The View From The Outer

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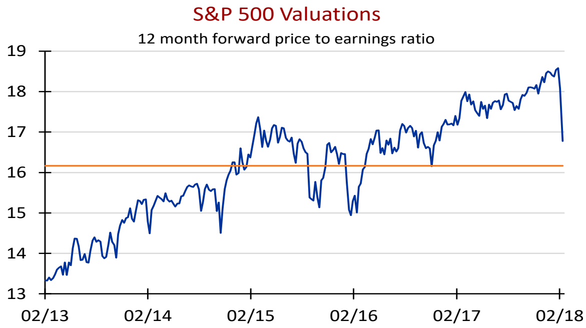
Watching and waiting

We review how February's market volatility has affected valuations across the asset classes. Equity valuations have improved significantly; credit has been surprisingly resilient; bond yields have moved closer to normal but have some scope further to fall; and the $A has moved closer to our fair value estimates.

Valuations for US equities have improved significantly because prices have been falling as earnings forecasts have been rising. It is a similar story in Europe where the market is now outright cheap.



Source: Thomson Reuters Datastream, Evans & Partners

The turmoil in equities has not been replicated in credit. US Investment Grade spreads have increased by only 5 basis points and emerging market spreads have actually fallen; it is only in High Yield spreads that there has been an impact.

This period has seen a small rise in the $US as is typical of risk events. The $US could rise by a more significant amount if the turmoil continues and this could push the $A further down towards our fair value estimates of $US0.74.

Recommendation

None of these moves in valuations are large enough yet to require changes to our current asset recommendations but we are monitoring developments closely. Looking at our key recommendations:

- Better equity valuations give us greater confidence in our overweight position in equities. We may add to these positions if equity markets continue to fall.
- The limited response in credit makes us more wary of valuations in this sector. However, we will consider adding to sovereign bond positions if bond yields continue to rise.
- The change in $US direction gives us confidence that international equity holdings should mostly be held on an unhedged basis.

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Watching and waiting

We review how February's market volatility has affected valuations across the asset classes. None of the moves to date are large enough to require changes to our current asset recommendations but we are monitoring developments closely.

Equities valuations improving

The equity market falls have had some interesting effects on valuations. In the case of Europe, this has been enough to now call the market cheap. The US and Australian markets are still stretched but this is changing quickly particularly in the US because earnings are rising as prices are falling.

1. The biggest change in valuations has been for the S&P 500 because price falls are occurring at the same time as earnings are being revised up. As a result the forward PE has fallen back to 16.8x, which is the lowest since December 2016.

S&P 500 Valuations

12 month forward price to earnings ratio

Source: Thomson Reuters Datastream, Evans & Partners

2. Similarly in Europe, good earnings and lower prices have pushed the forward PE much lower. In Europe's case it is back below the five-year average and below 13x.

EURO STOXX Valuations

12 month forward price to earnings ratio

Source: Thomson Reuters Datastream, Evans & Partners

3. In Australia, the ASX 200 has fallen back to its five-year average PE of 15.2x. This is better and still the lowest since April 2016 but still rich compared with earnings prospects.

ASX 200 Valuations

12 month forward price to earnings ratio

Source: Thomson Reuters Datastream, Evans & Partners

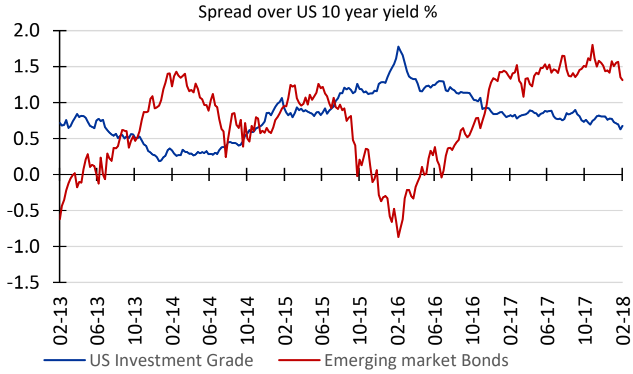
Credit has been complacent

Another interesting divergence in this sell off is between equity and credit. Most parts of the credit market have treated these events as an equity market event. Going forward this reinforces our view that equity remains the preferred asset class; if the equity market volatility continues there must be more contagion to credit markets.

International credit spreads are broadly unchanged since the equity sell off began. US Investment Grade spreads have increased by only 5 basis points and Emerging Market Bond spreads have actually fallen.

