Where's the equity market heading?

Georgina Taylor, Equity Strategist at Legal & General Investment Management, shares her view on whether those ubiquitous green shoots will grow into a sustainable recovery in both economic growth and equity markets.

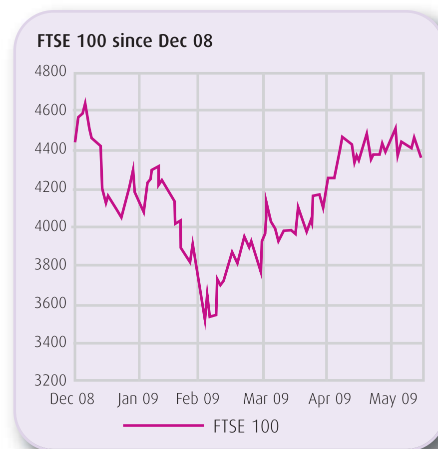
Great Expectations

Global equity markets have rallied significantly since early March. The FTSE 100 is now 23% higher and US equities are up an impressive 35%. So is this the start of a new bull market or is this just another bear market rally with more turmoil to come for equity investors?

There are fundamental reasons why equities have rallied over the past few months. Since the financial and economic turmoil began back in mid-2007, equity markets have experienced short-term rallies off the back of changes in sentiment and risk appetite, and news flow surrounding the banks sector. However, this time around there has been an improvement in underlying macro fundamentals which has led equity prices higher in anticipation of a turn in the global economic cycle.

Equity markets are driven primarily by expectations. Over the past two years, both economic and profits expectations have been revised down dramatically. For example, at the beginning of this year consensus expected just a 5% fall in profits growth for UK companies in 2009, consensus now expects a 32% fall. Last year and during the earlier part of this year these downgrades to expectations drove equity prices lower and meant continued uncertainty as to how to value equities and when to start to price in a rise in profits driven by an improvement in underlying economic growth.

Equity markets tend to move higher about six months before the economy starts to recover. There is a general expectation that economic growth will start to improve towards the end of this year and therefore a rise in equity prices since early March does make sense. There have been a number of key economic indicators which have suggested the green shoots of economic recovery. We would focus on a select number of indicators.



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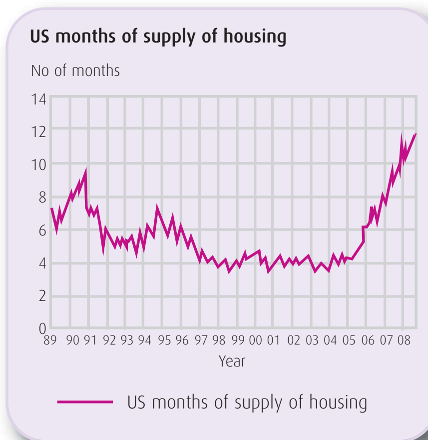

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Signposts to recovery

A major global inventory cycle is behind the recent improvement in economic data. As demand collapsed last year, firms were initially slow to react and stocks of unsold goods increased. Companies then responded by cutting production in excess of the fall in demand. This has led to aggressive inventory liquidation in the first quarter of this year. With inventories now becoming better aligned with the level of sales, firms have started to resume production. Global trade has stabilized and business surveys have begun to improve. As the inventory cycle turns, it should mean that fewer jobs need to be shed.

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The US housing market is critical for a sustained global economic recovery. US housing problems were at the epicentre of the credit crisis, taking us into the current economic downturn and we believe they will be a significant contributor to pulling us out. The US housing market is beginning to show signs of improvement as the months of supply of unsold homes data has started to fall and we expect US house prices to start to stabilise towards the end of this year. This is important for the banks because if asset prices start to stabilise, losses can be quantified and both investors and the financial sector can start to take a view on the future.

