Ted Scott on the wire

Ted Scott
Director, UK Strategy

March 2010

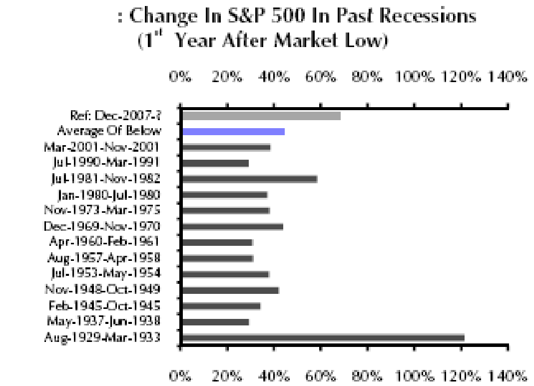
The Market hits new highs – So where now?

Summary

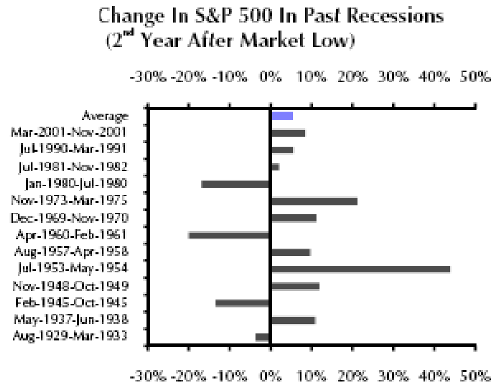
- The UK equity market has recently reached an 18 month high
- The market has embarked on a ‘second leg’ following a correction earlier this year
- Doubts persist about the sustainability of the bull market
- The sovereign debt scare provided a buying opportunity
- Fears of China overheating are exaggerated
- The market has discounted the UK economy’s slower growth profile
- Quantitative Easing (QE) has only been suspended, not terminated
- The market is reasonably valued but it is unlikely to be re-rated higher due to the nature of the financial crisis

Introduction

In the last week equities have reached an 18 month high almost exactly a year after the low of the preceding bear market. In the subsequent 12 months, the UK market is up over 50%, US equities have risen over 60% and many other overseas markets, especially in emerging economies have registered even larger gains. With the market having risen so far so quickly there is naturally some concern that we must be near the peak. The two tables below show the first two years of the bull markets over the last 80 years and, indeed, the gains are usually much larger in the first year and in four of the 13 occasions equities have fallen in the second year:



rces – NBER, Bloomberg



Sources – NBER, Bloomberg

As the market continues its ascent, it is right to consider whether we are approaching the end of the current bull phase and, if not, how much upside is still remaining? After all, much of the macro economic news remains poor, especially for the UK that has only lately crept out of the deepest recession since the Second World War. The recent strong run in the market has come only a few weeks after a period when the issue of sovereign debt was dominating the newswires and threatening to derail the equity bull market. That may have receded into the background for the time being but it highlights the fragile nature of the global economy as it emerges from the credit crunch.

