Equity market update - is a major correction imminent?

Wietse Nijenhuis
Equity Strategist
Tel: +971 (0)2 205 4923
wietse.nijenhuis@adcb.com

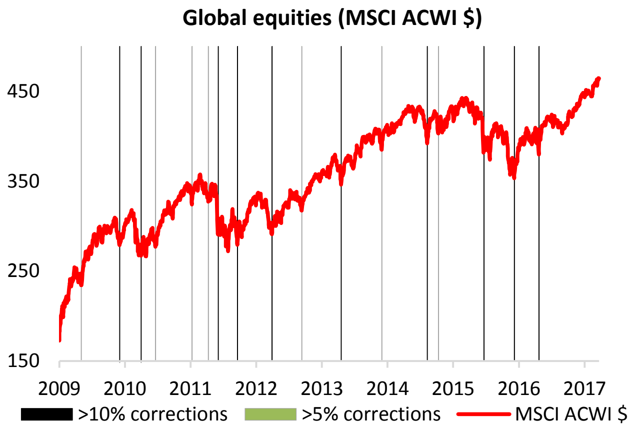
Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

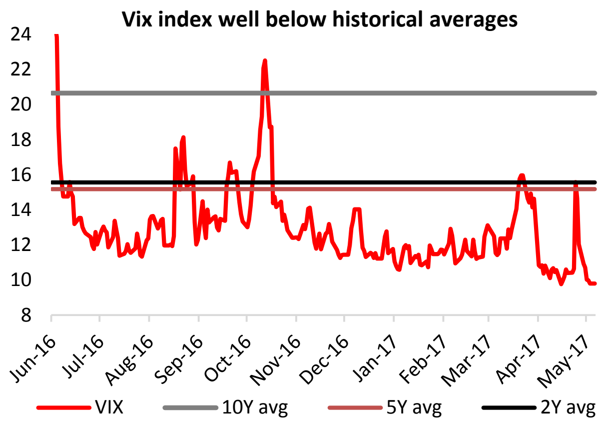
Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

- **The answer to this question is 'no' in our opinion**
- **Equities have been unusually calm over the past 11 months, ignoring a host of potential risks**
- **The foundations of the strong equity performance come not from Mr Trump's policy promises, but from robust global growth and strong corporate earnings**
- **This fundamental backdrop means equities are likely to bought very quickly after any dips, which can keep markets at elevated levels**
- **Having said so, we have now entered the period of the year when equities are seasonally weaker. Therefore we also don't expect another major leg up during the summer**

A period of consolidation at higher levels is likely

Equity markets have been strangely calm for almost an entire year, this in spite of a plethora of risks which could have unnerved investors. The below chart shows the global equity index since the depth of the global financial crisis in 2009. The black vertical lines represent corrections of at least 10% while the red vertical lines are pull-backs of between 5-10%. It immediately becomes apparent that **the last time global equities experienced any sort of pull-back was in the immediate aftermath of the Brexit referendum, 11 months ago. This is very unusual as equities typically experience 2-3 pull-backs of at least 5% every year.** Another way to view the same phenomenon would be to simply look at the VIX which has been spent almost all of the past 12 months below historical averages.



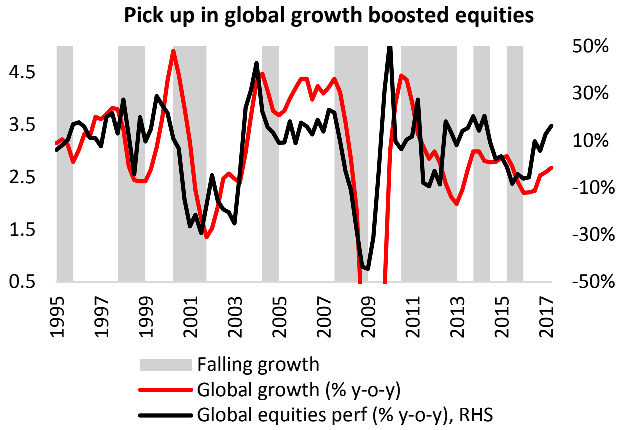


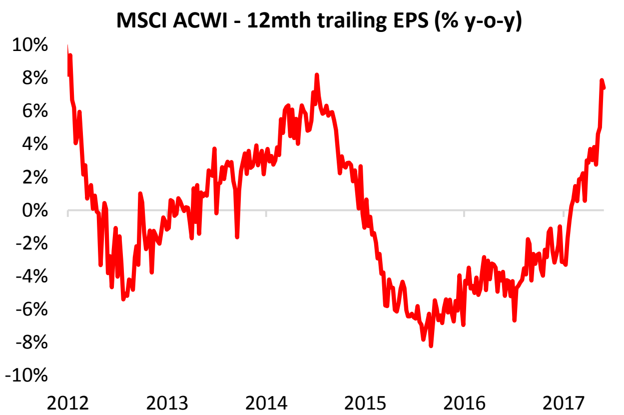
Source: ADCB, Thomson Reuters

Two key questions; 1) Why are markets so calm, and 2) is a correction imminent?

1) Equities enjoy environments of improving growth, but not growth that is so strong as to induce much tighter monetary policy, meaning that central banks remain accommodative. **This is the so-called 'sweet spot' and it is where equities have been ever since the Brexit referendum last year.** The shock outcome of the referendum ensured that major central banks remained more accommodative than would otherwise have been the case (recall the Fed delayed hiking rates before the vote took place). At the same time the global economy was already in the early stages of a cyclical upswing which was not derailed by the outcome in the UK vote (again because of central bank support). The chart below shows year-on-year change in global growth, post the global financial crisis we witnessed a mini revival in growth only in 2013, equities rallied during this time (in fact they rallied ahead of growth bottoming).

