September: time to go back to school

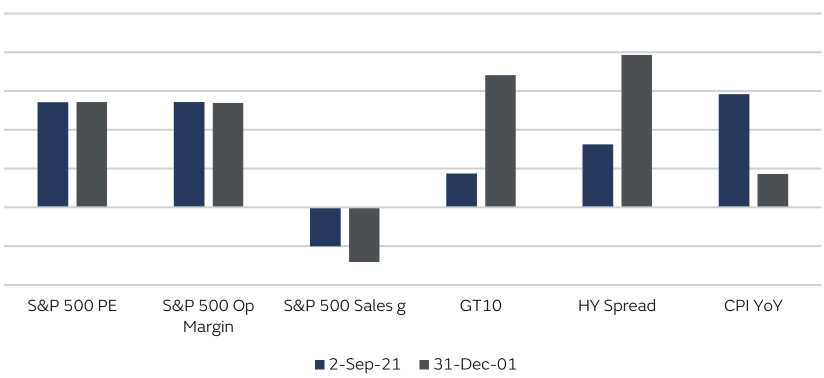
It's September, the summer holidays are over and time to go back to school. But did we do our summer reading and are we ready for the beginning of term quiz? Here goes:

The high yield bond default rate was up c.100% last year, the S&P 500 PE Ratio is 27, the operating margin of S&P 500 companies is 10% and LTM S&P 500 revenues have declined by 5%. What year is it? Too easy, the year is now. That's correct, but the bonus point goes to those who answered now and also 2001.

At school we are taught that the study of history can provide insights into the present and perhaps the future. "Those who cannot remember the past are condemned to repeat it" and all that. But the reverse is also true: knowing the past does not grant understanding of the present.

As we look back at historic market data we need to understand what is interesting and what is informing.

Chart 1



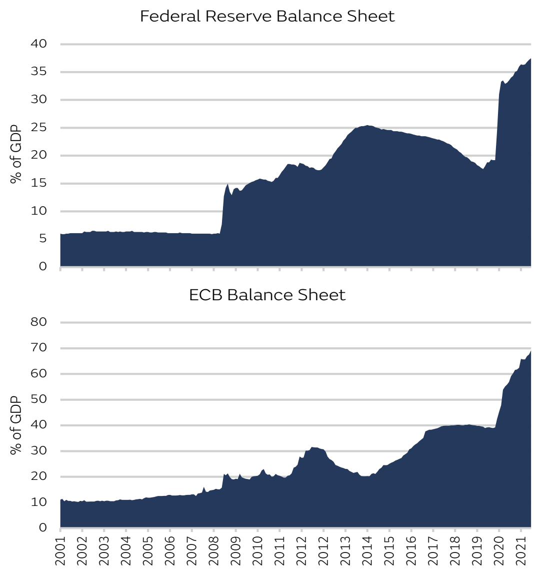
	2-Sep-21	31-Dec-01
S&P 500 PE	27.08	27.16
S&P 500 Op Margin	10.06%	9.98%
S&P 500 Sales g	-4%	-5%
GT10	1.29%	5.05%
HY Spread	3.01%	7.28%
CPI YoY	5.40%	1.60%

Source: Bloomberg

So while we see key equity market metrics repeating from 20 years' ago, we are clearly in a very different world today than then. If you've been on complete break during the summer you can be forgiven for thinking that there are typos in Chart 1. How can the 10 year Treasury be at 1.29% when inflation is at 5.4% and how can current credit spreads be so tight following the sharp uptick in high yield default rates? It's all transitory we are told. That may, or may not, turn out to be true but there are clear distortions upsetting the neatness of market data. Those distortions include Central Bank support, too much cash about, leverage and bullish expectations.

Both the Federal Reserve and European Central Bank have provided unprecedented balance sheet support over the past 2 years. While ECB balance sheet (as a % of GDP) generally runs higher than the US (reflecting the multi-country responsibilities of the ECB), the balance sheet expansion of both is stark to see, as shown in Chart 2.

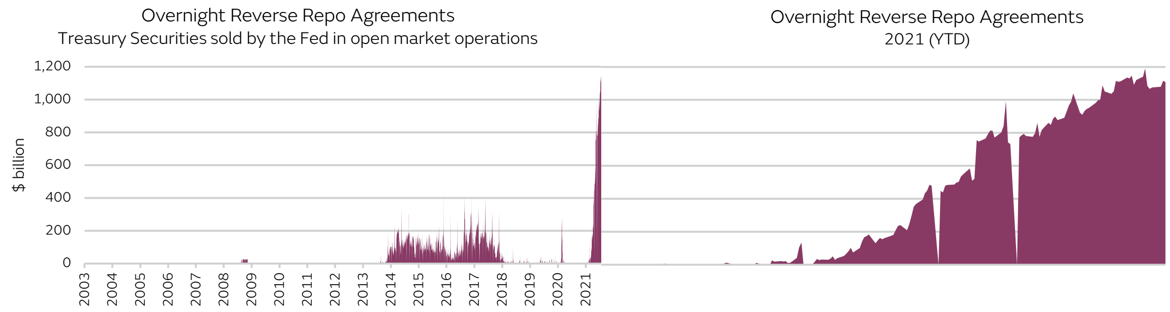
Chart 2



Source: Bloomberg

At the same time, the combination of low yields and trillions of dollars of stimulus/pandemic aid has left financial markets with more cash than they know what to do with. As a result demand for the Fed's reverse repo program has reached record levels (over $1 trillion) during 2021 and levels with no real precedent in history.

