KLEINWORT HAMBROS

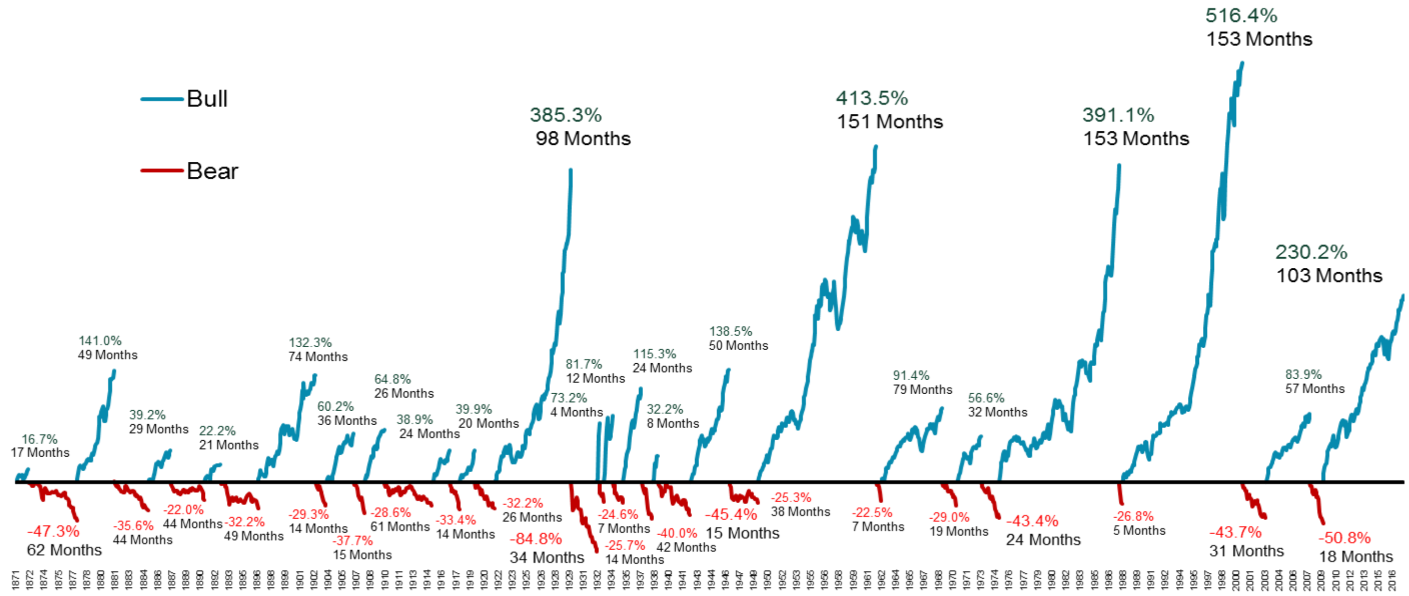
SOCIETE GENERALE GROUP

CIO BLOG

MOUHAMMED CHOUKEIR

Bovinity

Rebased Cumulative Performance of each Bull and Bear Market Since 1871
1871 - September 2017



Source: Kleinwort Hambros, Robert Shiller Data

In the eight-and-a-half years since March 2009, the S&P 500 – a global equity bellwether – has rallied by 230%. How much longer can this bull market* last? Are we in a bubble on the verge of popping? Can equities still produce decent returns from here? Purely on longevity grounds, there is precedent; the current bull is only the fourth longest. Bull markets that began in 1949, 1974 and 1987 lasted between 12 and 13 years. In terms of returns, this bull is a distant fifth historically, (see chart), far behind the 516% return produced by the legendary bull run of the 1990s; the top four have averaged returns of 427%, almost twice the return we have at present.

Nonetheless, measuring bull runs on simple tenure or magnitude is akin to measuring a book on the number of words it has or how long it takes to read it. No one can tell you precisely when a bull will end, or exactly when it becomes a bubble. Hindsight, however, is a wonderful gift.

*Bull and Bear runs on the S&P 500 since 1871 using Shiller data. Bull market defined as a rise in the market by +20% from its low; Bear defined market as a fall in the market by -20% from its high.

