ARTICLE
For professional investors
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The world upside down in this late-cycle bull market

- Returns have been higher than risk levels in the past two years
- Cyclical growth stocks have outperformed defensive dividend stocks
- Financial markets tend to mean-revert, but timing is difficult

Jan-Sytze Mosselaar

We are now in the ninth year of the current bull market, one of the longest in history. Moreover, what has characterized the last two years of this bull market, starting in July 2016, is a combination of unusual circumstances:

- Global equity market returns have been almost twice the historical average (15% vs 8%)
- Market volatility has roughly been only half the historical average (8% vs 16%)
- Cyclical growth stocks have outperformed low-risk and high dividend stocks by an unusually wide margin.

These three characteristics of the last two year's bull market have led low-risk and high dividend strategies to lag the market.

In this paper, we will give an overview of these three phenomena and also explain our expectations for the coming years. Will these trends persist? Or should investors reconsider their positioning within equity markets? Although we don't pretend to be able to time the performance of equity markets and factors, we aim to give investors some food for thought on the current and expected market environment.

'15% returns with 8% volatility is the world upside down'

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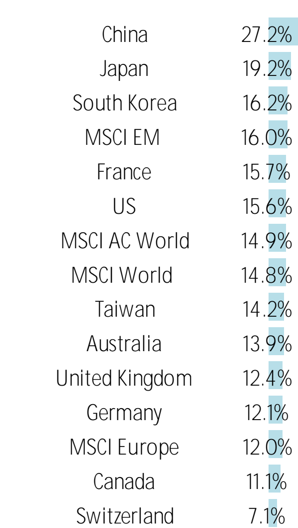
Global equity markets returns have been twice the historical average

Since July 2016, equity markets have posted strong returns, as Figure 1 illustrates. Chinese stocks have done especially well, helped by the good performance of index heavyweights Alibaba and Tencent. European markets have lagged somewhat, most notably non-euro markets such as the UK and Switzerland.

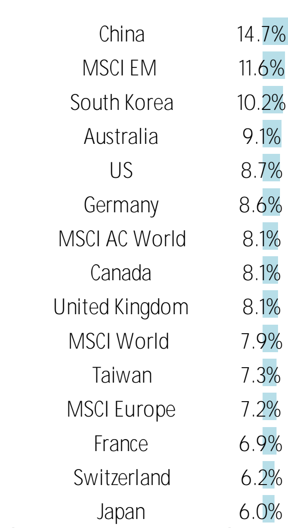
Over the period 30 June 2016-2018, the broad MSCI AC World has achieved an annualized return of around 15% (16% for the MSCI EM), which is almost twice the expected and historical average of 8% per year for global equity markets. Figure 2 shows equity returns over the last 15 years, confirming that long-term equity returns are, on average, in the 5% to 10% range.

Figure 1 | Local returns July 2016-2018



Source: MSCI, Robeco. Annualized total returns in local currency over the period 30 June 2016 – 30 June 2018.

Figure 2 | Local returns July 2003-2018



Source: MSCI, Robeco. Annualized total returns in local currency over the period June 2003– 30 June 2018.

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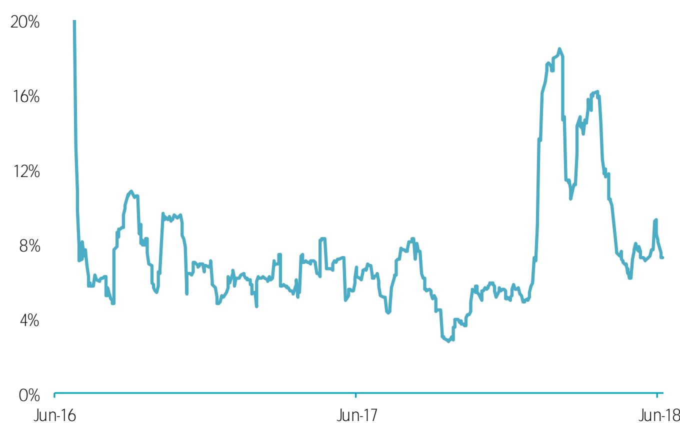
Market volatility has been only half the historical average

In the 24 months between July 2016 and June 2018, the volatility of the MSCI World has averaged approximately 8%, which is low by any standard. At the end of 2017, the 1-month rolling volatility, as shown in Figure 3, even fell below 4%. This level of volatility that is normally associated with bond markets.

