November 2015 Investment Newsletter

Is it all blue skies and rainbows from here?

1. Market has stabilized the past month

In our last newsletter we advocated monitoring the level of volatility and investors' reaction to central bank action for signs of stabilization in the financial markets. Chart 1 below is a handy summary of what transpired last month:

The first panel shows the percentage performance of the S&P 500, the Eurostoxx 600 and the Nikkei 225 over the month of Oct. The second panel shows the performance of the Vix index, a measure of volatility of the S&P 500. Equities last month rebounded 8-9%.

Chart 1: The top panel shows equity performance in percentage terms. The bottom panel shows the Vix index. Similar measures of volatility for other indices have the same moves.

Fed on 29th kept rates unchanged but talked up Dec hike—markets receptive and equities rose.

BOJ on 30th Oct refrained from adding to stimulus—volatility collapsed and equities rose.

Earnings have also largely met expectations, with roughly three quarters of reporting firms in the S&P beating estimates.

In particular, the S&P 500 has moved off its 200 day moving average (MA)—a bullish move, and with a solid percentage of firms in the NYSE index also closing above the 200 MA which signaled the rise was fairly broad-based.

A smaller and stable trading range implies that there are buyers ready to step up whenever the market dips.

In summary, the environment has stabilized for risky assets.

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2. Were gains broad-based?

Delving deeper into the 8% recovery of the S&P 500, the returns were fairly broad-based with the leading sectors being materials, technology and energy. Utilities were the laggards, gaining less than 1%.

We have here some interesting analytics of the sector performances from 1960 to present day.

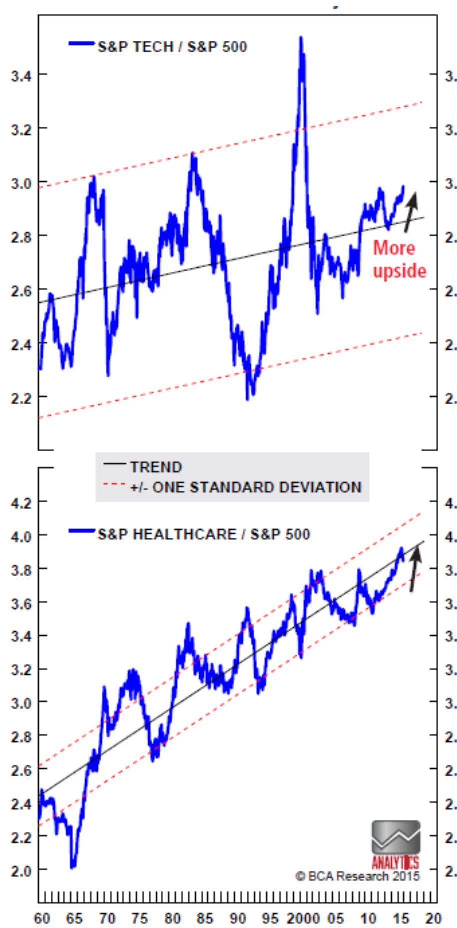
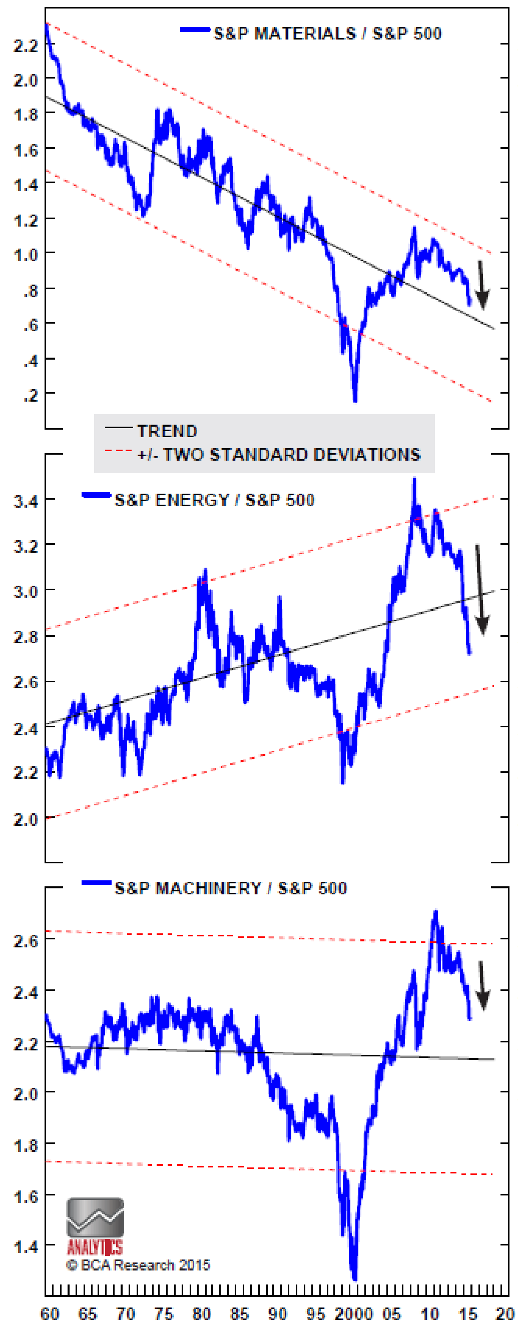


Chart 2: Sector performances of the S&P from 1960—present.



Regarding energy, it is often regarded as being at 'cyclical lows' - which implies potentially strong upside as it moves off from this level—the question is when? Unless you believe oil is going away totally for good, I believe there is merit in allocating a portion of the portfolio to energy; additionally some firms have high dividend yields. In recent developments, we also noted that a large fund is setting up office in Houston to focus on energy bets.

3. Conclusion: Don't discount more episodes of volatility; stock selection matters

Going forward, as we approach the Fed liftoff, there will be more episodes of volatility as the market tries to establish a new equilibrium after such a prolonged period of low rates. Baring a Lehman-like crisis (which seems unlikely at the moment), volatility could be viewed as an opportunity to scoop up quality names.

While a rising tide (of central bank easing) lifts all boats, going forward the returns would not be as broad-based as the market differentiates greater between country, sector and stock selection.

For example, Table 1 below shows the price/ earnings ratios (a measure of valuation) of various equity indices.

Country	Index	Price/ Earnings	Remarks
US	S&P 500	18.5	
US	Nasdaq	28.4	
US	Russell 2000	36.8	common benchmark for 'small-cap' stocks
China	Shanghai Composite	17.2	
China	Shenzhen Composite	43.9	
China	ChiNext	71.3	billed as China's 'Nasdaq'
Japan	Nikkei 225	19.7	
Japan	Topix	16.2	
Europe	Eurostoxx 50	20.7	
Europe	Eurostoxx 600	23.3	

Table 1: Valuations of various equity indices. Compared to developed markets, China's valuations, especially outside of the large caps, still look stretched.

China's valuations, especially outside of the large caps, still look stretched when compared to developed markets. For example, stocks listed on the ChiNext board, often billed as China's 'Nasdaq', has a P/E of 71.

We would also like to urge caution in China's debt market; the risk is that investors keep going longer in maturity in search for yields and in using leverage to boost returns.

Overall, we are positive on the long term outlook for China as it continues its stimulus program and as it transitions from a manufacturing to a consumption-driven economy. The government is intent on making the necessary economic reforms and had stabilized the currency; the Yuan looks set to be included in IMF's Special Drawing Rights (SDR) basket, which would be positive for China assets as we expect inflows from global central banks.

Date sources: Bloomberg, BCA Research

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