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Australian Strategy Insight

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Investment Strategy

A bull market health check

The current correction in equity markets has heightened concerns about a possible end to the US bull market and the implications for global markets. Concerns in the US include high valuations, Federal Reserve tightening, rising bond yields, low unemployment and the US-China trade war. In this note we take a bull market health check and conclude that the bull market is most likely intact. The health check includes:

Recession risks: Bull markets do not die of old age, but from recessions. While the flattening yield curve and low unemployment have lifted risks, the yield curve is still normal and recession risks moderate at below a 15% probability.

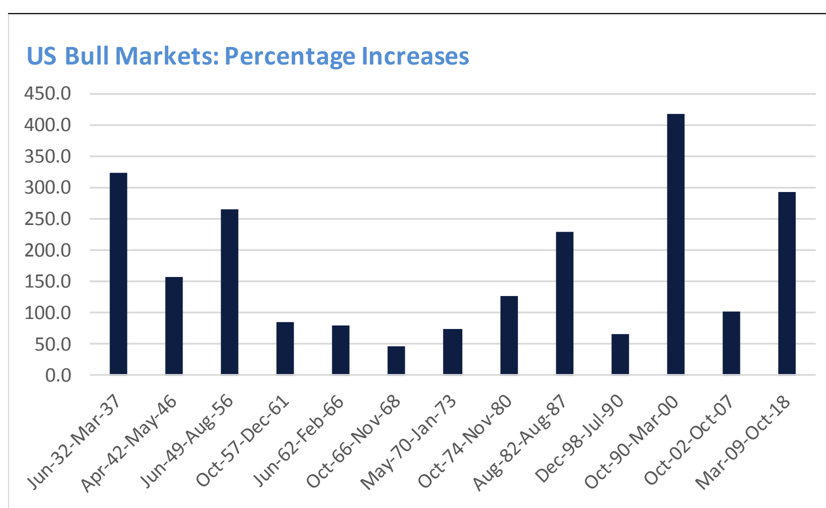
Valuation: The market correction and strong earnings have cut the US forward PE to a below-average ~15.2x. Overall US valuation metrics are no longer expensive but around neutral levels.

Earnings momentum: Consensus US earnings estimates are up 23% YoY, reflecting booming reported earnings growth of ~26% YoY over the first three quarters! The ISM surveys are consistent with strong earnings growth continuing.

Fed policy: The real Fed Funds rate is only about zero, well below the pre-GFC average of 1.6%. Policy impact metrics do not suggest the Federal Reserve is tight.

Excesses: Household leverage and asset prices are moderate. While margin debt is high, fund outflows are also high. Corporate leverage is about average, and a record level of buybacks should reaccelerate as earnings season winds down.

FIG. 1: The US Bull market – the longest in duration, but not in percentage gain



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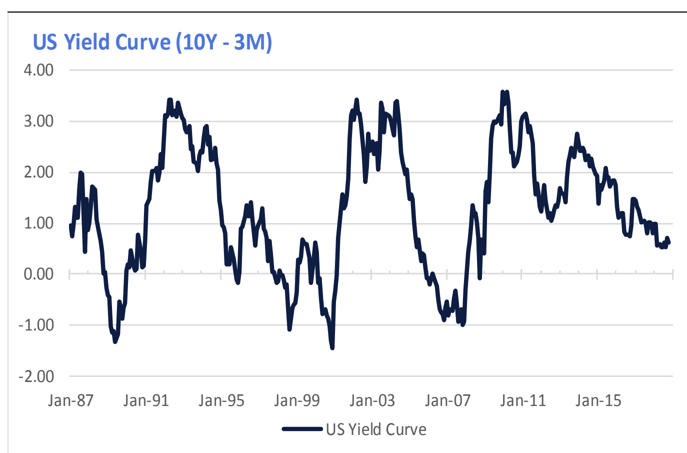
A bull market health check

- The current correction in equity markets has heightened concerns about a possible end to the US bull market, and the implications for global markets. Concerns in the US include high valuations, Federal Reserve tightening, rising bond yields, 49-year low unemployment and the US-China trade war. Whilst these concerns are mostly valid, we believe they are outweighed by a significant improvement in valuations, very strong earnings growth, moderate inflation, a normal yield curve and accommodative monetary policy.

