Ted Scott on the wire

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A Possible Breakout for Equities:
The balance of risks to market expectations has improved

Summary

- **A change in market view**
- **Technical support**
- **Fear of double-dip overplayed**
- **Inflation/Deflation expectations improving**
- **Valuations are supportive**
- **Credits spreads remain tight**
- **M&A activity on the up**

Introduction

In April this year, I became cautious of the market for two significant reasons. The first source of concern was the escalation of the European sovereign debt crisis. Bond yields in Greece had spiked up as early as January this year as rumours abounded that the country was effectively insolvent and could default on its debt. Confidence continued to be eroded in the euro sovereign bond markets and eventually culminated in the rescue packages for Greece itself (€110bn) and for the whole Eurozone (€750bn) in May. However, equities continued to rise until early June (see chart below) and hence my increased caution of the market around that time.

The second reason for my change of stance on the market was that I believed that bottom-up analyst earnings expectations had caught up with reality. Just as the rise in the market had been driven by several quarters of upgrades, I felt there was a risk of disappointment as the earnings upgrade cycle peaked. Over the summer, there were increasing signs that the US was not experiencing the V-shaped recovery that many buy-side strategists had expected earlier in the year.

To some extent, companies have been and will continue to be able to defy the slowdown of the broader economy by becoming more efficient and improving margins and Return on Equity (ROE), but it was becoming apparent that the leading economic indicators were rolling over and the period of rapid earnings improvement was ending. Outside the US, several other economies were also slowing, partly due to the implementation of austerity programmes following the sovereign debt crisis and even emerging economies, including China (now the second largest economy in the world) were decelerating. The corollary of all this was, in my view, that the risk to earnings was on the downside for 2011 and as we approached the period of the year when the market starts to factor in expectations for next year, I felt equities would be vulnerable as analysts were forced to downgrade.

During the summer months, the market did sell off, signalling the end of the bull market that started in March last year. Following the failure of the massive combined EU and IMF aid agreement to appease the markets, equities fell sharply in June and it seemed possible that we could have a repeat of the panic that ensued following the demise of Lehman Brothers in September 2008. Also, the US economy, and especially its housing market, revealed signs of a marked slowing down that raised fears of a double dip recession.

In the event, the equity market has recovered its poise, helped by a stress test for 91 European banks that increased confidence in the fragile financial sector and, latterly, economic data from the US that allayed fears of another recession. Despite this, the equity market was still characterised by low volumes and a lack of direction compared to earlier in the year and remained locked within a tight range. I now believe, however, that the market could break out in an upward direction and, therefore, I have made a tactical change in my outlook for the market for reasons that are discussed below.

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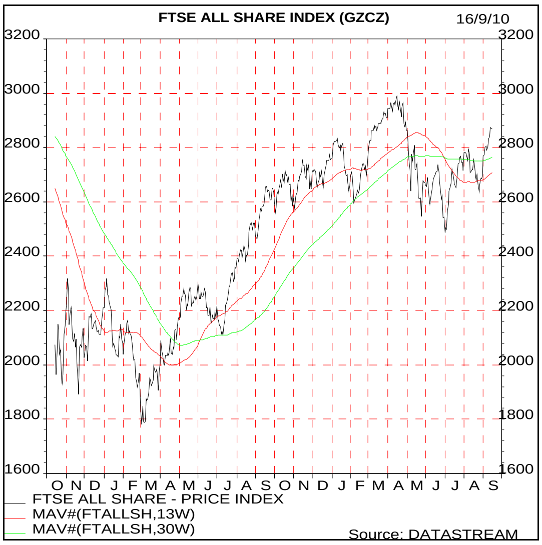
Reasons for a more bullish view

1. Technical support

The UK market has been range bound for a year now. Using the semantics of chartists the market formed a classic head and shoulders. Following the 'head' in April and May, the market has been forming the second shoulder as the chart shows.



As can be seen, there was a false breakout in June/July when the market fell sharply at the height of fears regarding the sovereign debt crisis. Since then, bond markets have soared as investors have fretted about the possibility of a double-dip recession and even deflation. Although there was a further wobble in the market in August, equities have been resilient and in the last few weeks have climbed a wall of worry towards the top end of the trading range.

From a technical point of view it will be positive for the market if the FTSE 100 Index can hold above 5,500, in which case I would expect it to run up to the next level of resistance of around 5,850.