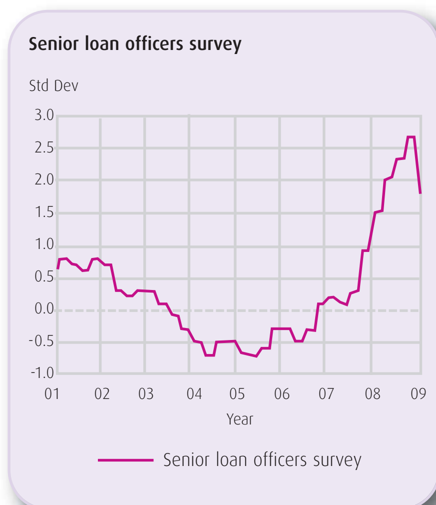
Georgina Taylor

Equity Strategist, Legal & General Investment Management (LGIM)

Georgina Taylor is the Equity Strategist within the Asset Allocation team, led by David North. She joined LGIM in September 2008 after four years at Goldman Sachs where she was a European Equity Strategist. Georgina has eight years of investment management experience and graduated from the University of Bath in 2000 with a BSc in Economics.

Credit where credit is due

Credit conditions are also incredibly important. If consumers and companies cannot borrow, the economic recovery will be significantly hindered. Therefore we look at both the cost and availability of credit to assess the sustainability of the economic recovery. Credit spreads have started to tighten which is good news for the cost of borrowing, but spreads remain wide by historical measures. The US Senior Loan Officers Survey gives a good indication of how tight credit conditions are and this survey has started to reflect an easing of credit conditions in the past couple of months.



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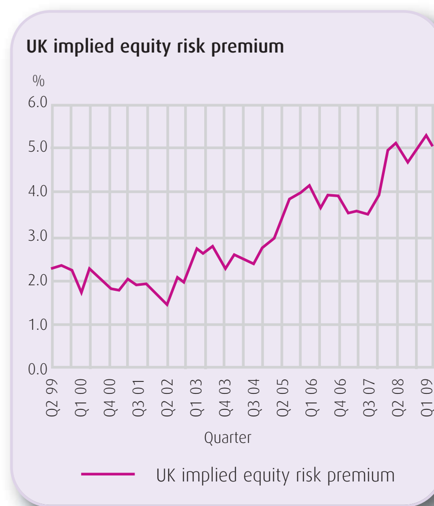

Source: LGIM

Managing expectations

As mentioned above, over the past two years economic and profits expectations have been downgraded significantly. However, in the past few months, as economic indicators have started to suggest signs of economic recovery, economic and profits expectations have gradually started to be revised upwards which has supported equity prices. For equity prices to continue on an upward trajectory, economic growth needs to pick up and stabilise in order for profits to start to meaningfully recover.

Unfortunately this is where the risk for equities now lies. Our own economic forecasts suggest the global economy will start to recover towards the end of this year–which is a positive for equities near-term. However we believe that when it does occur the eventual economic recovery will be very gradual and economic growth will remain below trend at least during 2010 which will be a negative drag on future profits growth. We believe equity markets are now in a transition phase, where future gains hinge on whether these positive economic data surprises cause investors to over-react and become too optimistic on the global economic outlook, and therefore face another round of disappointment as demand remains weak for a prolonged period of time.

The key inputs for valuing equities are (i) a profits forecast for 2009 and 2010, (ii) the discount rate based on the bond yield and the equity risk premium and (iii) an estimate for long-run potential profits growth. Changing any of these underlying assumptions significantly alters the view on where equities should currently be trading. For example, the current implied risk premium remains elevated which has a detrimental effect on the current fair value of equities.

Our central case for equities based on our own economic projections (as at 12 June) where growth starts to recover but remains below trend in 2010, suggests there is still some upside of around 5-10% for UK equities. A more typical cyclical recovery, where economic growth returns to trend next year, would support a further 30% rally in equity markets. However a deflationary scenario where economic growth remains weaker for longer than we currently expect would support a 35% fall in the UK equity market. As the market continually re-prices the risks surrounding the strength of the cyclical recovery and risk appetite also changes, equity markets will continue to be volatile leading to some weakness later on this year, in our view. More evidence is needed that the economic green shoots discussed above are improving enough to drive a sustainable recovery in economic growth and ultimately equity markets.

The views expressed in this article are those of Georgina Taylor of LGIM.