Can the bull still ride on?

Winter is closing in, British summer time has ended and I'm reminded of a quote from the great Yogi Berra, "It's getting late early". But while our evenings may be darker, in the context of equity markets, we think it is too early for the sun to go down.

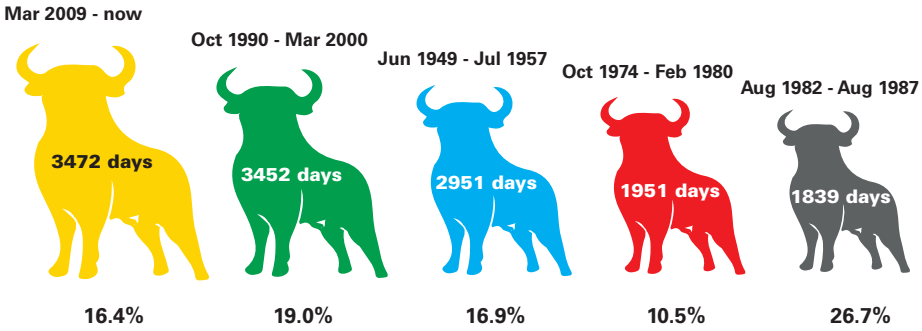
One-day corrections of 3% are always painful, especially when investors have become so accustomed to low volatility after almost a decade-long bull market[1]. Yet, this isn't just any bull market of course. We are currently in the longest US bull run since the second world war, as illustrated by Bull-o-meter below. This shows the last five longest bull markets in US equities, along with the annualised return earned during that period. During August the US equity market reached all-time highs, and the S&P 500 marked the longest bull market in its history at the end of September.

However, all seems to have changed over the last few weeks with markets around the world shaken by greater volatility and poor equity performance. US equities were down 9% from their peak when markets closed on 24 October and at their lowest level since May.

To put this into context, we have seen four S&P 500 moves of +/-3% this year, whereas there were only four moves of this magnitude in the entire six-year period prior to this (2012-2017). So, it is understandable that investors are a little concerned by the recent pick-up in volatility.

Figure 1: Bull-o-meter

Length and annualised returns of the longest bull markets in US equities (measured by S&P 500)



Source: Bloomberg and LGIM, as at 10 September 2018.

Whilst investor confidence has undoubtedly been undermined, it is important to try to look at the bigger picture and not get caught up in the day-to-day noise. If we were to look back a decade and take the six years before that, these kinds of +/-3% moves were a lot more common and occurred about five times per year. Whilst it's natural to put a lot of emphasis on recent newsflow and anchor decisions to recent market conditions, it is important to put this into context. Although equity market volatility has picked up and is above that of last year, it's important to remember that this is still in line with the average for the last 6 years, and well below the 10 year average[2].

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1. A "bull market" is defined as a period of rising prices without a drop of more than 20%.
2. There are various measures of risk but one of the most common is to use the VIX. The VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility for US equities.

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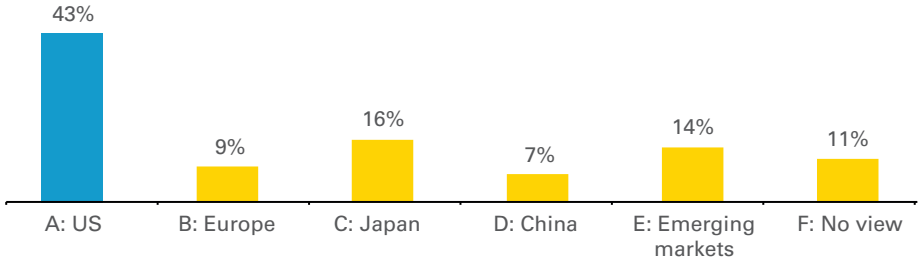
The recent weakness experienced by stock markets is consistent with the 'bumpy journey' our Chief Investment Officer Anton Eser identified in his recent outlook – anticipating that the removal of central bank largesse would stoke market volatility.

But it's difficult to identify a single convincing catalyst for the recent weakness. A long list of potential culprits mentioned in the market include the surge in US Treasury yields, a rotation out of tech stocks, the IMF growth forecast downgrades, US President Donald Trump breaking with long-standing tradition and attacking the Federal Reserve, risk parity funds needing to de-risk with a delay, a lack of corporate buybacks ahead of the earnings reporting season, and more companies complaining about a hit from the trade war. The list could go on even further.

Something that particularly rings true is that the declines were at least helped by the investors seemingly being overly optimistic on US equities (as can be seen in Figure 2). Assessing the magnitude of this optimism is often difficult but we tend to use a range of 'sentiment indicators'. Whilst not overly stretched these indicators had been flagging unusual, US-specific optimism for a while, whereas outside of the US equities, investor sentiment had been much less positive.

Figure 2: Investors were asked which major equity market do you expect to perform best in October?



Footnote: Goldman Sachs QuickPoll survey, Market Strats, October 2nd-3rd, 2018. A: S&P 500, B: Eurostoxx50, C: Nikkei225, D: MSCI-China, E: MSCI-EM, F: No view

Indeed, the sell-off has been most severe in the US despite the domestic equity market's perceived 'safe haven' status – US equities have typically fallen less than other equity markets. Yet in this recent bout of volatility, US equities has been the one of the worst performing markets relative to other developed market regions – a dynamic consistent with sentiment being an important factor in recent market movements.

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In our view, investors' optimism in US equities raised the risk that smaller catalysts could trigger a market correction. But we still do not see this as a reason to fear the beginning of a long bear market. As our patented Bull-o-meter indicates: although this may the longest bull run, it is certainly not the strongest in terms of magnitude of returns so there may be some more room to go. Bull markets do not die of old age – they tend to expire of excess or in anticipation of an economic recession.

In terms of excess, we have seen a correction that should be large enough to make US equities look less expensive than other equity markets. Overall, equity markets do not look expensive especially when compared to other asset classes such as government bonds. Secondly, the global economy looks to be in good shape with a combination of solid growth, low recession risk and transparent central banks: a generally supportive environment for equities.

Yes, the clocks go back on Sunday and winter is indeed coming. It will get darker earlier but in the context of equity markets, we believe it is much too early to turn the lights off.

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