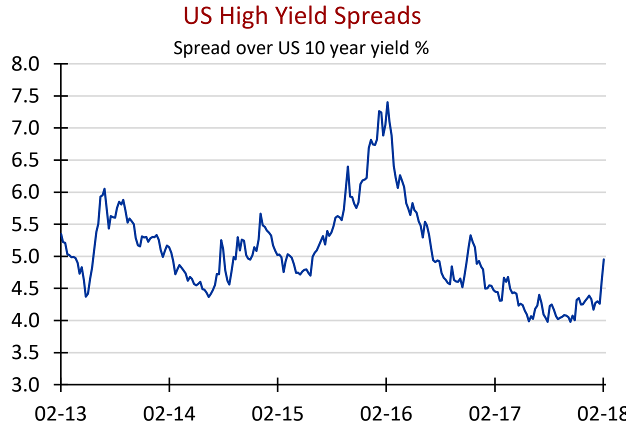
Credit Spreads

Spread over US 10 year yield %



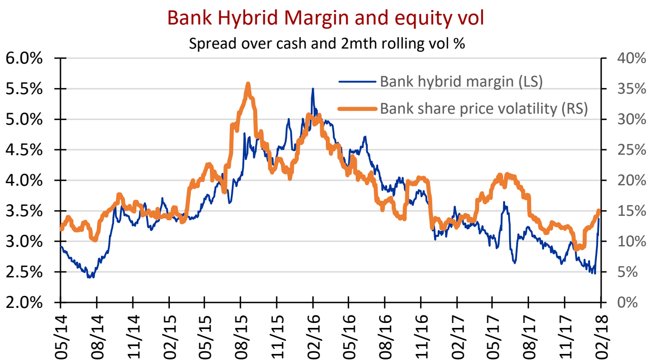
Source: Thomson Reuters Datastream, Evans & Partners

The High Yield market is different; this has behaved more in line with what you would expect.



Source: Thomson Reuters Datastream, Evans & Partners

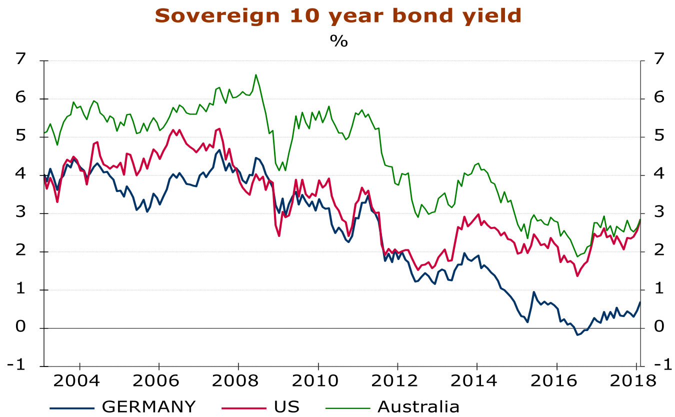
It has been different in Australia where major bank hybrid spreads have risen. The rise has been in line with the increase in share price volatility.



Source: Bloomberg, Evans & Partners

Bonds rising but a long way from normal

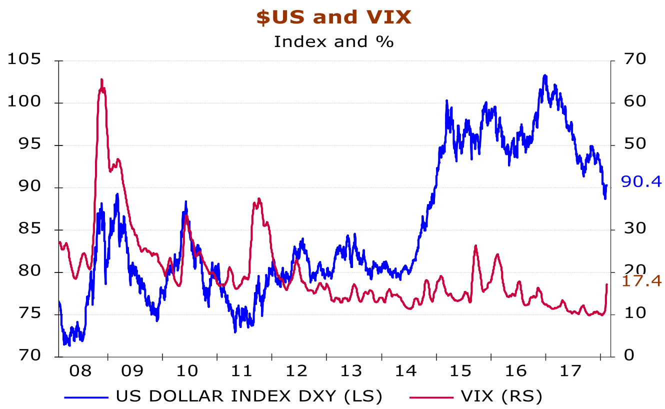
The rise in bond yields that sparked this equity market declines has taken bond yields to marginally more sensible levels but there remains significantly more potential for rises in Europe where 10-year yields remain below long term sustainable levels. Sovereign US bonds will begin to look more interesting if the 10 year yield rises above 3%.



Source: Thomson Reuters Datastream, Evans & Partners

$US might be on the turn

This period has seen a small rise in the $US as is typical of risk events. The $US could rise in a more significant way if the turmoil continues and this could push the $A further down towards our fair value estimates of $US0.74.



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