2. Fears of a double-dip and deflation overplayed

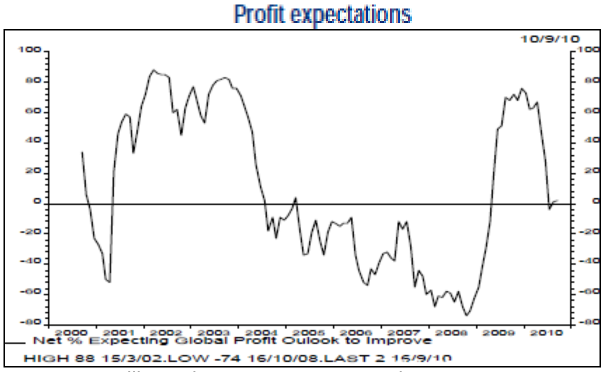
During the summer, against the backdrop of the euro sovereign debt crisis, the yield on government bonds of safer haven countries (including the UK, US and Germany) fell dramatically. This also contrasted with the rising bond yields of the periphery countries in the Eurozone.

The explanation for the strength of bonds was partly an increase in risk aversion resulting from the sovereign debt crisis and latterly, renewed fears of a global slowdown and deflation.

The phrase 'double dip recession' that had barely been mentioned in the early months of the year returned to the investment community's lexicon and the pessimistic sentiment contrasted sharply with the optimism of earlier in the year when the consensus believed in a sustainable V shaped recovery. The main reason for the increased caution was a series of poor data from the US, which is still by far the world's biggest economy. In particular, the housing market regressed as the stimulus of tax credit was withdrawn and unemployment remained stubbornly high at around 10%.

Despite the soft data, the ensuing slowdown was never suggestive of a double-dip recession. The move in bond market yields has spooked investors into thinking the economy was in worse trouble than it is, and with expectations having fallen so low the most recent readings of the important Institute of Supply Management (ISM) and non-farm payrolls provided some reassurance.

Profit expectations



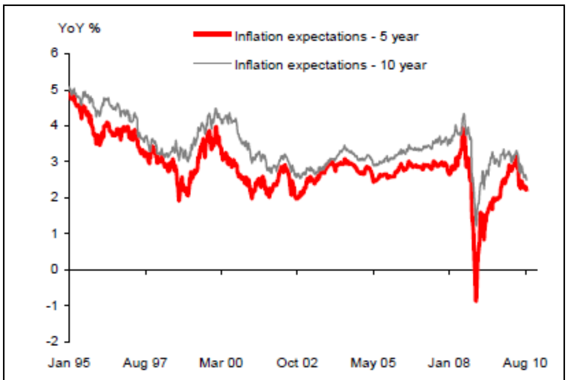
Source: Merrill Lynch: FM Survey September 2010

In forecasting the direction of the market one has to take into consideration what expectations are factored in. The famous analogy is Keynes' beauty contest where the successful judge does not pick the prettiest girl but the one he thinks everyone else believes to be the prettiest. In this respect, there has been a sea change in expectations since I became bearish on the market in April. The prevailing sentiment, especially among the buy-side and the media, was one of excessive caution and in the last few months there has been a steady flow of money selling equities and reinvesting in bonds. For this reason, newsflow that did not corroborate these bearish expectations was likely to be met with a positive response by the equity market. As I still do not think that a double-dip recession or deflation is likely, I think the balance of expectations is on the upside for the market in the short-term. This is the most significant reason why the market could have a run despite the continuing global economic uncertainty.

F&C Investments

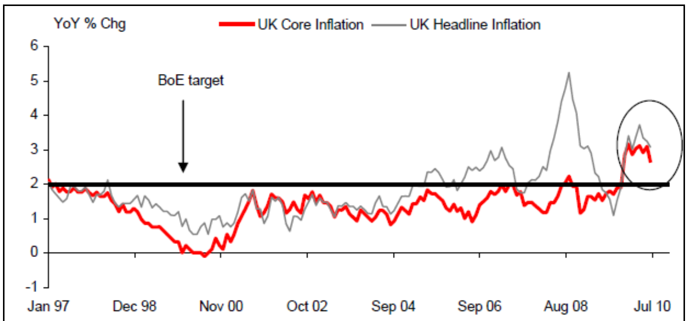
3. Inflation expectations

As mentioned above, while yields in the bond market declined so did the expected rate of inflation, as implied by the breakeven rate that reflects the difference between the inflation linked and nominal bond yields. For the UK, the breakeven rate of inflation fell to 2.4% at its low in late August and in the US it was even lower. Although this is still some way from deflation the direction of the move in inflationary expectations had been inexorably downwards.