Bull markets do not die of old age! Recession risk, the key, is moderate

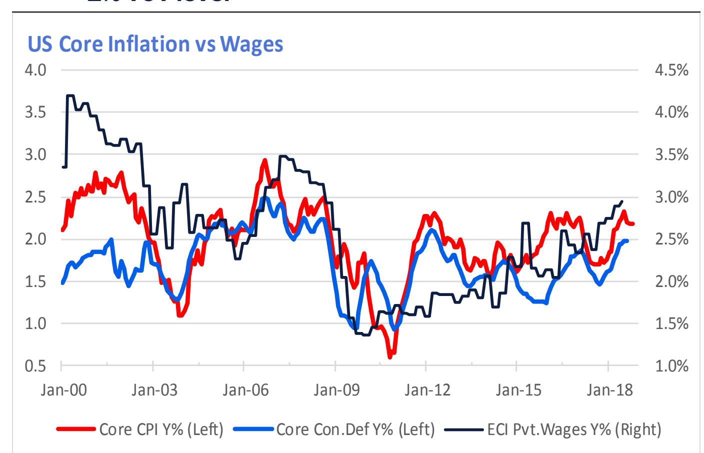
- The current US bull market is the longest since World War II. But bull markets do not die of old age. Indeed, aside from the October 1987 Crash, all bear markets – market declines of more than 20% – in the past 50 years have occurred against the backdrop of a US recession. Whilst recession risks have risen from abnormally low levels, three key indicators of US recessions do not point to an imminent recession:
  - An inverted yield curve: The US yield curve has inverted ahead of all seven recessions over the past 50 years, with a lead time of at least five months (with only one false signal). The yield curve has flattened to a slope of ~65bps, below the pre-GFC average of 115bps, but is still positive (Figure 2).
  - Inflationary pressure forcing the Federal Reserve to slow the economy: The core Consumer Deflator has risen to the Federal Reserve's symmetric 2.0% target. Given the Federal Reserve is emphasising the symmetry of its target, we expect it to tolerate moderately higher inflation, particularly given inflation over the past 20 years has averaged 1.7% pa, with just four years above the target (Figure 3).
  - **The New York Fed's modelled long-term recession probability rising well above 15%.** This model currently puts the probability of recession in the year ahead at 14.5%, well below the average of 35% preceding prior recessions.

FIG. 2: The US Yield Curve has flattened, but remains normal



Source: Datastream, Baillieu

FIG. 3: US Core Inflation has picked up to symmetric target 2% YoY level



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Absolute valuation metrics: No longer high

- The combination of strong earnings growth and the ~10% pullback in the US equity market has lowered the 12 month-forward PE ratio from a peak above 19x in January to ~15.2x currently, modestly below its long-term average forward PE of 16.0x (Figure 4).
- The Shiller PE is a more stretched ~23x – part of this reflects the Shiller PE's denominator, with the 10-year trailing real EPS still very affected by the GFC, as well as the Trump tax cut barely impacting the Shiller earnings measure.

- Valuation remains attractive against interest rates, both short-term rates and long-term bonds (Figure 5). Price to Book-Return on equity valuation models put the US market at fair-value. Overall, in our view, the US market is no longer expensive, but more neutral.

