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Equities will look more attractive later in 2012

By Robert Parker – January 18 2012

Since early October, the MSCI World Equity Index has climbed more than 10 per cent. Does this development in global equity markets represent the start of a more secular improvement? Or, if not, what further catalysts are required to boost markets?

For most of 2011, global investors were concerned primarily about five major risks; the possibility of the US returning to recession, the risk of a Chinese “hard” landing, the combined risks of a failure in the eurozone capital markets and the associated threat to eurozone banks, and finally the negative outlook for corporate earnings.

Consequently, 2011 was characterised by investors running high cash levels and focusing on perceived safe havens such as G4 government bonds.

In the past three months, there has been a slow movement in global capital flows in favour of corporate and high-yield bonds and into high dividend underleveraged cash rich defensive equity sectors. The outperformance of defensive equity sectors relative to cyclical stocks has been significant in recent months. This change in investor behaviour has partly been due to frustration with low money market yields and the perception that official rates will stay low for a sustained period. But it is also due to a changing risk profile in markets.

There has been a clear reduction in recession risk in the US while the probability of a hard landing in China has decreased. The US ISM manufacturing index has improved to 53.9, the non-manufacturing index has recovered to 52.6 and the University of Michigan confidence index for January rose to 74, all data consistent with real gross domestic product growth of approximately 2.5 per cent.

The year-on-year increase in Chinese real GDP in the fourth quarter was 8.9 per cent with December retail sales up 18.1 per cent on the year while the corresponding data for exports and industrial production were increases of 13.4 per cent and 12.8 per cent respectively; forecasts of Chinese growth in 2012 of 8 to 9 per cent remain plausible and China, in line with many emerging economies, is now starting to ease monetary policy.

In the eurozone, the increase in liquidity provisioning to the banking sector has had the desired effect of stabilising Italian and Spanish bond yields. Although the issues of financing the eurozone bail-out funds, finalising the Greek debt restructuring and implementing growth strategies remain unresolved, the recent sovereign downgrades were well discounted in markets and the reaction to the Spanish and Italian fiscal packages have so far been positive. Although much of the eurozone remains in recession, the composite PMI improved slightly to 48.3 while the German ZEW survey of economic sentiment improved dramatically last month.

And, while capital raising by the European banks is problematic, they are strengthening their balance sheets via asset disposals and have continued liquidity availability from the European Central Bank. Corporate earnings numbers reported so far have been erratic but the risk of a sharp fall in earnings growth is offset by improved US and emerging economy growth while eurozone companies are benefiting from the weakness of the euro. Corporate balance sheets remain robust with record levels of excess liquidity and low leverage at a time when large-cap corporations have good access to bond markets.

Consequently, a number of the risks facing investors in 2011 have diminished and, given the high level of investor cash and arguably the reduced attraction of safe havens, investor sensitivity to negative market news has probably decreased. However, the case for the start of a secular rally is still weak given the slow resolution to the eurozone crisis, investor uncertainty over political risk in Greece and Italy, a potential change in policy in France under a possible new government, an escalation in political risk in the Middle East increasing oil prices and the lack of progress in addressing the Japanese and US deficits.

The central case outlook is for global equity markets to trade sideways with a moderate upward bias but importantly with limited downside risk. A more durable rally in global markets could, however, evolve later in 2012 dependent on certain catalysts, examples of which could be a change in policy by Iran easing oil price pressures, a consensus agreement on the Greek debt restructuring, a significant increase in funds from the International Monetary Fund, the issuance of eurozone bonds, implying a change in policy by Germany towards eurozone transfer payments, a weaker euro boosting eurozone growth prospects, clear “pro growth” policies in Europe, faster than expected monetary easing in emerging economies and market credible fiscal plans being developed in the US and Japan.

Given the undervaluation of most equity markets relative to other asset classes and particularly compared with bond markets, any of these catalysts could trigger a rally similar to the market movements from 2003-07.

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