# Market Outlook

July 2020

## At a glance

- The market rally has been nothing short of stunning in magnitude. Pleasingly, we've been favourably positioned both prior to coronavirus, and with the timing of capital deployment during coronavirus
- There are plenty of good reasons for the market bounce, many of which we've touched on in webinars and prior Market Outlook reports. These include low-discount rates, material monetary and fiscal stimulus, and health interventions that have proven effective to permit a return to a prior way of life (masks, social distancing, test and trace)
- Given the speed of the recovery and where the markets now sit, we now look forward with notably increased caution.

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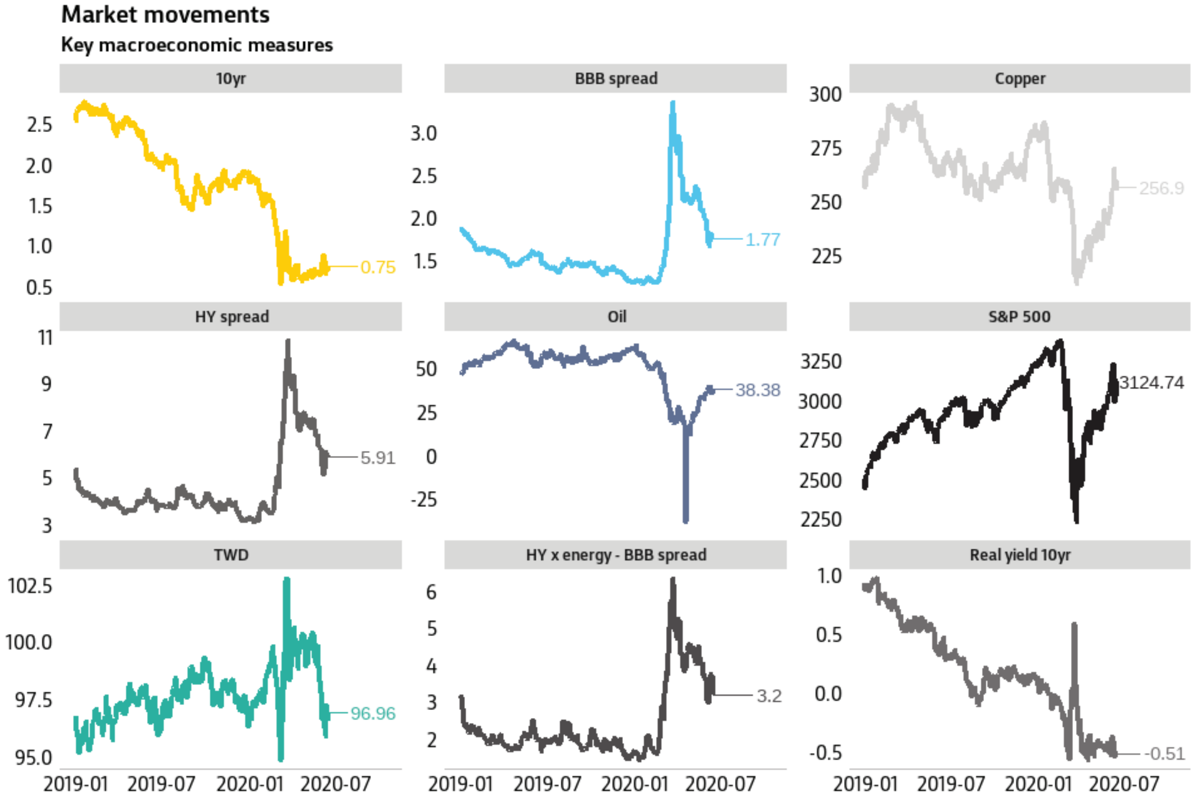
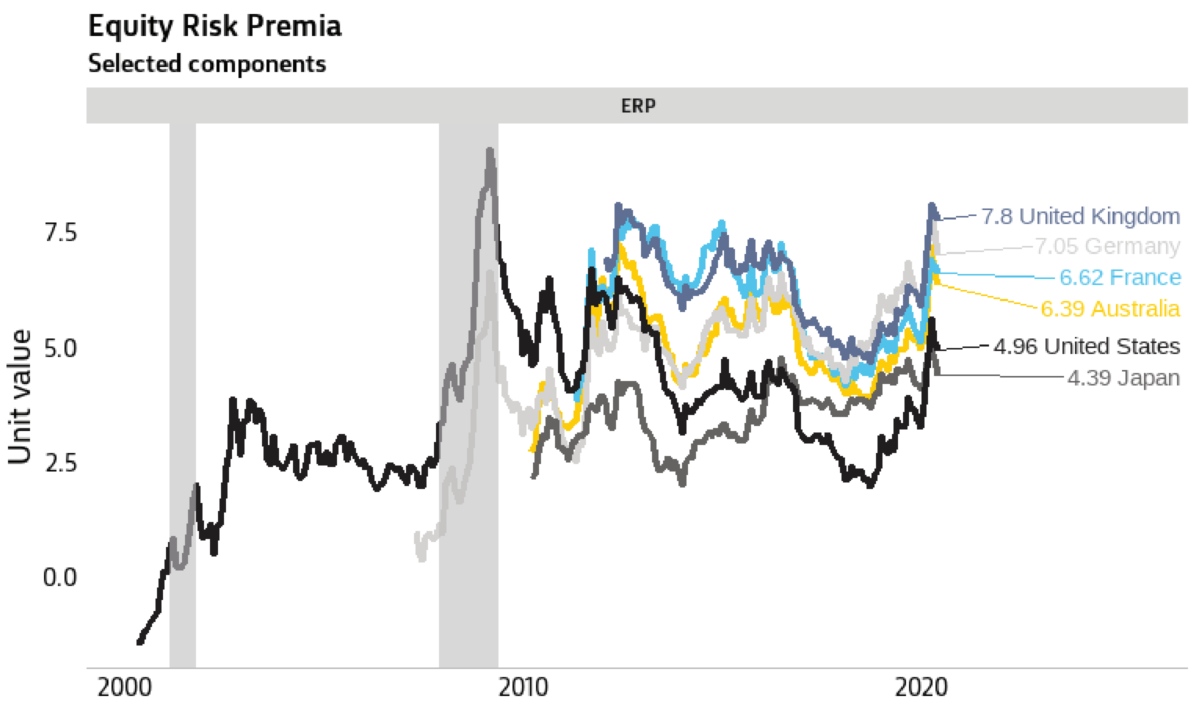
# Firstly, the state of play

