State of play in equity markets - now comes the hard part

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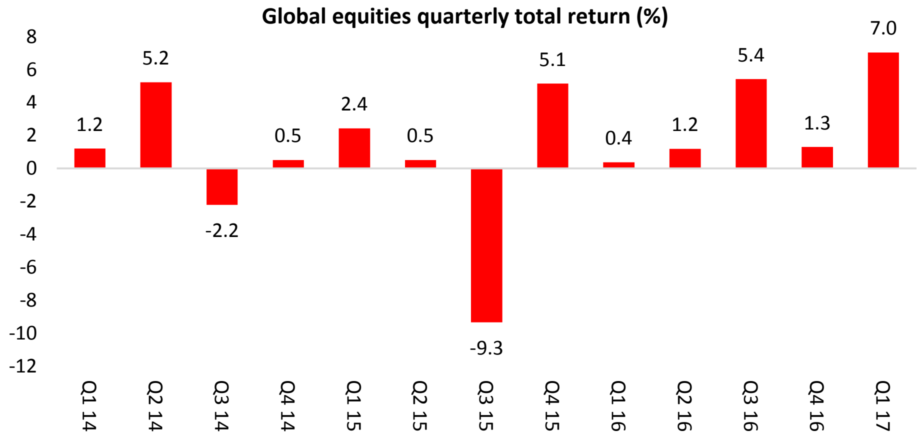
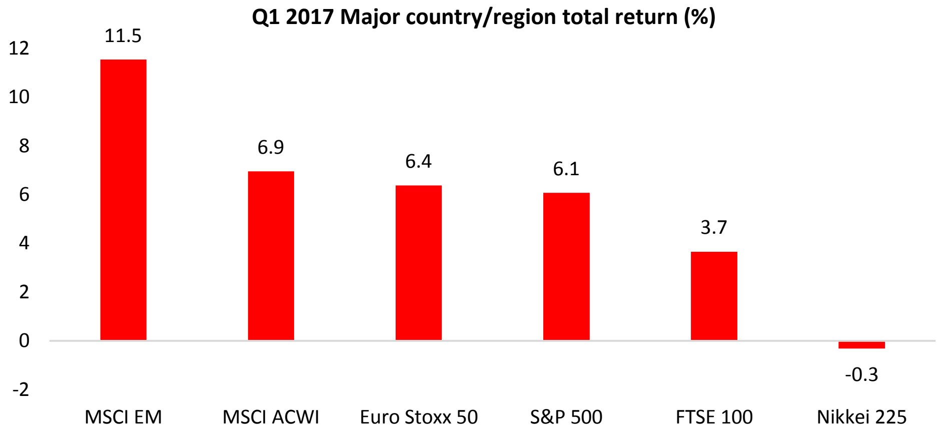
- **The strong rally in equity markets since the US elections has stalled recently**
- **For markets to remain elevated, validation from earnings and macro data is required**
- **Given expensive valuations, high levels of investor optimism and minimal political risk priced in to equities, failure to receive this validation will lead to a more difficult period for the asset class**

Validation now required

Equities have just had their best quarter in 4 years, rising 7% in total return terms. Within the equity universe the markets most sensitive to rising global growth expectations have performed the best. Emerging Markets stand out, while European equities have slightly outperformed US equities. However, the rally has stalled recently. The S&P 500 peaked at 2,400 on March 1st and has traded in a tight range since then. European equities managed to extend gains for another month, peaking last week. Emerging markets have performed strongly in Q1 but now also be losing momentum while Japanese equities are down year-to-date. **What is going on and what should we be looking out for?**



