MORABANC asset management

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MARKETS & STRATEGIES

Our vision

Is this year exceptional?

The Us equity market is again at historic highs and, on a global scale, few indices show returns under 15% this year. Fixed income is not far behind. The indices of emerging debt or high yield are already over 10%, and aggregates have returns of over 5%. An exceptional year – or not?

If you believe that, you've fallen into a psychological trap known as recency bias. It's a known fact that we investors favour personal experience over statistics. Our memory prioritises events in the recent past and those that are more emotive. The falling market at the end of 2018 still weighs on our minds.

The fact is that, since the 1980s, the stock market has reached November with returns of over 15% on 40% of occasions. As for the indices of global aggregate fixed income for EUR, these ended October with returns over 5% more than half the years. Generally speaking, returns such as we have now are followed by positive returns in the following 12 months, in most years.

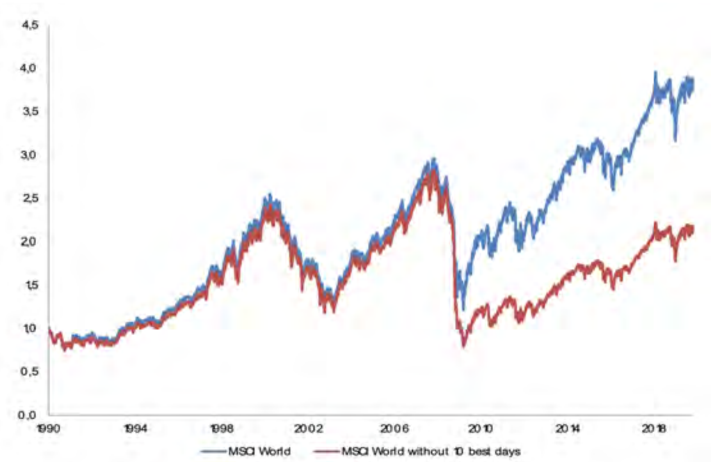
So, neither is it an exceptional year nor will this rising market die of old age. We ought to have learnt this lesson since 2009: rising markets do not end with time.

They do however end when the macro environment is weak, and indicators show that the probability of a recession in the next 12 months has risen. This could be a motive to slightly reduce exposure in risk assets.

Fixed income is also discounting a very different scenario to equity market, more in line with the macro economy. We always say that the time to make decisions should be when the markets are at a high. Otherwise, the market will force us to decide when it falls.

That said, this does not seem the moment to be excessively aggressive in reducing risk in portfolios. Different methods of relative valuation between stocks and bonds (earnings yield gap, dividend yield, etc.) show that equity does not appear expensive in comparison.

Nor can we speak of euphoria in equity market, although sentiment has improved. Or extreme valuations in absolute terms, although it is true that they are quite tight from a historical point of view.



Source: Bloomberg and Morabanc Asset Management

We know that the markets and high-risk assets in general tend to behave relatively worse in a recessionary environment than when the economy is accelerating, but history also shows that various "false positives" will occur before falls in variable income.

Staying outside the market can prove expensive because, if you miss the best days in the market, the final return may be quite different (if an investor in global shares missed the 10 best days since 1990 he would have earned 50% less than a simple buy and hold). Moreover, many studies (e.g. Barber and Odean in 2000) show that the greater the rotation of accounts, the lower the return (including the effect of commissions).

Like a game of chess: moving a piece for the sake of it, even if it's a pawn, without having a strategy, usually loses the game.

So, it seems worthwhile to actively wait and look for signs at this crossroad (see *Markets and Strategies*, October 2019), so we can make a decision when the opportunity arises.

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Currency

The US presidential elections are here

The end of the year is ever closer and, logically, time is running out to reach the target levels in the forecasts for many assets and focus on what returns to expect in 2020. Last week, taking stock of our experiences, we highlighted the fact that currency markets have not been "as peaceful" as stock markets, if we use the relative drop in latent market volatility as a measure. On reflection, we reach the conclusion that the main future currency crosses no longer pinpoint the meetings of the major central banks as crucial dates and tell us that the US elections are The Catalyst (this is the idea we aim to show in the adjoined graph). In recent sessions, there has been a divergence in the price of inherent risk in the options for EUR/USD between short-term and the year, resulting in "bets" that expire in November 2020 becoming relatively expensive. The fact is that history seems to repeat itself and the levels reached are very similar to those we previously saw in the midterm elections in 2014, when Obama experienced what the market feared and lost power in both chambers. We all remember what happened then, with movements close to 20% in the dollar, and this was not a one-off as this kind of upturn has been accompanied by significant movements in the past. It's hard to believe that we will be at these levels for the next 11 months, and the message to convey is the significance of everything we'll experience in the next year to our portfolios, as a "dance" is coming.

Lastly, I wanted to take a look at the market in which we operate, due to the regulators' initiatives to bolster monitoring of portfolio liquidity. It is notable that the currency market has an approximate daily turnover of USD 6 trillion (BIS 2019), spot transactions are four times higher than transactions in the US Treasuries market, benefitting from tight bid-offer spreads and showing no disruption in market events in the past. This is why I would encourage all investors to look into this market to improve liquidity and obtain the desired diversification of their portfolios.

12m Latent Volatility Ratio vs EURUSD 9m

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Variable income

Strength in the markets

This October was marked by generalised increases in all markets. New historic highs crystallised in the American stock exchange, with the S&P 500 gaining +2% that month. The positive note was also sustained in Europe, with Eurostoxx 50 at +1%, but without the historic highs, naturally. The German market stands out, with the Dax at +3.7%. On the other side of the coin, we find the IBEX 35 with a rise of +0.10% (if we can call it a "rise"). Obviously, Spain has been off the investors' radar for a long time, despite improved dynamics with double the European economic growth for more than three years.

According to the experts, the sectoral composition of the IBEX 35 is very biased towards banks at 26%, considering the major declines they have suffered in recent years both in price and valuation. This is one of the main factors holding back the index for several years and shows no sign of improving as, from what they say, it is reasonable to believe that bank business will become ever less profitable and have lower leverage, due to the regulator's capital requirements. This is combined with the prominence of communications at 11%, where the poor performance of Telefónica stands out, also with lows in price and valuation. In other words, the index has too much bias in forgotten sectors, far removed from the famous investment flows into momentum and quality from investors in recent years. However, we do know that nothing lasts forever, especially in the markets, so we have reason to believe that, in a normalised environment with recovering profits, we could finally see the Spanish stock market recover lost ground against its European counterparts. And if this begins next month, we can make the most of Thanksgiving Day to offer our appropriate thanks.

Graph 2: Evolution of the IBEX 35 compared with profits

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