Source: Datastream, Macquarie Research, September 2010

For the equity market the prospect of very low inflation or deflation is bearish. There is a strong correlation between the rate of inflation and the valuation of the market and just as an inflation rate that is too high and rising is a negative indicator, so the reverse is true. In the UK, the reported rate of inflation has been above the top end of the MPC's range of 1-3% (see chart below) in recent months so it may seem ironic that the market was becoming concerned about deflation. It is true that as the MPC had predicted, inflation was on a declining trend, but like the overwrought concerns about the prospects of a double-dip, the fears of deflation were also exaggerated.



Source: ONS, Macquarie Research, September 2010

Following the slightly improved data from the US in September and some reassuring growth figures for Q2 GDP from the UK, the yield on gilts has reversed somewhat and the breakeven rate of inflation has correspondingly risen to about 2.75%. Although this is a modest rise, it is directionally important and takes the rate of inflation back to a level that is consistent with a higher valuation for the market.

4. Valuation support

One of the reasons for my caution earlier in the year was that I felt that analysts' expectations were too high for 2011. The market had been driven by an upgrade cycle that began last summer and was still in evidence during the most recent results season. However, with leading economic indicators having definitely rolled over during the summer months, companies are going to find it more difficult to increase profits above expectations, despite the ability to enhance profit margins and improve ROE. Indeed, for some of the cyclical sectors such as mining, forecasts have come back as the US economy has faltered recently and this has contribute to the poor investor sentiment referred to above.

That said, the UK equity market remains on a modest valuation even if there are further downgrades, as I expect. Consensus earnings growth forecasts for the market in 2011 are around 20% that puts the market on a prospective Price Earnings ratio (PE) of just 9.5 x. Assuming that earnings come in with an increase of only 10% the market would still only be valued at 10.7x. This represents a modest figure compared to the recent past. In the 80s and 90s the market typically traded at a significant premium to the current PE and even though the valuation premium was more modest in the 2000s, equities have still suffered a severe de-rating since the credit crunch to leave the market on a rating not seen since the 1970s. I believe the de-rating is justified because of the extra risk inherent in holding equities. The high levels of private and government debt are likely to lead to a long period of below trend GDP growth and it will be reflected in reduced corporate profitability. The issue of sovereign debt default is likely to also remain relevant for a number years and provide a further cap on equity valuation.

I also think that the argument that equities look outstanding value against bonds is misleading. To be sure, to compare the dividend yield on equities with bonds gives a strong buy signal for shares based on the relationship between the two asset classes over the last few decades.

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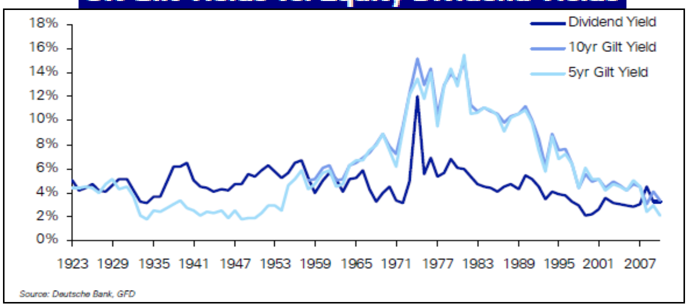
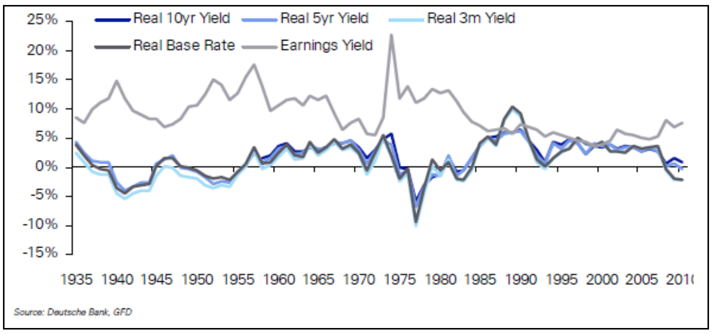
Recently, the yield on the FTA All-Share Index rose above the benchmark gilt yield and apart from a brief period in 2003 and 2008 this is the only time it has happened since 1959. On the two previous occasions it was a strong buy signal for equities as the yield gap in favour of equities was very short lived. However, it is likely the superior yield for equities will remain in place for longer now because of the de-rating of equities referred to above. Indeed, until 1959 the norm was for equities to yield more than bonds and following the cross over the reverse yield gap was established as pension funds switched out of bonds and into equities. This led to the cult of the equity in the last quarter of the 20th century that some commentators have recently argued has now ended. As pension funds have and are continuing to reverse the switch in asset classes it is probable that it will be reflected in the respective yields for bonds and equities.

