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The curse of the seventh year?

Increasing uncertainty in stock markets - how you can protect your portfolio for the worst case

There has been a noticeable rise of uncertainty in the stock markets over the past few weeks. The fear of a possible market crash is growing. Considering the recurring interval of seven years in between the last few market slides of 1987, 1994, 2001 and 2008, we should eventually take a closer look at 2015! Are we on the verge of another stock market crash? In other words, does the curse of the seventh year also apply to stock markets? As a first step, we take a closer look at what stock market slides of the past all had in common, and we soon realize that all major crises were preceded by an overly restrictive monetary policy by the Federal Reserve. But what does „overly restrictive" mean in our context?

The important factor monetary policy

Whether a monetary policy is too restrictive can most easily be detected by looking at the yield curve, reflecting interest rates of government bonds for different maturities. Because risk increases with the time horizon, interest rates will be higher for bonds with a more extended maturity. If a monetary policy is currently too restrictive, short-term rates will be comparatively too high. The so-called maturity premium, meaning the difference between long- and short-term rates (we compare the spread between 10-year and 3-month US government bonds) becomes negative, which shows that liquidity in the financial markets is too low. Low liquidity may cause bottlenecks and subsequently a slide in the stock market, which was always the case for market crises in the past. Current maturity premiums are positive, however.
As a second step, we consider the macroeconomic environment for equities by analysing a basket of global leading indicators. They include commodity prices of industrial metals, purchasing manager indices, as well as indicators of renowned organisations and institutes such as the OECD. As it happens, leading indicators are currently diverging. However, all-in-all positive signs predominate slightly. This situation leads us to the conclusion that for the moment the macroeconomic environment is still quite promising, although volatile.

Companies' expected earnings

Having not found a reliable answer to our question after the first two steps, we go one level deeper, looking at corporate earnings in various equity sectors of the MSCI All Country World, a global share index that is composed of 10 different sectors, e.g. health care, energy and finance.
We can see on chart 1 that expected earnings of the sectors energy and materials have been lowered, whereas all other sectors remain unchanged. Since during former market slides virtually all sectors displayed declining earnings expectations, it is reasonable to conclude that what we are currently experiencing is not a crisis, but merely a correction of the markets.

Equity portfolios at the mature stage of a stock market cycle

The stock markets have fundamentally increased over the last seven years, macroeconomic leading indicators are diverging and expected earnings are at a high level. At such a mature stage of a stock market cycle, you should ask yourself how your portfolio should be structured, which shares to hold or whether you should reduce your equity market exposure. Since bonds are hardly profitable in an environment of historically low interest rates, we suggest underweighting bonds in favour of equities.
For equities, there are different strategic options. Diversification remains key in such an environment. As such, we advise you to invest your money into a variety of shares with different characteristics. High-quality shares with a fair valuation and/or a low price fluctuation have proved themselves in mature markets of the past.

The necessity for quality shares

The quality of individual shares can be measured in many ways. Companies are often valued in terms of their profitability, financing or liquidity. Quality shares perform very well in the long term, losing less of their value than the market especially in times of crises.

Fair value?

The aim is to find undervalued shares whose price is, in relation to their earnings, turnover or book value, lower in comparison to their peers. But be careful! Usually, these ratios become attractive when expected earnings and therefore the stock price are falling.

A proven anomaly

Conventional financial market theory states that higher risk is compensated with higher returns. Reality shows, however, that on the long run, returns of low-risk shares exceed the returns of high-risk stocks. „Low-risk" shares are those whose price does not fluctuate much over time. Consumer staples, health care, utilities and telecommunications are in general classical low-risk sectors. Chart 2 shows the performance of the MSCI All Country World Index in comparison to its low-volatility counterpart.

Getting safely through the winter

In view of the positive stock market performance over the last seven years, when leading indicators deteriorate, it might be advisable to protect a portion of your portfolio. This can be achieved by following the above mentioned, defensive equity strategies, as well as through the use of a variety of financial instruments, each of it having its advantages and drawbacks. Possible instruments for hedging are put-options, index futures, volatility futures or short ETFs, for example; the latter being in our opinion the best suited for private investors. Short ETFs are exchange-traded funds whose price behaves inversely to the underlying index. The advantages of short ETFs are that they can be purchased in small quantities, are relatively reasonably priced and have no maturity date.
Whatever you will decide, whether or not you believe in the seven-year-rhythm, whether you will adapt your portfolio's structure or whether you will hedge it, there is always one thing to keep in mind: Always remain prudent!

Chart 1:

Source: Bloomberg

IBES 12-month earnings estimates per share in USD

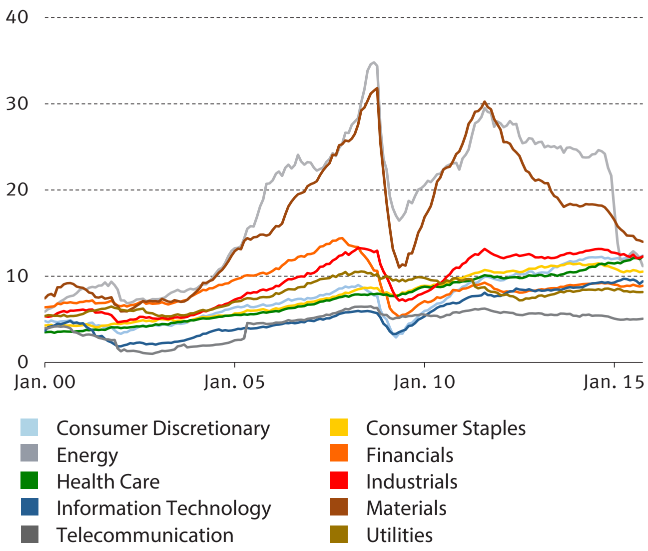
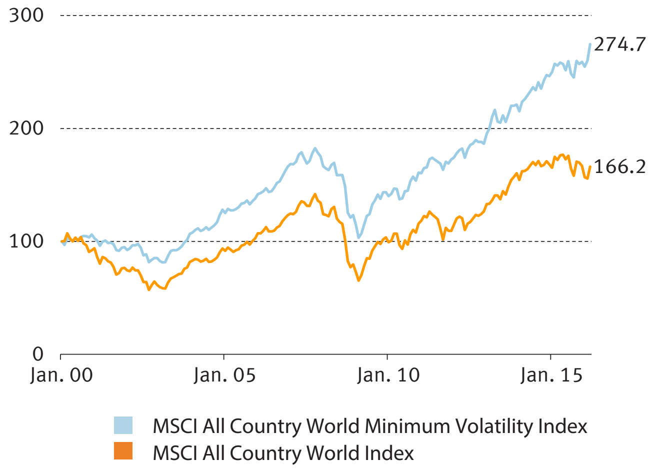


Chart 2:

Source: Bloomberg

Indexed performance in USD



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