Ted Scott on the wire

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The Market hits new highs – So where now?
(Do the technical indicators support the fundamentals?)

Summary

- Charts offer bullish signals
- Weaker sterling is correlated with a strong equity markets
- Current bull run is short by historical standards
- M&A activity could be on the rise
- Inflation concerns likely to be a drag on any increase in the market's PE

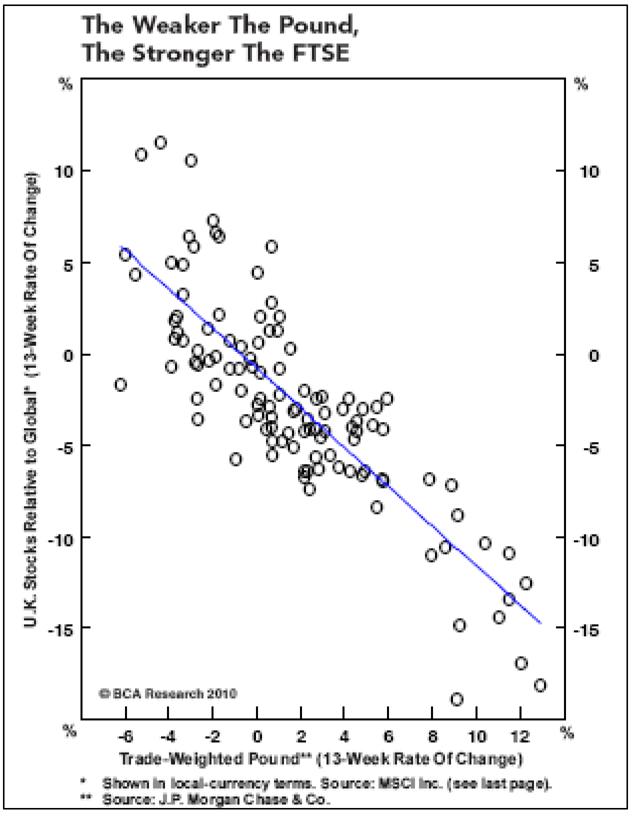
Technical Indicators of the market

The previous note looked at the fundamental factors driving the market and concluded that we are still in a bull market but the upside is limited by valuation, reflecting the severity of the recession. It is also worth looking at some technical indicators via charts to see if they are supportive of this view. Below are a few recent graphs that I have selected to illustrate some points:

This first chart is similar to the chart of the UK FTSE All-Share Index in the earlier note and the two should be compared and contrasted. Both charts show an inverted head and shoulders forming the base of the market from around November 2008 (the first shoulder) to July 2009 (the second shoulder) and then moving into the bull market uptrend. As for the UK, the US market has bounced convincingly following corrections in July last year and January this year to reaffirm its up trend. This means, as the chart shows, the advance/decline line makes new highs, also a bullish signal.

Source: BCA Research

The next chart looks at the correlation between the weakness of sterling and the strength of the market. As the chart shows, there is a clear line of best fit that confirms that a weak pound tends to help the market. This is what has been happening recently and with so much of the market having revenues and earnings derived from overseas, especially the US, it has resulted in some decent upgrades. Furthermore, the FTSE 100 Index is unusual among international markets in that it is top heavy with a few mega-cap companies. These companies, such as HSBC, GSK, Shell, BP and Vodafone, are all major international earners. Therefore, ‘all things being equal’, these companies tend to well in periods of sterling weakness so lifting the overall market.



The following chart looks at the strong correlation between the growth in GDP and the direction of the equity market. The chart is for the US economy and market but the trend is the same for the UK. The US has been recovering faster than the UK with GDP growth of 5.7% in the fourth quarter of 2009 compared with 0.3% in the UK. However, the dynamics are similar in the two economies and as we usually lag the US. Hopefully, the UK will show a rise in GDP during the rest of the year, notwithstanding the issue of the government deficit.

