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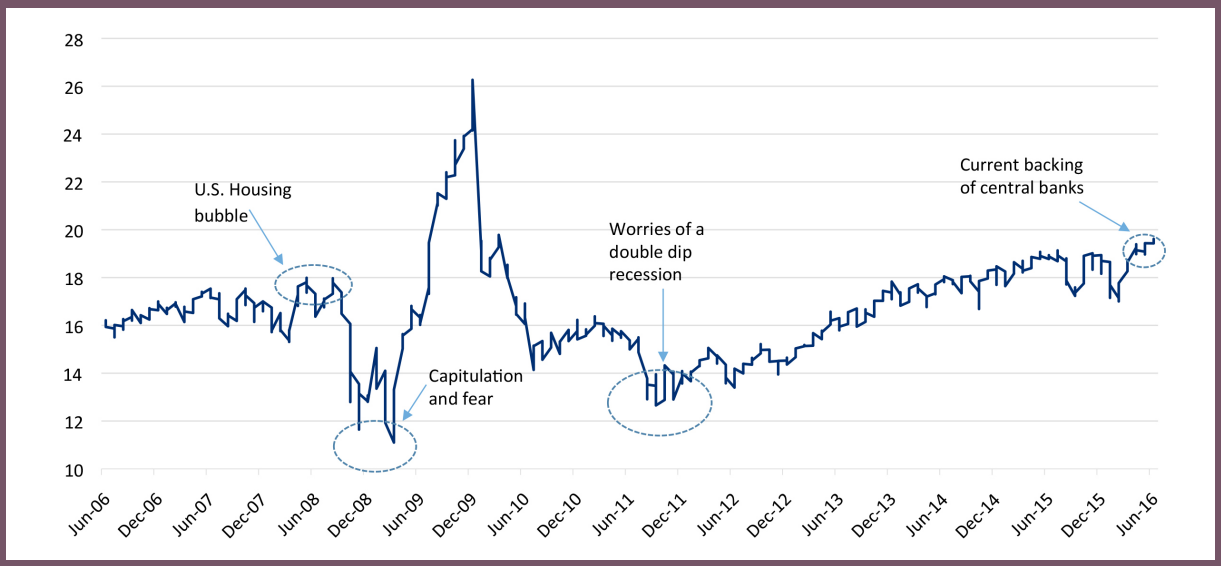
Investment Outlook

June 2016



The Standard and Poor's 500 index price to earnings ratio

The power of market sentiment

May 2016: It was an uneventful month for equity markets across the globe with most indices nudging slightly higher. The S&P 500 gained 1.53%, while the Eurostoxx was up 1.16%, and the MSCI World added only 0.23%. The big gainer this month was once again Oil, rising 6.9%. We still maintain our position in the energy sector albeit hedged against short term downside risks.

On the interest rates side, yields on the US 10 year remained unchanged closing at 1.84%, whereas the German Bund comparable ended the month at 0.14%, flattening once again as the ECB stood ready to keep their asset purchase program solidly in place.

The US Dollar rebounded this month, the DXY rose 3.02% when the rally was sparked by a hawkish Fed sent warning signals to the market that rates might be going up sooner than expected. Gold lost momentum on the back of the news, minus 6% ending the month at 1215. We like this level to go long or even add to existing positions with the first target being around $1290.

Positivity and pessimism

Two opposing feelings that can fuel market bubbles and cause crashes, when one reigns the other is dormant until the alarm bells ring. Exaggerations are always seen both on the upside and the downside, but why is that? The answer to this question lies in the human psyche, when we dig deep we find that investors do not behave rationally and tend to move in "herds". If everybody were to be mathematical, armed with a deep knowledge in finance and nerves of steel, asset prices would always range at fair value. We all know that this is almost never the case, the historical mean is only a number that acts a reference point; valuations are always some standard deviation away.

Let's take a look at the current state of affairs: the last ten year average price to earnings of the S&P 500 is 16.64, currently we are 3 full points higher at 19.6. In the old continent valuations are even slightly higher with the EuroStoxx 50 P/E currently at 21.78, 5.45 points away from the average of the last ten years. By historical standards markets look expensive today, however investors don't always measure prices in terms of valuations but more in terms of sentiment. With the massive support of central banks, money managers have long been positive, this is stemming from the record low yields or even negative in some cases and the purchase of public assets.

Are the levels we are at today exaggerated? The generic valuation of risk/return can give us an insight, know as Equity risk premium, it is calculated by subtracting the risk free rate from the Expected rate of return of an asset. The long term ERP of 3.8 is a widely accepted benchmark, applied to the equation above in the context of null risk free rate, the return on asset A converges towards 3.8%.

Let's examine the yield of the two major equity markets for this year's and last's, the S&P 500 lost 0.73% in 2015 and is up 3.68% to date. The Eurostoxx 50 gained 3.8% in 2015 and is down 8.64% to date. How do we justify holding equities in this kind of environment? It goes back to market sentiment, whenever a correction was triggered over the course of the last few years, buyers quickly rushed in to capture the return to normality and optimism reigned. It is true that over the course of one year returns aren't attractive, but buying the dips motivated by an acceptance of a mediocre 3.8% return, has been a rewarding strategy paying high single digit returns. So as long as risk free rates are kept excessively low, the market is always adjusting back to above its average valuation, and furthermore, as long as the black swans are at bay this behaviour can last until the current conditions change.

For three years running, markets, punctuated by a wave of pessimism, have dropped around 10 percent every six to twelve months, and despite the deteriorating fundamentals the animal spirits pushed prices back up.

Prior to the 2008 liquidity squeeze, every home owner in the US felt rich, most households believed that their place of residence would always keep on going up so everybody joined the party and prices went ever more higher. Until the day when buying exhausted, loan defaulters needed to liquidate and the downward spiral began.

The mood setting on the investment community switches suddenly even though inherent risks are always present, it is important to quantify those risks and to estimate their potential consequence, so if the day comes when the selling frenzy is the headline, you are hedged and invested in the assets that benefit from risk aversion. Looking at the chart above, the cyclical drop below the mean caused by the hangover of the liquidity crunch, and the highs witnessed right before (also currently), can give us a glimpse into the future.

Investment Conclusion

In the period of low "risk free" return and lower than average expected returns in the equity space, adaptation is the key. Money managers and investors must accept less for the same risk exposure in different eras: Where for example the reward for holding a US government bond in the 1980s' was in the double digits. The meagre return we have learnt to accept should not be assumed risk free, today's environment is largely favourable, however tomorrow is a different day.

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