FIG. 4: The US Fwd PE has eased back to a below-average ~15.2x

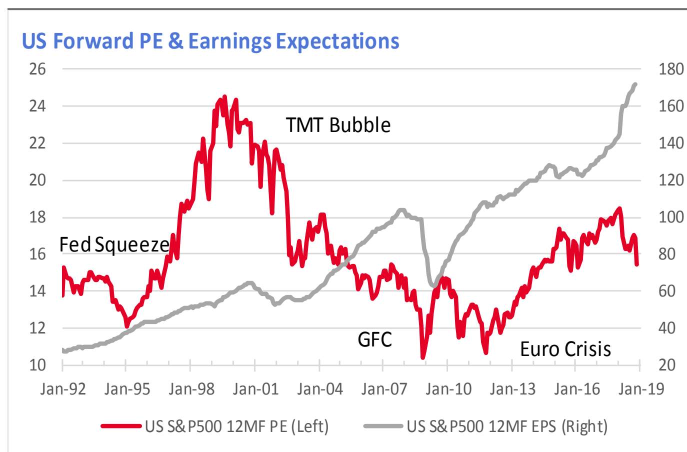

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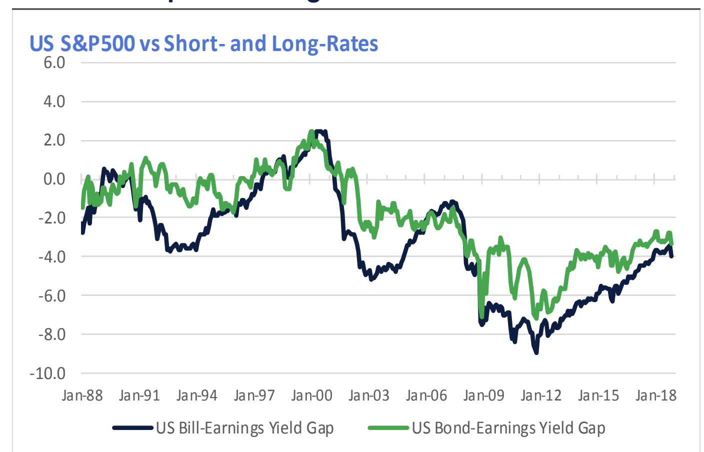
FIG. 5: US equities still attractive versus rates, particularly versus pre-GFC ranges



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Inflation risks: Low unemployment, but still some spare capacity

- The US unemployment rate of 3.7% is at a 49-year below, and below the Federal Reserve's estimate of sustainable full employment (the NAIRU) which it puts at a 4.5% unemployment rate. On our strong US economic outlook, the US unemployment rate seems likely to head toward 3% over the next year or so, the lowest rate of unemployment since the Korean War.
- Despite low and falling unemployment, US wages growth has been slow to recover. Our preferred labour cost measure, Employment Cost Index (ECI) private wages ex-commissions has risen 2.9% YoY, up from a low of 1.5% YoY in mid-2011 (Figure 6). We expect the pace of wages growth to pick-up- 3Q18 data is published this week- given the strong economy and low unemployment but note that it is still below the pre-GFC *average* of 3.2% pa.
- Three factors appear likely to moderate the pace of wages acceleration:
  - Still significant numbers of discouraged workers: The labour market is probably not as tight as the headline unemployment rate suggests, with the participation rate of people 25-54 years of age (81.8%) still 1.7ppts below the pre-GFC average (Figure 7).
  - Weak union bargaining power: US union membership at a post-WW2 low of 10.7% makes it difficult for workers to exercise collective bargaining power. That said, the quit rate as a measure of labour bargaining power is back to the highest level since 2001 (2.3%), suggesting that businesses are beginning to bid for labour.
  - Structural changes: The ability of firms to offshore support services, and not just manufacturing, means that the labour pool is more elastic than in the past.
- As such, in our view the key indicator is not the low unemployment rate, but rather growth in the ECI Private Wages measure. Wages growth above 3.5% would probably pressure the Federal Reserve to apply restrictive policy.

