AQUILA

Flash

Is it time to cut back on equities?

While there are a number of grounds for caution regarding stock markets we still believe it is right to overweight equities. That said, we have reduced incremental exposure that has resulted from the strong performance of markets since the start of the year.

There are reasons to be cautious about the equity markets

There are several grounds for caution regarding equities. Some analysts fret about the strength of the business upswing while others warn of the negative fallout from rising US interest rates. Many view current stock prices as expensive. Meanwhile "events" – such as an escalation of the crisis in the Ukraine, the possible exit of Greece from the Eurozone or the forthcoming UK general election – have the potential to unsettle markets. Almost all investors harbor concerns as to the longer-term impact of the furious monetary expansion now taking place.

Despite the strength of the dollar the US economy continues to do well

The US economy is robust enough to withstand the effect of the stronger dollar on its export sector and of the collapse of the oil price on its energy sector. These headwinds are being more than offset by favorable developments - better credit conditions, still very low interest rates, the beneficial impact of lower energy costs on spending power as well as a less restrictive fiscal stance. The balance of these forces should be reflected in a solid growth rate of around 3% this year. In China the government has enough leeway so to fashion its fiscal and monetary policies and its approach to regulation as to secure a growth rate in the range of 6.5% to 7% for this year. Meanwhile, both Japan and the Eurozone will benefit from low oil prices and now much more competitive exchange rates. All in all, the world economy is not without its problems but should still manage to grow around 3% this year.

No one can know just how markets will react when the Fed does start to raise rates

Events in the second quarter of 2013 – when the Fed indicated an intention to reduce the scale of its bond-buying – might give some guide as to how markets will react when the Fed does finally start to raise rates. From mid-May 2013, the S&P 500 lost nearly 6% in just over a month before starting a recovery. We think that, this time around, the market's reaction to higher US rates will also be fairly contained. After all, higher interest rates reflect the authorities' judgment that the economy is strong enough to make them appropriate. That said, emerging market economies may suffer from capital outflows in the context of rising US rates and a stronger dollar. Although many of the major developing economies are now in much better shape than they were, for example, during the Asian crisis of 1997 and 1998, several "heavyweights" – Brazil, South Africa and Turkey – are poorly positioned. Even so, problems from this direction seem unlikely to unsettle the world markets in a dangerous way.

Valuation analysis of stock markets does not help to predict market turning points

Opinions vary as to whether the equity markets offer "fair value" or are expensive. "Value-oriented" investors generally say that the markets are hopelessly overvalued. Their approach is reflected in the Shiller cyclically-adjusted price to earnings ratio. This relates current share prices to the 10 year inflation-adjusted average of earnings per share. Right now, the Shiller computation indicates that the S&P 500 US stock index trades at a multiple of 24 times cyclically-adjusted earnings, which is well above the long-term average. However, a comparison of US stock prices with current earnings, or with forecasts for earnings in the near future, suggests US stocks are fairly valued, as current ratios are not out of line with historic patterns. Bearing in mind the exceptionally low interest rate environment, we view US stocks as fairly valued. In any event, valuation analysis is not useful as a predictor of market turning points.

It looks as though the conflict in the Ukraine will become yet more problematic

Although the Ukrainian situation appears to have become calmer of late, we think this is deceptive and don’t expect much stabilization there. President Putin will continue to aggressively assert Russian hegemony in this part of the world until faced with a credible military deterrent. As the West remains unable to fashion an effective, coordinated response, we think the Ukrainian crisis is likely to escalate. The port city of Mariupol looks to be next in the rebels’ sights. The markets will probably not be threatened by events in the Ukraine so long as these are confined to the eastern part of that country. But if military confrontation were to spread to include the Baltic States, all of which are NATO members, then markets would be affected.

Brussels takes very seriously the political implications of a Greek exit from the Eurozone

In the medium-term the departure of Greece from the Eurozone would probably be best for all concerned, but for the near-term we rather expect that a compromise will be found which will keep Greece in the currency union. Now that the European Banking Union, the ESM stability mechanism and the ECB’s QE program are all in place, the Eurozone is far better positioned to withstand a Greek exit than it was in 2012. Brussels is very concerned as to the potential implications of a Greek exit, which could set a precedent for other countries. Greece, on the other hand, wants the financial advantages that stem from its Eurozone membership to continue as long as possible.

So far, the impending UK elections are not affecting markets

The UK’s general election in May looks like a very tight race, with Labour and the Conservatives running neck and neck. A Labour win might not affect the markets much, but a Conservative victory implies a referendum by 2017 on the UK’s continuing membership of the EU. This prospect could unsettle markets.

Central bank monetary policies are preventing market forces from functioning properly

The ultra-expansionary monetary policies of the central banks mean that the capital allocation function of markets is being impaired. In the end, the resulting misallocation of capital will become so serious that the markets are forced into a correction process which will involve significant losses. But we do not view this as a serious risk in the near-term.

We remain overweight in equities

Having considered the risks involved, we still believe that an overweight stance in equities is appropriate, especially in European stocks. However, we have removed the incremental exposure that has come from the strong performance of markets since the start of the year.

Aquila & Co. AG, 25. March 2015