Source: ADCB, Thomson Reuters



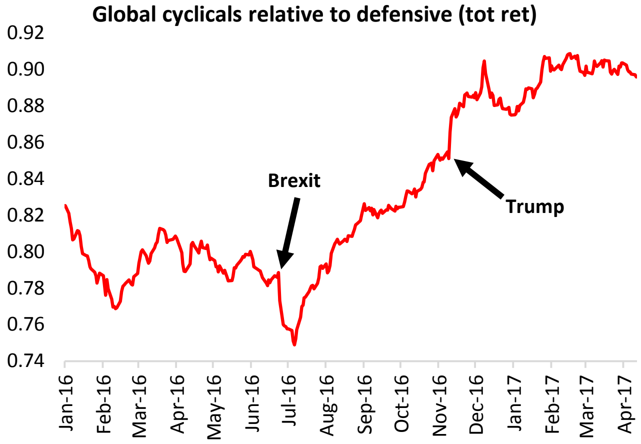
Source: ADCB, Thomson Reuters

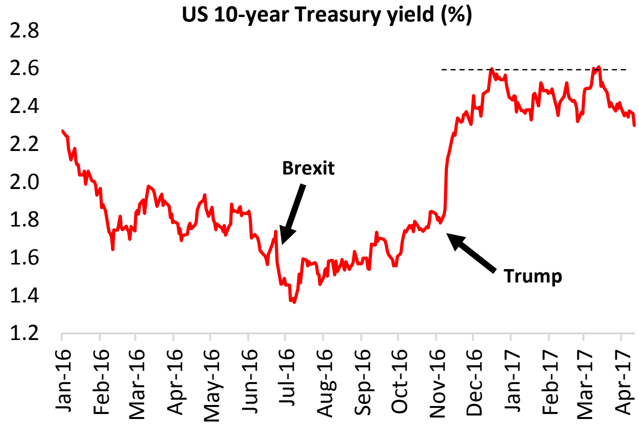
The reality is that markets have run a long way in anticipation of improving fundamentals. As is typically the case in a positive market environment, equities have rallied the hardest. The main drivers have of the strong equity performance in Q1 were:

1) *Softer US dollar*
2) *Rising US growth expectations on the back of Mr Trump's election*
3) *Expectations of stronger US growth spilling over to other parts of the world*
4) *Chinese authorities continuing to provide stimulus, underpinning EM growth as well*

These four factors combined to create a goldilocks environment for risk assets. **However, it is likely that these tailwinds are cyclical and not structural.** Given the scale of the equity rally, the market now requires validation, in other words, hope and optimism have driven equities higher, but these expectations have to be measured against reality. Validation could come in several forms, for example Mr Trump delivering on deregulation or tax reform. It could also come from earnings growth rising strongly or economic data strongly beating expectations.

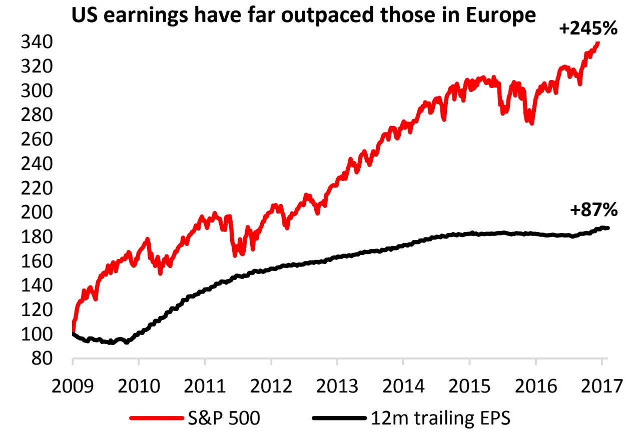
However, if this validation does not arrive, it is likely markets will be stuck in a weaker environment for a period. **We have already seen a number of the so called "reflation trades" unwinding.** For example, the performance of cyclical sectors (those benefitting most from a pick-up in growth) rose aggressively post Brexit and post the US elections. This outperformance has now stalled. US 10-year Treasuries are another clear example. If US economic growth is genuinely believed to be on a more positive path, treasury yields would have continued to rise in the US. Instead they peaked (twice) at around the 2.64% level and are currently at their lowest levels since mid-November.

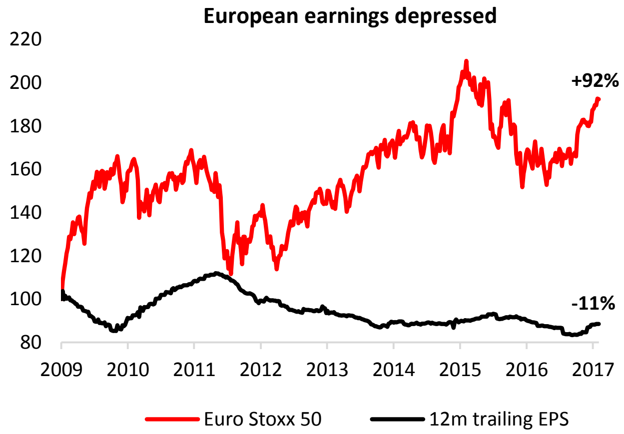




Source: ADCB, Thomson Reuters

On the immediate horizon is Q1 2017 earnings season in both the US and Europe. Europe in particular requires a healthy results season to underpin the strong price performance since the turn of the year (>6%) in the context of earnings which have not grown for a long time (see chart below). The market is expecting c13% earnings growth this year and c11% next year in Europe. In a historical context this seems a big ask, especially in light of (seemingly) capped economic growth, a central bank which will struggle to be more accommodating than what they are now and political risks which the market has priced out.





Source: ADCB, Thomson Reuters

Overall, markets have run a long way on little concrete news. Investor sentiment is very bullish, close to levels where it typically turns. Yes, data has improved but markets have more than priced this in. Further improvement in things like earnings are now necessary to prolong the rally. Within the equities universe we continue to believe it makes most sense to position in low beta US equities and to underweight European equities. We continue to overweight UK and Japanese equities (on currency hedged basis) whilst acknowledging that a period of risk-off sentiment will weigh on the yen in particular. Gold and Treasuries continue to look attractive as risk hedges in this environment.

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Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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