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Asset Management

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tailwinds of recovery

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Bill Dinning gives details of the factors he believes are supporting further growth in equity and bond markets.

We suspect that 'risk assets' – equities and corporate bonds for example – can continue to move higher in what remains of 2009. In the US and UK in particular we are some way from monetary tightening. Indeed here in the UK, deflation is certainly more of a concern than inflation and Mervyn King seems keen to renew quantitative easing in November. Meanwhile, the ongoing weakness in the US labour market suggests it's premature to expect the Fed to tighten given its dual mandate of seeking full employment and stable prices. The Fed has tended only to raise interest rates 12 to 18 months after unemployment peaks.

return to normality

A number of other factors seem supportive. First, the last seven months have been a lot more like a normal cyclical upturn than seemed possible earlier this year. Corporate credit has performed extremely well with spreads below the levels prevailing before Lehman Brothers failed. Having led equities higher, credit is now offering spreads that are still wide by normal cyclical standards but are no longer at the excessive, once in 75 years, levels prevailing earlier in the year.

Second, fundamental newsflow has seen some rolling over of data relative to expectations. To some extent, this is the natural consequence of the economic rebound being stronger in recent months than most had predicted. As the reported data has improved, forecasters have extrapolated that strength into future releases. Consequently, the actual data has had a tough time beating those elevated expectations. This is a natural cyclical pattern. The general thrust of economic data though has been consistent with recovery.

east over west

Corporate earnings have been supportive. Third quarter earnings reports are so far giving more grounds for believing that current estimates for this year and next are too low. This is true in the US and Europe. Here in the UK the corporate sector has been stronger than the UK economy. This is because 65% of earnings come from overseas and the Materials and Energy sectors represent 35% of UK earnings – one of the reasons the UK has been a good play on stronger growth in emerging markets – our East over West theme.

Third, valuations for equities are unlikely to be a hindrance to the market if earnings momentum can continue to be positive. Equities are also attractive relative to corporate bonds and government bonds. Our UK Equity Risk Premium remains higher than it was before Lehman failed.

challenges

It still seems difficult to believe that we can skip off jauntily into the bright dawn of a new multi-year bull market without a care in the world. The challenge from ongoing deleveraging in the household, and financial sectors in particular, will likely make future growth rates lower than in the past. And there are challenges coming in future years from the ageing population. There will be fewer workers and more dependants (children and the retired) for those in work. This will be a huge challenge in coming years, one likely to be met with longer careers for most of us and potentially big changes in savings patterns. It promises to be very good for the financial services industry but a further challenge to the sustainable growth rate of the economy.

These structural headwinds may cause markets to pause again at some point in the coming months. But for now, we think investors should focus on the cyclical tailwinds that are supporting markets.

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