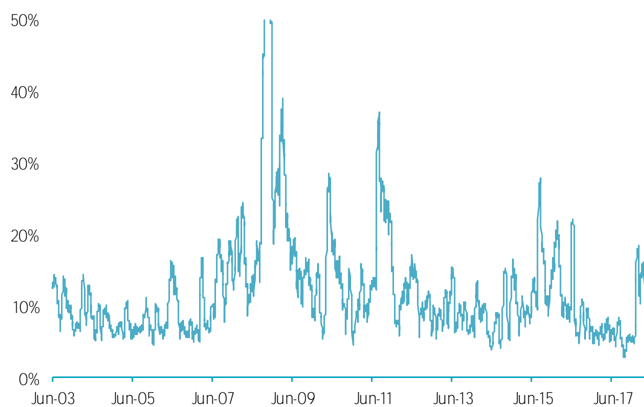
Figure 3 | 1-month rolling daily volatility MSCI World July 2016-2018



Source: Robeco, Bloomberg, MSCI

Historically, market volatility amounts to an average 15%, although there have been periods with substantially lower and higher volatility, as Figure 4 illustrates.

Figure 4 | 1-month rolling daily volatility MSCI World July 2003-2018



Source: Robeco, Bloomberg, MSCI

Given that market volatility historically tends to revert to the mean, we think an extended period of extremely low volatility is improbable. From this perspective, the recent jump in market volatility in early February and late March 2018 can be a sign that a new period of higher volatility is ahead of us.

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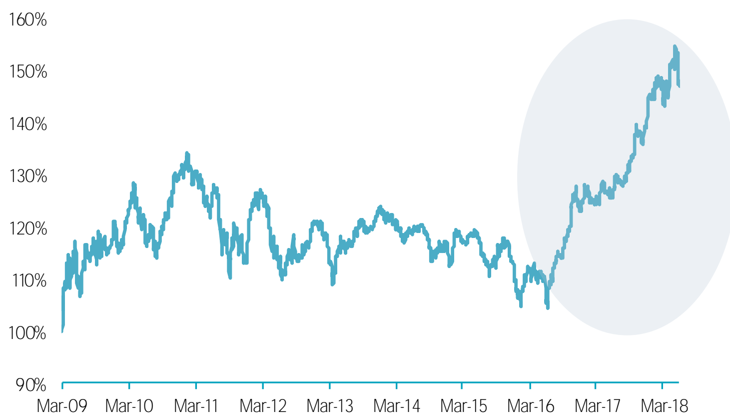
Cyclical growth stocks have significantly outperformed defensive stocks

The most significant turnaround in the current bull market happened in July 2016, when cyclical sectors started to outperform defensive sectors by a wide margin. This clearly is visible in Figure 5 that shows the relative, equal-weighted performance of the main cyclical MSCI AC World sectors versus defensive sectors since the market through in March 2009.

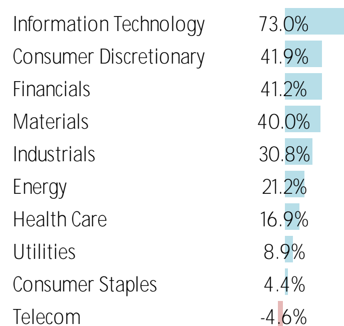
Figure 5 | Performance of cyclical sectors versus defensive sectors since market low



Source: MSCI, Robeco, Bloomberg. Cyclical index is equal-weighted average of MSCI World Industrials, IT, Consumer Discretionary and Materials. Defensives = Consumer Staples, Telecom, Utilities and Health Care.

Figure 6 shows individual sector performance over the same period. The gap between cyclical stocks, such as tech, materials and industrials stocks, versus defensive stocks, such as consumer staples, telecom and utility companies, has been exceptionally large. Most extreme is the performance gap between the global IT and telecom sectors, which has been a whopping (non-annualized) 77% over the period.

Figure 6 | Non-annualized MSCI World sector performance, local terms, July 2016-2018



Source: MSCI, Robeco.

