



Richard Cluver Predicts

In our 30th year of service to the investing public of South Africa



Volume: 30

25 August 2017

Issue: 22

When the concerns of investment analysts about the fragility of equity markets start grabbing news headlines, you better be very afraid.

Thus, this Friday I draw to your attention the following article published on Wednesday by Bloomberg News:

Wall Street Banks Warn Downturn Is Coming

By Sid Verma and Cecile Gutscher

HSBC Holdings Plc, Citigroup Inc. and Morgan Stanley see mounting evidence that global markets are in the last stage of their rallies before a downturn in the business cycle.

Analysts at the Wall Street behemoths cite signals including the breakdown of long-standing relationships between stocks, bonds and commodities as well as investors ignoring valuation fundamentals and data. It all means stock and credit markets are at risk of a painful drop.

“Equities have become less correlated with FX, FX has become less correlated with rates, and everything has become less sensitive to oil,” wrote Andrew Sheets, Morgan Stanley’s chief cross-asset strategist. His bank’s model shows assets across the world are the least correlated in almost a decade, even after U.S. stocks joined high-yield credit in a selloff triggered this month by President Donald Trump’s political standoff with North Korea and racial violence in Virginia.

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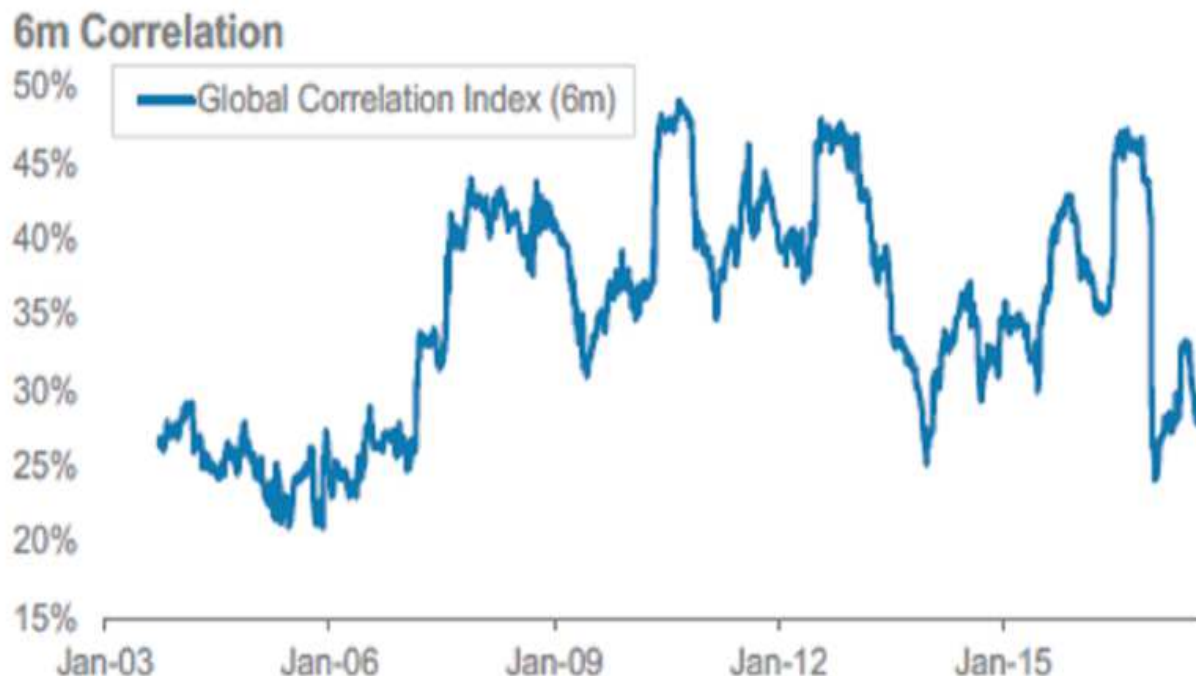
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Exhibit 3: Morgan Stanley global correlation index



