Strategy Expresso: 2011 vs. 2005

2011 vs. 2005: Data might have more bite this time

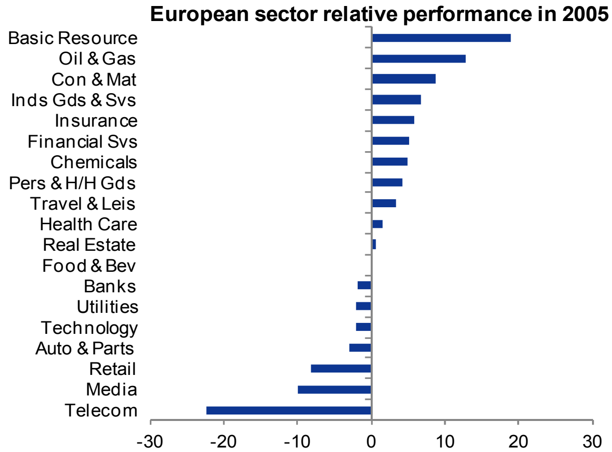
In 2004 / early 2005 the market rallied despite weaker data

After a flatish period over the summer markets rallied strongly at the end of 2004 and into 2005 largely ignoring weaker signals from lead economic indicators. At the time equities were inexpensive, bond yields were falling and companies had plenty of cash. Also the US election in November 2004 may have provided a catalyst. But this time around we suspect the macro data will be more important; just look at this last month for evidence.

But we'd expect the market to be more sensitive this time

This makes us nervous especially as our US economists fear the ISM could fall again to 50 or below. We expect European equities to be volatile and range bound over the next few months. But over 12 months we forecast strong returns (SXXP +23%) led by earnings. The sector pattern in 2005 (while not likely to be identical to 2011 esp. given the hang-over from the TMT bubble) is illustrative of the swing into cyclicals we'd expect in 2011.

Cyclicals and commodity-related sectors outperformed in 2005 (%)



Source: Datastream, Goldman Sachs Global ECS Research.

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2011 vs. 2005: The economic data might have more bite this time

Where we are now in late 2010 is similar to where markets were in late 2004. There had been a strong rally in 2003 post the trough in the market after the TMT bubble. Then in the spring of 2004 the market stalled and there were several months of relatively tight range-bound trading. Then in late 2004 the market broke out on the upside and never looked back (well not until the summer of 2007 ...but that is another story).

So far these last couple of years have been similar to 2003/04. The market rallied strongly last year but then stalled from around April of this year trading in a range until relatively recently. The volatility and magnitude of the moves within this range-bound market have been much greater this time around than they were in the middle of 2004. But the reason for this flatish performance in the middle of the year has been the same both this year as in 2004; Global lead indicators started to roll over.

So what got us out of the malaise in 2004 and what therefore might do so this time? Interestingly the link between performance and the economy was not as strong as one might think. Although it is clear that the lead indicators rolling over in early 2004 were associated with the correction at the time (shaded area in Exhibit 1) it is not clear that the rally in late 2004 and into 2005 was coincident with a decisive recovery in lead indicators. Indeed the headline GLI (our proprietary global lead indicator for the industrial cycle) was falling even as the market rallied in late 2004 and early 2005.