Shown below are the constellation of key macro market asset prices. Equities (levels), credit (spreads) and commodities have made sizeable recoveries.




Source: Bloomberg, author's calculations 2020-06-17

They didn't appear overvalued coming into coronavirus. Equity risk premia were not unduly low at the turn of the year, and into February. Mind you, they weren't especially cheap either.

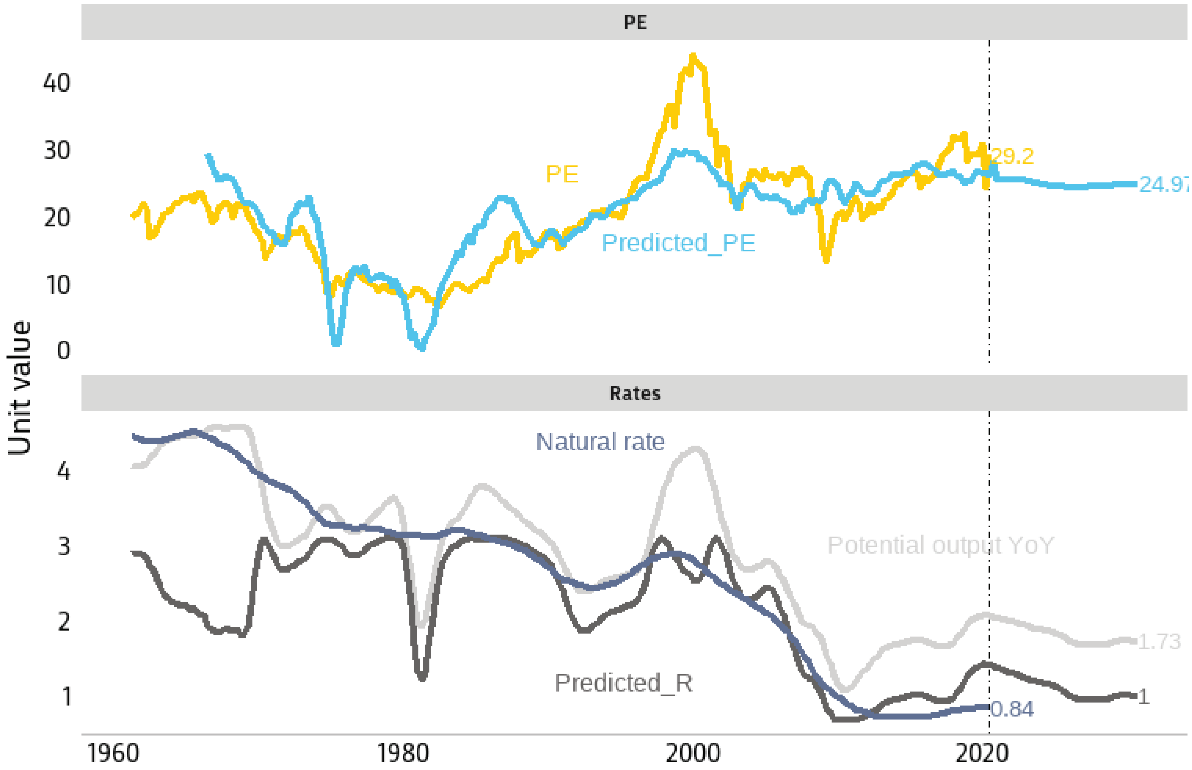



Source: Bloomberg, author's calculations 2020-06-17

Using another conceptually similar frame, cyclically adjusted Price-Earnings ratios (US shown below) were not unduly above where we'd expect them to be, on the basis of their relationship with inflation, interest rates (natural rates), and changes in interest rates. But again, not cheap either.