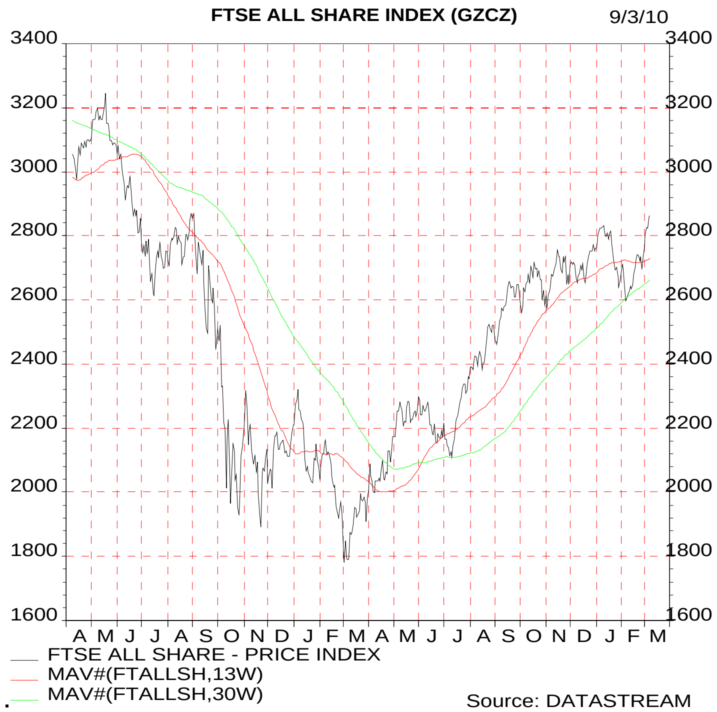
In this note we consider these points by looking at some of the issues that have unsettled investors since the beginning of the year and asking whether they are discounted in share prices. The piece will consider what is a fair valuation for the UK equity market given the current state of the economy and quoted corporate profitability. In so doing it will determine whether there is still upside in equities from current levels.

F&C Investments

A supplementary note will follow when we will look at the market from a technical point of view to determine whether they support the fundamental conclusion.

A new high

The chart below shows the bear market and the subsequent bull market that started in March 2009.



As can be seen from the chart, the market appears to be entering a second leg having had a correction in January that took the index down to the 30 week moving average. The fall in January, in retrospect, provided a buying opportunity but at the time there were various factors that were unsettling investors.

What factors could derail the bull market?

1) The sovereign debt crisis

This was the most worrying issue when the market suffered a correction in January. If Greece was allowed to default or leave the EU, as seemed possible at the time, then risk assets would have reacted badly. It would have been perceived as another 'Lehman's moment; the event of September 2008 that was the catalyst for the surge in risk aversion and collapse in the market in September 2008. However, authorities have learned from that policy mistake and the EU politicians are determined, it seems, to resolve the problem within the confines of the Union itself. With Germany and other partners voicing support for Greece the crisis has receded somewhat, but it is a long way from being solved and it does remain a significant risk for equity markets.

For the UK, the issue is especially pertinent because of our own public sector financial problems. We have a deficit amounting to almost 13% of GDP, which is larger than Greece, although the size of the Government's net debt as a proportion of GDP is much smaller. The pound has been weak partly because of the need for a period of austere fiscal consolidation and if the markets remain dissatisfied with the government's response to reducing its deficit, its recent weakness could turn into a sterling crisis.

I think that is unlikely because once the election is out of the way a tough package of measures to tackle the UK's financial problems is inevitable, whatever party is elected. Furthermore, the UK's financing needs are less than many other developed economies in the short to medium term because so much of the government debt is long dated.

The signs are that western governments are acting responsibly and pro-actively to the issue of sovereign debt and the various austerity packages of southern European countries and Ireland are evidence of that. For the UK, it is more complex because the impending election has created a short-term policy vacuum that will create further uncertainty ahead of polling day. However, once we have a clear policy response outlined in the summer markets should be appeased.

2) China slows down

The Chinese authorities have begun to tighten monetary policy by increasing reserve requirements as well as reducing targets for bank lending and money supply growth for 2010. This briefly unsettled the markets and was a contributory factor to the sell off in January but, as I recently argued in a note about whether or not a bubble is emerging in China, the economy is still on course to generate growth at least equal to last year of 8.7% (it has a target for GDP growth of 8%). Therefore, the early signs of a more constrained monetary policy are a sensible economic policy response by the authorities who have a much superior track record than their counterparts in developed economies.

The economy is still very much in growth mode and it is likely it will be some time before interest rate rise, which is a more effective and policy sensitive way of applying the brakes. Inflation is still relatively quiescent as well, although the recent Consumer Price Index data of 2.7% raised alarms that it is rising too fast. Partly in response, the authorities reduced the official target from 4% to 3% underlining their resolve not to create an inflationary bubble. (For a more detailed comment on this topic please read my recent note 'Can China learn from Japan?').

