

Strategy Matters

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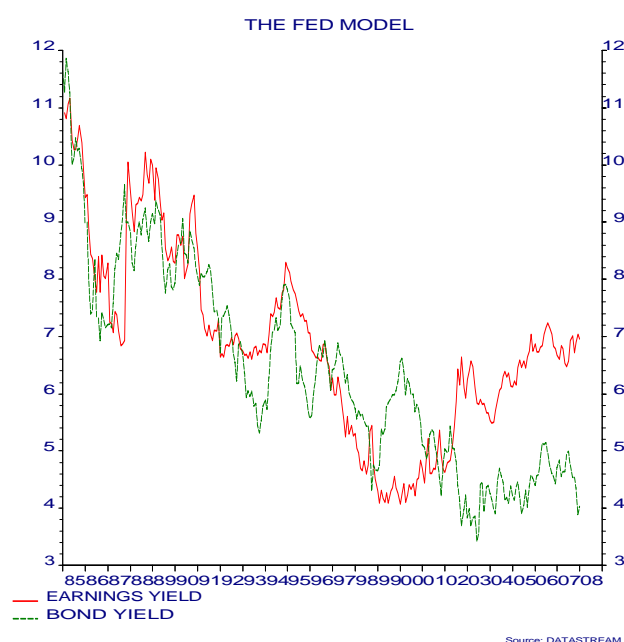
Is a recession priced into equity markets?

It has become increasingly common in the last few days to read that a US recession has been fully priced into equity markets. I do not believe this to be true.

Proponents of this view have two arguments. First, equity markets have fallen by around 15% from their peaks (and at one point last week were down by 20%). Second, equity markets are cheap.

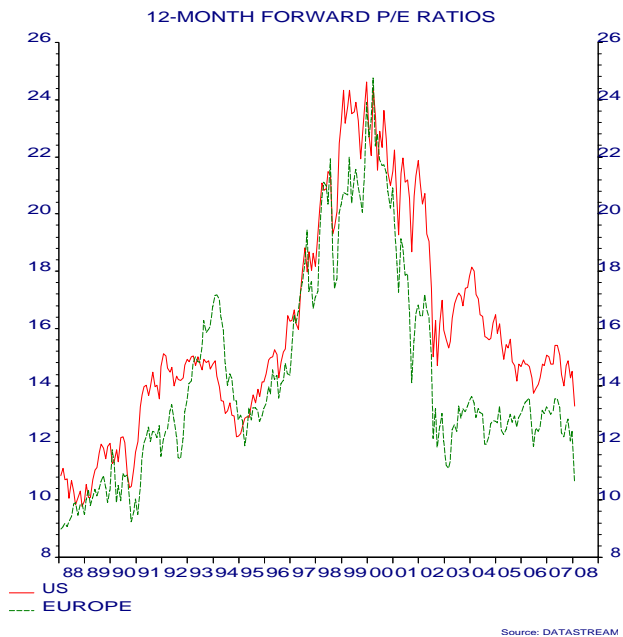
The first argument can be quickly dismissed. It is largely based on experience in 1998, when the peak-to-trough fall in the S&P 500 was 19%, and in 1990, when it was 20%. But the US economy did not go into recession in 1998 – it was just a growth scare. And in 1990 equity markets found a floor when the oil price, which had risen from around \$15 to \$40 a barrel when Iraq invaded Kuwait, fell back quickly to around \$25. They also benefited from evidence that US core inflation pressures were rapidly diminishing, allowing bond yields to decline. Remember at this point the favourite method for valuing equities was the ‘Fed model’, which hypothesised a relationship between equity and bond yields. So lower bond yields tended to lead to lower equity yields.

Very few analysts now value equities by reference to bond yields, not least because the ‘Fed model’ relationship no longer holds. The correlation between the equity earnings yield and the bond yield in the US broke down in 1998 and has never returned.



It is also worth noting that the US equity market has never bottomed out in the early months of a recession, so if there is a recession, in 2008 the low for equities is likely to be still ahead of us. The counter-argument is that the Federal Reserve has never cut interest rates so aggressively as early in the cycle as it has done this time around. All of which just goes to show that the past is likely to be an imperfect guide to the present.

For the last few years, the best measure of valuation in equity markets has been the price/earning ratio based on 12-month forward earnings, if only for the pragmatic reason that markets, especially in Europe appeared to be trading in ranges based on this measure. On the basis of 12-month forward earnings, equities look cheap and a recession is, arguably, in the price.



However, the level of earnings has risen well above its trend in recent years, profit margins are at 40 year highs and that there is a risk that investors will start to look at valuation measures based on trend earnings.



This point may have been reached because earnings are coming under threat. If the US economy goes into recession, earnings will disappoint significantly (analysts are looking for around 17% growth in US EPS in 2008 and 13% excluding financials). Despite the fall in markets in recent weeks, the US market still looks expensive relative to trend earnings.

Therefore, there is scope for equity markets to fall further if the US economic news continues to deteriorate.

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