Back to the future

Irish author, political theorist and philosopher Edmund Burke first said, “Those who don’t know history are doomed to repeat it”. Indeed, there are repeated instances where healthy asset price momentum turns into a bubble, only to burst dramatically, leaving investors with large losses. And they are hardly limited to equities. Perhaps the most frenzied of all time was tulip mania in 1636-37. At its peak, investors could buy one tulip for the same price as a house. Even sophisticated investors bought at absurd prices in the ludicrous belief there would be a “greater fool” down the road willing to pay an even higher price. When rationality dawned – a house and a tulip have very different intrinsic values – tulip prices collapsed, falling at par with those of onions. **The South Sea bubble** in 1720 was another infamous speculative frenzy where trading companies – backed by the government – saw their shares double every month to trade at astronomical valuations on the basis of potential trade with South America. Only, South America was controlled by Spain, and the prospect of actual trade for British companies was unrealistic, at best. Even Isaac Newton, the most influential mathematician and physicist of all time, miscalculated the risks of the South Sea bubble. He lost large sums of money at the time.

Around the turn of the previous century, publicly traded equity markets were established, and became the greatest expression of public attitude to financial risk. **The roaring 1920s** witnessed the first equity mega-bubble of the 20th century; the S&P 500 index climbed by nearly 400% in eight years. Many investors – driven by innovations such as consumer financing – began believing in preposterously optimistic growth projections. Of course, the **Great Depression** followed which led not only to staggering financial losses, but also to profound economic ones. To date, it has been the deepest, most painful bear market of all: equities lost 85% of their value in the three years that followed September 1929.

The most profound bull market in history, **in the 1990s,** coincided with a long period of stable inflation, a demographic tailwind from baby-boomers and rapid economic growth. At some point, fundamentals gave way to the **tech bubble** irrationality of the late 1990s. Hundreds of companies promised to change the world by harnessing the power of the newly created internet. The blue-chip names of that era included still dominant players such as Microsoft and Cisco, but also long forgotten ones like AltaVista and Netscape. New valuation measures – “eyeballs” and “clicks“ come to mind – were created as traditional price-to-earnings cannot be computed with a negative denominator. Like its predecessors, this bull too crashed, with equities down 44% from 2000 to 2003.

A new bull market born in 2003 was not particularly note-worthy by historical standards, but it still led equity markets to repeatedly hit all-time record highs in **2007**. What followed is seared in recent memory as the **sub-prime crash**. Equities lost over half their value, a bear market second only to the Great Depression. Similarly to the 1920s, the noughties euphoria was characterised by new financial innovations; acronyms such as CDO, MBS and ABS were all the rage. At its root was the widely held – but grossly erroneous – belief that house prices can only go up, and even more misguided acceptance that business cycles have been “tamed” by omniscient central bankers.*

Uncommon sense

The key question for investors centres on exactly when equity market bull markets become bubbles, primed to fall into bear territory? When does healthy bovine morph to dangerous ursine?

Although bubbles have taken different forms affecting all manner of investments, they do share some common characteristics. First, valuations are typically excessive – above long-term averages – sometimes absurdly and inexplicably so (e.g. tulip mania; tech bubble). A surge in economic productivity – stemming from some genuine technological advance or financial innovation – leads investors to believe that this time is “different”, justifying their complacency and excessive valuations.

Second, indirectly or directly, government fiscal or monetary policy tends to encourage risk-taking behaviour (e.g. South Sea Bubble; “the end of business cycles”).

Third, sentiment at the time is typically overly-optimistic, perhaps even euphoric. Successful investments made during the momentum of the bull-run confirm risk-taking biases, and make investors less wary. Animal spirits are stoked; investors simply do not want to miss out on gains.

Although each bubble is different, these three traits prevail more often than not, and should act as warning signs for future bubbles. Where are we now?

Valuations (red): Every Bull Market in history has witnessed multiple expansion, where investors are increasingly willing to pay more for each unit in corporate earnings. Using the cyclically-adjusted price-to-earnings (CAPE) multiple – which removes the effects of inflation and the business cycle – we find multiples have expanded by 1.9x on average in equity bull markets through history. The median is 1.4x, and probably a more useful measure of central tendency in this case as it eliminates some wild outliers. The current bull market, began in 2009, has witnessed a multiple expansion of 2.3x, so well over both the median and average. Moreover, the current CAPE value is at its third

*Weber, Steven. "The End of the Business Cycle?" Foreign Affairs. 1997.