FIG. 6: Despite low unemployment, wage growth has been gradual

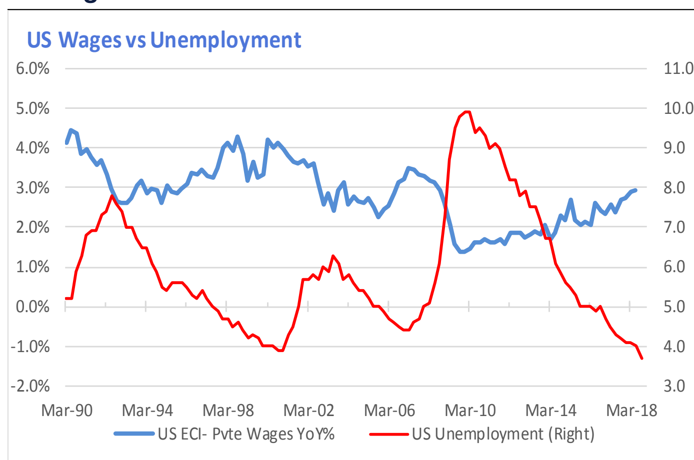

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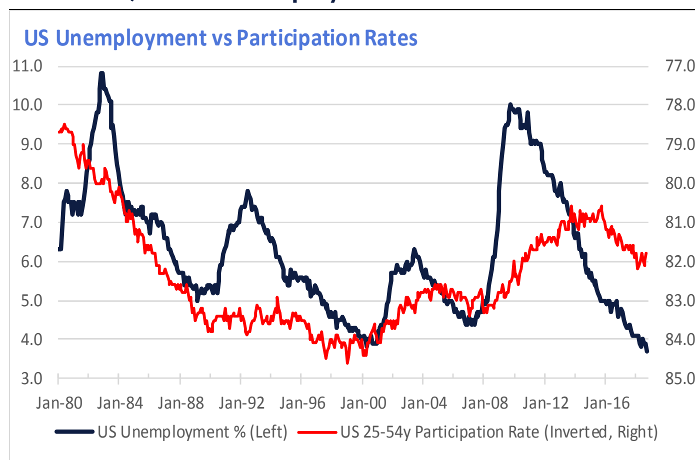
FIG. 7: US discouraged workers reflected in low participation rate, not the unemployment rate



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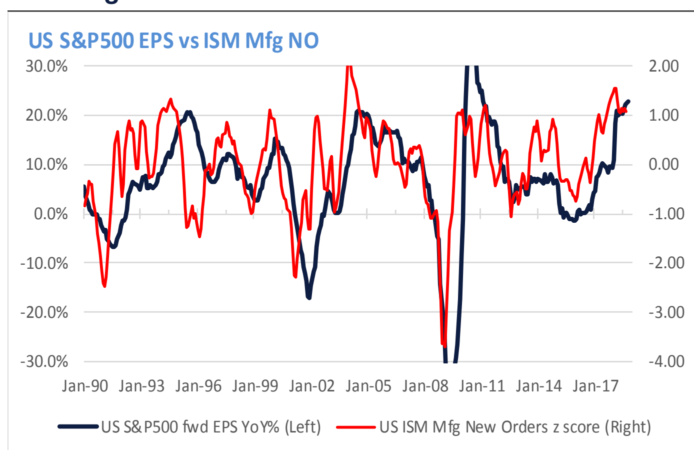
Earnings momentum still strong

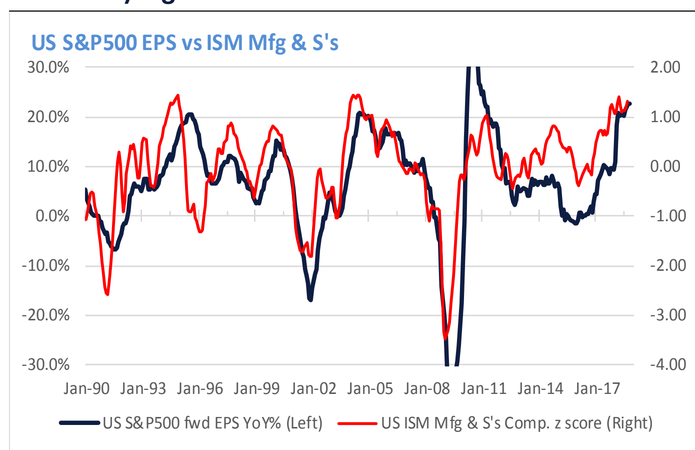
- US forward earnings estimates have risen a rapid 23% YoY, a reflection of strong underlying activity and the large Trump tax cut (see again Figure 4). Reported earnings rose ~26% YoY in both 1Q18 and 2Q18 and earnings appear on track to report a similar 26% YoY rise in 3Q18. The 3Q earnings outcome, similar to 1Q and 2, has been driven by high-single-digit revenue growth (~8% YoY), margin expansion contributing ~7ppts, an 8% direct earnings benefit from the tax cut and a ~2% contribution from share buybacks.
- On-going strong earnings momentum is consistent with the unusual strength in the US ISM New Orders index (Figure 8), as well as the Composite Manufacturing and Services indices (Figure 9). This is supported by strong household and business fundamentals, with strong income growth, balance sheets and the tax benefit.

