Stanhope Capital

Stanhope Capital Flash Bulletin

7th February 2018

As I write, the S&P 500 index has fallen 5.5% from its peak on 26 January, whilst volatility has increased with Monday's 20-point jump in the VIX index* being the largest ever one day move, albeit from a very low level.

It is worth putting the recent setback in the index into context. For the past few years, equity markets have performed well, gently rising with relatively little volatility. The economic outlook has been equally benign, growth has picked up, inflation has remained low and companies have in general reported strong earnings growth. Confidence in the economic and investment outlook has been high for consumers, businesses and investors as demonstrated by numerous surveys.

S&P 500 index

(to February 6 2018)

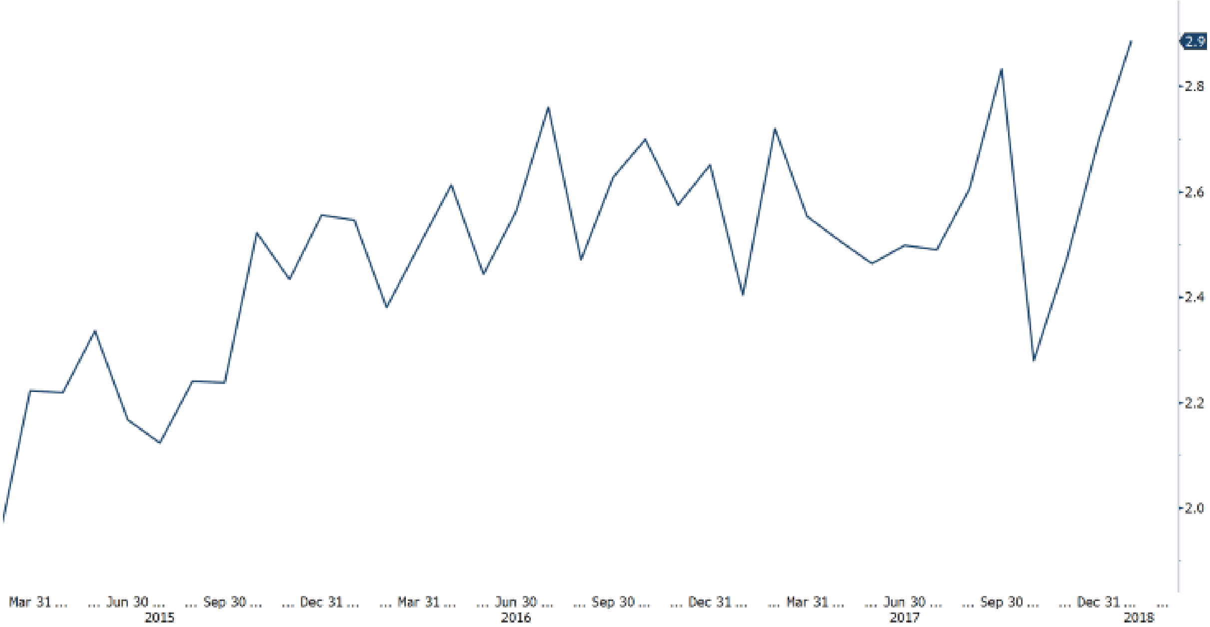
Source Bloomberg

The fall in the S&P 500 only takes the index back to the level of 2 January this year and leaves the index still over 17% higher than a year ago. In this respect the impact is relatively minor.

The trigger for the fall in the market was a growing concern that inflation may be rising, as demonstrated by last Friday's report that year on year wage growth in the US had edged up to 2.9%. An increase in wage inflation is likely to cause inflation elsewhere and will lead to higher interest rates over time. As a result, bond prices fell, pushing the yield on the 10 year US Treasury bond from 2.4% at the start of the year to 2.8% today. As long-term interest rates rise (as reflected in higher bond yields), the discount rate by which equities are valued rises and this justifies lower current prices.

*a volatility measure for the S&P 500 index

US Average hourly earnings growth



Source Bloomberg

It is too early to tell whether the recent increase in wage inflation will continue and lead to a significant change in interest rate expectations or in the growth outlook.

You have heard us say many times that 'interest rates will continue to increase gradually and as a result we are underweight bonds'. Well, this is now happening, and we expect it to continue. We have also highlighted that we are worried that inflation could pick up significantly at some point. It is not yet clear whether this is the case, but the risk of inflation has increased. We continue to believe that although US equity valuations are high, strong earnings growth means that current levels could be justified, particularly if inflation remains close to current levels. In portfolios we maintain our cautiously optimistic stance given the outlook for strong earnings growth, but as ever remain vigilant in case the current positive environment for equities should change.

JONATHAN BELL

7th February 2018

Important Information