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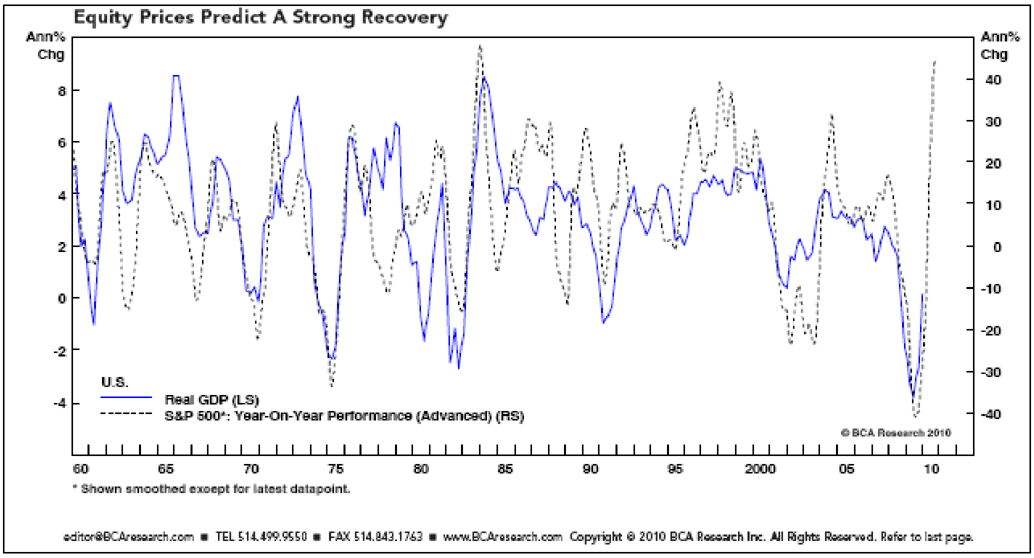
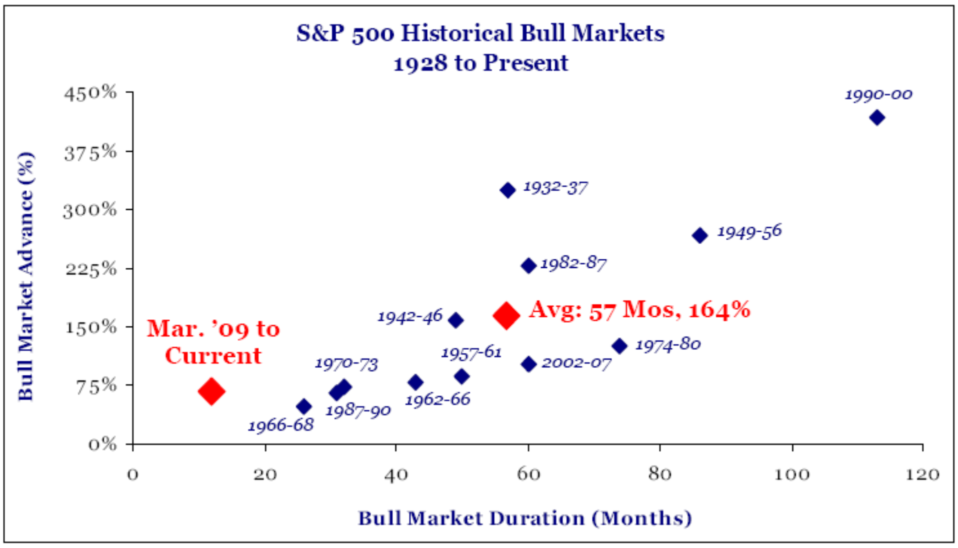
As the chart indicates, this should bode well for the market.



Source: BCA Research

The next chart compares the current and historic bull markets. Again, the data is from the US but the message can be read across to the UK as we have tended to have bull and bear markets at the same time. It looks at both the duration and the magnitude of the bull market.