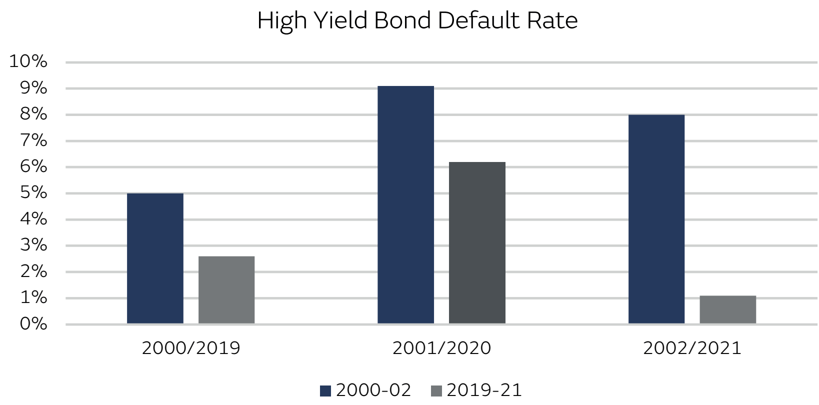
Chart 3



Source: Federal Reserve Economic Data, Federal Reserve Bank of St Louis

Amid all this fiscal support and surplus liquidity there is a sense that the worst of the financial and economic situation may be behind us and certainly there are indicators suggesting just that with high yield bond defaults declining sharply from the c. 100% uptick in 2020 and also well below our "precedent" period of 2000-1.

Chart 4



Source: Moody's Investor Service, JP Morgan

Against this backdrop we see plentiful examples of risk-on sentiment in markets. Leveraged investing is at an all-time high with almost $1 trillion outstanding in US securities margin accounts (Chart 5). Bullish expectations are also manifested in a sharp uptick in total option call volumes (Chart 6) and ETF flows generally away from fixed income and into equities and alternatives (Chart 7).

Chart 5

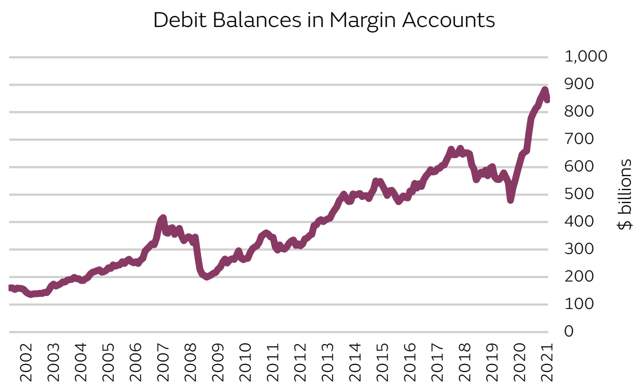
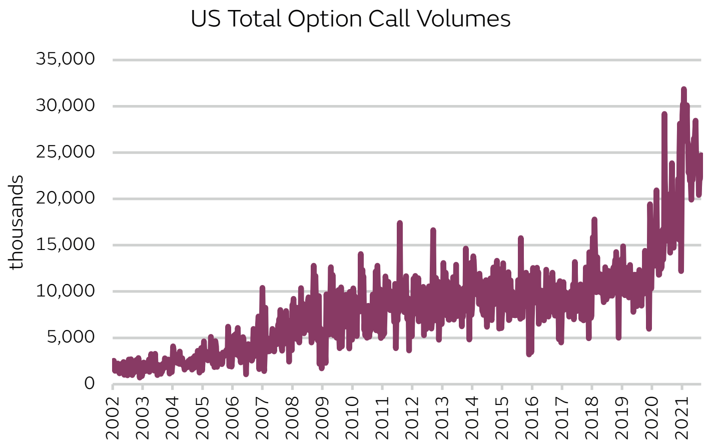
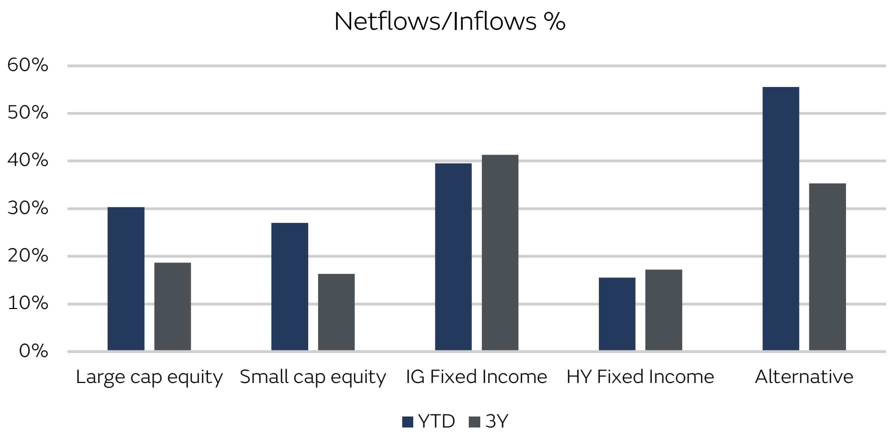


Chart 6



Source: Bloomberg (OPCVTOTC Index)

Chart 7



Source: Bloomberg, GIBUK analysis

History cannot tell us what is going to happen next. We assume that these distorting inputs are going to be withdrawn from the market at some point. While there is a sense that this will start sooner than later, how long the withdrawal process will last and the market's reaction are unknowns. Where there is uncertainty there is generally volatility and an expectation of choppy waters ahead may reverse bullish expectations.

Against this backdrop it's important not to forget the basics. That means investing based on long term expectations to create investible themes prioritizing those investment sectors that will prevail over your investment horizon. The basics are not necessarily easy. Investing is hard and there is no short list of data points to provide a cheat sheet. So let's study the challenges the world faces today and identify those companies and sectors best able to meet them.
Let the new school year commence!