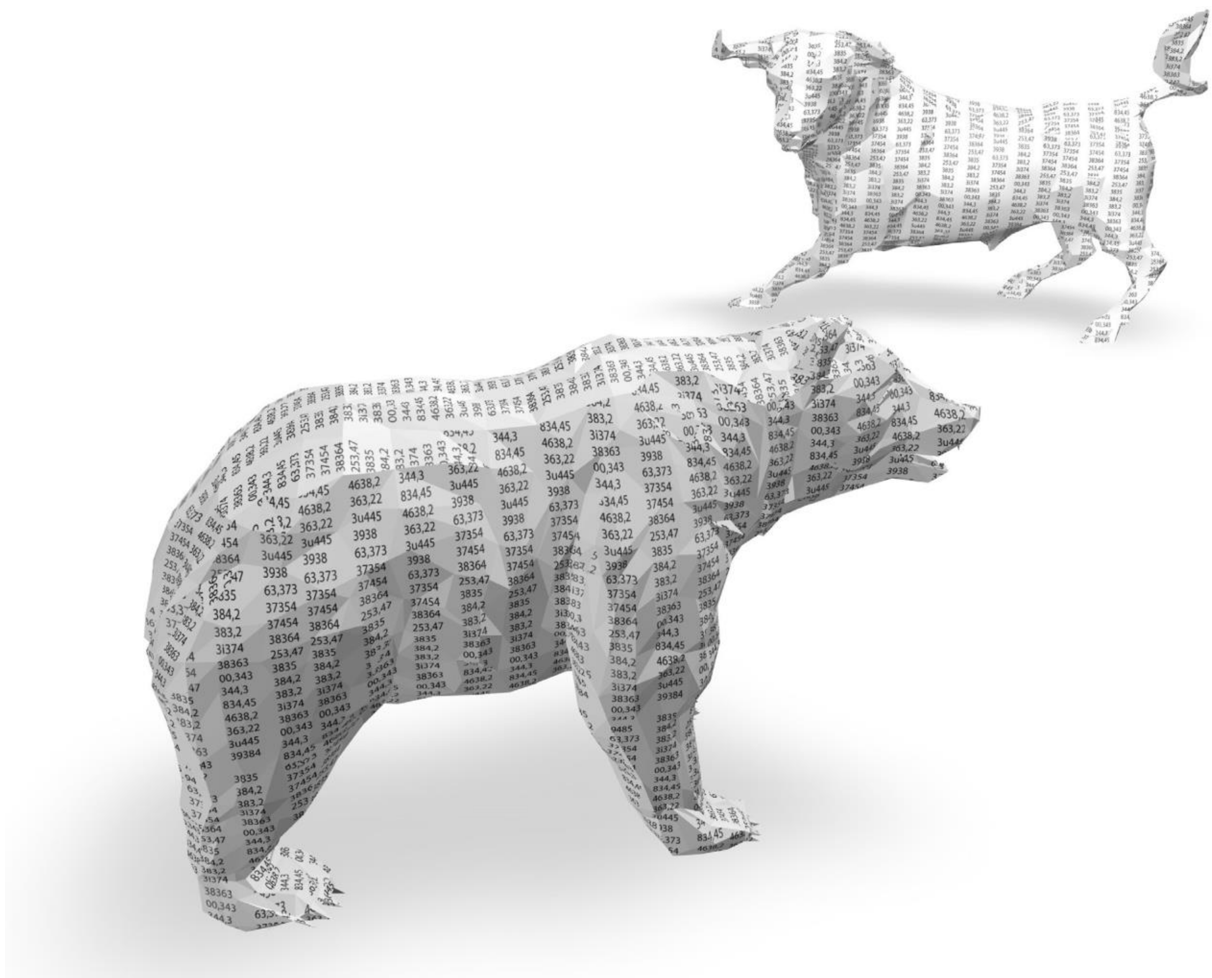
SOCIETE GENERALE GROUP

CIO BLOG

MOUHAMMED CHOUKEIR

Grin and Bear it



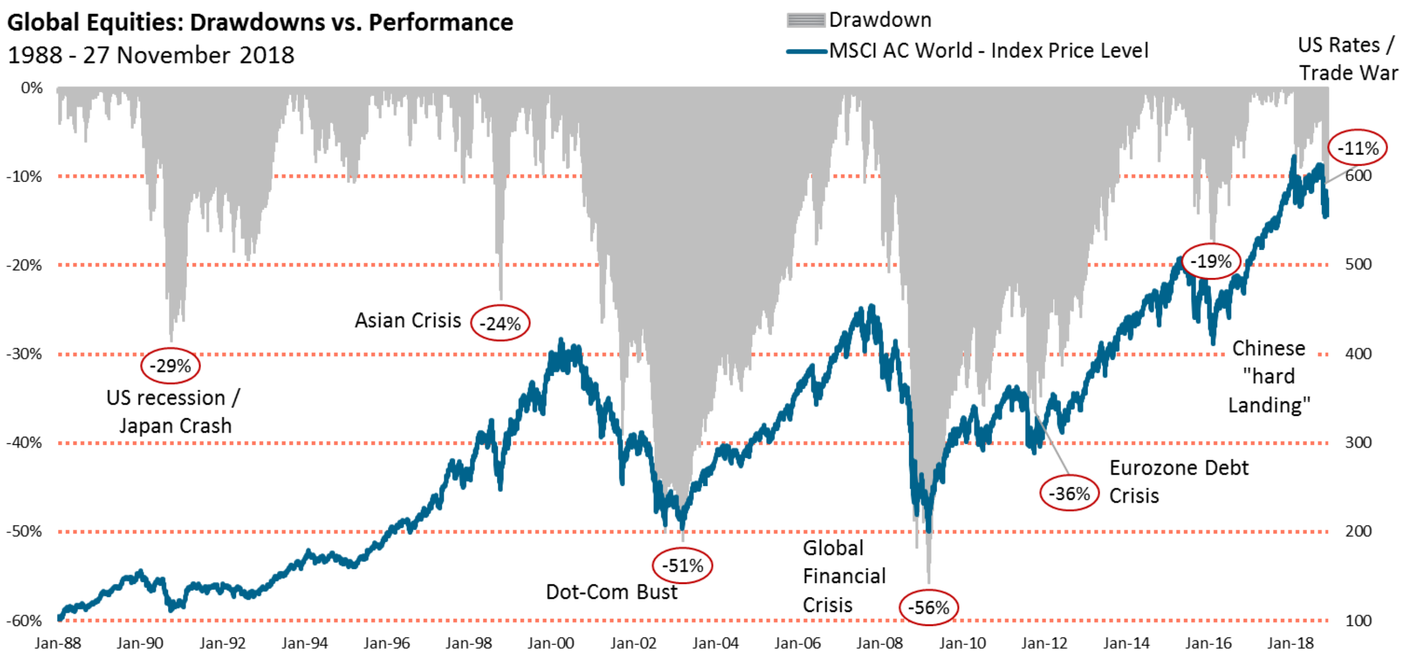
Following a nearly comatose 2017, 2018 has witnessed a resurgence of volatility for risk assets. In January, global equity markets were roiled by fears rising bonds yields would provide the elusive alternative to increasingly expensive equities. Then, potential trade wars, technology company jitters and fractious geopolitics – Italy, Iran, Brexit, US mid-term elections – also weighed. Through it all, the bulls – led by the tech titans in the US – fought back, and the bellwether S&P 500 returned 7.4% in the third quarter – its best quarter in five years – en route to an all-time high in late September. Then came October.

In a near identical repeat of January market machinations, a booming US economic report sent bond yields soaring. Ten-year US government bond yields hit 3.22%, a seven-year high. And following a well known script, risk assets sold off: global equities were down over 7% in the month, and 11% lower than the peak hit earlier in the year.

A cacophony has since ensued, led by bears – fully awake after a long-hibernation – roaring that this decade long bull market is now finally coming to an undeniable end. Their voices create noise. Noise, often, demands a call to action: a primal instinct to protect; to act; to react; to do something, anything. Are they right?

Just bear with us

Figure 1.



Source: Kleinwort Hambros, Factset, Data as at close of 27th November 2018.

Past performance is not an indicator of future performance.