Start	End	Duration (Months)	Annualized Return	Cumulative Return	Starting CAPE	Ending CAPE	Multiple Expansion
Jan 1871	May 1872	17	1.0%	16.7%	NA	NA	NA
June 1877	June 1881	49	24.6%	141.0%	NA	19.0	NA
Jan 1885	May 1887	29	15.2%	39.2%	13.1	18.1	1.4
Dec 1890	Aug 1892	21	12.8%	22.2%	14.4	19.2	1.3
Aug 1896	Sep 1902	74	14.9%	132.3%	15.7	22.9	1.5
Oct 1903	Sep 1906	36	17.5%	60.2%	15.3	19.2	1.3
Nov 1907	Dec 1909	26	27.1%	64.8%	10.6	14.8	1.4
Dec 1914	Nov 1916	24	18.7%	38.9%	10.2	12.1	1.2
Dec 1917	Jul 1919	20	23.6%	39.9%	6.4	7.1	1.1
Aug 1921	Sep 1929	98	21.6%	385.3%	5.2	32.6	6.3
Jun 1932	Sep 1932	4	NA	73.2%	5.6	9.8	1.8
Mar 1933	Feb 1934	12	91.8%	81.7%	7.9	13.9	1.8
Mar 1935	Feb 1937	24	49.2%	115.3%	10.4	22.2	2.1
Apr 1938	Nov 1938	8	61.3%	32.2%	11.8	16.1	1.4
Apr 1942	May 1946	50	23.7%	138.5%	8.5	16.0	1.9
Jun 1949	Dec 1961	151	14.0%	413.5%	9.1	22.0	2.4
Jun 1962	Dec 1968	79	10.5%	91.4%	16.8	22.3	1.3
Jun 1970	Jan 1973	32	19.0%	56.6%	13.8	18.7	1.4
Dec 1974	Aug 1987	153	13.4%	391.1%	8.3	18.3	2.2
Dec 1987	Aug 2000	153	15.4%	516.4%	13.4	42.9	3.2
Feb 2003	Oct 2007	57	14.0%	83.9%	21.2	27.3	1.3
Mar 2009	Sep 2017	103	15.1%	230.2%	13.3	30.7	2.3
	Median:	34	17.5%	82.8%	11.2	19.0	1.4
	Average:	55	24.0%	143.8%	11.5	20.2	1.9

Source: Kleinwort Hambros, Robert Shiller Data, CAPE denoted Cyclically Adjusted Price to Earnings Ratio

highest level in history, surpassed only by valuations during the roaring 20s and the tech bubble. *This is worrying, and we recognise that this current bull market is increasingly mature and multiple expansion is likely to be subdued.*

Policy (red): Nearly a decade on from the financial crisis, there is a broad-based global economic recovery. Indeed, our macro-cycle indicator shows a favourable backdrop for risk-taking, with the global economy in an expansionary regime while being less supported by central bank policy.

Nonetheless, the colossal efforts of central banks continue to underpin equity and bond markets. Resulting lower yields on government bonds make equities appear more attractive in comparison. Many investors are holding more equity risk in portfolios to get “pre-crisis returns”. *This is undeniably one of the pillars of previous bubbles, and makes us wary.*

Sentiment (green): The collective emotional state of investors is perhaps the hardest to factor to gauge, let alone quantify. As stock markets keep marching to new highs, few would describe the mood amongst investors as complacent. *If anything, this long-running bull-market has been characterised by caution, and some key sentiment indicators are displaying “oversold” characteristics* (e.g. hugely overvalued safe-haven assets such as government bonds; strong support for both gold and the Japanese yen).

Investment Implications

We are well aware that valuations, while not alarming, are not cheap. Our analysis also shows multiple expansion during this bull market is already well above the average and median of previous bulls. We also note that current policy environment has tilted the investment landscape towards undue levels of risk.

However, **equities** are not overvalued across a number of measures (e.g. price-to-forward earnings; price-to-book) and the asset class continues to be supported by strong momentum. Moreover, while volatility is low, few would describe the mood amongst investors as complacent. If anything, this long-running bull-market has been characterised by caution and some “oversold” attributes.

In investing, things are rarely black or white; or red and green. At present, while US equities are looking stretched, we find better value in other regions such as European and emerging market equities. But equities have had a strong run and we live in a low return world, there’s no escaping from that fact. Nonetheless, we remain mildly sanguine, and still consider equities as a core asset class, supported by a strong economic backdrop, positive momentum and attractive fundamentals. Should any of that change, we will adjust our positions accordingly.

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UK ENQUIRIES
+44 (0)20 3207 7400
enquiries@kleinwortbenson.com

GUERNSEY ENQUIRIES
+44 (0)1481 727 111
guernsey@kleinwortbenson.com

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