3) The UK has a double dip recession

The recovery in the UK has been notable for its feebleness. Although we belatedly emerged from recession in the fourth quarter of last year, the growth in GDP was only 0.3%. That compares badly to a rise of 5.7% in the US for the same period. Economies in Europe mostly came out of recession earlier than the UK as well, although there are increasing signs that growth is now stalling on the Continent, which would be further bad news for the UK as Europe is our largest trading partner.

With the pressing need to sort out our public finances it will mean government spending will fall and taxes will rise. This will exert further pressure on what is already a fragile economy and if the consumer responds to the forthcoming period of austerity by cutting back on spending it is possible the economy could lapse back into recession.

A further period of recession, so long as it was not prolonged or deep, would not, however, necessarily spell the end of the bull market. Firstly, the market would recognise that it was a necessary price to pay to restore financial probity to public finances. Secondly, and more importantly, the quoted UK stock market does not reflect the UK economy. Approximately 70% of UK earnings from public companies are derived from overseas and about 40% from the US. Therefore, in that respect, the performance of overseas economies and especially the US is more important than the UK in determining the direction of the equity market.

Indeed, the recent strength of the market has paradoxically been mainly due to the weakness of sterling, which has fallen partly due to fears about the fragility of the UK economy. Many companies, particularly those with US earnings have had upgrades in earning forecasts underpinning the recent strength in the market its overall valuation has actually gone down slightly as share prices have advanced in recent weeks (i.e. earnings upgrades have outpaced the rise in share prices).

4) The end of QE

Much of the rise in the market since last March has been attributed to the overtly aggressive monetary response to the credit crunch. The most obvious manifestation of this has been the policy of QE by the Bank of England's Monetary Policy Committee (MPC), whereby assets have been purchased by the Bank, thus injecting liquidity into the market and, by design if not reality, the economy. The UK authorities have made greater use of QE than any other developed economy and it is estimated that it amounts to about 15% of GDP.

There is no doubt that QE has been a factor in boosting asset markets and was one of the catalysts that launched the bull market a year ago. Furthermore, almost all of the asset purchases have been concentrated in gilts with £200bn worth of stock bought to date. This represents about 25% of all outstanding government stock and, therefore, the heavy demand from the Bank has artificially depressed gilt yields by, it is reckoned, up to 1%. This has also helped equities to perform well as higher bond yields and interest rates invariably depress equity valuations.

Now that QE is over does it mean that asset markets will retreat without the life support of a steady supply of liquidity? The answer should be no for 3 reasons:

1. As Mervyn King, the Governor of the Bank, has made clear QE has only been suspended and not cancelled. If it is deemed the economy still needs to be stimulated then it will be resumed at a later date. Given the economy is barely growing and we have the prospect of onerous fiscal measures being introduced after the General Election a resumption of QE is a strong possibility.

2. The suspension of QE has been well signalled by the MPC and has contributed to the recent rise in gilt yields, which has seen the yield on the benchmark 10 year gilt rise from 3.5% in December to 4.2% now.

