Climbing higher and higher

Equities hit new records, helped by good economic data in China and the US, excellent results from major US banks and fading trade tensions.

The S&P 500 and Nasdaq indices improved their records for the eighth consecutive day. Over the week, the S&P 500 index gained 1.7% and the Stoxx Europe 600 index 1.1%. Curiously, gold also appreciated at the end of the week.

The Sino-US agreement was well received

Investor optimism was lifted by the start of the truce period rather than the content of the trade agreement itself. The lack of tariff cuts is disappointing and the $200 billion in US goods and services that the Chinese have committed to buying within two years might not be so easy to achieve.

Reassuring economic data

In China, industrial production and retail sales surprised positively. GDP growth slowed in 2019 albeit to a decent figure: 6.1%. This stronger-than-expected activity in December augurs well for a stabilisation in early 2020, but the situation is likely to remain challenging as import duties should continue to weigh on exports and confidence will remain fragile.

In the US, retail sales also surprised positively, as did new home starts.

A good start to the earnings season

The large US universal and investment banks have reported excellent profits for 2019. Earnings have more than doubled since 2009 despite tighter regulation, lower interest rates and technological breakthroughs. They have immensely benefited from economic growth that is now in its eleventh year. Pure investment banks (e.g. Goldman Sachs and Morgan Stanley) underperformed universal banks because the former are laden with more capital constraints and deemed riskier by investors.

What else can we expect from the markets?

The current period is reminiscent of the beginning of 2018: will this nearly interrupted rise lead to a correction? As in 2018, the markets are in overbought territory and a pause would be normal, if not healthy. Are there any early signs of an imminent correction? Not really at this stage. We do not see any weakness in the credit sector for example.

The rise is spreading to other parts of the stock market (particularly small caps), not only in the US but also in South Korea and Germany, which is a sign that the rally may continue.

The US equity risk premium (the gap between the earnings yield on equities and the 10-year yields on Treasury bonds) is far larger at the moment, as 10-year yields have fallen sharply (from 2.6% to 1.8%) and are showing no inclination to rise.

In the short term, with corporate earnings remaining the most decisive factor for stock markets, investors will remain focused on the results published in the coming days and, above all, the communication of companies and their guidance for the coming months.

The week ahead

The World Economic Forum in Davos is taking place this week. The main themes will be deglobalisation, the fourth industrial revolution and the challenge of capitalism dealing with climate change. The summit should increase pressure on companies to report on their ESG policy and incite institutional investors to vote accordingly at annual general meetings.

(Xavier Timmermans)