Investment Note

May 2009

The Economy Will Recover

But will it be a V, U, or W shaped?

What are equity markets telling us about the state of the global economy since bottoming in early March? Technically, the scale of the recovery in equity indices, over 25%, has led to headlines declaring the end of the bear market. If we look at the causal historical link, equities have tended to discount economic indicators by something like 9 months in advance. If this were to hold true this time, it would appear that the market is telling us that an economic recovery could be beyond any doubt by the end of 2009. Whilst everyone would acknowledge that the absolute state of the economy is universally bad, it is certainly true that some economic indicators appear to have bottomed or, at the very least, the rate of decline is slowing. It is this 'second derivative' of the data that is the source of debate in the market and media. The bulls argue that the turn in the data coincides with the turn in the stock market and, therefore, this rally is different from the short rallies in April and December last year when both the economy and the stock market were doomed to fall further still.

A 'V' Shaped Recovery?

As stock markets fell around the world, the combined efforts of central banks and Governments saw unprecedented levels of intervention to cut interest rates and provide financial assistance to break the deadlock in credit markets. However, a return to any notion of normality will not be a simple unwinding of these measures in reverse and, as such, the `V' shaped recovery in equities, is unlikely to be matched by measures of economic health. Firstly, the level that equities sold off to was so low in absolute terms that talk of shares in valuation terms became increasingly meaningless, particularly in the financial sector. A bank share trading on 3x price/earnings ratio is so far from a normal level around 12x as to be not much more than a binary bet on its survival from bankruptcy or nationalisation. Other sectors suffered from indiscriminate selling albeit not to the same extent, as money flowed out of equities as an asset class en masse. The price of crude followed the negative consumer confidence down until it reached US $50 per barrel. In a sense, a sharp rebound from such poor sentiment required only the relative easing of bad news rather than confirmation of the much taunted green shoots of recovery.

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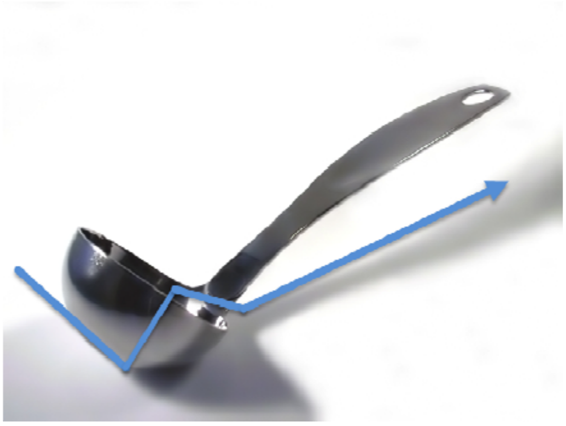
A ‘U’ Shaped Recovery?

Whilst the stock market may have bounced, confidence among the consumer, particularly in the USA remains low and the prospect of further job cuts is hampering consumption led recovery. Seasonally, this will vary according to the changes in the cost of living. Home fuel bills will fall whilst the need for credit and holiday spending will rise. In a perfect world, the changing behaviour patterns of the consumer would be perfectly matched by corresponding policy response from central banks and Government in the form of a normalisation of interest rates and the gradual re-introduction of higher taxes, respectively. However, this is a fragile state of affairs and vulnerable to external shocks, geopolitical, inflation or policy change. With stock markets, consumer confidence and central banks all focused on the short term, any confusion over the real state of company earnings, and hence the economy, resulting from a misalignment of indicators, could cause economy to fluctuate in short cycles even as the general health of the economy recovers. We may find ourselves at the top of a rally with the macro indicators having definitely turned. At that point, one might ask how much the market has factored in the turn and whether, proportionally speaking, there can be any upward surprises as things improve relative to expectations. In other words, "how much better can it get?”. Yes, the figures will have turned, or bottomed, but they will still be `bad' and a bit of profit taking will be no surprise and may serve as a reality check. It is hard to reconcile this complex and vulnerable scenario with a `U’ shaped recovery.

The ‘W’ or ‘Ladle’ Shaped Recovery



Rather, we believe that the prospect of a `W’ shaped recovery is the more realistic outcome and does not rule out a setback or two in equities along the way. Indeed, any number of unexpected geopolitical setbacks could be serious and knock the confidence of the bulls that may be very quick to take profits. Given that the financial collapse scenario that pushed stock markets into extremely oversold states will not return the expected pull back will be more modest and far from the lows reached in March. Investors will realise that many of the fundamental underpinning for the current rally (technical buying, printing of money, and PR spin campaigns from the banks) will not result in sharp and sustained economic growth. But rather as the lagging indicators (employment, GDP) start to stabilise we will witness a ‘W’ shaped recovery will a more elongated tail; a recovery we are referring to as a “Ladle” - shaped recovery.

How does this affect our investment decisions?

Firstly we are always methodical and unemotional when we make investment decisions; each of our portfolios is positioned for long-term capital appreciation, with lower volatility than the broader market. Unfortunately this may mean we witness short periods of modest underperformance, but

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more importantly will not participate so fully in any market decline, such as last year. We will therefore continue to maintain balanced and diversified portfolios able to perform in all market conditions.

As it became apparent that the worst of falls were over we reduced our sovereign fixed income exposure to bolster our directional equity exposure, leaving us in a strong position to make further focused investment within sectors that we believe are still highly undervalued.

The investment grade corporate bond market is certainly appealing, with spreads still far above normal levels, potentially unjustified given the improving financial position of the issuing companies. Additionally the global energy markets offer an unprecedented opportunity should our thesis of economic recovery materialise. Oil will not rally to $150 again, but $70 to $80 is looking increasingly feasible and would result in a massive boost for the sector.

We will, as always, be sending you more detailed notes on some of the opportunities we have identified and begin to exploit over the coming weeks.

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