

Investment Note

August 2009

Equity Market Rally

“Will there be a Sting in the Tail?”

Equity markets have rallied strongly since their mid-March lows on optimism that a global economic recovery is under way; however, in their fervour, are investors actually ignoring the underlying economic fundamentals? In this note we ask, “Will there be a sting in the tail for equity investors?”



The pace of equity market decline accelerated in February, with markets falling on fears that the global banking sector would collapse. The multi-billion £/\$ bail-out packages and quantitative easing programmes that followed in the UK, allayed these fears and some rationality returned to the markets. Since then, equity markets have surged, albeit with some volatility, to their current levels. The FTSE 100 index, for example, rose from 3,500 to 4,700, a rise of over 30% and one of the sharpest short-term rallies for many years.

But, what spurred this remarkable about-turn and, more importantly, what has sustained it?

The original relief after the global financial collapse had been averted was tangible and a number of positive growth outlooks from Central Banks and eminent research organisations has now added weight to the upward momentum. A better-than-expected second quarter earnings season (particularly amongst Banks) and reports that several countries had emerged from official recession (France, Germany & Japan), certainly started (and kept) the ball rolling.

Intriguingly, however, the most recent driver appears to be fear! This fear derived from the fact that investors, who have deleveraged their portfolios and reduced equity exposures in the fourth quarter of last year (and even more unfortunately the first quarter of this year), felt they were missing out. The higher the market climbs, the harder it becomes for these investors to retain their conviction and stay out of the market ... and so fear spreads! Their subsequent capitulation led to the surge of money invested that kept markets rising throughout July.

Unfortunately, TAM is now increasingly worried about the sustainability of the current levels in the equity markets and below we summarise three areas that are causing us concern:-

- **A broad based rally?** Unfortunately not - the rally was driven by a select number of high-beta sectors; Banks, Mining and Metals all significantly outpaced the Index. This was in contrast to

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defensive sectors, Utilities, Consumer staples and Healthcare and Pharmaceuticals which lagged (or even fell) during the rally. It is certainly significant that investors favoured companies with historically volatile share prices and higher earnings growth expectations and ignored profitable companies with stable free cash flows and high dividends. This partly explains why Funds such as the Invesco Perpetual Income Fund (the Manager sticking with “solid” transparent companies) under-performed the Index over the last three months considerably. Within the UK, we expect clear rotation into the more defensive sectors as some normalisation returns.

- **Earnings growth.** Second quarter earnings results were better than expected, reassuring investors and helping boost the market. When one looks at how companies increased earnings, however, a more worrying trend emerges which relied on cost cutting rather than revenue growth as witnessed by the thousands of redundancies we have witnessed. Unless economic growth actually increasing, it will certainly be harder for companies to increase earnings during the next quarter!
- **Economic fundamentals remain weak.** Unemployment continues to rise and is now at its highest level in fourteen years. More worryingly, it is also forecast to rise above three million by next year. Retail sales, one of the principal foundations of economic growth, has stagnated, and house prices reportedly also fell in the last quarter, despite much “buoyant” talk. Inflation has shown no signs of returning to normal levels and is low enough to force the Bank of England to unexpectedly continue their quantitative easing campaign.

Taking the above in totality, we believe there are some strong signals to suggest that further returns will be far harder to obtain in the equity markets over the next few months. We will, therefore, continue to maintain a balanced portfolio approach, spreading our equity exposure across a number of geographic regions and market sectors. We believe that a core Absolute Return Equity exposure will, certainly, prove a foundation to further performance, with directional exposure more affected by medium term trends.

Be assured that we will not be afraid to book profits if we feel that appropriate!

Our Fixed Income exposure remains squarely focused in investment grade corporate credit and we are waiting for more certain times before extending risk in the higher yielding sectors. As already advised, our Gilt exposure has been reduced considerably.

In summary, therefore, there may certainly be “a sting in the tail” for some investors who may not be prepared to act on the market and we anticipate sector swings will be a feature of the next few months.

Clients who took out their risk in late 2008 or early 2009 are either convinced of a bear market style collapse now, below the lows of 3,600 in March, (which is unlikely in our opinion), or they are hopeful for as sharp a setback as possible to allow them to re-enter the markets. There will be difficult times ahead and market setbacks will feel painful but, at this point, we will try to avoid the scorpion’s sting and be mindful of the volatility that, we believe, will permeate the next few weeks and months.

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