Illumination: Equity strategy and market outlook

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Strategic perspective

- The recent decline in global growth expectations has re-focused attention on the trajectory of developed market debt in the US and Europe. These two economic blocs account for nearly 50% of world GDP.
- The combination of declining growth expectations and the re-emergence of credit stress within the Eurozone banking system has substantially raised the risk of a recession. Investors are concerned that policymakers have few tools left to combat waning demand growth. Certainly the appetite for further fiscal measures is now muted on both sides of the Atlantic. For growth, the biggest risk is an over-zealous shift towards austerity.
- In contrast to the fiscal constraints, fiat currencies allow central banks to avoid deflationary outcomes, should they choose to do so. Recent market events have resulted in swift changes in the outlook for interest rates. The Federal Reserve is now indicating US interest rates will be near zero for the next two years and the ECB is also on hold.
- Inflation expectations have been falling but are not yet at the levels that triggered the second round of quantitative easing in 2010. However, the Federal Open Market Committee (FOMC) has disclosed that at its most recent meeting a range of policy tools were discussed to promote a stronger recovery. Further unconventional monetary policy should be expected if US core CPI expectations fall back to 1%.
- While the outlook for GDP growth is highly uncertain the outlook for the European and UK equity markets is much more positive. Even if we have a recession – and if US experience over the past 140 years is a guide – a further catastrophic collapse in UK and European share prices is unlikely from current valuations. While a volatile time lies ahead, conservatively valued markets have in fact generated perfectly adequate returns during recessions.
- European non-financials have given back all of the gains made since 2008 and are trading at their lowest price/book multiples for the last 20 years. UK non-financials are not trading at such distressed levels but are still well below their median price/book. Despite all the downbeat commentary, should the world economy *not* go into recession the market rebound would be powerful.
- Rather than trying to handicap the risks of recession we believe that valuation is the best driver of medium-term returns. Value investing is not easy from either an individual or institutional perspective – invariably purchases have to be made when the outlook is most uncertain to get the best price.

Declining growth expectations have re-ignited credit fears

Growth expectations

We believe declining global growth expectations have been responsible for the renewed concerns over Eurozone sovereign debts and banking system stability. In the US, growth expectations have been falling since the start of the year. One of the unfortunate effects of quantitative easing was the substantial rise in oil prices, which acted as a brake on discretionary spending. Furthermore, the US housing market has been declining in the first six months of 2011, creating a secondary drag on household wealth and optimism.

In Europe, while GDP expectations rose sharply in Q1, they are likely to have peaked. Eurozone manufacturing PMI has declined sharply in the second quarter to levels just short of contraction while quarter-on-quarter German economic growth stagnated in Q2. In the UK, despite continued and substantial falls in the value of sterling against the euro, economic expectations have also been falling rapidly.

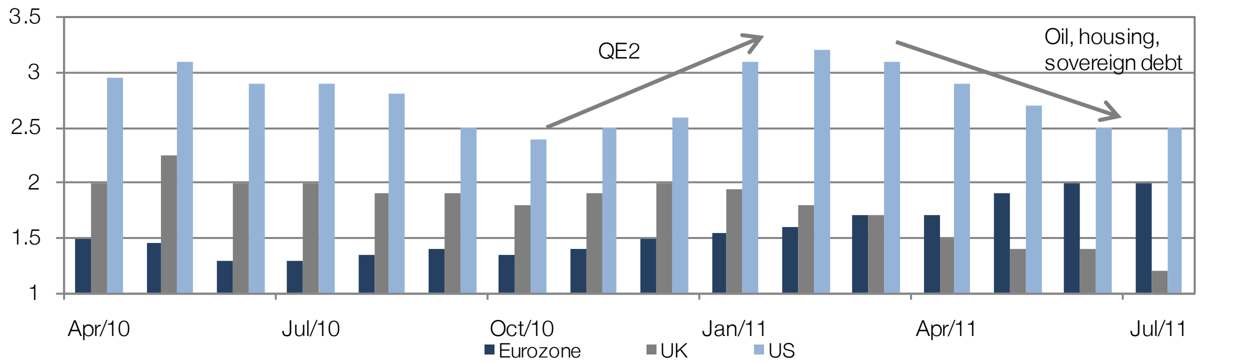
While focused on developed markets we should add that in the background emerging markets have been tightening monetary policy to combat domestic inflation by moderating growth. We note that China's M2 money supply growth has now shrunk to cyclically low levels following the stimulus-led credit binge of 2009.

Re-ignition of credit fears

The fiscal response to the credit crisis of 2008 was aimed at stabilising levels of economic output to give nations time to work through problems in an orderly way. This always left the periphery of Europe at the mercy of expectations. If a strong and durable recovery was a rational expectation we would not be where we are today.

Declining GDP growth expectations have led to the widening of spreads on peripheral sovereign debt which, in turn, have impacted the solvency of banks and directly reduced potential GDP growth in a negative feedback loop. The credit stress has infected the entire Eurozone banking system – swap spreads which embed future expectations of LIBOR over equivalent risk-free assets remain at elevated levels, Exhibit 2.