Source: Bloomberg, Morgan Stanley Research

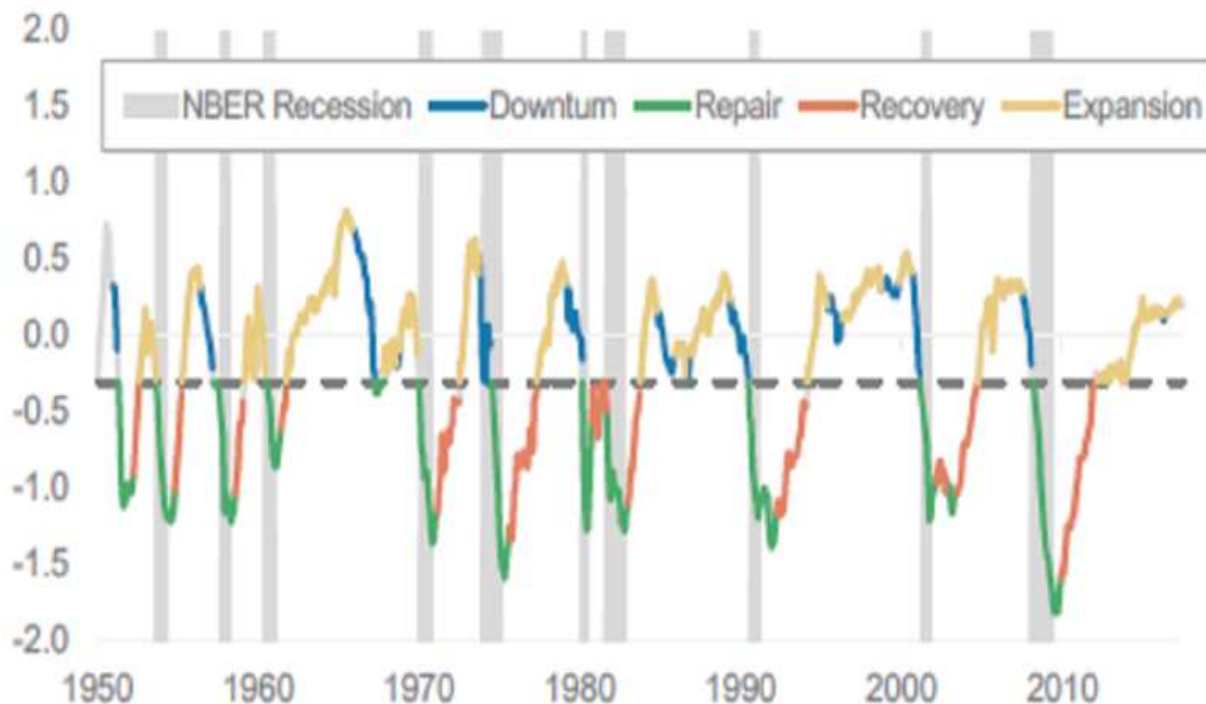
Morgan Stanley

Just like they did in the run-up to the 2007 crisis, investors are pricing assets based on the risks specific to an individual security and industry, and shrugging off broader drivers, such as the latest release of manufacturing data, the model shows. As traders look for excuses to stay bullish, traditional relationships within and between asset classes tend to break down.

“These low macro and micro correlations confirm the idea that we’re in a late-cycle environment, and it’s no accident that the last time we saw readings this low was 2005-07,” Sheets wrote. He recommends boosting allocations to U.S. stocks while reducing holdings of corporate debt, where consumer consumption and energy is more heavily represented.

That dynamic is also helping to keep volatility in stocks, bonds and currencies at bay, feeding risk appetite globally, according to Morgan Stanley. Despite the turbulent past two weeks, the CBOE Volatility Index remains on track to post a third year of declines.