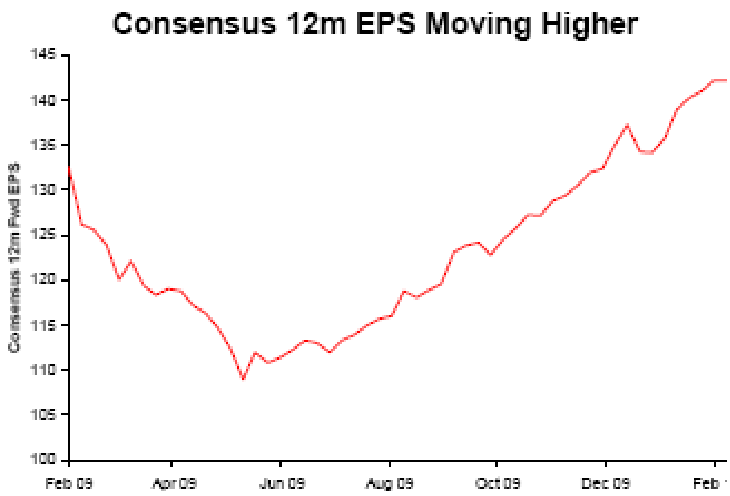
3. And most importantly QE has successfully served a purpose for which it is no longer necessary. At the time when the policy was introduced the UK's financial system was under grave threat and with the demand and supply of credit having dried up an injection of capital via the authorities was desperately needed. While QE has not succeeded in generating loan growth as hoped, it has helped stabilise the financial system, not least by contributing to the recapitalisation of the banking sector. It has also helped generate wealth by shoring up asset markets and while the latter part of the bull market has been about earnings upgrades the first part was driven by extra liquidity, mainly through QE.

The valuation of the market

As stated above, the rise in the market has been increasingly driven by strong corporate performance as reflected by the increase in profit estimates. Initially, the bull market was all about the improvement of the macro economic environment as it became clear that a depression similar to the inter-war years was likely to be averted. The market, as it tends to do, rose ahead of improved company performance as it discounted the upgrades to come; this started in the third quarter of last year and has continued in the first quarter of 2010 for December year end companies that have recently announced results.

Ted Scott on the wire

The pace of upgrades is beginning to slow down but the trend will probably remain intact for a few more quarters, especially if sterling continues to be weak. The chart below shows how the upgrades have lagged the rise in the market:



Source: IBES, Datastream, Morgan Stanley Research

One feature that has changed over the last three quarters is that companies are beginning to show improved revenue performance as well as earnings. This is important as it indicates that demand is beginning to recover and that the upward trend in profits should be more sustainable. In this respect, the US has performed better than the UK and Europe. The tables below show the details of the recent results season and for both regions the improvement in sales showed a material improvement over the previous quarter.

Stoxx 600 - EPS and Revenue vs. Consensus Estimates

	EPS					Revenue				
	Count	%	Avg. Beat	Median Beat	MCap. Wt. avg. beat	Count	%	Average Beat	Median Beat	MCap. Wt. avg. beat
Beat	226	53%	10.1%	6.8%	0.0%	215	52%	4.7%	1.6%	0.0%
Miss	196	46%	-10.6%	-6.2%	0.0%	197	48%	-2.1%	-1.1%	0.0%
In-line	3	1%	N/A	N/A	N/A	1	0%	N/A	N/A	N/A
All	**425**	**100%**	**0.2%**	**0.5%**	**0.0%**	**413**	**100%**	**1.4%**	**0.0%**	**0.0%**

Note: In calculating averages and medians we have excluded outliers (i.e. all EPS and revenue data that beat consensus by more than +50% or missed consensus by less than -50%). The statistics includes only those DJ STOXX companies where EPS numbers (both actual and consensus) were available.
Source: Deutsche Bank, Bloomberg

S&P 500- EPS and Revenue vs. Consensus Estimates

	EPS					Revenue				
	Count	%	Avg. Beat	Median Beat	MCap. Wt. avg. beat	Count	%	Average Beat	Median Beat	MCap. Wt. avg. beat
Beat	361	76%	11.0%	7.3%	0.0%	327	69%	5.3%	3.4%	0.0%
Miss	104	22%	-8.9%	-4.6%	0.0%	144	30%	-6.2%	-2.3%	0.0%
In-line	8	2%	N/A	N/A	N/A	4	1%	N/A	N/A	N/A
All	**473**	**100%**	**6.6%**	**4.5%**	**0.0%**	**475**	**100%**	**1.7%**	**1.6%**	**0.0%**

Note: In calculating averages and medians we have excluded outliers (i.e. all EPS and revenue data that beat consensus by more than +50% or missed consensus by less than -50%). The statistics includes only those DJ STOXX companies where EPS numbers (both actual and consensus) were available.
Source: Deutsche Bank, Bloomberg