No one can predict the future. Being labelled a bear – some are even called “perma-bears”! – is one definition of insufferable hubris. The chart above (Figure 1) shows the performance of global equities (MSCI All-Country World Price Index) in a blue line since 1988, soon after the index’s inception: it started at 100; it is currently hovering about the 600 level – those price returns have smashed past any competing asset class. Had one had a 30-year time horizon, one desirable outcome would have been to just stay invested.

The chart above illustrates a basic reality: equites are a volatile asset class, almost every year sees 10%, even 20%, drawdowns (sell-offs are also called “drawdowns”, and are represented by the grey shaded inverted peaks in figure 1). These “bumps” are usually not worth trying to avoid: they are impossible to predict with any certainty, and occur far too often to bother reacting to, as buying and selling in such frequency would cause portfolio friction without any benefit.

A real-life example for 2016 crystallises the point. The year got off to a terrible start, with the sell-off triggered by a steep fall in Chinese equities, which in turn led to rampant global speculation on the economic growth prospects for China (i.e. “hard landing”). This set in motion a sell-off in commodities, particularly oil. Finally, plummeting commodities not only sunk the share prices of energy companies, but also pulled down seemingly unrelated companies, bringing down wider equity indices. Bears were roaring: headlines screamed “‘Sell Everything”[1]. Imagine if they had known Brexit and Trump election victories were to come! But then – unexpectedly – oil prices received a fillip on rumours of a production “freeze”. This triggered an oil rally (currently on-going). Equities, then taking their cue from oil, also rallied strongly. As we know all too well, geopolitical events to occur later in the year turned out benign for equities too. The bears would have been dead wrong, as they have with regularity over the last decade.

Ideally, long-term investors should seek to stay invested through the bumps – the “noise” – *but to sit out of equities during the gut-wrenching sell-offs* (e.g. “Dot-Com bust”; Global Financial Crisis). Those are more than worth avoiding. Big losses can devastate portfolios with short time horizons. Moreover, mathematically speaking (emotionally too), it is harder to recover than to fall. If you start with 100 and lose 10%, you must gain 11% to get back to 100. If you lose 50%, you must gain 100%. The bigger the fall, the more difficult the recovery. For these two reasons, big drawdowns are worth avoiding, and doing so is a fundamental tenet of our investment philosophy. Of course, in real-time, it is impossible to know if a 10% sell-off in equities – is just “noise”, or a precursor too harrowing 50% loss.

[1] https://www.telegraph.co.uk/business/2016/02/11/rbs-cries-sell-everything-as-deflationary-crisisnears/

* Drawdown The peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough. It is the measure from the time a retrenchment begins to when a new high is reached.

Bear to the right

As the chart implies, equites are ever-oscillating. So, how do we decide when to cut, and when to stay in? Our view is not based on “noise” or screaming heads on television. History shows making knee-jerk reactions due to short-term noise is a terrible strategy. We are long-term, well-diversified investors, and have no intention of making any sudden, emotional moves in reaction to short, sharp drawdowns: they are almost always wrong. On the contrary, we rely on a process. At its simplest, when an asset is unloved, and cheap, we look kindly upon it. History shows the best returns are to be harvested from undervalued and unloved positions, particularly as momentum starts to trend upwards. The opposite is equally true: even quality assets can be bid to the point where they offer poor prospective returns, often a precursor to momentum turning. Ironically, at these times, many investors are far too complacent, oblivious to the actual levels of risk. Of course, none of this happens in a vacuum: the economic scenario is of critical importance, and we dispassionately gauge if the stage of the business cycle is fruitful for risk taking.

At present, the global macroeconomic environment remains supportive of risk assets and is bolstering corporate profits. This is particularly true for the US, where corporate earnings should grow by over 20% in 2018 due to a confluence of positive factors, including highly stimulative fiscal policy (i.e. slashed taxes) and a slow, predictable pace of rate hikes by the US Federal Reserve which does not threaten risk – assets at present. Driven by bumper earnings, the price-to-earnings ratio for US equities is 16.4x (next 12 months), significantly cheaper than 18.0x at the beginning of the year. All other global regions remain cheaper than the US. Admittedly, while momentum is not giving a clear positive trend at present, sentiment remains oversold – a positive signal for us - on a number of measures following October’s spike in volatility.

