CREDO WEALTH

Devil take the hindmost

At the height of the South Sea Bubble, William King, the Archbishop of Dublin, concluded that “most that go into the [South Sea] matter are well aware it will not [succeed], but hope to sell before the price falls”. An anonymous pamphlet of the time declared “the only way to prevent [loss] to oneself must be to sell out betimes, and so let the Devil take the hindmost”. Following one of the longest bull markets in recent history, concerns are mounting that, inevitably, the party is running low on punch. In light of this, is it now time to run, clamouring for the exits?

Concerns have stemmed from the recent rally in the S&P 500 – the predominant gauge of the US equity market. This surge, however, has been almost entirely driven by price earnings multiple rerating; that is, the price has expanded without corresponding growth in earnings. Yet this is no short term trend: S&P earnings per share have been flat for two years, and the weakness has not gone unnoticed. Consensus estimates now expect Q3 2016 to be the sixth consecutive quarter of declining earnings, whilst Q3 2016 forecasts have turned negative for the first time, falling from 0.4% to -0.1%.

When it comes to explaining economic phenomena, there can be few certainties. However, a dominant line of reasoning for the current malaise in valuations attributes it to the unconventional monetary policy that has been in place since the Global Financial Crisis. Specifically, as the risk-free rate in the market has been driven lower by record low interest rates and unprecedented Quantitative Easing, so too has the “cost of equity.” Put simply, the yield that investors are prepared to pay on “risky” invesments, such as stocks, is influenced by what they can get on “risk free” invesments, such as government bonds. The rate at which investors discount coupon payments on government bonds directly affects the rate at which equity investors discount dividends.

In terms of monetary policy, we are operating in a somewhat artificial environment. With investors forced to accept negative real returns on government bonds, we tread unknown terrain. For some, this unusual arrangement bodes ill: interest rates exist to encourage deferred gratification as the future is less certain than the present. Negative interest rates, so the argument goes, turn that on its head. In the years to come we shall slowly appreciate the ultimate effects of this policy. For now, however, all that we may be certain of is that there shall be unintended consequences.

Normalisation of interest rates will undoubtedly take years to achieve, the forecasting of which we do not consider a useful endeavour. We cannot claim to walk the corridors of power nor offer any special insight into the conduct of monetary policy. Yet we do not begrudge our ignorance of precise timings – over the long-term the expected trend in interest rates is upwards, and we invest.

For those of a financial leaning, there is a glaring incongruity in the S&P 500 trading at all time highs whilst suffering six consecutive declines in earnings. However, we would caution our clients against acting in undue haste, as one can never overestimate the market’s capacity for surprise. Our portfolios are designed to be defensive should a downturn occur: over the lifetime of the Best Ideas Portfolio, we have outperformed the MSCI World in 17 of the index’s 22 down months. As long-term investors, we shall not be the hindmost; chasing performance is a fool’s game.

Important Notice

This document has been created for information purposes only and has been compiled from sources believed to be reliable. None of Credo, its directors, officers or employees accepts liability for any loss arising from the use hereof or reliance hereon or for any act or omission by any such person, or makes any representations as to its accuracy and completeness. This document does not constitute an offer or solicitation to invest or divest, it is not advice or a personal recommendation nor does it take into account the particular investment objectives, financial situation or needs of individual clients and if you are interested in any of the information contained herein, it is recommended that you seek advice concerning suitability from your investment advisor. Investors are warned that past performance is not necessarily a guide to future performance, income is not guaranteed, share prices may go up or down and you may not get back the original capital invested. The value of your investment may also rise or fall due to changes in tax rates and rates of exchange if different to the currency in which you measure your wealth. Credo Capital plc is authorised and regulated by the Financial Conduct Authority, is a member of the London Stock Exchange, and is an Authorised Financial Services Provider in South Africa.