FINANCIAL
PARTNERS

Weekly Digest

Week ending **11 September 2016**

Putting PE in its place

When people say equity markets are expensive they generally mean price multiples are high. And it's true. Yesterday morning the price-to-earnings (PE) ratio of the S&P 500 index stood at 20 times, 20% higher than its average over the past 50 years, even when we allow for the market crashes (and resultant distortions this created in the PE ratio) of 1972, 2000 and 2007. Does it matter? History shows that investing when PEs is high leads to markedly worse returns, so the answer appears obvious. Or is it?

Ignoring the limitations of the PE ratio, a topic in itself, the key problem with this approach is that it makes no reference to other asset classes. In order to establish whether an investment is worth making, it is instructive to compare it to other asset classes.

When thinking about the decision whether or not to invest, people often picture a fairly simple binary choice; if investment returns look attractive I will invest my money; if they don't I'll leave it in cash. As investment returns shrink therefore, the perceived wisdom of leaving money in cash gains popularity. But cash also offers a return when we take into account inflation. In which case a paltry real return of 0% from bonds may start to look more attractive if the real return from cash is running at -2%. But then again, why settle for -2% from cash or 0% from bonds if you can make 5% from equities or property, notwithstanding the higher attendant levels of risk. The key point, therefore, is not what return you stand to make from bonds for example, but how this return compares to what you can get from other asset classes.

Here's a simple build-up approach to assessing relative returns from different investments. Let's assume that government-backed bonds carry the lowest risk of all our available investments – again, an important topic in its own right. The rate of return on a 1 year government bond affects the rate of return on a 2 year government bond, because no investor would buy a two year bond that had a markedly worse return than a one year bond, other things being equal. And the return on a 10 year government bond has a big impact on the return of, say, equities, because why accept an expected equity return of 5% if you can invest with the government for 10 years and earn 6% per annum. There are always nuances, by which investors mean term premia and liquidity premia, etc., but the basic principle that the return available from one asset class affects the return available from other asset classes holds true.

Investors can influence the return from most investments through their buying and selling decisions. The one investment they cannot alter is short term interest rates or cash returns, which are set by the central bank. If short term interest rates are low and expected to remain low, longer term bond yields are pulled lower and equity prices are pushed higher, with the result that we may observe justifiably higher PE ratios.

You can see then, that a key determinant of investment returns is the path of short term interest rates, and we know that this path is a function of the central banks mandate and whether they are focused on inflation, employment or both. If you understand what the outlook for short term interest rates is, you'll understand what the return from all other asset classes is likely to be and then you'll know whether equities are currently expensive or not.

So what do the the managers of our core portfolios think? They think interest rates will normalise quicker than is currently discounted by markets over the next five years, with the result that bonds do poorly. In this environment you want to hold relatively more variable paying assets (assets whose returns are likely to increase as short term interest rates and inflation increase, such as equities and inflation-linked bonds) and relatively fewer assets that offer fixed rates of return at today's low interest rates, notwithstanding the perennial need for diversification and a balance of risks.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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The **Marketplace**

- ECB keep monetary policy on hold
- Fed Governor makes case for rate rise despite poor US data
- Global financial assets sell-off late in the week
- UK services sector strong, whilst trade deficit decreases
- Chinese trade data encouraging

Market **Focus**

Global

- The drop in global risk appetite following the European Central Bank's meeting on Thursday developed into a broad market sell-off on Friday, as the usually dovish Federal Reserve governor Eric Rosengren delivered comments hinting at the suitability of an upcoming US interest rate rise despite the release of some weak economic data.
- Global developed market equities fell 1.5% over the week and -2.1% on Friday.
- The VIX volatility index rose 39.9% on Friday as turbulent trading saw bond yields rise and equity prices fall. US 10-year Treasury yields rose 7.6 basis points to 1.7%, their highest since Brexit. European yields also rose, with 10-year German Bund yields closing above zero for the first time since July 15th (0.009%).
- US equities lost 2.5% on the day (and 2.4% for the week) as expectations of an upcoming rate hike increased, even after the US non-manufacturing index hit its lowest level since February 2010 and the Federal Reserve's Labour Market Conditions Index dropped to -0.7 in August from 1.0 in July.
- UK and Continental European equities were similarly down: 1.7% and 1.0% respectively for the week.

Europe

- The ECB kept monetary policy unchanged at its meeting on Thursday, leaving the main refinancing rate at zero, the deposit rate at -0.4%, and asset purchases (QE) at EUR 80 billion a month. The outcome was not unexpected, but was disappointing for some investors hoping for further stimulus.
- The euro rose to a two week high against the dollar following the announcement, and was up 0.7% over the week at 1.12 dollars to the euro.