FIG. 8: US ISM Manufacturing New Orders is at unusually high levels



Source: Datastream, Baillieu

FIG. 9: US ISM Manufacturing and Services indices are at very high levels

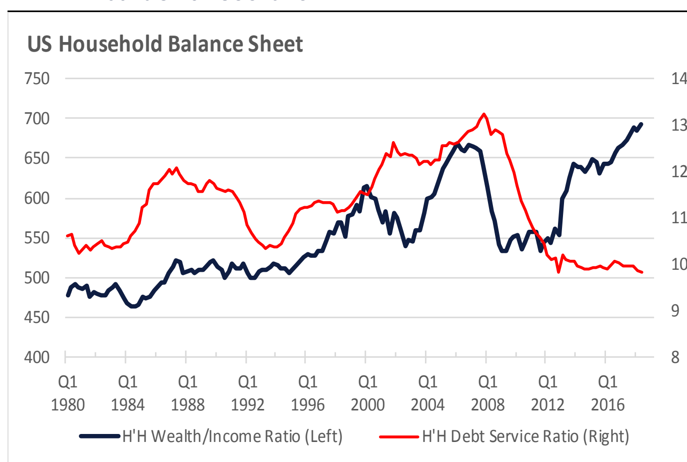


Source: Datastream, Baillieu

Federal Reserve policy: Not tight

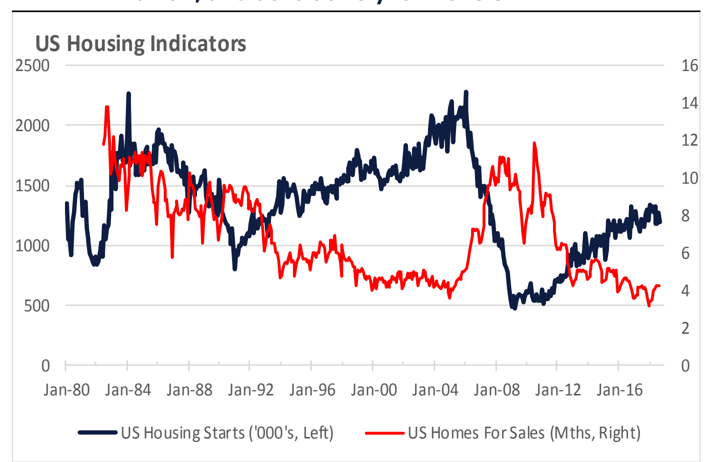
- This Federal Reserve tightening cycle has been unusually cautious and gradual. Indeed, it has taken almost three years for the real Fed Funds rate to reach zero. This is still very accommodative by historic standards when compared to the pre-GFC average of 1.6%.
- An analysis of the four major transmission networks for monetary policy would suggest that policy is not yet restrictive:
  - Interest-sensitive spending has moderated but is not weak: Higher bond yields have slowed housing activity, but housing starts are still up 4% YoY, though Permits are flat. From a longer-term perspective, starts are still 20% below the pre-GFC average (Figure 11). Vehicle sales have also moderated but are only down 1% YoY.
  - Record low interest burden: Households have refinanced their fixed-rate mortgage debt at around record low rates, protecting themselves against rising rates. Indeed, helped by the tax cut, over the year to 2Q18 the US household debt burden fell 14bps to a record low 9.8% (Figure 10).
  - Positive wealth effects: Even with the correction, the S&P500 is still up 5.7% YoY. Home prices are also up 5.7% YoY. Together, these rising asset prices have driven household wealth to record levels (Figure 10).
  - US dollar: Despite seven Fed rate rises over the past two years, the narrow US dollar index has fallen 3.5% and the broad US dollar index is roughly flat.