Exhibit 1: The GLI did not turn up with the market in '04

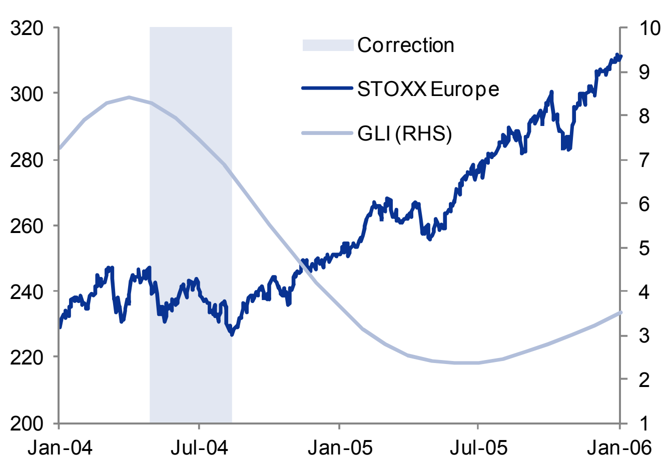

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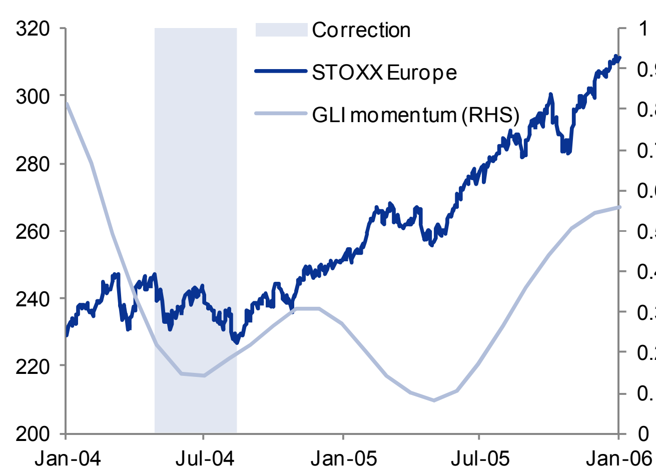
Exhibit 2: ...nor really did the GLI momentum



Source: Datastream, Goldman Sachs Global ECS Research.

Our GLI momentum index (which takes the monthly change in the GLI and is more sensitive at turning points) does show a rise in mid 2004 – if anything leading the rally in the market itself (Exhibit 2). But again the relationship with the European equity market is not strong. Indeed the monthly GLI momentum index fell again in early 2005 but the STOXX Europe index seemingly ignored this.

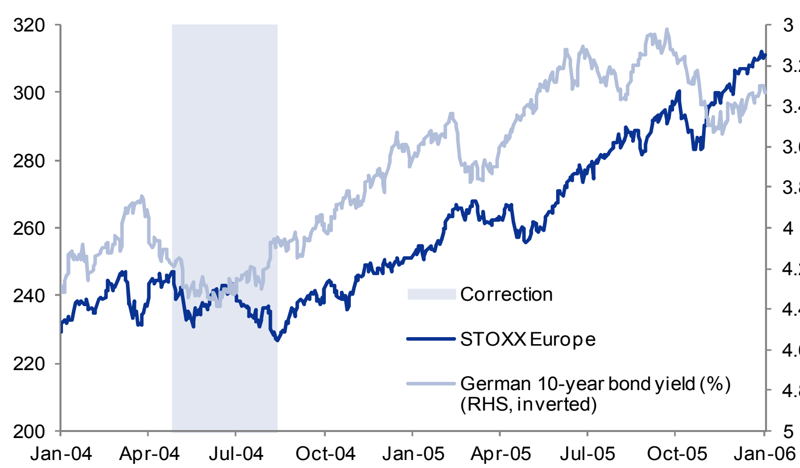
One reason was that the European indictors such as the IFO stayed strong while the US weakened in 2004/05. Another difference is the importance of the macro data then versus now. In 2004/05 there were not fears of deflation or a severe double-dip recession and the Fed did not have interest rates set at zero. This time around we expect the market to be more sensitive to the economic environment because the outcomes are much more binary. The volatility of the European equity market in the last few monthly has been much higher than in the summer of 2004 (even though ultimately in both cases the market could be described as moving sideways) which is evidence of the heightened uncertainty today.

The evidence of performance in September certainly suggests macro data will be more important now. As our US strategy team said in their US Weekly Kick-start (*Upcoming macro data poses risk following biggest September rally in 70 years,* September 25, 2010) the S&P 500 is on pace for its best September performance since 1939 and that the rally has been spurred by better-than-expected economic data.

Our US Economists' US-MAP scores show September tracking as the best month versus consensus for reported US data since August 2009. They find that monthly equity returns have tracked these scores well since 2008 – i.e. since the financial crisis hit.

Another difference between now and 2004/05 is the bond market. German 10-year bond yields were 4.5% in mid 2004 and fell through the next 18 months so that by the end of 2005 they were around 3%-3.5%. In many ways the performance of the equity market in 2005 tracked this fall in bond yields (Exhibit 3).

Exhibit 3: Bond yields fell through 2004/05 which seemed to support equities



Source: Datastream, Goldman Sachs Global ECS Research.

A fall in bond yields today is unlikely in our view to precipitate a rise in equities. Indeed we would argue the complete opposite; that falling bond yields, insofar as they are a reflection of more economic trouble ahead, would be bad news for equities.

We are therefore comfortable with the idea that equities can rally in 2011 (our 12 month forecast price performance is 23% for the SXXP) even if the bond market sells off. We are looking for Euroland bond yields to rise from 2.3% now to 3.2% in 12 months from now. But provided that improvement in the global economic data is the reason for this move in yields we don't see it as an impediment to equities.

The index rose sharply in 2005 (it was up 23% through the year) and while it may not have been entirely coincident with the turn in lead indicators the rally was driven by strong global growth, the abundance of corporate cash and a return of M&A. We can see a similar picture evolving in 2011.

