Luminor

Luminor financial markets update

December 2017

November highlights:

- More than a year of rising prices without a correction
- Political and geopolitical issues still largely ignored by investors
- Over 72% of companies in the US beat analyst earnings estimates
- European earnings were conservative in Q3, but strong growth is expected ahead
- Is the global technology sector in a bubble?
- Technology is taking over the global retail sector
- Robots are replacing humans in many sectors
- Emerging market equities are not a commodity play any more
- Indicators confirm equity uptrend

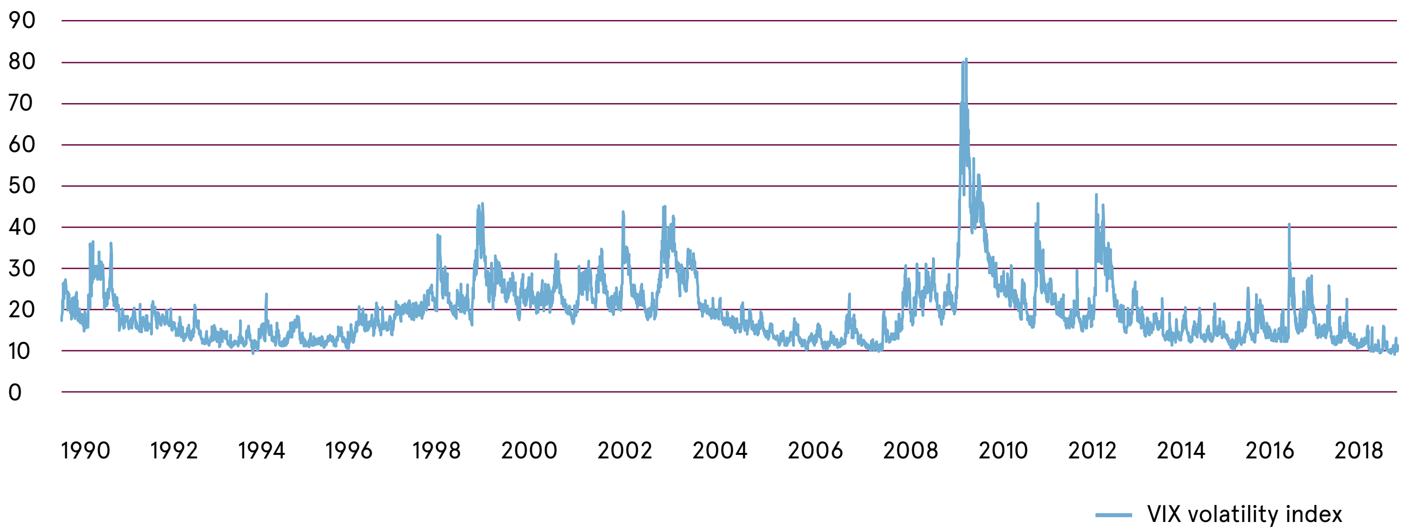
Despite mainstream opinion, more than a year of rising prices without a correction

It has been slightly over a year since the last US election. This is a good time to evaluate what has happened in the financial markets afterwards. The mainstream opinion was that in case of Trump's victory, we'll see a meltdown in the markets. There were even public accounts of people selling all their retirement investments and going to cash in anticipation of this. Their logic was that in case of a fall, they would look smart and avoid the drawdown, but in case they are wrong, they'll get back in on the next correction.

The reality, however, is that the US market hasn't witnessed even a 3% correction since the election. The S&P500 went up for 390 days without a 3% downside, the longest such period ever. The All Country World index has also witnessed a maximum downside of just 7% during the last 655 days. The S&P500 index gained 21.6% during this period, though euro-based investors enjoyed roughly half of that due to EUR appreciation. The All Country World index measured in EUR appreciated by 13.2%, while Emerging Markets in general and Emerging Asia equities specially stood out with gains of 17.5% and 23% respectively.

So the result is that the people who decided to exit the financial market before the election are most probably still sitting on cash, earning nothing and missing out on the bull market. This is a great example of the complexity and dangers of market timing for long-term investments, especially when based on the wrong factors.

