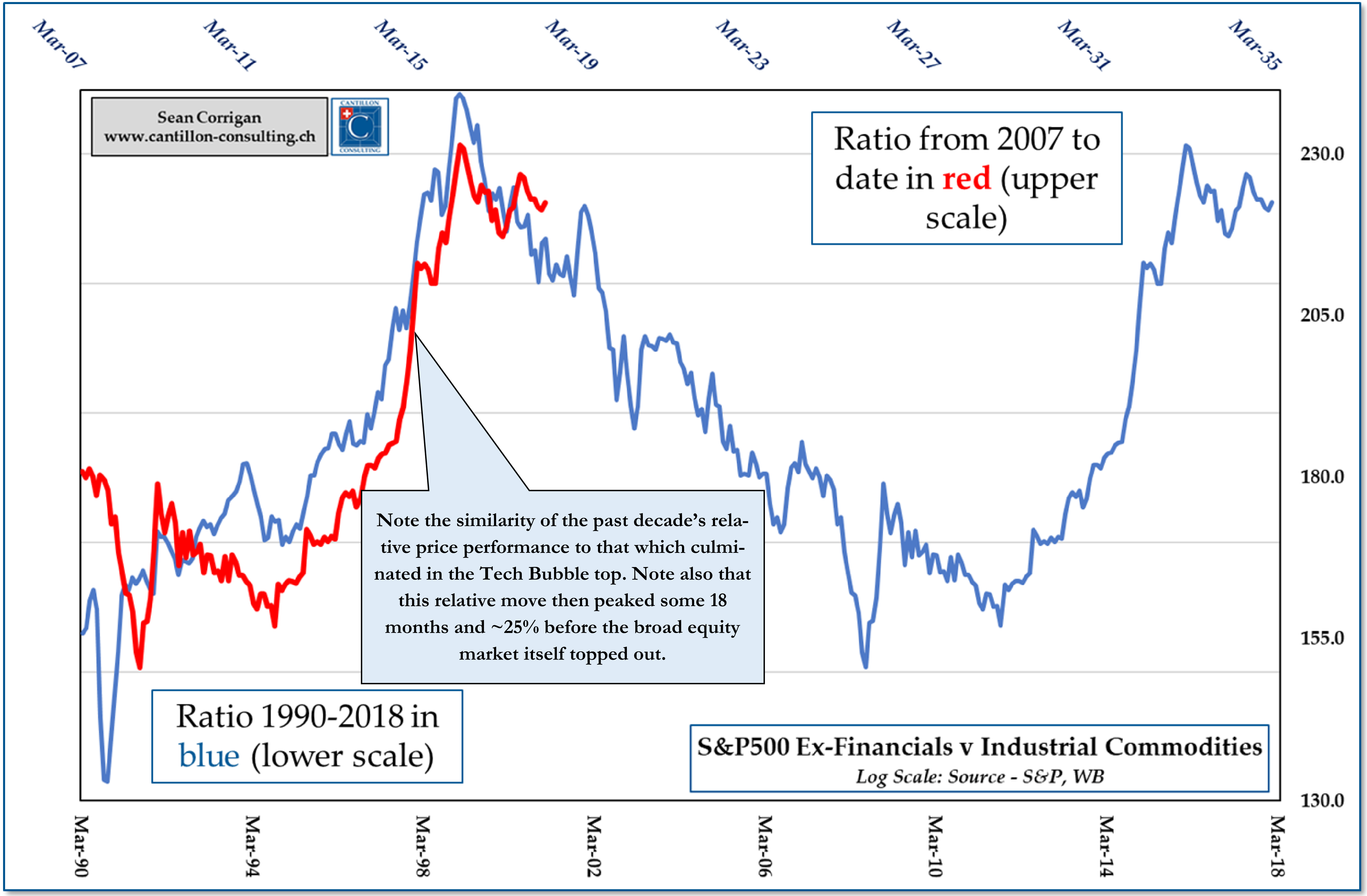
Jan-73
Jan-78
Jan-83
Dec-87
Dec-92
Dec-97
Dec-02
Dec-07
Dec-12
Dec-17