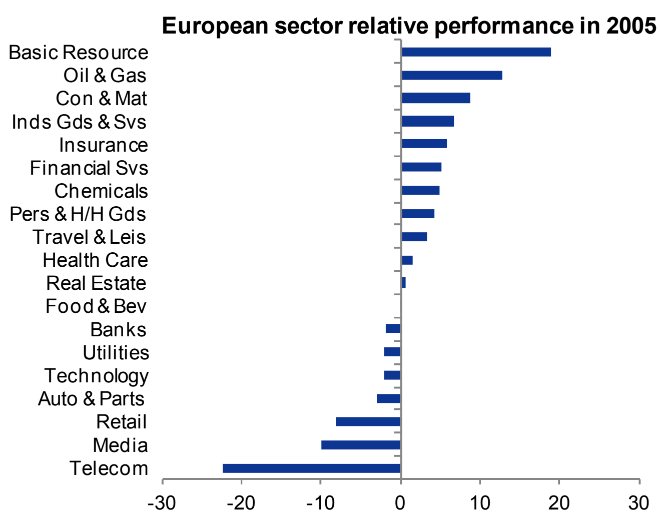
One final point on the rally in 2004/05 is that the start of the rally coincided closely with the US presidential election in early November 2004 and the victory of George W. Bush, the Republican Party candidate, to a second term in office. The uncertainty in the run up to the election may have overshadowed market performance and hence once the election was decided markets were able to focus more closely on the good earnings data and macro outlook.

Such an election-driven stimulus to markets is not a factor on this occasion, and many of the uncertainties worrying investors at the moment (government debt in peripheral Euro-zone, US double-dip) have less definable endings. This is another reason why the lead indicators may matter a little more than they did in 2004/05.

Cyclical performed well in 2005

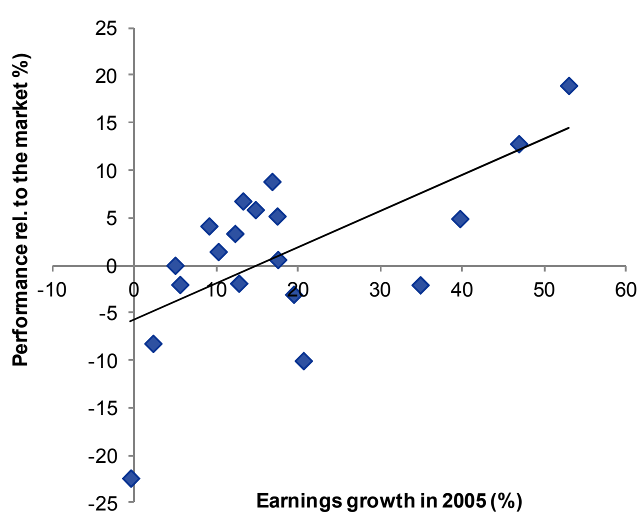
Cyclicals outperformed in 2005 which is a pattern we'd expect in 2011. Exhibit 4 shows sector performance in 2005. The winners were either BRICs exposed, commodity-related or cyclicals, whereas the underperformers were either TMT or defensives. Autos is the only sector that's an exception to this pattern. The TMT sectors were still de-rating after the bubble. Does this suggest banks – the bubble sector this time – will continue to suffer into 2011? We think not. The TMT sectors needed a long period of de-rating whereas banks are on multiples significantly below the market average and these multiples may well fall over time as provisioning levels come down without the need for the sector to fall.

Exhibit 4: European sector performance in 2005 (%)



Source: Datastream, Goldman Sachs Global ECS Research.

Exhibit 5: Sector performance in 2005 was correlated with earnings (correl: +63%)



Source: Datastream, Goldman Sachs Global ECS Research.

We are overweight of basic resources, oil & gas and personal care & household goods all of which we expect to gain from strong global growth in 2011 in a similar way to their performance in 2005. But in the very near term, over the next 3 months or so, we are nervous that the lead indicators could take a setback especially in the US where our economists' expect both 4Q2010 and 1Q2011 to be weak quarters. **And unlike late 2004 or early 2005 we think the market may not so easily shrug-off this news.** We are therefore not as cyclically biased in our portfolio as the experience of 2005 would suggest. We recently upgraded Telecoms to Overweight in our European Strategy Portfolio, a nod to a slightly more beta-neutral portfolio in the short term, and towards high dividend yield which we continue to like as a theme. See *Strategy Matters: Treading water before breaking the range,* September 24, 2010.

The two factors that were best correlated with sector performance in 2005 are earnings and balance sheet quality. Indeed the levels of cash that companies now have are comparable to the levels in 2005 and we believe these cash piles are likely to rise further in 2011 and 2012. See *Strategy Matters, Leveraging the M&A theme,* September 17, 2010.

Reg AC

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