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If we focus on individual stock performance, in Figure 7, the performance gap between cyclical growth stocks, such as Amazon and Apple, and defensive and high dividend stocks, such as Procter & Gamble and AT&T, is particularly telling. Also, cyclical materials stocks, such as Glencore, Rio Tinto and BHP Billiton, have performed well on the back of the strong global economic growth and higher commodity prices.

Within the large and diverse financials sector, high-beta large-cap banks such as JP Morgan, Bank of America and Citigroup have outperformed low-risk Canadian banks and insurance companies around the world.

Figure 7 | Price returns largest stocks per AC World sector, non-annualized, July 2016-2018

Information Technology	Energy	Consumer Discretionary	Materials	Health Care	Industrials	Real estate	Utilities	Insurance	Banks	Consumer Staples	Telecom
Apple Inc	Exxon Mobil Corp	Amazon.com Inc	DowDuPont Inc	Johnson & Johnson	General Electric Co	American Tower Corp	NextEra Energy Inc	Allianz SE	JPMorgan Chase & Co	Nestle SA	AT&T Inc
100%	-5%	138%	40%	5%	-54%	32%	35%	49%	76%	9%	-18%
Microsoft Corp	Chevron Corp	Home Depot Inc/The	BASF SE	Pfizer Inc	Boeing Co/The	Simon Property Group	Duke Energy Corp	AIA Group Ltd	Bank of America Corp	Procter & Gamble Co/	Verizon Communicatio
101%	30%	60%	27%	11%	172%	-15%	1%	53%	119%	-2%	-1%
Facebook Inc	Royal Dutch Shell PL	Comcast Corp	BHP Billiton Ltd	UnitedHealth Group I	3M Co	Crown Castle Interna	Enel SpA	Chubb Ltd	Wells Fargo & Co	Coca-Cola Co/The	Vodafone Group PLC
70%	38%	4%	96%	79%	18%	15%	27%	1%	24%	3%	-9%
Alphabet Inc	TOTAL SA	Walt Disney Co/The	Rio Tinto PLC	Novartis AG	Siemens AG	Equinix Inc	Dominion Energy Inc	Prudential PLC	Berkshire Hathaway I	Philip Morris Intern	SoftBank Group Corp
61%	34%	10%	102%	1%	29%	15%	-5%	46%	29%	-14%	39%
Alphabet Inc	BP PLC	Toyota Motor Corp	Glencore PLC	Roche Holding AG	Honeywell Internatio	Prologis Inc	Southern Co/The	AXA SA	Citigroup Inc	PepsiCo Inc	Deutsche Telekom AG
61%	50%	52%	146%	-8%	30%	42%	-5%	30%	63%	9%	-6%
Visa Inc	Royal Dutch Shell PL	McDonald's Corp	Air Liquide SA	Merck & Co Inc	Union Pacific Corp	Public Storage	Iberdrola SA	American Internation	HSBC Holdings PLC	British American Tob	Telefonica SA
81%	49%	37%	36%	12%	70%	-4%	20%	5%	71%	-14%	-4%
Intel Corp	Schlumberger Ltd	Charter Communicatio	BHP Billiton PLC	Amgen Inc	United Technologies	Welltower Inc	National Grid PLC	Prudential Financial	Royal Bank of Canada	Altria Group Inc	KDDI Corp
60%	-10%	28%	97%	28%	28%	-8%	-16%	39%	40%	-11%	3%
Cisco Systems Inc	Enbridge Inc	Starbucks Corp	Praxair Inc	AbbVie Inc	United Parcel Servic	AvalonBay Communitie	American Electric Po	MetLife Inc	Banco Santander SA	Walmart Inc	Orange SA
61%	-5%	-11%	47%	61%	5%	2%	6%	31%	48%	24%	7%
Oracle Corp	ConocoPhillips	Netflix Inc	Linde AG	Sanofi	Lockheed Martin Corp	Weyerhaeuser Co	PG&E Corp	Zurich Insurance Gro	Toronto-Dominion Ban	Unilever NV	Nippon Telegraph & T
11%	67%	328%	50%	-1%	25%	32%	-31%	39%	47%	22%	11%
Mastercard Inc	Suncor Energy Inc	LVMH Moet Hennessy L	Shin-Etsu Chemical C	Celgene Corp	Caterpillar Inc	Equity Residential	Exelon Corp	Marsh & McLennan Cos	Commonwealth Bank of	Anheuser-Busch InBev	BT Group PLC
126%	59%	118%	70%	-19%	90%	3%	26%	24%	9%	-21%	-42%

Source: MSCI, Robeco, Bloomberg. Non-annualized stock price returns in local currency. Period 30 June 2016 – 30 June 2018.