Of course, risks to equity markets are ever present, such as escalating global trade wars and possibly tighter-than-expected US monetary policy to name but a few. Nevertheless, we continue to focus on implementing our disciplined investment strategy. It is deliberately long-term. It aims to eschew the market “noise” which inevitably surrounds October like months, and look to what we consider indelible, longstanding drivers of asset returns: valuation, momentum and sentiment. To the degree that the fundamentals change, we pay attention. To the degree the “noise” fills the air, we remain positioned to take advantage of any excessively bearish sentiment.

Source: Kleinwort Hambros, Bloomberg, data as at 27 November 2018

Important Information

This document is provided for information purposes only. It does not constitute and under no circumstances should it be considered in whole or in part as an offer, a solicitation, advice, a recommendation or a contract. It is intended to be used by the recipient only and may not be passed on or disclosed to any other persons and/or in any jurisdiction that would render the distribution illegal.
It is the responsibility of any person in possession of this document to inform himself or herself of and to observe all applicable laws and regulations of the relevant jurisdictions. This document is in no way intended to be distributed in or into the United States of America nor directly or indirectly to any U.S. person.

Limitation

Information herein is believed to be reliable but the Kleinwort Hambros Group does not warrant its completeness or accuracy and it should not be relied on or acted upon without further verification. The Kleinwort Hambros Group disclaims any responsibility to update or make any revisions to this document. Opinions, estimates and expressions of judgment are those of the writer and are subject to change without notice. As such, the Kleinwort Hambros Group, Societe Generale and its other subsidiaries shall not be held liable for any consequences, financial or otherwise, following any action taken or not taken in relation to this document and its contents.

Investment Performance

Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest. Changes in inflation, interest rates and the rate of exchange may have an adverse effect on the value, price and income of investments.

Marketing

If you do not wish to receive this document in the future, please let your private banker know or call us on +44 (0) 207 597 3000. Telephone calls may be recorded.

Legal and Regulatory Information

Kleinwort Hambros is the brand name for the following legal entities;

United Kingdom

SG Kleinwort Hambros Bank Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The firm reference number is 119250. The company is incorporated in England and Wales under number 964058 and its registered address is 5th Floor, 8 St James's Square, London SW1Y 4JU.

Channel Islands

SG Kleinwort Hambros Bank (CI) Limited, which is regulated by the Jersey Financial Services Commission ("JFSC") for banking, investment, money services and fund services business. The company is incorporated in Jersey under number 2693 and its registered address is PO Box 78, SG Hambros House, 18 Esplanade, St Helier, Jersey JE4 8PR. SG Kleinwort Hambros Bank (CI) Limited – Guernsey Branch is regulated by the Guernsey Financial Services Commission ("GFSC") for banking, investment and money services business. Its address is PO Box 6, Hambro House, St Julian's Avenue, St Peter Port, Guernsey, GY1 3AE. The company (including the branch) is also authorised and regulated by the UK Financial Conduct Authority ("FCA") in respect of UK regulated mortgage business and its firm reference number is 310344. This document has not been authorised or reviewed by the JFSC, GFSC or FCA.

Gibraltar

SG Kleinwort Hambros Bank (Gibraltar) Limited, which is authorised and regulated by the Gibraltar Financial Services Commission for the conduct of banking, investment and insurance mediation business. The company is incorporated in Gibraltar under number 01294 and its registered address is 32 Line Wall Road, Gibraltar.

General

Kleinwort Hambros is part of the wealth management arm of the Societe Generale Group, Societe Generale Private Banking. Societe Generale is a French Bank authorised in France by the Autorité de Contrôle Prudentiel et de Resolution, located at 61, rue Taitbout, 75436 Paris Cedex 09 and under the prudential supervision of the European Central Bank. It is also authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Further information on the Kleinwort Hambros Group including additional legal and regulatory details can be found at: www.kleinworthambros.com
Any unauthorised use, duplication, redistribution or disclosure in whole or in part is prohibited without the prior consent of Societe Generale. The key symbols, Societe Generale, Societe Generale Private Banking and Kleinwort Hambros are registered trademarks of Societe Generale.

KLEINWORT HAMBROS

SOCIETE GENERALE GROUP