

Strategy Matters

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The equity market sell-off

Equity markets have had a terrible start to 2008, culminating in major sell-offs on Monday and Tuesday of this week.

The underlying cause of these falls in equity markets is growing fears of a US economic recession. These have been increased by a run of weak economic releases in the US – most notably sharp drops in the ISM manufacturing index and in employment growth.

Although there have been no notable US data releases in the last few days, the more recent acceleration in the pace of equity market decline is probably attributable to increased fears about the depth and length of any US recession. This may be due to rumours about the possibility of further downgrades to US monolines (bond insurers). These rumours have again raised the possibility of an extended credit crunch in the US that will prove resistant even to aggressive further cuts in US interest rates.

There are also signs that any residual faith in the global “decoupling” argument is fading. Domestic cyclical stocks are performing poorly in Europe and commodity prices have fallen, suggesting global growth expectations are being downgraded. The US is, after all, still the world’s largest economy and if it is to experience a steep and/or long downturn, then it is unlikely that the rest of the world will be immune.

On most measures that investors use, equity markets now appear to offer good value (and excellent value when compared to government bonds). This may not, though, be enough to prevent further falls.

First, any serious recession would cause large falls in corporate earnings, changing the valuation picture significantly for the worse. Second, markets are clearly being driven by momentum and news flow, not valuation.

That does not mean that markets cannot rebound in the short-term – if there is some positive news to lift them. The best hope appears to be action by central banks. A 50bp cut in US interest rates at the next FOMC meeting (announcement due on 30th January) is now the minimum requirement, and more may be needed. A cut in European rates would probably have a big impact because it would represent a change of direction for the ECB.

There is also talk of a fiscal stimulus in the US, though markets in the last two days have appeared totally indifferent to President Bush’s announcement on the subject at the end of last week. Investors are sceptical about the ability of the authorities in the US to deliver a big enough package in a timely manner.

Looking back over the last fifty years, equity markets have fallen in January about one year in every four or five, on average (though 2008 is shaping up to be one of the worst, if not the worst, January’s on record). On more than half of these occasions, they ended the year higher, recovering the losses in January and more. When this was not the case, it was because of an economic crisis – usually a recession.

It is still possible, therefore, to believe that equity markets might make some gains in 2008, if the US economy can avoid recession. That, though, is now looking like a very close run thing. About the only thing we can be sure of is that equity markets will be very volatile in coming months.

To repeat the summary of a note we sent out last week:

“If [the US recession] turns out to be mild, equities might recover, perhaps quite strongly, in the second half [of 2008] 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.”

This week investors are behaving as if the odds have tilted towards a deep recession.

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