UK Gilt Yields vs. Equity Dividend Yields



The earnings yield of the market appears even more attractive against bonds than the dividend yield. This is the inverse of the PE (prospectively about 10.5%) and obviously reflects the volatile component of earnings that is subject to the vagaries of the economic cycle. At present, the PE multiple has come down – and so the earnings yield has risen – and therefore the high earnings yield partly reflects the stage we have reached in the economic cycle after almost a year and a half of strong upgrades.

UK Real Fixed Income Yields and Equity Earnings Yield



Overall, the modest valuations of the equity market are justified by the more challenging environment for equities that is likely to remain for some years. However, they do provide a floor for the market and when I became more bearish in April I believed the downside for equities was fairly limited because of its historically low valuation. On the upside, the valuation will also be supportive of an improvement in sentiment as it becomes clearer that a double-dip recession and deflation is likely to be avoided.

5. Credit spreads remain tight

While the decline in bond yields may be suggestive of deteriorating economic prospects this has not been confirmed by a widening of credit spreads. In fact, the spreads on commercial paper have narrowed recently suggesting corporate default is becoming less and not more likely. Part of the reason is that the decline in government bond yields has meant there has been a scramble for yield in fixed interest investments elsewhere. However, there is also no doubt that the corporate risk of default is much lower than it was during the credit crunch itself as asset prices and the economy have recovered to some extent.

Source: ASR

It is also worth noting that Libor (the London Interbank interest rate) and the spread of TED (the forward US Treasury yield over the future Eurodollar rate of the same expiration) have fallen back recently. Both these are indicative of credit risk and if there was a short-term likelihood of renewed recession then it is highly likely that these indicators would have been rising. The fact that credit risk has fallen in recent weeks is supportive of a further run in the market.

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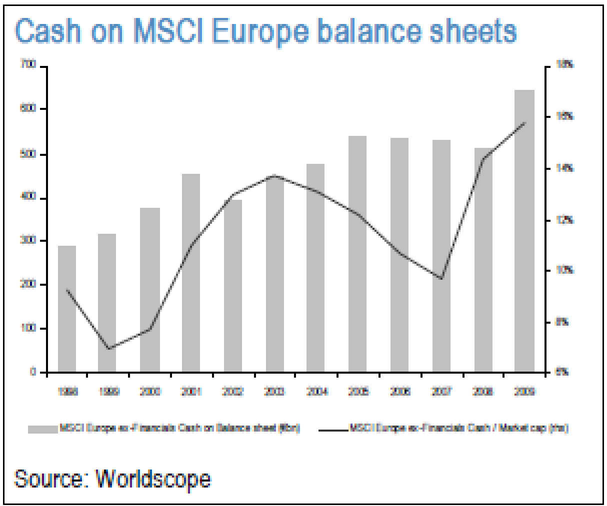
6. Increased M&A

Because the yield on cash or cash equivalents is so low at present, there is an incentive for corporates to invest liquid assets to achieve a superior ROE. Unlike the private or the government sectors, quoted companies have relatively strong balance sheets with above average cash to invest (see chart below showing cash on company balance sheets). There has been understandable reluctance to invest in capex and R&D given the uncertain economic outlook, but there is a strong argument to use the excess cash on balance sheets by mergers and acquisitions.



The recent upturn in M&A is, perhaps, indicative of a trend that has much longer to run and should continue to be a supportive factor for the market. There have already been some very large deals such as Intel's bid for McAfee and BHP Billiton's bid for Potash Corporation. Also, in the UK there have been several deals recently including bids for BSkyB, SSL, International Power and Tomkins.

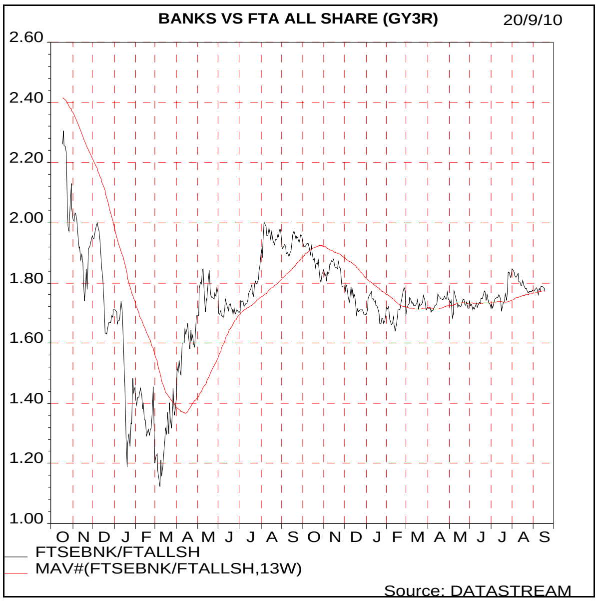
What sectors should do well in the above scenario?

