

Strategy Matters

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The outlook for equity markets

Does the poor start to the year for equity markets presage a bear market, or will prices recover as the year progresses?

A bad start to 2008

The New Year has started very badly for global equity markets. In the first ten trading days of the year, global markets – as measured by the MSCI All Countries World Index – fell by over 6%. This is their worst start to a year for decades.

Equity markets have two main worries: the possibility of a US recession and the scale of losses being racked up by financial institutions because of their exposure to US sub-prime mortgages and the complex range of financial instruments that were built on the back of such mortgages.

Losses in the financial sector

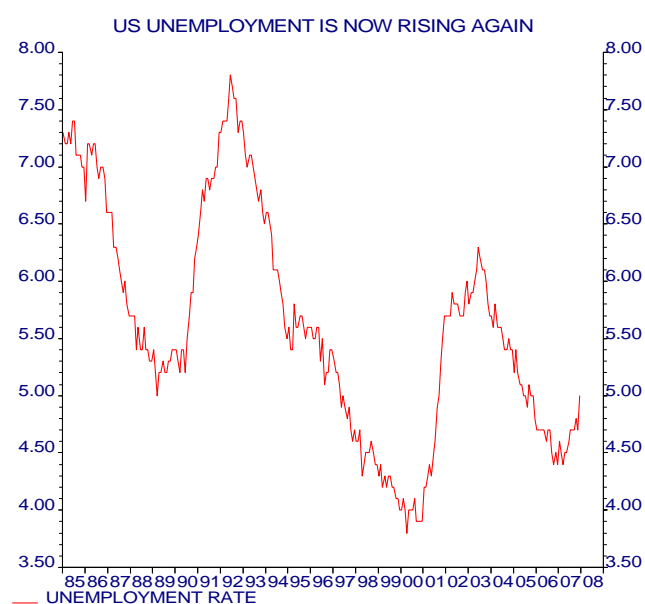
It is very difficult to gauge the ultimate scale of these losses. Already this year, Citibank has announced a massive \$18 billion write-down of the value of its sub-prime mortgage investments. Other banks may follow suit and it could be several months before we know the full scale of their losses. At best, this means that equity markets are likely to remain volatile throughout the first half of the year. But if the losses continue to exceed expectations, this news alone could drive them lower.

Over the full year, the direction of equity markets is likely to be determined by whether the US economy goes into recession, and how the rest of the world reacts if it does.

The US economic outlook

The outlook for the US economy does not look good. Recent data releases have shown falls in consumer and business confidence, disappointing retail sales and a rise in unemployment to 5%. Employment growth has dropped to just 1%, which in the past has been a reliable signal of an impending recession.

During 2007, the US economy avoided recession because consumers managed to increase their spending at a healthy pace despite falling house prices. They were able to do so because income growth was strong and unemployment remained low for most of the year. Most households believed their jobs were safe, so they continued to spend, and companies believed that consumers would continue to spend, so they did not cut back on their workforces.



Source: DATASTREAM

Source: Thompson Datastream

The recent increase in unemployment may, though, have brought us close to the point where consumer spending weakens. Households might have shrugged off falling house prices, but it will not prove so easy to ignore weaker income growth, rising unemployment and the higher energy and gasoline costs associated with the oil price at close to \$100 a barrel.

The odds, therefore, are tilting in favour of the US economy experiencing a recession in 2008.

The US is still the world's largest economy. If it goes into a recession in 2008, there will be a substantial slowdown in economic growth in the rest of the world. This is not just due to trade links with the US. It will also be because the factors that are combining to weight down on US economic activity – higher interest rates, reduced credit availability and record oil prices – will also have an impact in Europe, Asia and Latin America.

Implications for equity markets

Investors need to be careful in such an environment. Equity markets appear to offer good value, especially in relation to bonds, but profit margins globally are at very elevated levels and valuation measures, such as price-to-earnings ratios may be misleading.

If the global economy experiences a sharp slowdown in 2008, then we can expect to see margins return to more normal levels. This would involve sizeable downgrades to earnings expectations. It is quite possible that the level of earnings will fall for the first time since 2002. It is hard to believe that equity markets could produce positive returns in such an environment.

The most likely outcome, therefore, at least for the next few months, is that the US economic outlook continues to deteriorate and the economy comes perilously close to recession. Given this outcome, global equities will struggle to advance in the first half of 2008. What happens in the second half of the year will then depend on the severity of any recession. If it turns out to be mild, equities might recover, perhaps quite strongly, in the second half on the hope of continued improvement in 2009. Alternatively, if the recession turns out to be a deep one, then we may be on the brink of a serious equity bear market. Only time will tell.

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Source: Thompson Datastream

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