
Are Investors Becoming Too Complacent?

March 2017

Have Current Technical Factors Overshot Fundamentals in the US?

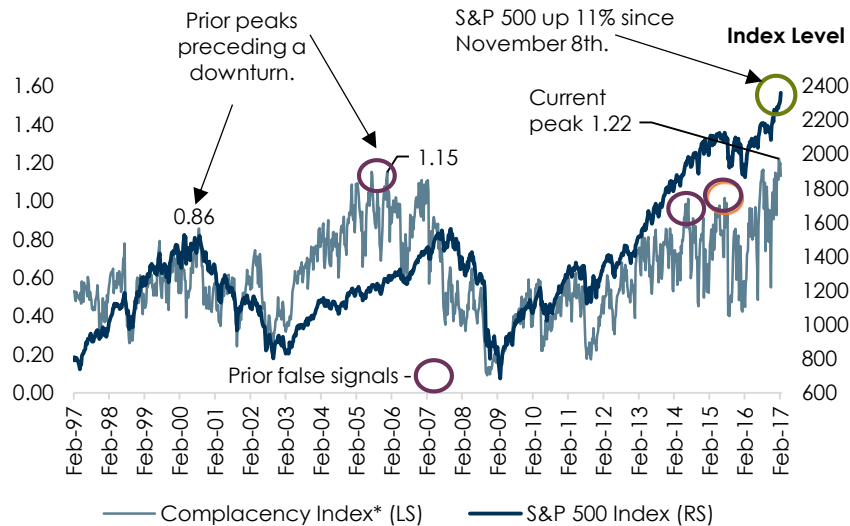
Technicals

- Current technical indicators suggest US economic growth and corporate profitability could surge in the period ahead, driven by a combination of lower taxes, less regulation and spending on infrastructure.
- Since the November 8th US election, the S&P 500 has gained 11% to reach a record high, while stock market volatility has declined to the lowest level in a decade.
- The Complacency Index, which is a combination of stock valuations (currently high and rising) and market volatility (currently very low) has reached a level exceeding both the 2008 Global Financial Crisis and 1999 Tech Bubble.
- Additional factors supporting the recent rally include fund flows into passive equity strategies. In the past three months alone, nearly \$117 billion has flowed into US ETF's.

Fundamentals

- While current fundamentals remain steady, we have entered the eighth year of an economic expansion. Economists forecast the US economy will grow 2.3% in 2017, still below long-term trend growth of around 3%.
- Labor markets and business activity continue to improve as illustrated by the US Consumer Confidence Index which is near a 13-year high. US profit margins remain at fairly high levels as companies have benefitted from low wage inflation and low interest costs over the prior eight years.
- With several factors pointing to a more positive outlook there are risks that key expansionary government policies could stall in Congress and not come to fruition as soon as expected, if at all.
- Other potential headwinds to the current optimistic profit outlook include, rising wages, rising interest costs and a slowdown in trade due to a stronger US dollar and/or rising tariffs.

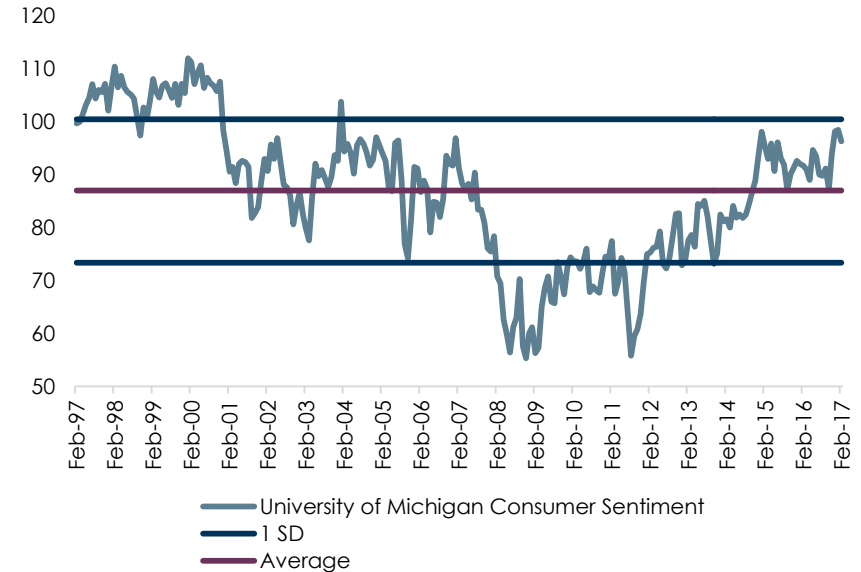
S&P 500 Index versus Complacency Index*



*Relates the ratio between enterprise value and Ebitda in the S&P 500 index to the VIX