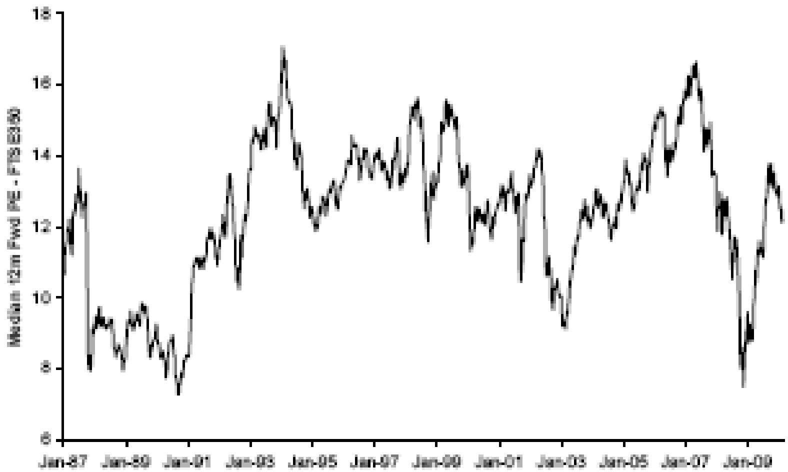
F&C Investments

While the better profitability is an encouraging trend for companies, further optimism is provided by the relative strength in their balance sheets, in contrast to the heavily indebted public and private sectors. Free cash flow as a percentage of GDP is at a record high and the investment share of GDP is at a record low indicating that corporate entities have the potential to raise capital expenditure or make acquisitions as a way of investing in their businesses. As confidence improves managements will invest more and recent surveys about future intentions suggest this is going to be the case. This will create more jobs that, via the multiplier effect, will create more demand, more growth and more jobs and so on. Already there are signs this year that M&A activity is beginning to pick-up with a number of deals, again a sign of increased corporate confidence.

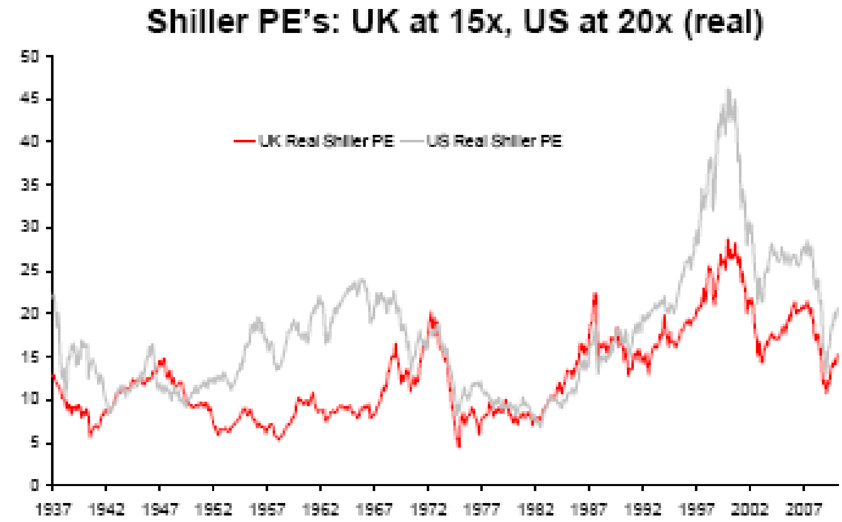
In the UK, the quoted sector derives most of its earnings from overseas where, especially in emerging markets, economies are growing much faster than the UK. The weakness of sterling will also help the translation of those earnings as well as aiding the domestic export sector. Therefore, the market will continue to be supported by solid earnings and dividend growth, despite the relative weakness of the UK economy and the fiscal consolidation to come.