**Calculating CAPE**

**Using macroeconomic fundamentals**

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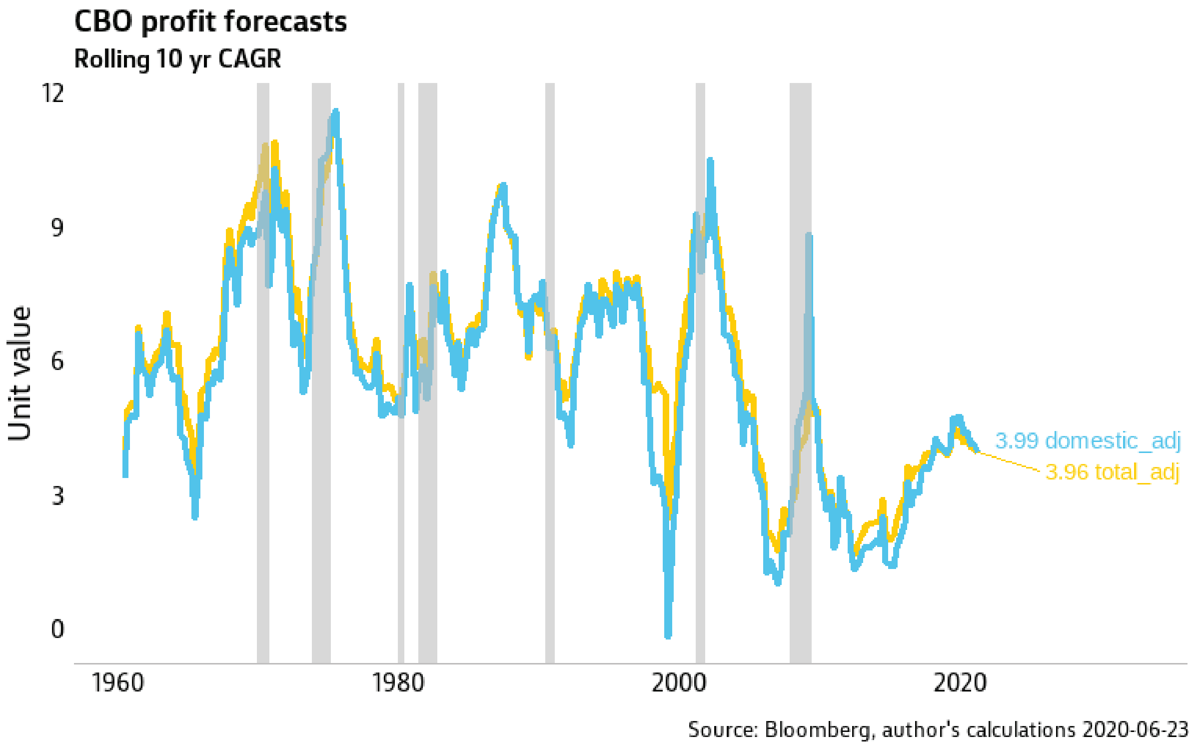
Note that the model correctly signals the overvaluation of the tech bubble, and correctly signals just how cheap stocks had become post the GFC (which was about a housing bubble and financial weaponisation, rather than an equities bubble).

With that in mind, it's worth thinking through another valuation frame. You have Price (P) and Earnings (E), which can be expressed as **P = P/E * E**. It's a very simple formula. If the P/E ratio is about right, and you don't expect it to change, then growth in Price P is going to equal growth in Earnings E.

Likewise, a stocks total return is the capital gain plus the distribution component. We can suggest in the model above that the capital gain component is driven entirely by the future growth in profits, plus some percentage of the earnings yield. For example, assume a dividend payout ratio of 70%, and multiply it by the earnings yield to the distribution component. Add them together, and you've got your total return forecast. Very simple, a bright high school student could do it, but very effective when compared to the long run.

So what do current market conditions tell us? Well, here is the Congressional Budget Office rolling 10-year forecast of corporate profits. We can see profits just prior to coronavirus (so January 2020, 10-year estimates) were not unduly low. Nothing like the growth of decades past, but not on par with the lows either. Given we're in a low-productivity, low-demographic-growth world, that makes sense as a ball park figure.




Note also, for example, the period of the tech wreck and the Global Financial Crisis. 10-year profit growth, in 1998, was projected as negative! And, the stock market at record highs by valuation (refer to the PE graph above, but I think everyone recalls the nosebleed valuations coming into the 2001 tech wreck anyway).

Let's tie it together. We've got a near 4% long-run expected capital component, and a yield that's a bit over 2% for dividends (an inverted P/E ratio gives an earnings ratio of ~3% * 70% assumed payout ratio). Net out inflation, and we've got a 4% real return, compared to bonds which are offering a slightly negative real return. Asset allocation is all about trade-offs, and those trade-offs don't look too bad.

# The rub

But, that is for a world that's more akin to steady state. We have all the bad things you know about (unemployment, bankruptcies etc) plus all the stuff we don't (like the shape of forthcoming stimulus, which will absolutely be needed). Then there's the second wave of the virus.

So, having been favourably positioned (overweight defensive assets) coming into coronavirus, and having been right/lucky/skilful in capital deployment over coronavirus (equities, commodities, reducing defensives, changed hedging ratio) across our diversified funds, we're looking ahead with increased caution.

## Before you go...

Don't forget you can also click through to the new Commonwealth Private Economic Insights Hub. On the Hub, you'll find a copy of our past two updates, and more information about our advisory offering. You can access the Hub here.