Source: ACG Research, Bloomberg

US Consumer Confidence

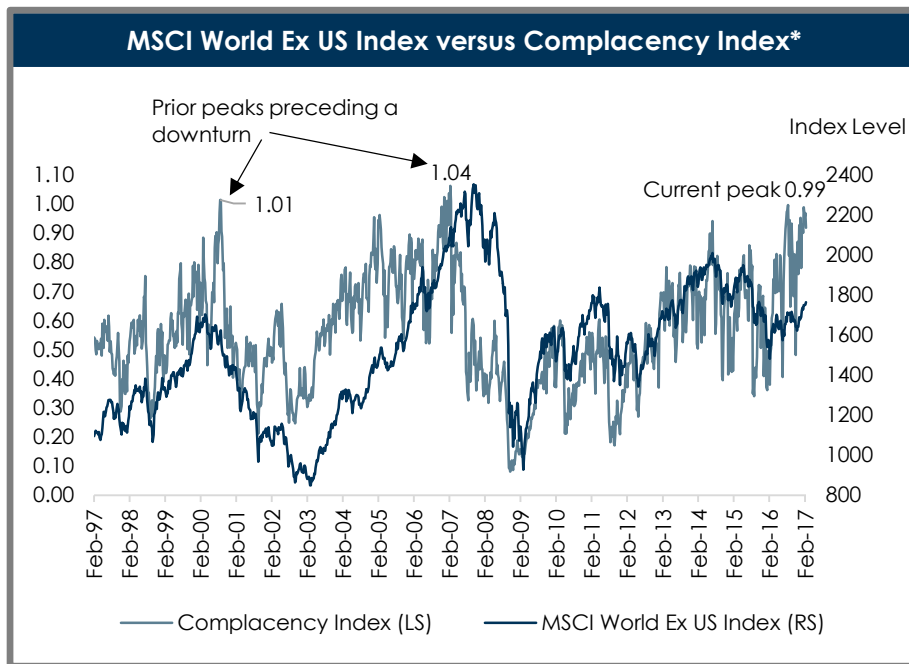


Source: ACG Research, Bloomberg

Is The Mood Consistent in Non-US Markets?

Technicals

- The MSCI World Ex US index complacency ratio climbed to a current cyclical peak on January 27 at 0.99, but stood below the peak of 1.04 logged on Feb. 16, 2007.
- Additionally, while complacency is building within non-US developed equities, the MSCI World Ex US index remains 35% below its all time record.
- Fund flows into Europe and Japan ETFs also gathered momentum in recent months (\$23 billion during the last quarter).

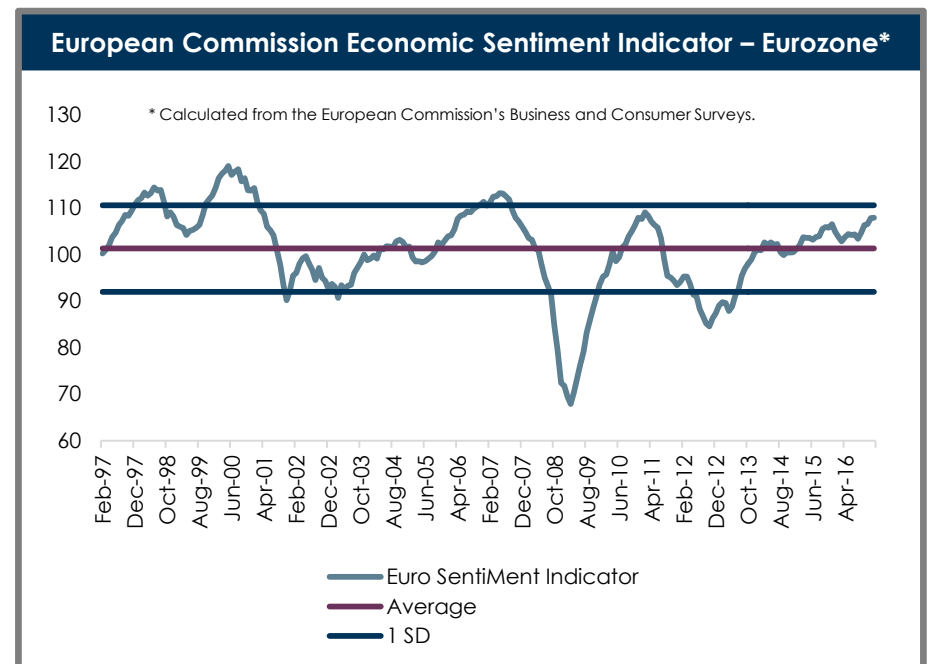


Source: ACG Research, Bloomberg

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Fundamentals

- From a fundamental standpoint, developed economies outside the US are improving, and ongoing easy central bank monetary policy and weak currencies versus the US dollar provide a constructive backdrop to corporate earnings.
- The euro area economy has gathered momentum, with improving consumer and business sentiment. The region's economy is expected to grow 1.5% in 2017.
- Additionally, corporate earnings for the MSCI World Ex US index are projected to rise 41% in 2017, coming off flat growth in 2016.



Source: ACG Research, Bloomberg

Conclusion

- The recent Complacency Index level for US stocks is similar to other highs that foreshadowed equity downturns.
- That said, the pullback in equities has often lagged the complacency peak by several months.
- Additionally, there have been episodes of "false alarms" in which the index peaked but stocks did not suffer a drastic sell off.
- Nevertheless, the S&P 500 has avoided losses of 1% or more for more than 90 consecutive days, the longest since November 2006.
- A similar measure of Non-US markets suggests complacency/optimism is also at an elevated level.
- However, central bank policies remain very accommodative in Europe and Japan (keeping interest rates low), labor markets have not recovered as fast as the US and equity market multiples still trade at attractive discounts to US equities.
- **We believe now is an opportune time for investors to thoughtfully review strategic asset allocation targets, and to rebalance as appropriate.**
- **Further, if risk mitigating strategies (long/short equity, absolute return fixed income, etc.) have not already been incorporated into the asset mix, it may be the appropriate time to consider taking such action.**

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