

Margin for error

– Richard Stutley, CFA

Readers will be aware of Momentum's heritage: a South African firm with a London investment arm, hence next weekend's sporting fixture takes on extra significance in our offices. Luckily there is plenty to keep us busy this week and thus prevent sparring around the watercooler, with a slew of GDP and inflation data out on Wednesday and Thursday. Today I wanted to unpick a topic that has been receiving a reasonable amount of airtime recently, namely US margins. Margins on the S&P 500 are running high, with explanations varying from accounting shenanigans to opaque tax structures. While this in-and-of-itself is not enough to cause us to abandon the world's largest stock market, our own analysis nonetheless prompts us to be cautious.

US margins rebounded sharply following the Great Financial Crisis and have remained consistently high ever since, peaking in January of this year. Today they are almost one and a half standard deviations expensive looking at data on the S&P 500 back to 1990, and have been above one standard deviation expensive for 19 months, longer than ever before.

This has prompted many commentators to say the end is nigh, with the inevitable contraction in margins bringing the expansion to a sudden halt. We consider this scenario in our modelling but it is not the main risk we are concerned about. Firstly, margins are not necessarily mean reverting. Some companies like supermarkets exist with very low margins while other companies like luxury car manufacturers require high margins in order to make production worthwhile. What is true at the micro level is generally true at the macro level, and hence the aggregate margin on the stock market will vary through time as the size of sectors rises and falls. Where margins may vary between companies, the factor that unites them is return on equity: low return on equity is the

best cure for low return on equity as unprofitable firms quit the industry. The same is true of high return on equity which encourages new entrants and competition. Were return on equity extended in the same way as margins we would agree that companies are overearning and forecast a reversion to the mean. However, return on equity is not particularly extended currently at only 0.6 standard deviations expensive. Secondly, while some commentators believe margins are being inflated by aggressive accounting practices, we are reassured by the performance of free cash flow per share, which has broadly tracked the upward path of earnings.

Where we are more concerned is with the multiple, which in the case of the S&P 500 is currently at 22 times trailing earnings, 10% above its 20 year average (note we use earnings excluding extraordinary items, which results in a higher multiple than the figure quoted by most commentators). A rise of this magnitude is broadly consistent with the decline in interest rates as the discount rate applied to future stock market earnings is now lower, but given equities are perpetual investments this means investors are discounting today's low interest rate environment for forever, which is not a view we subscribe to.

The upshot of this analysis is twofold. Firstly, we are not rushing to cash but now is not the time to be overweight the US in our opinion. Secondly, we do not want to be taking a passive exposure given the wide dispersion in valuations between cheap and expensive stocks in the US market, which currently stands at a 17 year high. Instead we think investing with experienced and deeply analytical active fund managers is the best way to navigate these competing forces and help us to deliver on our target outcomes for investors.

The Marketplace

- The European Central Bank announced it would keep their policy rate unchanged
- The IMF forecasted China's economic growth down to 5.8% for 2020, from 2019's figure of 6.1%
- Brent crude rose 4.4% to \$62.0 a barrel, as inventories unexpectedly dropped
- Gold rose 0.7% to \$1502.7 an ounce

Market Focus

US

- Earnings season continues to progress and so far companies have been largely beating estimates.
- It was reported that Chinese buyers are repurchasing US soybeans following a new set of tariff waivers.
- The manufacturing PMI (purchasing managers index) rose to 51.5, 0.6 higher than expected, whilst the services PMI reported 51.0, a marginal increase from the previous month.
- Following the quarterly earnings reports, US equities returned 1.2% over the week. The technology-heavy benchmark outperformed its broad market comparison.

Europe

- Germany's composite PMI was underwhelming and the broader Eurozone figure (50.2) was largely as expected.
- The gap between the Eurozone manufacturing (45.7) and services (51.8) PMI continues to widen, now at 6.1 percentage points.

- Developed European equities returned 1.4% over the week with a number of companies beating earnings estimates, though concerns remain over the absolute level of earnings.

UK

- Lawmakers in Parliament voted on Tuesday to reject a limited time frame for reviewing legislation related to Brexit, reducing the prospects of the UK leaving the EU on its current October 31st deadline.
- The Confederation of British Industry's survey of manufacturing fell to -37 (vs an expected -30) for October, its lowest reading since March 2010, with business optimism falling to -44, its lowest level since July 2016.
- UK equities rose over the past week, returning 2.3% over the period.
- In fixed income, gilts returned 0.6% whilst their investment grade counterparts returned 0.7%.