Volatility at historically low levels



Political and geopolitical issues still largely ignored by investors

The complacency and low volatility came as a surprise to many, given the many political and geopolitical issues. In Germany, Angela Merkel had trouble forming a coalition government as one of the parties pulled out of the talks. And although the coalition deal was finally reached, these troubles may raise some concerns about the stability of that coalition.

Then there are increasing tensions in the Middle East. Recently Saudi Arabia and the Arab League held an emergency meeting to discuss confronting Iran and Hezbollah. Although war was not declared against Iran at the moment, Tehran was accused of destabilising the region.

Finally, there is still the North Korean nuclear threat, as no resolution has yet been reached. Moreover, after a period of quiet, North Korea launched an intercontinental ballistic missile capable of reaching most of the US territory.

Investors, however, have been wise enough to concentrate on the real driver of equity markets – corporate earnings. As the Q3 earnings season is gradually coming to an end, it is evident that this year corporate earnings are showing robust growth across the globe, with growth rates in many regions reaching double digits.

Strong earnings momentum for US companies: 72% beat analyst estimates

Third quarter earnings In the US increased 8.3% from the levels of a year ago. 72.2% of the companies that have reported results so far have exceeded analyst earnings expectations, which is well above long-term average of 64%, confirming the strong earnings momentum of US companies. Considering the sectors, energy companies have shown the biggest increase in earnings, due to low base and a rebound in prices. Without the energy sector however, the technology sector's earnings were the strongest, with an almost 24% increase.

For the fourth quarter, analysts are expecting earnings growth in the US to pick up and reach 11.5%, while for the year ahead earnings growth is expected to reach 12.3%. As a result, the S&P 500 is currently trading at an 18.3 four-quarter forward P/E. Additionally, Goldman Sachs has calculated that Trump's planned tax reduction may increase the EPS by around 10 USD or about 7%. Such an increase is currently not fully discounted by the market. And although the tax plan will most probably not be approved this year, there is a big chance that it will be implemented in the first half of next year.

Significant growth expected ahead for lately conservative European earnings

For European companies represented by the STOXX 600 index, the third quarter of this year was fairly weak. Earnings increased 1.3% compared to Q3 2016, while revenue is expected to grow 3.6%. And only 46.3% of companies reported better than expected earnings, which is lower than the long-term average of 50%. Such mild results may be partly explained by euro exchange rate appreciation. As European companies derive around half of their revenue from abroad, rising exchange rates reduce the euro value of this revenue. And if the cost base is mostly in euro, such developments also pressures the margins.

From the sector perspective, energy companies' earnings grew the most (53%), followed by utilities with 15.4%. The European technology sector also reported great results, showing a 15.1% earnings growth. On the opposite side, financials were driving the full result down with a 15.9% drop in earnings.

For the full year 2017, European companies are still expected to deliver a remarkable 15.4% earnings growth, as financials and energy sector earnings rebound. Moreover, the uptrend in earnings is expected to accelerate, as analysts are estimating a 17.6% earnings growth for Q3 2018 compared to Q3 2017.

Is the global technology sector in a bubble?

The common topic of the above earning review is that globally the technology sector is delivering strong results and the outlook for growth remains extremely bright. Moreover, the gap between performance of tech sector equities and the second-best sector has reached its widest margin since 1999, with the tech sector decisively leading the market. Some analysts are pointing to that and proposing that a bubble may be forming. We, however, believe that this time may actually be really different.

Technology is taking over the global retail sector

Technology is already impacting all aspects of the economy and this trend is only expected to accelerate. This fact in the retail industry is indicated vividly by the results of Thanksgiving sales campaigns. According to Adobe Analytics, online purchases are up by close to 18% from a year ago. Moreover, BofA notes that 40% of Black Friday online purchases were from mobile phones, compared to 29% last year. As a result, in anticipation of good sales, Amazon stock price reached new highs and made Jeff Bezos's net worth surpass 100 billion USD, the second person since Bill Gates reached that level in 1999.

And this is not only a US or developed market phenomenon. In China during Singles Day, an online shopping festival that started in 2009 and falls on 11th of November, Alibaba is smashing its sales records every year. This year Alibaba recorded sales of 25.4 billion USD in that one day, beating US sales for the whole Thanksgiving weekend.