The trend of cyclical growth outperforming defensive high dividend stocks has been quite consistent over the last two years. As a result, both the minimum volatility and high dividend factor have lagged the market by quite a wide margin, in developed and emerging markets. Given these trends, it come as no surprise that momentum has worked well, especially over the past 12 months.

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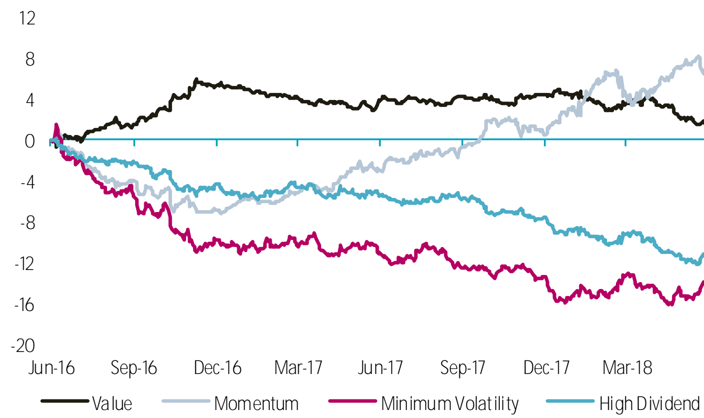
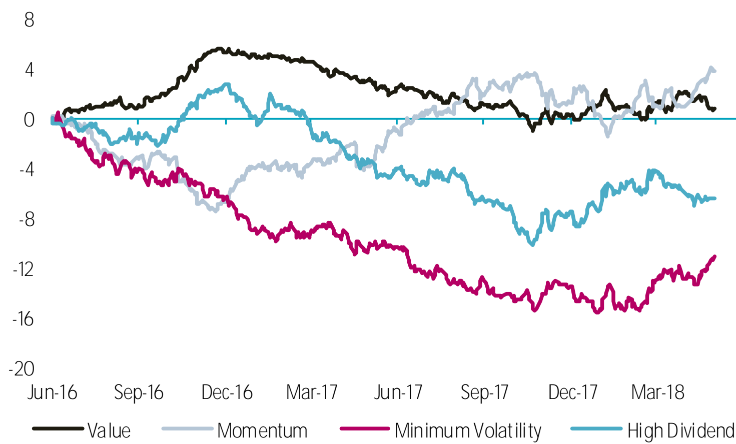
Figure 8 | Relative performance MSCI DM factor indices July 2016-2018



Source: MSCI, Bloomberg, Robeco. Relative returns of MSCI World Factor Indices in USD versus the MSCI World

Figure 9 | Relative performance MSCI EM factor indices July 2016-2018



Source: MSCI, Bloomberg, Robeco. Relative returns of MSCI EM Factor Indices in USD versus the MSCI EM

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The extraordinary rise of the "Seven Sisters of Tech"

The acronyms FAANG (Facebook, Apple, Amazon, Netflix and Google) and BAT (Baidu, Alibaba and Tencent) have become synonyms with the rise of US and Chinese technology companies. Another way to refer to the group of major US and Chinese tech giants is the "Seven Sisters of Tech". This term leaves Baidu and Netflix out of the equation, and brings in Microsoft. This makes sense from a market capitalization point of view, as Microsoft has a much larger weight than Netflix in the MSCI World and the weight of Baidu in the MSCI EM is significantly lower than that of Alibaba and Tencent.