FIG. 10: US household wealth is a record high, and the debt burden a record low



Source: Datastream, Baillieu

FIG. 11: US housing starts have moderated, but are still up 4% YoY, and at relatively low levels

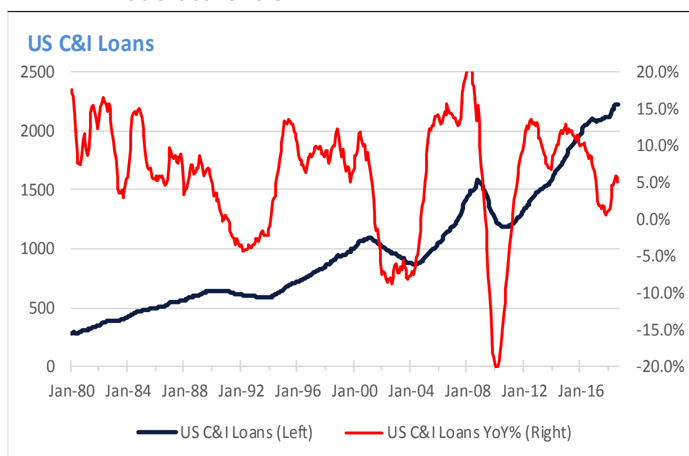


Source: Datastream, Baillieu

Signs of excess: Still limited

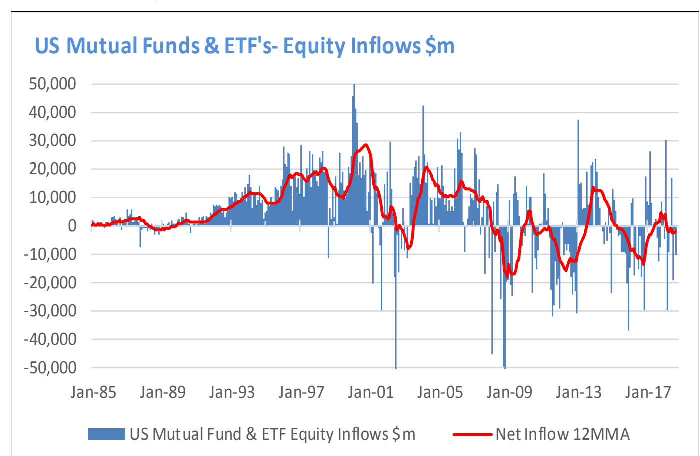
- In the household sector, the debt ratio is at a cycle low of 99% and the lowest since 2001. Home prices have fully recovered from the GFC but are still only up 10-17% in nominal terms since their prior peak in 2006-07, 12-13 years ago. While margin debt appears high, households have been withdrawing funds from the equity market almost continuously since the GFC (Figure 13).
- In the business sector, with investment now including intellectual property, it is at above-average levels as a share of GDP. US S&P500 net debt/equity is around average levels, and while there are concerns about the Leveraged Loan market, Commercial and Industrial loans are only up 5.2% YoY (Figure 12). Share buybacks are running at record levels, supported by the US tax cuts, and should start to accelerate back to the ~US$190 billion quarterly rate of 1H18 as companies re-emerge from blackout periods.
- With tax reform, the chances of investment-led growth in the US is high. As we saw in the 1990's, such an environment can be very positive for earnings growth and equity performance.

FIG. 12: US Commercial & Industrial Loan growth is at moderate levels



Source: Datastream, Baillieu

FIG. 13: Funds are flowing out of equity mutual funds and ETFs



Source: Datastream, Baillieu

Investment Implications

- Our bull market health check suggests that the US bull market is most likely intact. While the US yield curve has flattened, and unemployment is very low, wages growth is still below average levels, and inflation is around the Federal Reserve's symmetric target. Valuation is back below average levels, earnings are rising rapidly, earnings indicators are strong, Federal Reserve policy is still a long way from tight and there are few signs of excess. We continue to recommend being overweight growth assets and overweight international equities in particular.

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