Exhibit 7: Our US cycle model – late-cycle reading



Source: Bloomberg, Haver Analytics, NBER, Morgan Stanley Research

Morgan Stanley

For Savita Subramanian, Bank of America Merrill Lynch's head of U.S. equity and quantitative strategy, signals that investors aren't paying much attention to earnings is another sign that the global rally may soon run out of steam. For the first time since the mid-2000s, companies that outperformed analysts' profit and sales estimates across 11 sectors saw no reward from investors, according to her research.

"This lack of a reaction could be another late-cycle signal, suggesting expectations and positioning already more than reflect good results/guidance," Subramanian wrote in a note earlier this month.

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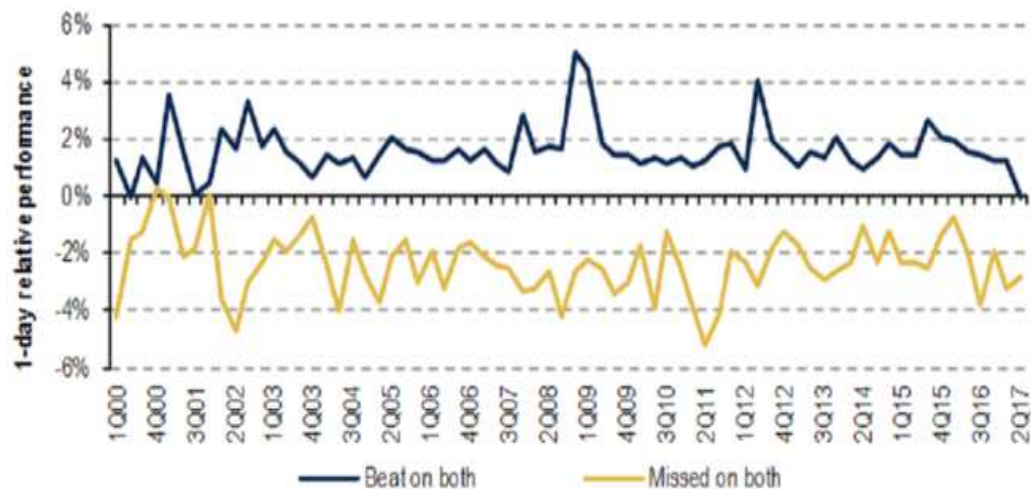
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Chart of the Day: Top & bottom-line beats are at a 13-year high, but with no reward - we've seen zero alpha for beats for the first time since mid-2000

Relative one-day post-reporting performance (vs. S&P 500, in ppt) for companies that beat on EPS and sales (1Q00-



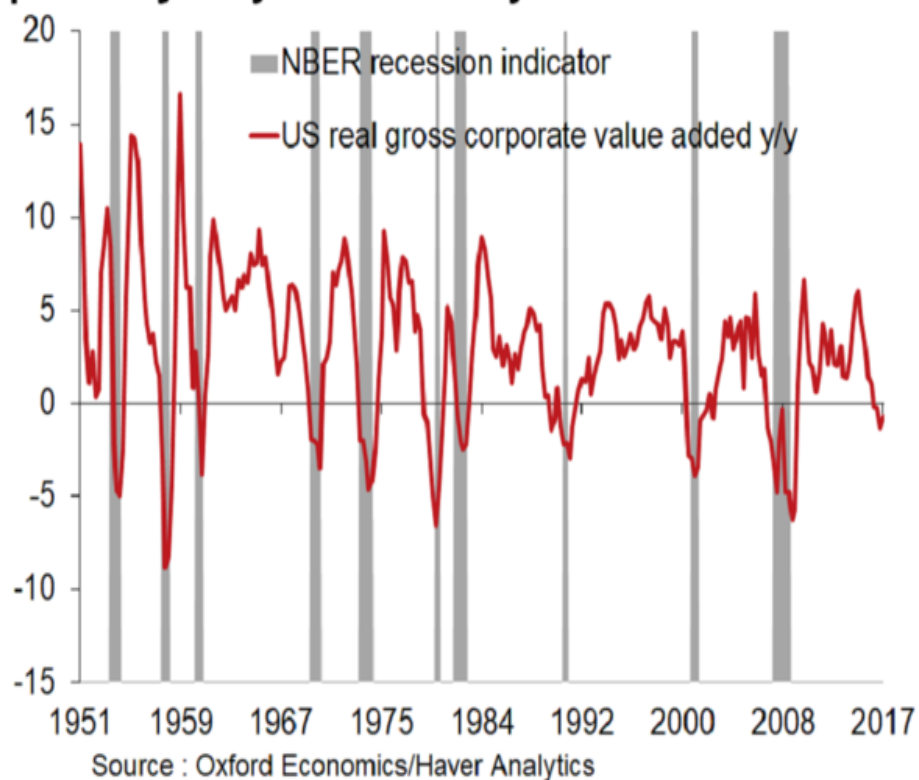
Source: FactSet, BofA Merrill Lynch US Equity & US Quant Strategy