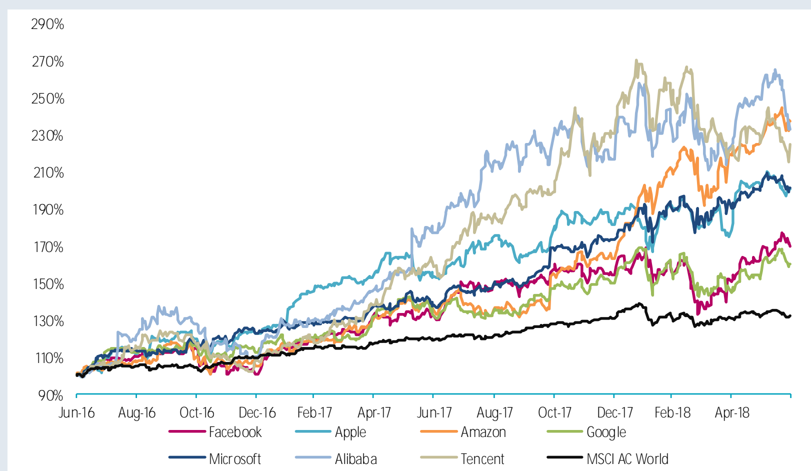
Figure 10 | Non-annualized performance and valuation levels of the Seven Sisters

	Local stock price performance June 2016-June 2018	Current index weight MSCI World	Current trailing P/E
Apple	100.4%	2.1%	19.1
Amazon	137.5%	1.5%	347.7
Google (Alphabet)	60.5%	1.5%	32.4
Facebook	70.0%	1.0%	28.9
Microsoft	101.4%	1.6%	29.8
MSCI World	*32.0%*		
		MSCI EM	
Tencent	124.6%	5.4%	42.2
Alibaba	133.3%	4.3%	47.9
MSCI EM	*34.5%*		

Source: Robeco, MSCI, FactSet. Data as of 30 June 2018

Figure 10 shows their non-annualized local stock price performance over the past two years, their current index weight in the MSCI World and MSCI EM Indices respectively, as well as the current 12-month trailing price-to-earnings ratio. The good performance of the MSCI EM has been largely driven by the good performance of Alibaba and Tencent, which have a combined weight of almost 10% in the MSCI EM Index. Unsurprisingly, having very limited or no exposure to these large index weights has been of the main driver of the lower relative performance of both minimum volatility and high dividend strategies, over the last two years.

Figure 11 | Indexed performance of the Seven Sisters and MSCI World: July 2016- June 2018



Source: Robeco, MSCI, Bloomberg. Local price returns. MSCI World is local total return.

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Outlook: Long-term expected returns and risk levels

The trends described in this paper have been quite persistent over the last couple of years. One would almost forget that equity markets are dynamic and that investment circumstances change over time. Therefore, every forward-looking investor constantly has to make a well-educated judgement on whether trends will persist or change in the foreseeable future.

We find that timing the short-term direction of markets and factors is a daunting task. But, given the strong performance seen in global equity markets over the past couple of years, we expect equity returns to be significantly lower and more in line with long-term averages going forward. The same is true for volatility levels, but in the opposite direction.

Robeco's asset allocation team expects equity returns over the next five years to be 5% for developed markets and 6.25% for emerging markets, as shown in Figure 12, which is an excerpt from Robeco's award-winning five-year outlook. The higher expected returns for emerging markets come from higher underlying economic growth and lower valuation levels. Volatility is expected to mean-revert to historical averages of around 15% for developed markets and 22% for emerging markets.

Investors that subscribe to this 'back-to-normal' view might want to think about their positioning within their equity portfolios. Although equities are still expected to give a higher return than other asset classes, it seems likely that the equity returns will be lower than they have been in the past years. In that sense, the spikes in volatility in early February and late March might a signal that times are changing, to paraphrase Nobel Prize winner Bob Dylan.

Figure 12 | **Robeco's expected return and risk for 2018-2022**

Table 2.1: Expected returns 2018-2022 and changes in five-year expected returns (arrows)

	Returns	Medium-term influences*		Returns	Returns	Risk
Bonds	Long term	Macro	Valuation	2018-2022	2017-2021	Volatility
10y German government bond	4.25%	-/-	-/-	↑ -2.50%	-3.50%	6%
Cash or money markets	3.50%	+		↓ 0.50%	0.75%	1%
Investment grade credit bonds	5.00%	-/-	=	↑ -0.25%	-1.25%	5%
Emerging markets debt	5.75%	+	+	↓ 4.25%	5.50%	10%
High yield bonds	6.00%	=	-/-	↓ 0.25%	1.00%	9%
Equity-like						
Developed markets	7.00%	=	-/-	↓ 5.00%	6.50%	15%
Emerging markets	7.50%	=	+	↓ 6.25%	7.25%	22%
Indirect real estate	6.00%	-/-	=	↓ 4.25%	5.00%	19%
Commodities	4.00%	=	=	= 2.75%	2.75%	17%
Consumer prices						
Inflation	3.00%	=		↓ 1.25%	1.50%	