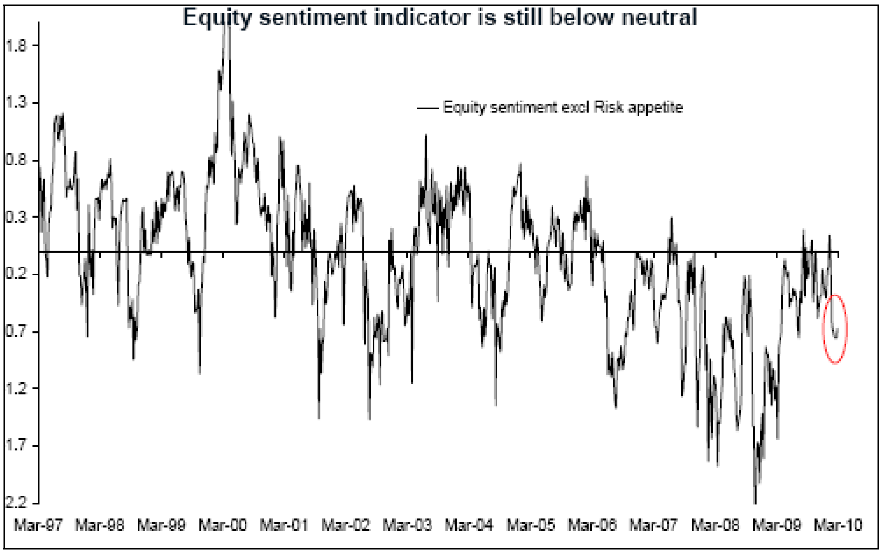
Some bears currently point to the fact that the market has moved a long way in a short space of time. However, as the chart makes clear, in an historical context the bull market could have a long way to go. What is more unusual about the current bull market is that it rose very quickly once it turned, but this partly reflects the depth of the recession preceding it and the fact the market had halved. Remember the FTSE 100 went on to peak at 7000 in December 1999 and it is still almost 20% below that level. Also, if the bull market were to end soon it would be easily the shortest one since 1928.



Source: Strategas Research

Usually, bull markets climb a wall of worry, particularly in their early stages. It is only in the final months of a bull market that euphoria takes over and takes the market beyond fair value, so providing a selling opportunity. The chart below is a measure of sentiment by Credit Suisse for the UK market and shows that although there has been considerable improvement since this time last year, when the market bottomed, it is still below the mean line. Compare that with the excessive optimism at the height of the dot com boom in late 1999 and early 2000 when the market attained its all time high.

The lack of positive sentiment, despite over a year of a bull market, is because of the financial nature of the deep recession that is still posing major challenges for the economy. The recent alarmism to do with sovereign debt is a good example of this and contributed to the first major correction for the bull market. As it is not an economically driven recession, the subsequent recovery will be different and more difficult than a normal recession. Therefore, sentiment is likely to remain mixed until recovery is assured and public finances are in better order. Although this could lead to volatile markets, it will be supportive of equities as the market continues to climb a wall of worry longer than is normally the case in a bull market.



Source: Credit Suisse

One ingredient notable for its absence in the bull market has been M&A activity. There has been some with the deal for Cadburys and a proposed takeover by the Prudential the most notable in the UK. However, as the chart below shows, the aggregate M&A whether by the number of deals or value, has been very low. This is not unusual in a recession and the chart shows that something similar occurred after the mild recession in 2000. Management need confidence that the economic cycle has turned and that their intended target has emerged from the downturn in a sufficiently robust state to still appear attractive to the predator. This is why few deals are done near the bottom of the market when prices are at their lowest. Also, if the deal involves paper or raising money it is easier to do it after the market has rallied.