Zero Alpha Beats - Bank of America Corp

Oxford Economics Ltd. macro strategist Gaurav Saroliya points to another red flag for U.S. equity bulls. The gross value-added of non-financial companies after inflation -- a measure of the value of goods after adjusting for the costs of production -- is now negative on a year-on-year basis.

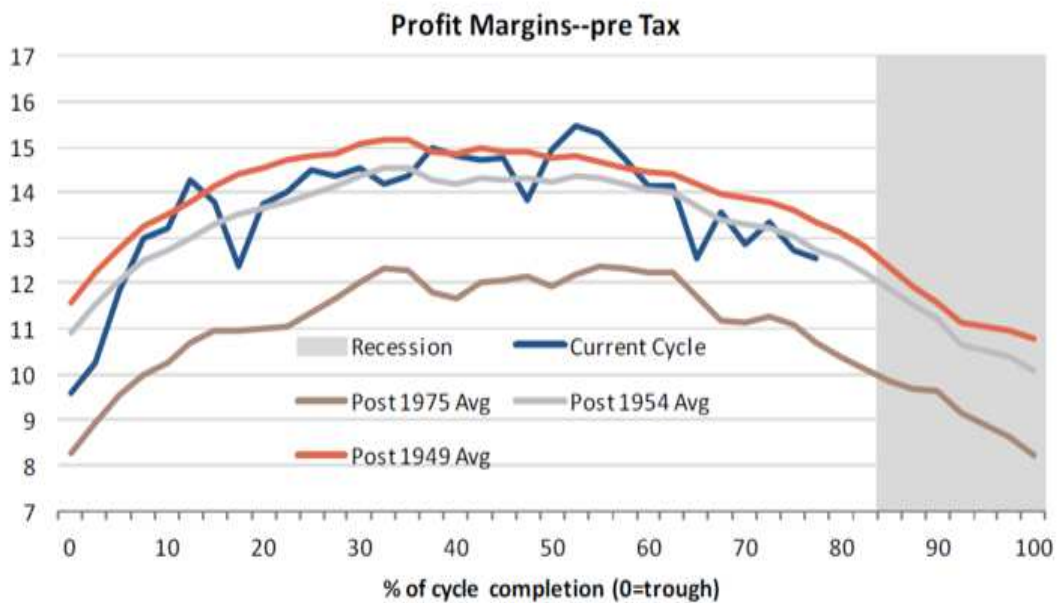
“The cycle of real corporate profits has turned enough to be a potential source of concern in the next four quarters,” he said in an interview. “That, along with the most expensive equity valuations among major markets, should worry investors in U.S. stocks.”

US real corporate surpluses show we are probably very late in the cycle



The thinking goes that a classic late-cycle expansion -- an economy with full employment and slowing momentum -- tends to see a decline in corporate profit margins. The U.S. is in the mature stage of the cycle -- 80 percent of completion since the last trough -- based on margin patterns going back to the 1950s, according to Societe Generale SA.

