COLUMBIA THREADNEEDLE INVESTMENTS

# Learning to love the bull market

November 30, 2017

*It feels like selling stocks is the right thing to do. But our insights tell us to resist the urge to invest based on feelings.*

Jeffrey L. Knight
Global Head of Investment Solutions and Co-Head of Global Asset Allocation

As 2017 enters its homestretch, we can't help but marvel at the state of things: the U.S. stock market, the duration of its bull market, the magnitude of its gains, the incessant drumbeat of new all-time highs (over 50 record closes for the Dow Jones Industrial Average for 2017 as I write) *and* the absence of volatility (we set a record for the longest stretch without a 1% down day). Every investor, even those who eschew all forms of market timing, must now be asking the same question: "How much longer can this last?" For loss-averse investors, selling now probably feels like the right thing to do. And if we made our investment decisions on the basis of feelings, it would be much easier.

But we don't. Instead, we base our decisions on empirical investment research combined with a factual assessment of current conditions. This approach can certainly feel uncomfortable, but it's guided us to recommend a tactical upgrade to equity allocations for the rest of 2017.

Every month, we update our suite of proprietary investment tools designed to provide guidance on our asset allocation decisions. The tools honor the inherent uncertainty of markets, and in many cases they emphasize risk aversion. For most of the last 12 months and especially during our last monthly outlook meeting, our indicators have unanimously supported equity exposure. The collective message for the fourth quarter of 2017 was so strong, we simply couldn't argue against an overweight to equities as the quarter began.

### Three pillars drive our market views

We rely on three pillars to develop our views: valuation, context and asset class drivers, and they're maintained on an ongoing basis. **Valuation** considers how various asset classes are priced relative to their intrinsic value, history and each

other. **Context** considers factors that matter across all the asset classes that make up our portfolios like economic growth, inflation and monetary policy. **Asset class drivers** consider each asset class in turn and explore the unique forces that create better or worse performance over time. The views that drive our portfolio decisions, and that we publish routinely, are derived from a synthesis of these pillars: one that argues for ongoing strength in equities worldwide.

**PILLAR I: VALUATION**

*Absolute valuation of equities is expensive, but relative valuation is more supportive.*

We won't argue that stocks aren't expensive. The widely followed cyclically-adjusted P/E ratio shows that the S&P 500 resides in its most expensive quintile relative to history. Forward-looking equity returns also become less favorable as valuations surge. Investors should expect less favorable equity returns on this basis alone, but they should not expect negative returns. Let's suppose that the S&P 500 delivered its historical average 5% return from these elevated starting valuations. Doesn't 5% seem acceptable when bond yields hover around 2% and credit spreads are near their all-time tights?

**PILLAR II: CONTEXT**

*Today's economic context of broadening expansion supports equities.*

We've conducted research on the effect of economic conditions on equities, and the results have been unsurprising. In one approach, we categorized prevailing conditions through history into one of four modes: expansion, recovery, slowdown and contraction, and we found that equities tend to do fine in every condition other than contraction. Said differently, unless we detect an upcoming recession, we're content giving equities the benefit of the doubt.

As 2017 wears on, we're confident in saying that the probability of an imminent recession is minimal. The Purchasing Managers' Index (PMI) readings by month across the world's major economies indicate that the proportion of world countries that are expanding has been steadily rising. This broadening pattern of global economic growth is simply not consistent with an imminent recession.

**PILLAR III: ASSET CLASS DRIVERS**

*Equity market specific indicators remain robustly positive.*

The idiosyncratic asset class drivers round out our asset allocation analysis. For equities, we consider forces such as momentum, volatility, earnings and sentiment. All year, this work has reminded us that historically, when the U.S. equity market follows a low volatility and positive momentum pattern, positive trends generally persist. These influences have become more supportive of equity gains through 2017.

## Bottom line

We readily acknowledge that our approach cannot offer infallible guidance. But it does offer an analytical assessment of market conditions that relies on empirical evidence of historical asset class behavior. It forces us to reckon with the past lessons we've learned about the forces that drive markets and where they stand right now. Our process pillars collectively suggest that we resist the urge to invest based on feelings during the fourth quarter of 2017. Today, they align in a convincingly bullish way for equities. Until that changes, we'll position our portfolios accordingly.

*The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. It is not possible to invest directly in an index.*

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