Exhibit 1: Declining growth expectations



Source: Bloomberg

Exhibit 2: Credit stress in the Eurozone bank sector

Source: Bloomberg

Monetary policy to the rescue – but when and how?

The recent political debacle over the US debt limit and the determination by Eurozone institutions to push rapid austerity measures on already rapidly shrinking peripheral economies shows the political appetite for continued fiscal stimulus is limited. Continued attacks on sovereign debt markets are arguably pushing politicians into deficit cutting measures that will cause precisely the economic stagnation that debt investors fear.

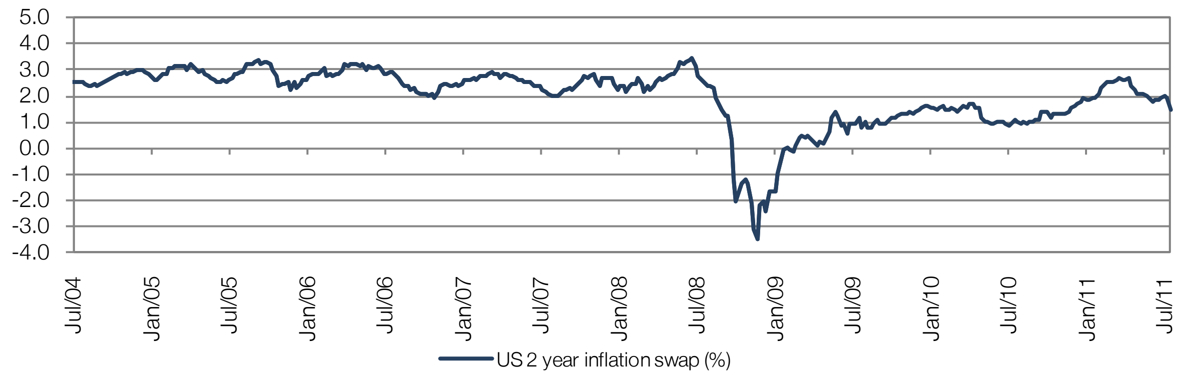
In contrast monetary policy is likely to play a key role in preventing a growth slowdown turning into a deep recession or worse. With a fiat currency system, policymakers who wish to prevent deflation should be able to do so (a bull point for commodities and gold but whether this will create real economic growth is another matter).

Further unconventional monetary policy was discussed at the most recent meeting of the FOMC. We believe at the present time that inflation expectations, (Exhibit 3), have fallen insufficiently thus far to warrant another round of quantitative easing. However, if inflation expectations were to fall as they did in 2010, the policy response is very likely to be similar and equally positive for asset prices.

140 years of recessions and S&P returns – the US experience

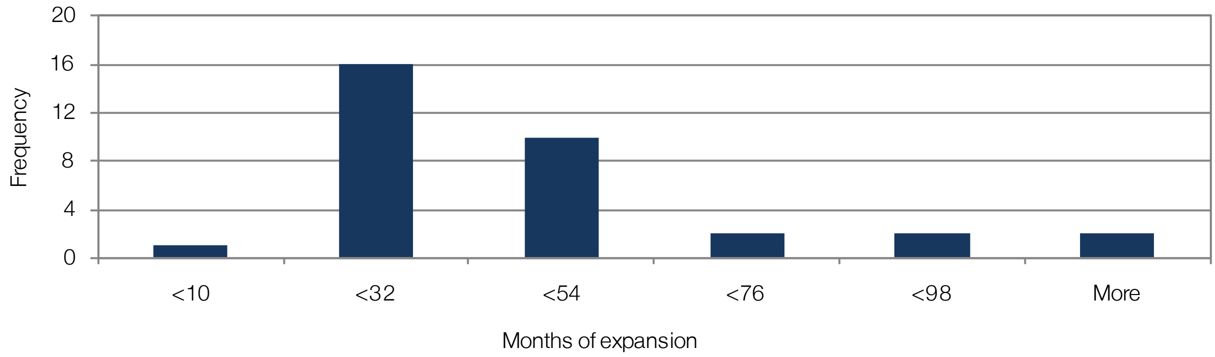
With substantially higher risk of global recession we have looked at whether recessions are correlated to equity market returns. We have chosen to look at the US as it still represents the world’s largest economy, has the world’s leading equity market and also publishes high-quality historical data. During recessionary periods equity market returns have been highly variable. But adding a measure of value – in this case Shiller's cyclically adjusted P/E – shows again it is not future prospects that are important but the price being paid for them.

Exhibit 3: US 2-year inflation swaps (%)



Source: Bloomberg

Exhibit 4: Duration of US expansions since 1873



Source: NBER

Recessions are not the end of the economic universe

It is important to remember a recession does not represent the end of the economic universe as fluctuations in economic activity should be regarded as normal. In the US alone there have been 29 recessions since 1873. The average length of an expansion (ie, from trough to peak) has been 40 months since then, although over the last 40 years the duration of expansions has been somewhat longer at 60 months. The length of the expansion is highly variable, skewed and has a standard deviation of 30 months, Exhibit 4.