Asia/Rest of The World

- Japan's preliminary composite PMI for October printed 49.8, compared to 51.5 in the month prior. It was flagged that the recent typhoon disrupted supply chains and a rise in sales tax may have caused the weakness in the data.
- Chinese stocks gained over the week due to positive earnings reports and a large liquidity injection of 250 billion yuan (~US\$35 bn) from the People's Bank of China.
- Protests and rioting in Chile, initially sparked by an increase in metro fares, caused a selloff in the equity market on Monday.

Asset Class/Region	Currency	Currency returns			
		Week ending 25 Oct. 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	1.2%	1.6%	21.9%	13.3%
United Kingdom	GBP	2.3%	-1.0%	12.6%	8.6%
Continental Europe	EUR	1.4%	1.2%	22.1%	16.5%
Japan	JPY	1.6%	3.8%	12.9%	5.6%
Asia Pacific (ex Japan)	USD	0.9%	3.1%	11.1%	14.2%
Australia	AUD	1.4%	0.8%	23.5%	24.2%
Global	USD	1.3%	2.0%	20.0%	13.0%
Emerging markets equities					
Emerging Europe	USD	3.4%	5.9%	24.2%	23.7%
Emerging Asia	USD	0.7%	3.3%	9.5%	12.7%
Emerging Latin America	USD	3.1%	5.0%	11.7%	8.3%
BRICs	USD	1.3%	3.7%	12.6%	15.3%
MENA countries	USD	1.8%	-0.7%	2.9%	2.6%
South Africa	USD	-0.6%	5.4%	2.6%	9.7%
India	USD	-0.2%	0.9%	6.3%	20.0%
Global emerging markets	USD	1.2%	3.6%	9.7%	12.0%
Bonds					
US Treasuries	USD	-0.3%	-0.7%	7.3%	10.6%
US Treasuries (inflation protected)	USD	0.1%	0.1%	8.1%	9.1%
US Corporate (investment grade)	USD	0.0%	-0.1%	13.1%	14.1%
US High Yield	USD	0.3%	0.5%	12.0%	8.4%
UK Gilts	GBP	0.6%	-2.3%	9.5%	10.9%
UK Corporate (investment grade)	GBP	0.7%	-0.5%	10.6%	9.9%
Euro Government Bonds	EUR	-0.1%	-1.4%	8.5%	10.5%
Euro Corporate (investment grade)	EUR	0.1%	-0.4%	6.4%	5.8%
Euro High Yield	EUR	0.0%	-0.1%	9.2%	6.5%
Japanese Government	JPY	0.0%	-0.5%	2.8%	4.2%
Australian Government	AUD	0.4%	-0.3%	10.1%	12.6%
Global Government Bonds	USD	-0.3%	-0.3%	6.3%	9.2%
Global Bonds	USD	-0.2%	0.1%	6.6%	8.8%
Global Convertible Bonds	USD	0.6%	1.4%	7.5%	6.7%
Emerging Market Bonds	USD	0.2%	0.6%	9.6%	11.2%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	0.0%	1.1%	27.0%	20.0%
Australian Property Securities	AUD	1.9%	2.3%	19.7%	19.5%
Asia Property Securities	USD	0.4%	2.6%	10.9%	19.7%
Global Property Securities	USD	0.0%	2.2%	21.6%	20.2%
Currencies					
Euro	USD	-0.8%	1.6%	-3.3%	-2.6%
UK Pound Sterling	USD	-0.9%	4.3%	0.6%	0.0%
Japanese Yen	USD	-0.3%	-0.6%	0.8%	3.5%
Australian Dollar	USD	-0.4%	1.1%	-3.2%	-3.6%
South African Rand	USD	1.1%	3.8%	-1.6%	-0.6%
Swiss Franc	USD	-1.1%	0.2%	-1.3%	0.5%
Chinese Yuan	USD	0.2%	1.2%	-2.6%	-1.7%
Commodities & Alternatives					
Commodities	USD	1.6%	3.3%	7.9%	-4.2%
Agricultural Commodities	USD	-0.4%	2.2%	-4.2%	-6.2%
Oil	USD	4.4%	2.0%	15.3%	-19.3%
Gold	USD	0.7%	2.2%	17.3%	22.2%
Hedge funds	USD	0.2%	0.2%	6.1%	3.5%

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