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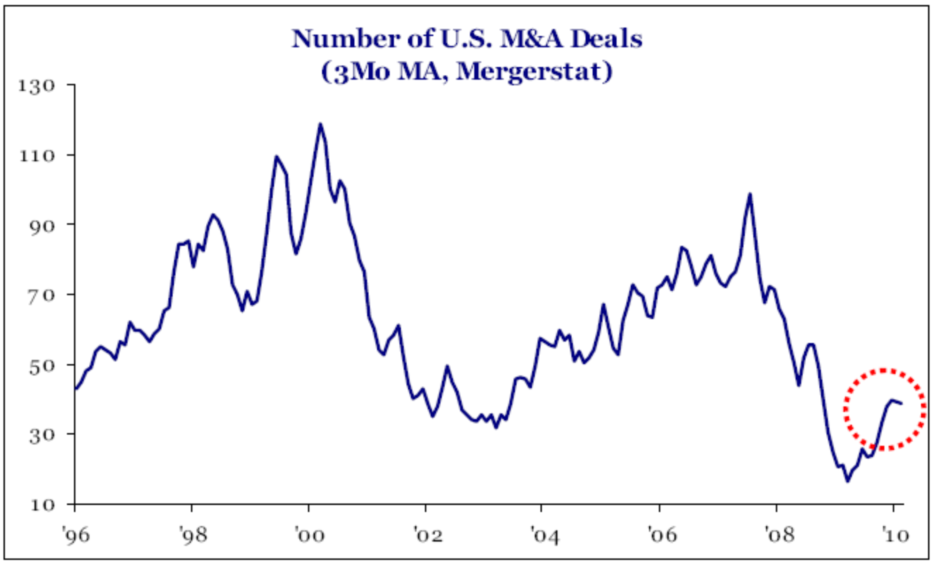
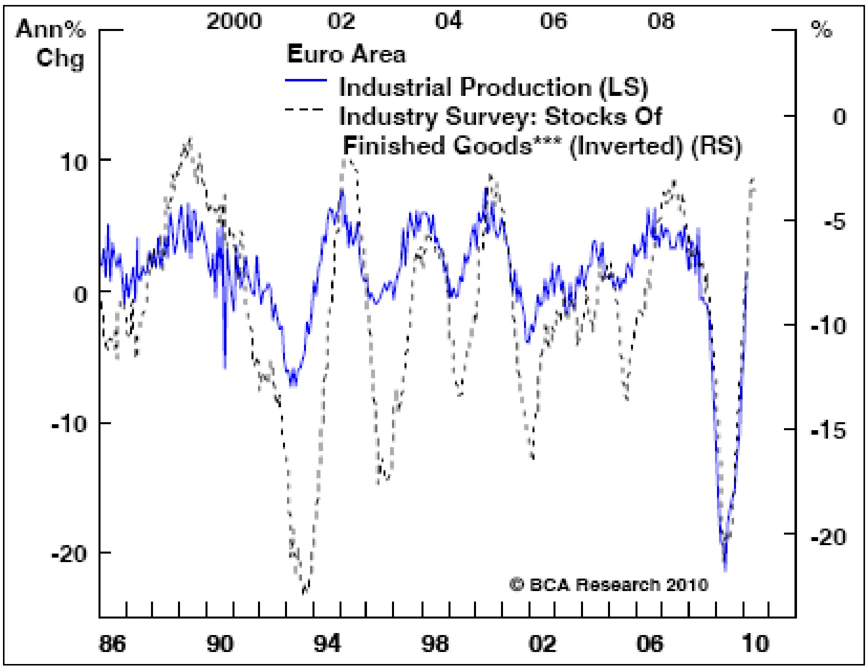
The recent upturn in M&A activity should point to a nascent recovery in deal making that will help underpin the equity market.



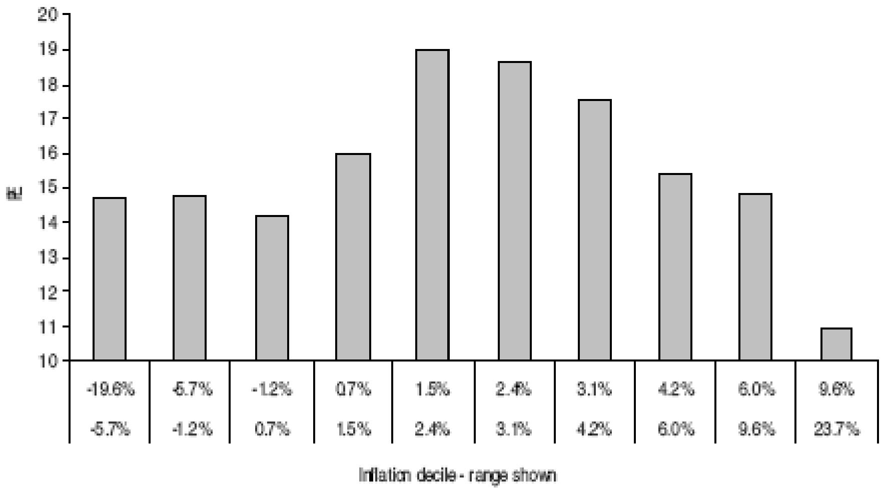
Source: Strategas Research

One reason why GDP growth has been so lacklustre in the UK and Europe has been the inventory cycle with companies being cautious about anticipating final demand and, therefore, carrying falling levels of stock. The destocking phase can only go on for so long and there are signs that it has turned, as the chart below shows. An increase in capital expenditure should create more jobs that will boost income and consumption and accelerate GDP growth. This in turn will be good for company profits and will help underpin the market.