Robots are replacing humans in many sectors

It is already widely accepted and well-known that robots are replacing many manufacturing workers all over the world. However, a new trend is that automation is starting to come to many other sectors. For example, great progress in self-driving car technology may soon replace many taxi, bus and truck drivers. Automation is even affecting the financial sector, according to Deutsche Bank's CEO, as robots could replace half the company's 97,000 employees.

Such a trend is worrying to many people as they become concerned about their job security. One option to cope with this problem is to study new professions, such as programming. Another option is to just own the companies that are driving these changes. By investing in technology companies people can participate in this emerging trend and take their share of the gains. This looks to be the option adopted by many and is one of the factors driving technology sector stocks.

Emerging market equities are not a commodity play any more

The technology sector accounted for around 40% of equity gains globally this year, on average. What is more interesting, however, is that technology sector dominance is not only a developed market phenomenon. What many investors may not realise is that currently emerging market equity indices are also dominated by technology stocks. The times when emerging market stocks were dominated by a handful of big commodity producers, banks and telecoms are over. In fact, the weight of the technology sector in the emerging market index is currently higher than in the S&P 500.

In emerging markets the technology sector is helping drive a robust earnings growth, as earnings in this sector grew 23%. Consumer discretionary sector companies also saw an almost 20% growth, signalling health of the domestic economy and consumer demand. As a result, earnings growth in emerging markets reached close to 16% in total.

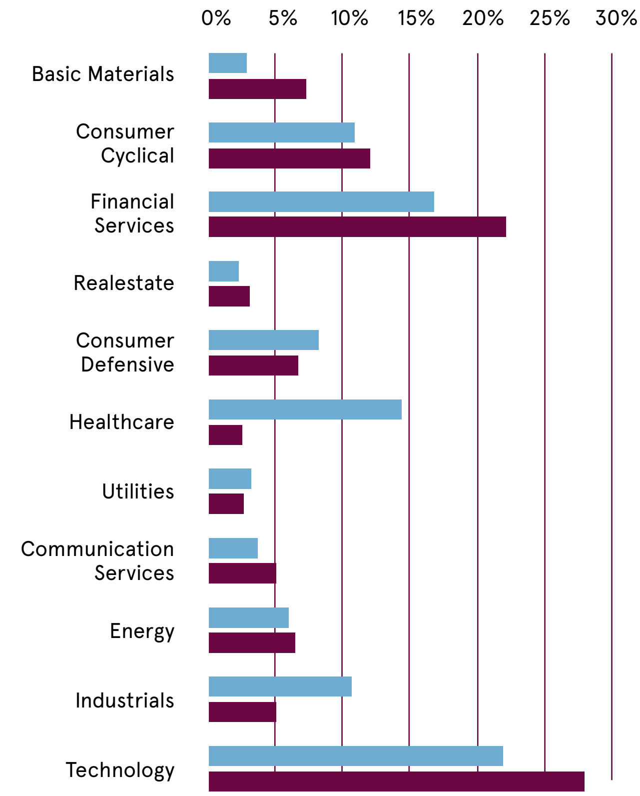
Indicators confirm equity uptrend

With a big part of gains accruing to tech sectors, some investors have become concerned about the health of the current bull market. For the uptrend to continue it is important that the price increase is broad-based, with most stocks participating, whereas the situation when the majority of stocks are not participating in an uptrend is often a sign of a topping process. That was the case in both 2000 and 2007.

The current situation is different, as currently the uptrend is broad-based with many stocks participating. This was just confirmed by the Value Line Geometric index, an equal-weighted aggregate of approximately 1,700 companies, which has broken above long-term resistance to a new all-time high. This is a good sign that the strength of the equity market is expected to continue.

As a result, equities still provide attractive opportunities for investors, especially compared to bonds. Returns from bonds in the medium term will most probably be mediocre, but in any case they will continue to provide diversification benefits for equity portfolios.

Sector Weightings



SPDR S&P 500 ETF (SPY)

iShares MSCI Emerging Markets ETF (EEM)

Sources: Nordea Markets, SeekingAlpha.com, Reuters, J.P. Morgan, Goldman Sachs, TheReformedBroker.com