US business cycle dating based on profit margins



Source: BAE, Haver Analytics, SG Cross Asset Research/Research/Economics

Societe Generale SA

After concluding credit markets are overheated, HSBC's global head of fixed-income research, Steven Major, told clients to cut holdings of European corporate bonds earlier this month. Premiums fail to compensate investors for the prospect of capital losses, liquidity risks and an increase in volatility, according to Major.

Table 2. Seven selected indicators of credit bear markets

Importance	Indicator	Lead, lag or coincident	Stage in cycle
High	Yield curve flattening	Lead	Late
High	Credit expansion and corporate balance sheet leverage	Lead	Mid
High	New issue quality, lending, covenants and the vintage cycle	Lead	Late
High	Stock market cap to GDP	Coincident	Late
Medium	Foreign ownership of USD	Lead	Late
Medium	The M&A cycle	Lead	Mid
Medium	Tighter monetary liquidity conditions and short rates	Lead	Mid

Source: HSBC estimates

HSBC Holdings Plc

Citigroup analysts also say markets are on the cusp of entering a late-cycle peak before a recession that pushes stocks and bonds into a bear market.

Spreads may widen in the coming months thanks to declining central-bank stimulus and as investors fret over elevated corporate leverage, they write. But, equities are likely to rally further partly due to buybacks, the strategists conclude.

“Bubbles are common in these aging equity bull markets,” Citigroup analysts led by Robert Buckland said in a note Friday.

— *With assistance by Cecile Vannucci*

The problem, as I have highlighted frequently lately is that when professional fund managers sense that the end of a bull market is nigh, they increasingly hedge against the risk by using highly-g geared variants of put options, the effect of which is that if a significant market decline were to occur and these option instruments were to consequently kick in, share prices would be likely to fall at lightening speed. And such is the connectivity of world markets today that the impact would be global and intense.

Commentators are consequently expecting that when, rather than if, the downturn begins it will be “*the mother of all market collapses.*” Nowadays, most stock exchanges have a limit on the extent of such declines before all trading is suspended to enable an overnight calming to occur. But in the absence of any practical reassurances it is likely that further steep declines would follow in subsequent days.

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And market activity this past week has reinforced the view that a decline is already under way. The only question at this stage is whether it will accelerate into a panic or whether it will merely be postponed until some other political or economic event triggers it once again. Turning then to the graph of New York's S&P500 Index, the broadest measure of Wall Street share activity, note the very distinct roll-over that has occurred since July 27 with each successive peak lower than the previous one..... and this Wednesday's peak was no exception. To the right of the graph in yellow, ShareFinder has predicted that recovery is likely until September 12 when the next major decline will begin falling sharply until late November.



The JSE All Share Index has presented almost a mirror image of Wall Street except that recovery began rather earlier and the final peak is projected to occur ahead of Wall Street. In the graph below, ShareFinder predicts that the final peak could occur around Monday September 4 which, if correct, means you have only a week to get your investment affairs in order.



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Your simplest response would be to rid your portfolio of any risky shares. The alternative would be to ask your broker about put options on a suitable JSE index

The next month:

New York's SP500: I correctly predicted a recovery which I still see lasting into mid-September.

London's Footsie: I correctly forecast the down phase would continue. I now expect it to continue down until at least early October.

JSE Industrial Index: I correctly predicted a recovery. But it is likely to be short-lived, possibly peaking as early as next Tuesday.

Top 40 Index: I wrongly predicted a down phase but I believe I was merely premature and that the downturn could happen as early as next Tuesday.

ShareFinder Blue Chip Index: I correctly predicted a recovery which I saw lasting until the end of the month. Now I see the peak possibly occurring today.

Golds: I correctly predicted a down phase which I still see continuing until the last week of August or early September before the next recovery begins. But it is likely to be short-lived ending as early as September 8 to 15.

The Rand: I correctly predicted a recovery which I now expect to continue to mid-September. However, be warned, there is a possibility of fresh weakness occurring from the middle of next week.

The Predicts accuracy rate on a running average basis over the past 629 weeks has been 84.24%. For the past 12 months it has been 91.43%.

Richard Cluver