In the first part of this note I contended that the UK market was unlikely to sustain a much higher price earnings ratio (PE) than its current level (around 12.5x). This is because of the different composition of stocks that make up the market now compared with the preceding decades; we currently have more slower-growing defensive stocks that merit lower earnings multiples. Secondly, the nature of the financial crisis is likely to mean that GDP growth in the near term will be below trend and the risk of policy error is higher. In particular, the market enjoyed a higher PE in the late 1980s and 1990s as inflation was brought under control and the chart below (for the US market that has always traded at a premium to the UK) shows that a low inflation rate, as long as it is not too low or negative (deflation) is associated with a higher valuation for the stock market. There are already signs that inflation is proving more difficult than the Bank of England anticipated to bring under control and as the chart shows, if it looks as if it may rise to 3% and beyond a further de-rating of equities is possible. The ideal rate commensurate with the highest rating for equities is between 2.5-3%, which is where we are at the moment. Any significant deviation from this is a risk for the market.

Figure 27: **Average P/E during periods of different inflation rates since 1871**



Source: © Datastream International Limited ALL RIGHTS RESERVED, Credit Suisse research

Arguably, even more of an influence on asset markets than the actual level of inflation is the expected rate. The chart below illustrates inflation expectations from the bond market for the UK and US; as can be seen early last year there was virtually no inflation expected and deflation was widely feared. Quantitative Easing and other policy measures helped dispel that fear and since then inflation expectations have risen to levels approaching those before the crisis.

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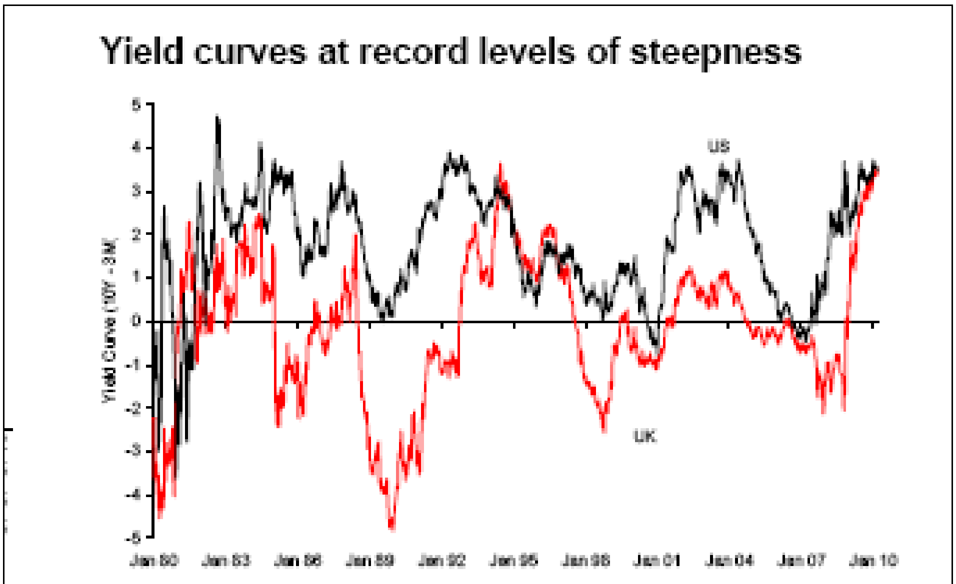
At these levels (2-3%), it has helped the market to recover as it reflects higher confidence in the economy but, as pointed out above, if expectations were to rise much above 3% there is a danger the market valuation could be de-rated.

Source: Datastream, Morgan Stanley Research

Often the end of a bull market is brought about by a rise in short term bond yields as the gilt market anticipates a tightening in monetary policy. Equities have been in a sweet spot for several months as the economy is slowly improving and company earnings are being upgraded while at the same time monetary policy has remained very loose. Indeed, interest rates have been at record lows for a long time and, as the chart shows, the market does not expect them to rise in the near future. This means the yield curve is steep because short term bond yields are much lower than longer-dated yields. This continues to be supportive of the equity market.



Source: DataStream, Morgan Stanley Research

Conclusions

The charts above support the thesis set out in the first part of this note that looked at whether the bull market could be sustained and what valuation was fair, given the economic and financial environment we find ourselves in. Technically the charts point to a bullish breakout for equities although the market is becoming a bit overbought (a lack of new buyers coming into the market and existing buyers have what they want) in the short term. The charts on inflation also highlight the risks and illustrate that the upside is limited by a lower valuation that could be attributed to equities compared to that of recent history, where inflation seemed to be under greater control.

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