October 12, 2016

Market Prices, Expectations, and Risk

A Benign Third Quarter

2016's third quarter was a favorable one for investors, as global markets shrugged off concerns about several issues including the UK's "Brexit" from the European Union, the US Presidential election, continued slow economic growth, and the effectiveness and risks of continued easy money policy. Volatility was generally low, and most major stock and credit markets experienced solid positive results. As of the end of Q3, year-to-date returns were 7.8% for the S&P US large cap stocks (S&P 500), 2.2% for international developed market stocks (MSCI EAFE), and 16.2% for emerging market stocks (MSCI EM). The rally in credit continued. The Barclays US High Yield Bond Index return of 15.1% for the year well outpaced its investment grade bond index (Barclays US Agg), which posted a solid 5.8% return. Aided by dollar weakness and a rebound in gold and oil prices, commodity indices have experienced a reversal of recent fortunes, and are up 5-10% on the year.

What is "Priced in to the Market"?

In our last commentary (A Tale of Two Markets), we discussed the different messages currently being sent by the US stock and bond markets (and by most developed country stock and bond markets for that matter). Stocks are trading at lofty valuations relative to historic levels, implying a sanguine view, while low bond yields imply a very poor growth outlook. We can infer that these expectations are, to some extent, reflected in market prices, i.e. they are "priced in to the market". This note will reflect on the importance of noting the expectations built into a given market, and the fact that ***deviations from market expectations*** (rather than good or bad news per se) is what tends to move markets. In other words, it is the **unexpected** that is generally more impactful than nominally "good" or "bad" news.

This observation has important implications for portfolio risk management. First, we need to be aware of what market expectations actually are. Second, we need to assess the risk that the market may be overly optimistic or pessimistic; if so, it might create a risk or opportunity, as the ultimate result may be less good or bad than expected. For example, it might seem like very good news if the US economy experiences a monthly gain of 300k new jobs. However, stocks might fall despite such a robust result, if the market had been expecting the addition of 400k new jobs.

Chart 1 shows Citibank's US Economic Surprise Index, which does not reflect the actual strength of economic data, but rather depicts the net percentage of major US economic releases that ***exceed market expectations***: a positive number indicates that more estimates are being beaten than missed. Note that in July of this year the index turned positive after a lengthy period of net missed expectations; this breakout was coincident with the US stock market setting new highs, after failing to do so for over a year. While the relationship between economic surprises and stock performance is quite imperfect, it is nevertheless important to be aware of expectations when assessing risk.

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Chart 1

A recent example of an unexpected result involves the pace at which the market expected the US Federal Reserve bank to hike short term interest rates. At the end of 2015, the market expected the Fed to hike rates much more aggressively than it ultimately did. As expectations of rate hikes moderated due to market turmoil and slow growth, the US dollar declined considerably, falling 7% against a basket of major currencies in early 2016. While the dollar would typically be expected to rise when the Fed is the only major central bank raising rates, the dollar nevertheless declined largely because the policy divergence was less than had been previously priced into the market.

Among the metrics we watch most closely are corporate earnings. Typically, analyst estimates for future earnings are overly optimistic and tend to be revised down over time. The more optimistic the estimates, the greater the risk, as unrealistically high estimates create the potential for greater earnings misses, and subsequent market declines. Chart 2 below shows forward year earnings estimates for the MSCI EAFE international developed market stocks (in white, and actual earnings (in orange), for the last three years. The market consistently expected very large earnings gains during that period, and was consistently disappointed. Over that time, the EAFE index fell by 7%. During this period, the S&P 500, which generated earnings much closer to expectations, rose 28%.

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Chart 2

When the market expects a particularly positive result, such an expectation may increase the potential extent of a disappointing outcome, and the market downside risk as a result. Currently, analyst consensus is that S&P 500 earnings will increase by more than 20% over the next year, and that EAFE company earnings will increase by over 68%. While such results are possible, we believe that they are overly optimistic. The magnitude of these positive expectations, and the risk of a significantly worse result, contribute greatly to our current cautious view on stocks.

Year-to-Date Performance, Positioning, and Outlook

Our investment performance has been quite strong so far this year, with all risk models enjoying not only strong absolute returns, but also significant outperformance relative to our benchmarks. We, of course, recognize that we will not always achieve such favorable results for our clients; nevertheless, we are particularly pleased that we have been able to do so in a year of rising markets, at a time when we have held stock allocations significantly below those of our "neutral" strategic positioning.

As noted above, we have held our underweight equity position due to concerns about equity valuations (the current S&P 500 price/earnings ratio is roughly 25% above its 60 year average), and declining corporate earnings. Additionally, we are keeping our average bond maturity extremely short, given the limited upside and significant downside risk for high grade debt in today's low rate environment. We have held a significant overweight exposure to high yield bonds, a position that has produced favorable results; given the significant rally in the sector, we are currently evaluating whether we might reduce this exposure. Overall, we are quite comfortable with our current cautious positioning, which we believe positions our clients well in the event of a correction.

Thank you for your business and support, and please don't hesitate to contact a member of the SFA team with any questions or feedback.

David Marion, CFA®
Partner and CEO

Disclosures

Chart 1
Source: Bloomberg.

Chart 2
Source: Bloomberg.