* The medium-term influences correspond with our qualitative assessment on the valuation and macro influences described in Chapter 2. Medium-term influences on equity-like are relative to developed equities. In line with the recommendations of the Dutch Association of Financial Analysts, the expected returns are geometric returns that are better-suited to long investment horizons. Equity-like returns are in local currency. Bond returns are hedged to euro except for EMD which is the unhedged return in EUR. The 10Y bond return has been derived as follows: we assume the bond is sold each year and that a new 10-year bond is bought with the proceeds. In this way we replicate a strategy in which investors retain their investment in the 10-year benchmark bond. Note that the return will vary for other strategies such as a buy-and-hold strategy. The value of your investments may fluctuate, and past performance is no guarantee of future results.

Source: Robeco, https://www.robeco.com/hk/en/themes/expected-returns/

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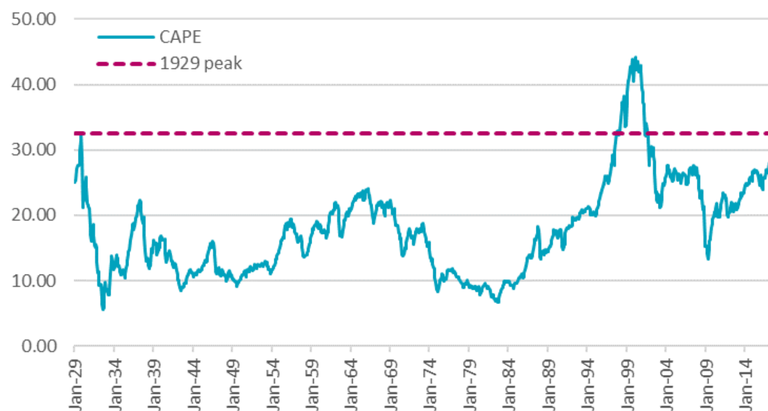
One of the reasons why Robeco expects lower returns for developed equity markets over the next five years, is the current above-average stock market valuation, illustrated in Figure 13 by the popular cyclically-adjusted price earnings ratio (CAPE), also referred to as the Shiller PE.

Figure 13 | US 10-year cyclically adjusted price earnings ratio, 1929-2018



Source: Shiller

Historically, higher valuation levels have led not only to lower equity returns in the following years, but also to higher risk levels, as confirmed by recent Robeco research.[1] Figure 14 illustrates this: a higher CAPE is associated with higher equity market drawdowns going forward, as markets typically trade around new highs when valuation levels are high.

Figure 14 | US stock market risk conditional on CAPE

CAPE 1929-2018	All	<10	10-15	15-20	20-25	>25
% observations	100%	12%	28%	24%	31%	6%
Chance of loss	22%	4%	7%	32%	28%	65%
Average loss	-21%	-4%	-10%	-20%	-26%	-24%
Downside risk	-4.7%	-0.2%	-0.7%	-6.3%	-7.0%	-15.8%

Source: Robeco

[1] Pim van Vliet, *Risky CAPE: repair the roof when the sun is shining*, Robeco research paper, June 2018

Final remarks

Equity investors have benefitted from one of the longest bull markets on record, accompanied by low market volatility and a significant outperformance of cyclical growth stocks over defensive and high dividend stocks. This has led low-risk and high dividend strategies to lag the market, which is not unusual in the last legs of a strong bull market.

However, investors have to look forward instead of looking in the rear-view mirror. They need to gauge how long this 'upside down market' of high returns and low volatility will persist, since financial markets tend to mean-revert in the long term. Timing these market turnarounds is difficult. But, as always, it is wise to periodically check whether one's equity portfolio is coherent with his long-term expectations.

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Additional Information for investors with residence or seat in United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment Funds that are not investment Funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

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