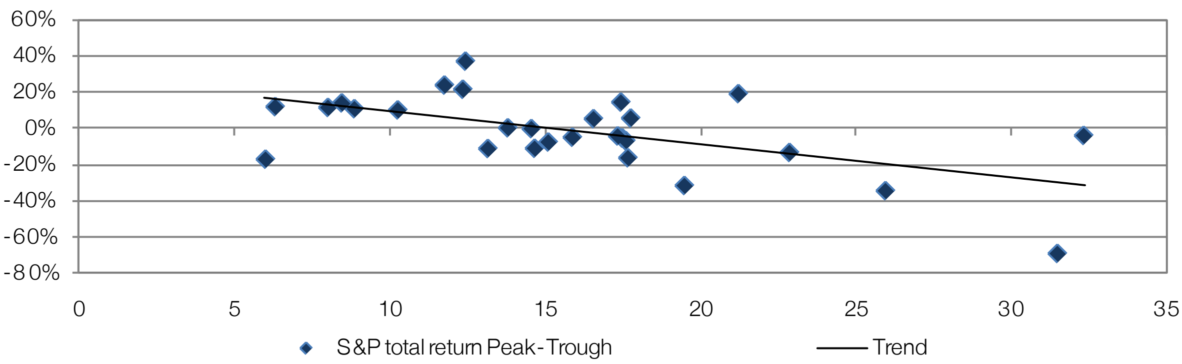
A further important point is that it takes on average 12 months for the US National Bureau of Economic Research (NBER) to determine the date of a peak or trough in economic activity. Therefore, for market participants there can be significant uncertainty as to whether the prevailing environment is recessionary or not.

On the basis of these averages a peak in US activity would have been expected between late 2012 and 2014. Thus if a recession were to occur in H211 the expansion would have been one of the shortest of the post-war period. Nonetheless, Martyn Feldstein, a member of the Business Cycle Dating Committee of the NBER, recently put the probability of recession at 50%.

Though certainly an important factor, recession risk is not synonymous with equity risk. In the case of the US, the S&P has risen in 11 of the 29 recessions identified by NBER since 1873. If we include dividends the equity market has delivered positive returns in just over half of the recessionary episodes. Though there is no doubt that *in the event of recession* equity returns are muted, there is no reason to fear catastrophic losses unless medium-term valuations are far too high.

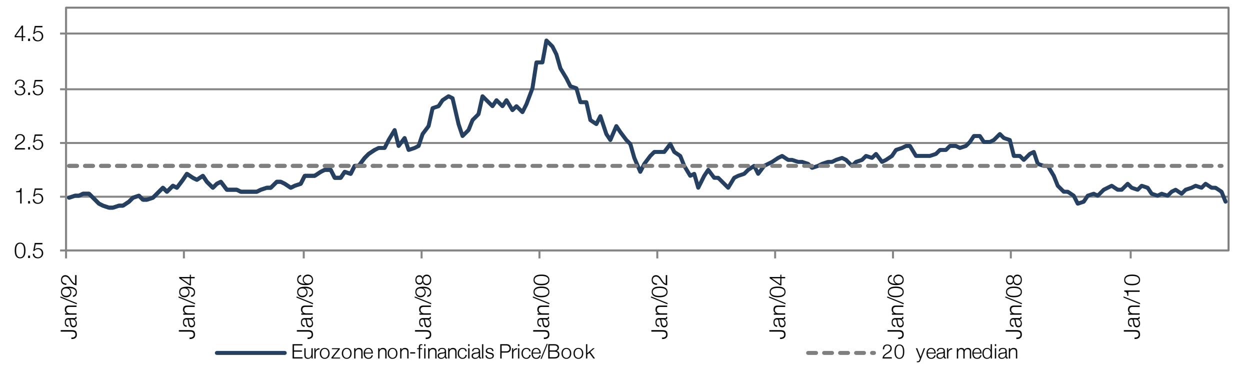
Valuation is a critical factor in a recessionary environment

Exhibit 5: S&P performance during recessions against Shiller (10-year average) P/E



Source: Shiller, Edison Investment Research estimates

Exhibit 6: European non-financials price/book



Source: Edison Investment Research estimates

The relationship between medium-term valuation parameters and recession share price performance is shown in Exhibit 5. When the S&P was valued at below-average multiples of the 10-year cyclically adjusted P/E (also known as the Shiller P/E) when GDP peaked, the median total return from the peak to trough of the cycle was +11%. This represents a 7% pa return over the average recession duration of 18m.

To assess the impact of a recession on portfolio performance equity investors should therefore carefully differentiate between overvalued and undervalued market conditions. At present, UK and European equities are trading significantly below their 20-year median price/book. European equities are particularly cheap on this measure and indices are trading at levels not seen since the peak of the global credit crisis of 2008.

On the basis of these data, *if* a global recession occurs then equity performance is likely to be modest but still positive given the valuation signals in the UK and Europe. If there is *no* recession, equities should deliver strong returns as corporate earnings and cashflows will remain at very strong levels. We also note “this time may be different”, but the data show there have been no deflationary US recessions in the post-war period. Bond investors beware.

Exhibit 7: UK non-financials price/book

Source: Edison Investment Research estimates

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