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A return to valuation-driven markets

Anatole Kaletsky | GaveKal | 17 September 2014

In the earlier articles in this four-part series, I argued that the medium-term outlook for economic fundamentals and monetary policy is more predictable now than at any time since 2008, and possibly since the late 1990s. If I am right, then over the next year or two, asset prices will no longer be driven by the economic statistics and monetary policy decisions which have dominated the post-crisis financial debate and which still obsess market and media analysts, but by something else.

What will the new driving force be? We have always maintained that there are three main forces that determine asset prices: (i) economic activity or corporate fundamentals, (ii) liquidity and monetary conditions, and (iii) valuations. These three forces are obviously inter-related. Nevertheless, in principle, they are independent, as illustrated in Figure 1.

If we accept that economic and monetary conditions are now exceptionally predictable, and that financial markets tend to react to whatever is least predictable, then it follows that the main driver of asset prices in the next year or so will be the third leg of our triangle – the valuations that investors attach to predicted future cash flows.

If valuations are emerging as the main variable of adjustment in asset pricing, then the macro-driven markets of the post-2008 period are a thing of the past, and will not return for a while at least. Instead, relative valuations will be the main force driving markets. If so, we can draw three optimistic conclusions and one that is potentially alarming.

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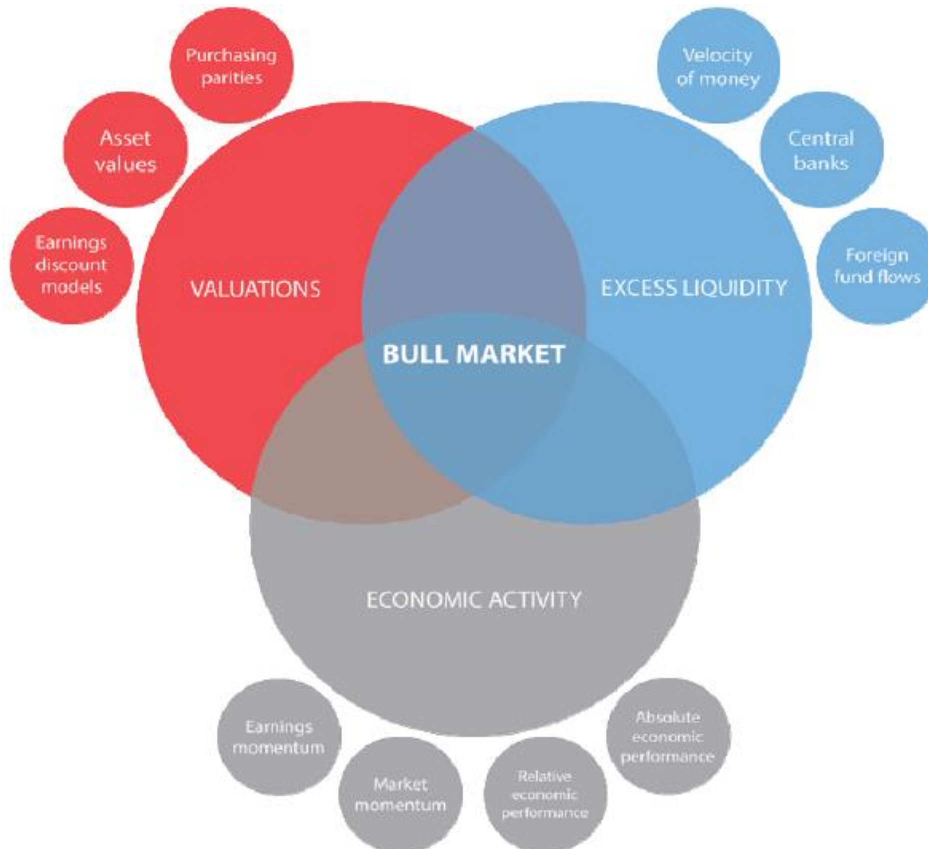
Figure 1: Three main forces that determine asset prices



Source: GaveKal

The good news is that a valuation-driven environment should provide better opportunities for profits based on fundamental analysis and relative value arbitrage. Specifically, three major rotations that have already started in major asset classes are likely to continue and gather pace:

1. **A rotation within individual equity markets from growth to value.** As investors grow more confident about the economic and monetary environment, they will begin to search for companies that are attractively valued on reasonable economic assumptions, rather than for social networking and biotech businesses whose prospects seem completely independent of either an economic recovery or a global slump.

2. **A rotation within global equity portfolios away from the US, which is the most expensive market with the fewest value opportunities, and towards other regions.** The simplest illustration of this divergence in valuations can be seen in the MSCI World index (Figure 2). When this broke through to a new all time high two months ago, the gains were due entirely to the US components. The World ex-US index is still

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14% below its 2007 peak. As investors become more confident about the US economic outlook they will expect other regions to follow the US policy road map (see the second article in this series *The Global Obsession With US Data*). Paradoxically, this means that as the US economic outlook continues to improve, the equity rotation out of the US is likely to accelerate. The main question for investors will be whether to shift equity weightings in favour of emerging markets, Europe or Japan. Personally, I would favour the three regions in that order, with the more volatile, 'lower quality' emerging markets such as Brazil, Russia and China likely to benefit the most from a value-driven cyclical 'dash for trash'.

3. **A rotation in bond markets away from Japan and core Europe and into the US, Britain and the European periphery.** At yields between 2.5% and 3%, US Treasuries and British gilts look like deep value opportunities to Japanese, German and Dutch investors faced with domestic yields of 0.5% to 1%, especially as they can buy foreign bonds with little currency risk. As I argued in the third article in this series, Monetary Policy Is No Threat To Markets, this global hunt for value by bond investors has major macroeconomic implications, as it will moderate (though not completely prevent) the yield curve steepening that would normally take place in the US and Britain as growth and inflation accelerate. This resistance to curve steepening will paralyse the 'bond-market vigilantes' who might otherwise have forced the Federal Reserve and the Bank of England to bring forward monetary tightening.

Figure 2: MSCI World and World ex-US indexes

Sources: Gavekal Data/Macrobond

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Now for the bad news.

If macroeconomic and monetary conditions remain reasonably benign and predictable, asset valuations will keep rising until they become so over-stretched that even a small shock will be enough to trigger a massive correction. In this sense, the situation today is more reminiscent of 1987 than of 2007 or 1999. The question is whether the market dynamics today have more in common with the autumn of 1987, when stock markets crashed by 30% in one week, or with January 1987, just before equities gained 40% in eight months. The final article in the series will attempt to answer this question.

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