MARKET INSIGHTS

from Ziegler Capital Management

History Lesson?

"Those who do not remember the past are condemned to repeat it."

— ***George Santayana: Spanish philosopher, poet, and novelist***

As I watch the markets and read opinion pieces from peers, I keep hearing that phrase over and over again, no doubt a consequence of one of my more eccentric professors repeating it on a daily basis. Scholastic flashbacks aside, at this stage in the present market cycle, Mr. Santayana's warning begs further reflection. Winter is coming. Everyone knows that. The question is when? Hardly a day goes by that the talking heads don't pontificate about new market highs while breathlessly questioning, "Is the next recession just around the corner?" For us it all devolves into background noise, a kind of CNBC generated static created to hypnotize rather than educate.

So, how does one approach the paradox of a possibly overvalued market with strong earnings and an economy seemingly at full employment? Isn't this precisely the time when rising stock prices should run out of steam? No doubt many keyboards have suffered mercilessly under the pounding of pundits and opinion writers reminding us what the current cycle has "taught" us. We all know the drill. Since the end of the recession, value has underperformed while growth has surged. Passive investing, including index ETFs, has exploded in popularity and active management has fallen out of favor. Momentum investing and the collective euphoria that accompanies it have taken center stage. So, should one continue to run with the bull or rather place bets on the still hibernating bear? Indicators and data can be analyzed to make strong arguments for either position. However, and perhaps worryingly, the collective thought seems to be that the market has to increase in value because it ***has*** increased in value. Nobody wants to miss the boat. Hmm… when have we heard that refrain before?

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ABOUT ZCM MARKET INSIGHTS

A series that provides a glimpse of our internal thought process through current topics effecting our clients and colleagues.

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We are a premier asset management firm comprised of investment teams employing repeatable processes providing tailored investment solutions across the fixed income and equity markets.

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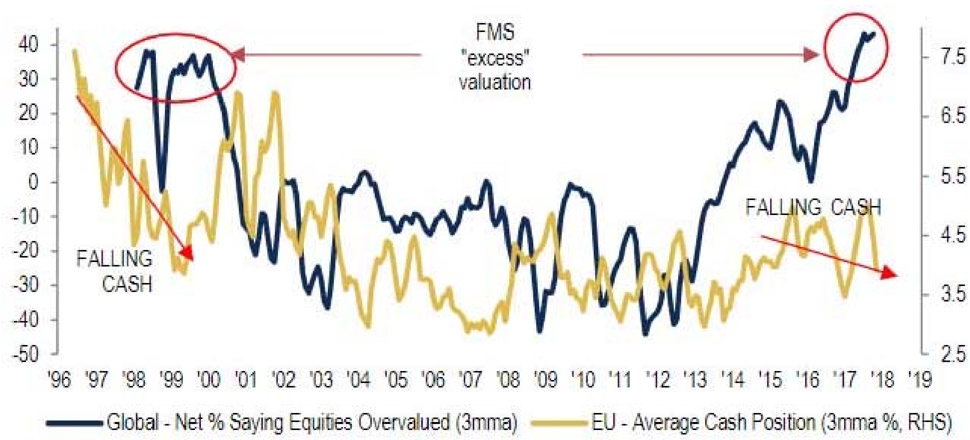
Cutting through the noise

Having seen much of this before, we believe history is trying to tell us something. Here are some facts from the not too distant past that we hope will lend perspective to the current situation: The MSCI USA Momentum Index has posted over a 37% total return so far in 2017. When comparing the MSCI USA Momentum Index to the S&P 500, Momentum has outperformed by 17.2%. The next closest period of such dramatic out performance was back in 2007 when Momentum outperformed by 12.3%. If we go back even further, the next period of largest relative gain was in ’98 and ’99 where it outperformed by 20.4% and 19.6%, respectively.[1] We know what happened during those last two cycles; in the first case it was, a bursting tech bubble and in the second, a housing crash led to the global financial crisis.

What does it all mean?

Breaking down the data, one could easily connect the dots between the increasing divergence of the S&P 500, compared to the MSCI USA Momentum Index and the propensity for extreme recessionary events. Interestingly, the parallel between the exuberance on display today compared to those other two events just now seems to be recognized. BAML’s Global Fund Manager Survey (FMS) has a chart that shows the spread between fund managers who are concerned that equities are overvalued and corresponding declining cash positions. Currently, manager perceived excess valuations levels are above the 1999 high, and cash positions are close to their 1999 lows.

RECORD FMS “EXCESS” VALUATION[2]
Global FMS Net 5 Saying Equities Overvalued (3mma) and EU Average Cash Position (3mma %)



Source: BofA Merrill Lynch Global Fund Manager Survey.

Translating that into English, investors are starting to believe that valuations actually *are* too high even as they carry less and less cash. Based on an ever increasing volume of data, now might be the time to re-evaluate some of the “truisms” that have defined the current environment: growth over value, passive and index ETFs over active, etc.

We are NOT predicting an imminent correction, but the previously mentioned data points to an opportunity. A cooling in the overheated momentum space is entirely possible, maybe even probable. Having said that, if such cooling were to occur, it might not systemically threaten the uptrend. Perhaps the broader market's lagging performance in relation to the MSCI USA Momentum Index against a conducive low rate, tame inflationary environment, ensures against that. However the potential for such risk is demonstrated, at least anecdotally, by the data. Point being, if investors run too close to the bull, they will get trampled when it decides to turn. Our response to Mr. Santayana's note on history from an investment perspective is this: That's precisely why you need active managers! We don't care to predict the future, but we do believe that partnering with managers who take the time to conduct fundamental sector and security analysis offers investors the flexibility to better manage their individual risk profiles in these otherwise challenging times.

Thanks again for the reminder George, but allow us to tweak it just a little bit: "*Investors* who do not remember the past are condemned to repeat it".

References

1. Source: Bloomberg, as of 11/30/2017
2. http://www.zerohedge.com/news/2017-11-14/bank-america-clear-sign-irrational-exuberance

For the MSCI USA Momentum Index, a momentum value is determined for each stock in the MSCI parent index by combining the stock's recent 12-month and 6-month local price performance. This momentum value is then risk-adjusted to determine the stock's momentum score. A fixed number of securities with the highest momentum scores are included in each MSCI Momentum Index, generally covering about 30% of the parent index market cap. Constituents are weighted by the product of their momentum score and their market cap. Constituent weights for broad MSCI Momentum Indexes are capped at 5%.

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