However, although the outlook for quoted companies looks much brighter can the market also move onto a higher valuation that would provide much more upside for equities? Despite the magnitude of the rise in the bull market so far, the Price Earnings ratio (PE) to December 2010 is only just over 12x (see forward looking PE chart below). This is because earnings increases have kept up with the rise in share prices. Compared to recent history, the multiple appears attractive; at the peak of the bull market in early 2000 equities were valued at 21x historic earnings and through most of the late 80s to late 90s the historic PE averaged around 15x. The second chart below shows the Shiller PE for the market, which looks at the 10 year PE ratio and illustrates the rising valuation for the UK market in the 80s and 90s. This also suggests that the PE looks attractive based on the recent past but compared to the decades prior to the mid 1980s it is only fair value or expensive.

12m forward PE for median stock is 12 (LT avg = 11.6)



Source: MSCI, Factset, Morgan Stanley Research



Source: Global Financial Data, Datastream, Morgan Stanley Research

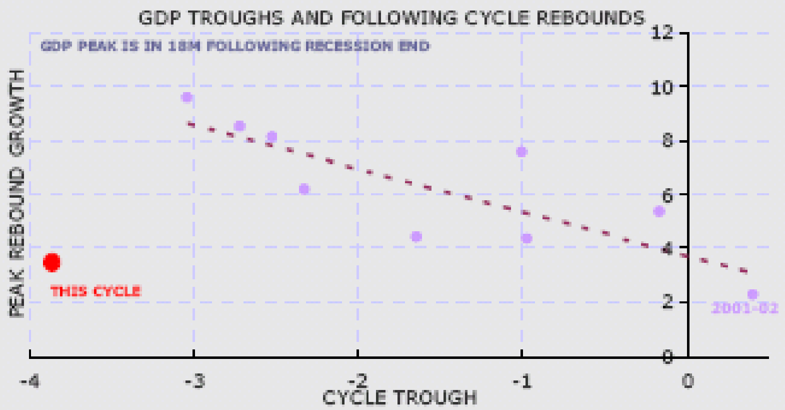
The main reason for the higher rating in the latter years was that economic policy was more stable with fewer and shallower recessions combined with a low (but not too low) rate of inflation. It helped that the Bank of England was made independent in 1997 when Labour came to power with a mandate targeted at low inflation, which has subsequently been successfully applied. Several years of uninterrupted growth followed and equity market bulls argued that it merited a higher valuation for the market.

If we were to revert to an average PE of 15x it would imply over 20% upside from current levels. However, I believe that this is unlikely to happen and that a PE of about 12.5x (i.e. around the current valuation) already represents fair value.

The reasons for this are two-fold: firstly, there are fewer growth stocks within the large company area than was the case in previous decades. For instance the big pharmaceutical and telecom companies that are still a major part of the index have evolved into slow growth defensive businesses on modest ratings. The same is true of many of the technology stocks that drove the market in the late 1990s.

Secondly, and with more relevance to what is happening today, the credit crunch and the subsequent recession have had such a profound effect on the economy it is likely to lead to lower trend growth for many years ahead. On average GDP growth in the UK has been around 3% through the cycle but this is going to be difficult to achieve over the next decade given the level of debt in the private and public sector. The same is probably going to be true in the US and the graph below shows this. The cycle will be unusual in that it has been very deep but will not be followed by a sharp rebound as is usually the case after a severe recession due to its financial nature. It seems reasonable to assume that GDP growth over the next 5-10 years in the UK will be nearer 2% rather than the normal 3%.

An Unusual Recovery



Note: Peak growth is expected to be 3.8% over the four quarters to Q3 2010 (forecasts by Dick Berner and Dave Greenlaw).
Source: BEA; Morgan Stanley Research

Although earnings growth will be less affected, because so much of the corporate sector's earnings come from overseas, the concerns over the size of the budget deficit and how and when it will be reduced, with the inevitable impact on the rate of economic growth, will raise the equity risk premium (i.e. investors will demand a higher premium for investing in equities versus risk free bonds in such an uncertain environment). Therefore, there is still more upside to come from further company earnings upgrades, especially if sterling remains under pressure. While an improvement in the rating of the market is unlikely, it is usually the case that in a bull market equities overshoot on the upside just as they overshoot on the downside in a bear market. Together, these may provide another 20% (10% for higher earnings and 10% for an overshoot) upside from current levels.