This is a question that I will turn to in more depth in my next note when I consider what sectors and industries should do best given the global economic environment and the level of the market, discussed above. It will take into account the slowdown in the US, the sovereign debt crisis and the various austerity packages – including the UK of course – and the impact all this may have on growth and earnings.

For the moment, if the market (and it seems to be doing so) breaks out of the narrow range it has been trading in and moves up towards the next level of resistance, it is probable that the higher beta sectors and larger cap stocks will perform best.

Larger companies would be favoured as there would be a short-term scramble to invest liquidity in equities and they can be easily bought. More fundamentally, the higher beta sectors (i.e. those with the closest positive correlation to the direction of the market) would be preferred. The 2 obvious sectors are banks and miners.

Banks are dominated by HSBC in terms of size but it would lag the rest of the sector because of its defensive nature as well as a full rating compared to its history. Also, although it has the capacity to raise its dividend payment it only yields in line with the market after cutting it last year. HSBC has a relatively robust balance sheet and therefore will not benefit like others in the sector from the apparent leniency of the new regulations, especially the recent Basle III accord. Not only does this not prevent banks expanding the derivative assets that were the primary cause of the financial crisis, but also the implementation of the more stringent capital requirements are to be spread over many years. The UK banks, in comparison to most European banks, are relatively well capitalised in any case and with most institutions significantly underweight in the domestic bank sector they should enjoy a good run if the market runs up. The graph below the sector has marked time and while I would not expect a bull run equivalent to early 2009, it could break out of its recent narrow range, notwithstanding the dominance of HSBC.



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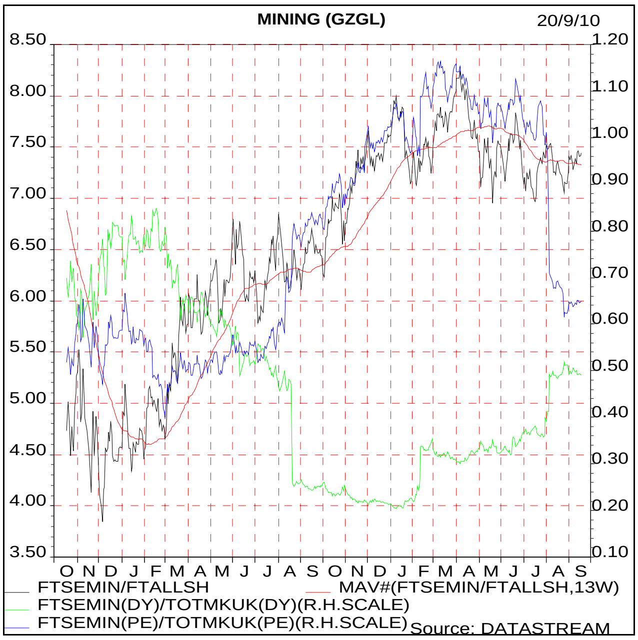
The **mining** sector remains volatile but has been trading sideways (see graph below) against the market for several months, reflecting the uncertainty of the global economic outlook. Unlike most other cyclical sectors, the valuation of the miners fully reflects an economic slowdown and given their exposure to the faster growing emerging markets, and China in particular, these fears are exaggerated. The blue line in the graph shows the relative PE ratio to the market and at less than 70% the sector is clearly discounting a large fall in relative earnings. I have written before that I believe that China will not suffer a hard landing and more recent data has corroborated that belief.



Furthermore, the industry remains disciplined with an absence of excessive capital investment following the caveat to the companies from the recent recession. Supply remains tight and demand is still robust for most metals and minerals and coupled with stronger balance sheets following the capital raising exercises and cut dividends, the sector is an attractive play on a rising equity market. One final point is that the threat of a swingeing tax by the Australian government has been diluted by the closely fought election that reduced the prime minister's and her party's power base. The sector is more widely owned than banks but it not one of the 'loved' sectors of the market.

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