FLAGSHIP QUARTERLY COMMENTARY

FLAGSHIP ASSET MANAGEMENT

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END Q4 2017

2017 has been a significant year for global equity markets. Riding the wave of low interest rates, abundant liquidity and solid global growth, the MSCI global index advanced by almost 25% to new highs. [CHART 1]

Remarkably, this has been achieved with an almost unprecedented lack of volatility. At year end, the US equity market had advanced for an astonishing 380 days without a 'correction' (defined as a pullback of more than 5%).

And this during a period when equity valuations – on almost every measure – have been elevated well above historical norms. [CHART 2] Some measures have only been higher in 1929 and 2007. The 380 day streak is the third longest on record and just short of the all-time 394 day record which preceded the dot-com bubble of the late 1990's. (Over the long term there have been an average of more than three 5% falls per year.)

The key measure which has been supportive of equities has been the relationship between dividend yields of equities and the 10 year US treasury rate. [CHART 3] Given the environment of unprecedented low interest rates, the rotation into equities has been understandable and, indeed, to date fully justified. But, with all other measures indicating a more than fully valued equity market, the downside risks have undoubtedly increased significantly.

These include the prevailing high valuation levels, a possible spike in inflation, rising interest rates and a steeper slide in Chinese growth as it tightens its debt control measures. But the key risk, in our view, is the removal of the punchbowl.

Markets have been powered by the unparalleled tailwinds provided by the Fed in response to the global financial crisis. These included the dramatic slashing of the Fed funds rate (from 5.25% in 2007 to 0.25% in 2008) and massive buying of treasuries and related fixed income stock. These purchases have resulted in the Fed's balance sheet ballooning from $900bn in 2008 to over $4.5 trillion in just nine years! It will now unwind this by ending its buying program, cutting $1.5 to $2 trillion from its balance sheet by 2020.

With reduced demand from the Fed and increased issuance of Treasuries to fund the higher tax-reform budget deficit, the enlarged funding gap will have to be met by offshore buyers and domestic institutions. Unlike the Fed, these are price-sensitive buyers who will demand more attractive entry levels, particularly in a rising interest rate environment. The risk of higher than expected rate increases is thus significant and will impact heavily on both the equity and bond markets.

That the bull market will end at some stage is a forgone conclusion. The synchronised global economic recovery and strongly rising global earnings suggest that markets could continue to power ahead over the next few months. As bull markets often end with a euphoric blow-off phase, there could well be further (possibly significant) upside, but there is no doubt that we are in the late stages.

Will the end be preceded by a euphoric bubble-bursting surge? Could it end with a flash crash reminiscent of the 1987 plunge? The risk of the latter has risen sharply given the extraordinary growth of passive funds where significant sales of major ETF's can trigger domino-like plunges in individual stocks as the ETF's unwind their positions.

The question for investors is whether they should forego the potential rewards of the final run-up in the market in order to avoid the risk of a severe setback in the event of a fundamental change in sentiment?

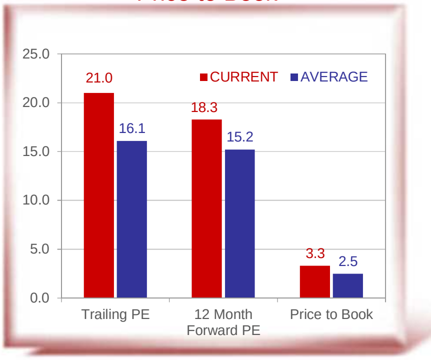
Lest we forget, bear markets can be vicious – particularly those following a euphoric blow-off phase [CHART 4]:

- In 2000 we had the tech bubble ⇨ following bear market -51%
- In 2007 it was the housing bubble ⇨ following bear market -59%
- In 2018 it will undoubtedly be known as the QE bubble ⇨ following bear market (-??%)

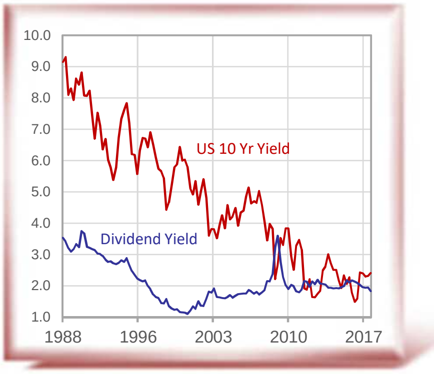
World Equity Markets

January 2014 to December 2017

Price to Earnings and Price to Book



US Dividend Yield and 10 Year Treasury Rates



Recent Global Bear Markets

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