UK

- The UK services Purchasing Managers' Index (PMI) for August mimicked the record post-Brexit rebound experienced in July by rising 5.5 points to 52.9, above the forecast of 50.
- Meanwhile the UK's trade balance for July showed a GBP 11.8 billion deficit, shrinking from a GBP 12.4 billion deficit in June. Driving the smaller deficit was an increase in exports following the pound's weakness: year-to-date the currency is down 10.0% versus the dollar.

China

- Chinese trade data in August improved from July, suggesting improving domestic and external demand. Imports rose 1.5% year-on-year, whilst exports, although down 2.8% year-on-year, were better than the 4.4% drop in the previous month.
- The Shanghai Composite index was up 0.4% for the week, despite a 0.6% drop on Friday.

Richard Stutley & Oliver Bickley

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Asset Class/Region	Currency	Currency returns			
		Week ending 09 September 2016	Month to date	YTD 2016	12 months
Developed Market Equities					
United States	USD	-2.4%	-2.0%	5.2%	11.3%
United Kingdom	GBP	-1.7%	0.0%	12.3%	13.2%
Continental Europe	EUR	-1.0%	0.5%	-3.1%	-2.0%
Japan	JPY	0.2%	1.1%	-12.1%	-9.0%
Asia Pacific (ex Japan)	USD	1.8%	2.0%	12.5%	14.9%
Australia	AUD	-0.4%	-1.4%	4.3%	6.8%
Global	USD	-1.5%	-0.6%	4.3%	7.1%
Emerging Market Equities					
Emerging Europe	USD	1.2%	2.3%	15.7%	8.2%
Emerging Asia	USD	2.0%	2.2%	14.0%	15.8%
Emerging Latin America	USD	-2.8%	-0.8%	32.3%	22.8%
BRICs	USD	1.7%	3.0%	18.1%	16.0%
MENA countries	USD	1.1%	0.6%	0.4%	-8.3%
South Africa	USD	0.4%	3.9%	20.7%	7.0%
India	USD	0.3%	1.1%	11.8%	14.2%
Global Emerging Markets	USD	1.1%	1.9%	16.7%	15.1%
Bonds					
US Treasuries	USD	-0.5%	-0.7%	4.9%	4.7%
US Treasuries (inflation protected)	USD	-0.4%	-0.6%	6.5%	5.7%
US Corporate (investment grade)	USD	-0.7%	-0.9%	8.4%	8.1%
US High Yield	USD	0.0%	0.0%	14.4%	8.4%
UK Gilts	GBP	-1.7%	-2.7%	14.4%	13.7%
UK Corporate (investment grade)	GBP	-1.1%	-1.8%	13.0%	13.2%
Euro Government Bonds	EUR	-0.4%	-0.7%	5.4%	6.8%
Euro Corporate (investment grade)	EUR	-0.1%	-0.2%	5.9%	6.2%
Euro High Yield	EUR	0.0%	0.0%	7.7%	6.7%
Japanese Government	JPY	-0.2%	-0.7%	4.6%	6.0%
Australian Government	AUD	-0.6%	-0.8%	6.5%	6.8%
Global Government Bonds	USD	-0.1%	-0.4%	9.7%	9.2%
Global Bonds	USD	-0.1%	-0.3%	8.4%	7.7%
Global Convertible Bonds	USD	-0.3%	-0.1%	2.3%	2.8%
Emerging Market Bonds	USD	0.0%	-0.1%	15.1%	15.7%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 09 September 2016	Month to date	YTD 2016	12 months
Property					
US Property Securities	USD	-3.8%	-3.3%	9.4%	22.7%
Australian Property Securities	AUD	-3.4%	-5.0%	9.8%	13.3%
Asia Property Securities	USD	3.9%	4.3%	11.6%	15.2%
Global Property Securities	USD	-1.5%	-1.0%	10.5%	18.6%
Currencies					
Euro	USD	0.7%	0.7%	3.5%	0.2%
UK Pound Sterling	USD	-0.2%	1.0%	-10.0%	-13.7%
Japanese Yen	USD	1.2%	0.7%	17.1%	17.3%
Australian Dollar	USD	-0.4%	0.3%	3.5%	7.4%
South African Rand	USD	0.5%	2.2%	7.3%	-4.3%
Swiss Franc	USD	0.5%	0.9%	2.8%	0.0%
Chinese Yuan	USD	-0.1%	-0.2%	-2.9%	-4.6%
Commodities & Alternatives					
Commodities	USD	1.5%	1.9%	7.0%	-5.3%
Agricultural Commodities	USD	1.5%	3.0%	-0.1%	-0.8%
Oil	USD	2.5%	2.1%	28.8%	0.9%
Gold	USD	0.2%	1.4%	25.1%	19.9%
Hedge funds	USD	0.5%	0.6%	1.2%	-1.1%

Source: Bloomberg

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