SPOTLIGHT

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Opinion ◦ Analysis ◦ Commentary ◦ 15 November 2017

THE FTSE 100 AT 8000

With Halloween and bonfire night disappearing in the rear-view the FTSE seems to be bounding onwards and upwards as Christmas and the end of the year approach. Up to 14 November, 2017 has been a boom year for equities with the DOW having risen almost 19%, the S&P 500 over 15% and the Euro Stoxx 50 more than 8%. Global equities then, are soaring, with one noticeable exception; the FTSE 100 whose growth has been rather more muted, at just under 4%, year to date. So, whilst other markets around the world keep notching loftier and loftier all-time highs, the question now is "Can the FTSE 100 ride the wave and make it to 8000 before 2018?"

There is no doubt that residual Brexit uncertainties still linger and continue to affect the index's performance. This, combined with a heavy reliance on only a few sectors which have, so far, this year, underperformed seems to be holding the FTSE back. So, can the magical 8000 barrier be reached? And, if so, what is it that could drive the market higher? Or have we reached the market peak and will the Brexit effect and surrounding uncertainty now start to weigh heavily on the UK economy moving forward?

Source: Bloomberg, 8/11/2017. The FTSE 100 since January 2016

What could drive the market higher?

UK shares might not be as expensive as we thought - Although, so far this year the FTSE 100 has risen, the ratio between the price of shares and earnings of the constituent companies has steadily fallen. Whilst it's clear that the index has made positive ground, we might assume from this that earnings have had to have grown at a faster rate than price to see a falling P/E ratio. Interestingly, this has not been the case everywhere, as analysis of the S&P 500 shows that not only has the index risen but so has the P/E ratio, suggesting price has grown at a faster rate than earnings. If you apply this fundamental analysis to the FTSE it would suggest that there's room for the index to catch up.

Graham has been the Managing Director at Meteor since its creation in 2006. He has over 30 years experience in the financial services sector and brings his skills in product design, marketing and relationship development to provide customers with the best service possible. His voice is one of the most experienced and respected in the industry today.

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M01389_15November2017

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THE FTSE 100 AT 8000 CONTINUED

Investor sentiment is strong...or rather, investors are incredibly confident! Options activity is often a good barometer for current and expected volatility in equity markets. Options prices become inflated when investors buy up protection in anticipation of future uncertainty, so when option prices rise the amount of implied volatility rises. Implied volatility indices like the VIX "fear gauge" therefore, spike up when there is greater uncertainty. When investors expect big moves and demand for insurance rises, so does the VIX. Taking this into account, and seeing that the VIX is currently at a low, we might interpret this as a sign that investors are feeling very self-assured.

Residual geopolitical worries are subsiding - The depressed state of the VIX might be representative of the fact that perceived macro risks really are dissipating. There is no doubt that investors were given several reasons to sell this year, not least of these being the American/North Korean muscle flexing. Despite tensions reaching fever pitch after Trump's repeated use of aggressive rhetoric on North Korean missile testing, and the subsequent show of military force on both sides, US equities, in particular, have consistently shrugged off the conflict and exhibited confidently bullish behaviour. So, is there really anything to worry about? Or is it all just chest puffing that will never amount to anything more than that and can therefore effectively be discounted as a risk?

And what may signal we've reached the current peak?

Much of the growth is artificial - Think back to June last year and the sudden surge in the level of the FTSE post Brexit. What was it that drove this rapid rise? Improved fundamentals around UK equities? Not at all. The vast majority of this rally was fuelled by the devaluation of Sterling and the benefits a weaker pound gives the companies that make up the FTSE 100, who generate about three quarters of their income from overseas activities. As a result, every time the pound suffers losses, the index gets a boost. The question is, how much longer can equities rely on currency flavoured steroids? The most probable answer: "not very long".

Firstly, currency is an artificial source of corporate growth generation. Instead of being driven organically by increased profits and rising consumer demand for goods, a currency devaluation only serves to benefit bottom lines on balance sheets. Secondly, Brexit "talks" have started unconvincingly, with little to no progress on giving corporates peace of mind, and the growing consensus from the likes of Mark Carney is that this will prove detrimental to the UK.

The Trump effect is becoming increasingly questionable - Equities surged following Donald Trump's election. His pro-growth and accommodative tax agenda was well received by market participants who foresaw future benefits to key sectors in the FTSE 100, including banking. The idea was dubbed the "reflation trade"; with fiscal policies that would boost economic activity and infrastructure/defence spending. This relies heavily, however, on policy wording that has been fluffy at best actually becoming a reality. Recent revelations have been controversial too, with many analysts suggesting tax changes will benefit the highest earners most. To date, there seems to be little or no evidence that his targeted spending will work in the end. Indeed, currently it looks like it could well be a case of cart before the horse.

Sector sensitivities - Another reason to question the longevity of the stock market's euphoric state is a more fundamental issue surrounding the way the FTSE 100 is constructed. As is common knowledge, the index is calculated based on capital weighting, which means that bigger companies have a larger effect on index performance. As a result of this, the FTSE 100 is highly sensitive to oil & gas producers, banks and miners. Whilst these sectors have performed relatively well in the latter half of 2016 and 2017 year to date, for the FTSE 100 to reach the lofty milestone of 8000, these sectors would need to deliver some real profit surprises over the coming weeks/ months to lift them even higher.

So, is the current upward trend a sign of things to come? Or will we look back in 2018 and reflect on the lofty highs of 7500?!?!

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