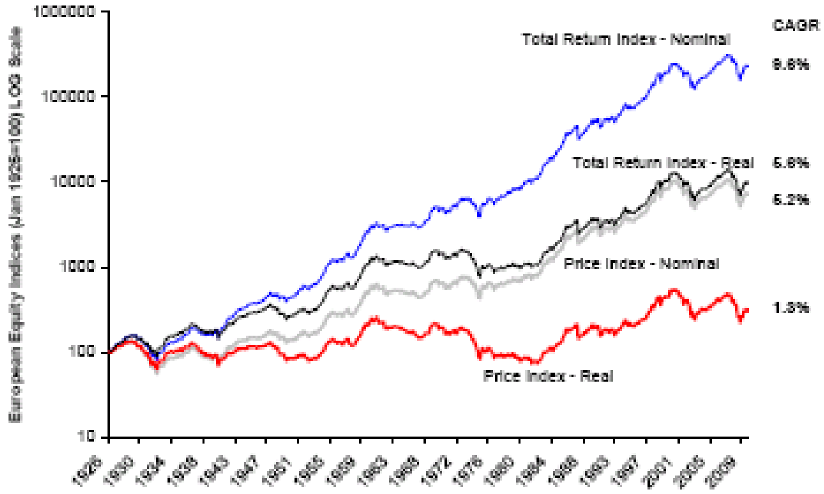
Equity markets will also be given support by dividend growth, especially as we are in a low return environment and likely to remain so for some time. The table below shows how much dividends contribute to total return, a factor that is often overlooked as investors have become increasingly short term and the average holding periods of shares has steadily fallen. It is estimated that dividend payouts fell 17.2% and 21.3% in 2008 and 2009 respectively, but with companies now having reduced the level of dividends they are forecast to rise again this year by over 6%. The yield on the FTSE All-Share Index is around 3.3%, not far short of the benchmark gilt, and there are plenty of good quality companies with higher yields than gilts that are also increasing dividends.

IBES			
	DPS	EPS	Payout ratio
2006			
2007			
2008	-17.2%	-16.4%	44.0%
2009	-21.3%	-39.2%	57.0%
2010	6.6%	33.3%	45.6%
2011	10.4%	24.5%	40.5%
2012	12.6%	12.9%	40.4%

Source: CSFB

Do not forget about the long term effect on total return by reinvesting the proceeds from dividends. As the chart below illustrates, over 50% of total returns in the long run comes from dividend income and now that companies are increasing payouts again it is a good time to invest with the overall environment in other asset classes still offering meagre returns.

In the long-run (reinvested) dividends boost equity returns by around 4%



Source: Global Financial Data, Datastream, Morgan Stanley Research

Summary
The correction the market underwent in January was a response to several factors that unsettled investors at the time and led to a large rise in risk aversion after a confident start to the year. In particular, the sovereign debt crisis centred on southern European countries, and in which the UK itself has become embroiled, evoked memories of the collapse of Lehman's, an event that most market participants thought would never happen. The analysis above takes the view that the concerns are insufficient to undermine the bull market and the correction we saw was a healthy pullback in a longer term uptrend.

The market is, however, already at fair value. Equities are unlikely to trade at the levels they enjoyed in the late 1980s and 90s because of the inferior composition of quoted companies as well as the after effects of the financial crisis that will result in many years of sub par growth for the UK economy. Nevertheless, company performance is still on an improving trend and with so much of the UK's profits coming from overseas the stock market's earnings should grow much faster than UK GDP. This will provide more upside from current levels together with the usual exuberance in the latter stages of a bull market that leads to it over-shooting fair value.

Ted Scott
March 2010