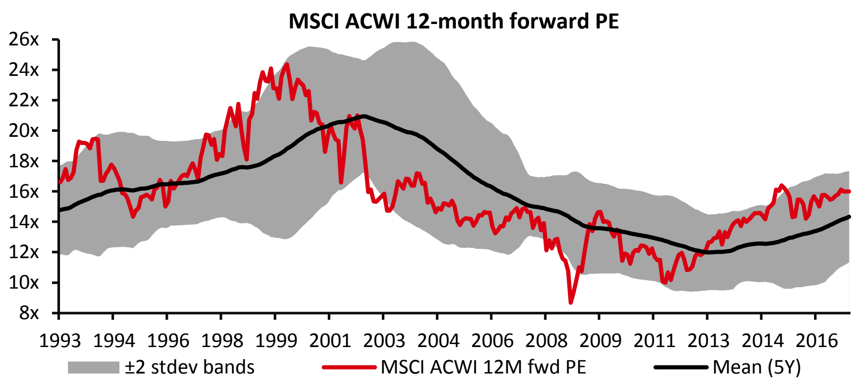
The most recent pick up in global growth started in Q2 last year, this again has coincided with strong global equity market performance. **The difference now compared with 2013 is that global growth is broad-based, meaning that most economies are growing.** According to IMF data, not a single G20 economy will post a decline in output this year (the first time since 2010). Ever since the 2008-09 financial crisis global growth has been positive, but uneven. The US was growing around the 2% rate while Japan and Europe were growing between 0%-1%. The same was happening in emerging markets where India and China were growing healthily but Russia and Brazil were heading into deep recessions. **This time around, however, it seem that the global cyclical upswing is more synchronized, and this is what is helping markets stay elevated, not least because earnings growth is picking up** too (below right hand chart).





Source: ADCB, Thomson Reuters

2) Unless a major risk event occurs (for example Italian elections get pushed forward from 2018, Greek debt negotiations break-down or “Russia-gate” escalates) a >10% equity market correction does not look imminent. Neither however is it likely that we will see a major renewed leg up in global equities during the summer months. Typically from the current starting point in valuations, at around 16x forward PE, equity market returns tend to be relatively paltry on a 12-month view. **The most likely outcome is a period of consolidation during which investors will assess the sustainability of the economic and corporate earnings upswing.** The Fed is likely to hike in June but the most recent FOMC minutes suggest that considerably stronger economic data would be required from here in order to persuade the Fed to tighten more than the indicated 75bps this year (one more 25bps after a June hike). **This means that the Fed is happy to remain more reactive rather than proactive. It also means that monetary conditions will remain supportive and equities can continue to stay at elevated levels.** Yes equities are at all-time highs (or close to them) and valuations are expensive. However, valuations are very poor indicators of market inflection points and can remain in overshoot territory for a long time. Global equity valuations have yet to reach levels which typically cause a reversal irrespective of fundamentals (usually around +2 or -2 standard deviations from the long-term average).

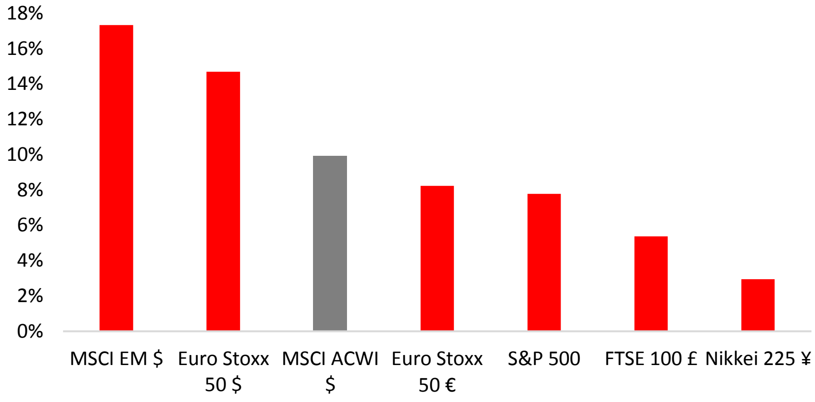


Source: Thomson Reuters, IBES, MSCI

In conclusion, despite the extended run without any sort of correction, global equities can continue to consolidate at higher levels helped by the synchronized pick up in global growth and still overall supportive global monetary policy. **The key things to watch are no longer what Mr. Trump does in terms of his policy agenda, but rather if economic data continues to show the global economy is improving.** The 2013 rebound in global growth turned out to be a mini-revival within a broader down-trend. Although signs are positive so far, it is not yet certain that the current upswing will last. If the strong data does manage to extend through the summer and into year-end then earnings can continue to improve allowing markets to eke out further gains, albeit these are likely to be more moderate than what we have seen over the past 11 months.

Although the supportive equity environment is likely to last, we maintain our more cautious preferences within the asset class. Our main call has been to overweight US equities relative to Eurozone equities. The two regions are both up c8% in local currency terms year-to-date (see chart below) but in dollar terms Eurozone equities have outperformed considerably. The difference therefore has been euro strength which we believe is unlikely to last as expectations of scaling back of ECB monetary stimulus are premature in our view (the most recent soft Eurozone inflation reading confirms this), whilst at the same time political considerations will also keep a cap on euro strength.

Major equity market performance ytd



Source: ADCB, Thomson Reuters

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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