Mar-07
Mar-11
Mar-15
Mar-19
Mar-23
Mar-27
Mar-31
Mar-35
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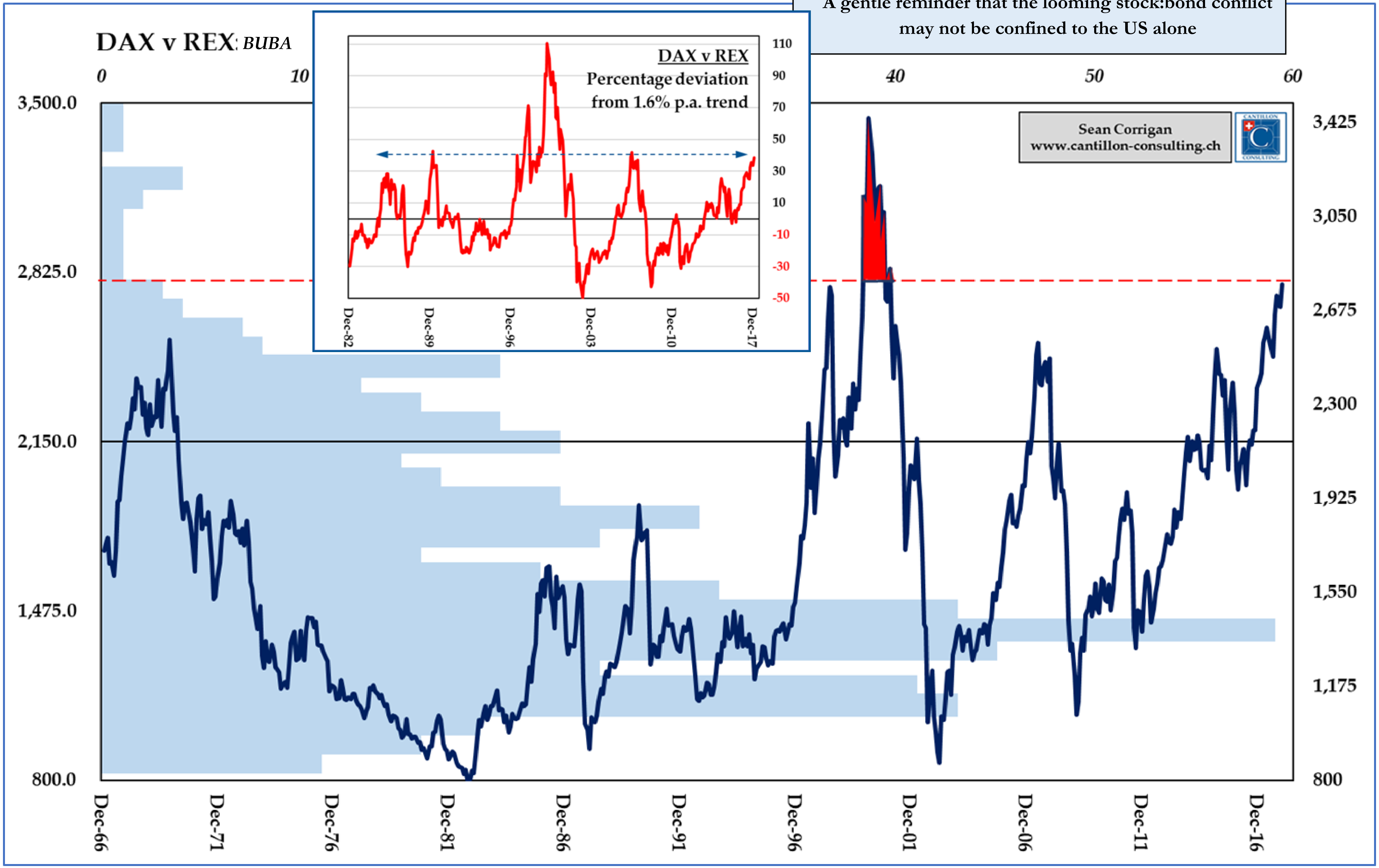
Ratio from 2007 to date in red (upper scale)
230.0
205.0
180.0
155.0
130.0
Note the similarity of the past decade's relative price performance to that which culminated in the Tech Bubble top. Note also that this relative move then peaked some 18 months and ~25% before the broad equity market itself topped out.
Ratio 1990-2018 in blue (lower scale)
S&P500 Ex-Financials v Industrial Commodities
Log Scale: Source - S&P, WB
Mar-90
Mar-94
Mar-98
Mar-02
Mar-06
Mar-10
Mar-14
Mar-18

A gentle reminder that the looming stock:bond conflict may not be confined to the US alone



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