News from the financial markets

What argues in favor of stocks?

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Bernd Hartmann, Asset Allocation Strategist

Contrary to our original thinking, the equity markets have broken down below the sideways channel that formed on the chart in November. Today, Wednesday, the globally leading US equity market will start roughly 3% below the penetrated support line. We are going on the assumption that it will be recaptured.

Market has doubt in the fiscal measures

The announcement of bank rescue packages and economic stimulus programs, as well as the unconventional monetary policy of key central banks, managed to calm the markets last October. Shares went from a downward trend into a sideways trading pattern. At the time, we raised step-by-step the equities quota in our discretionary mandates to a level representing the benchmark. To those clients who followed our recommendation to sell stocks last autumn, we advised getting back into the market in a staged manner at the low end of the sideways channel.

US stock market (S&P 500)

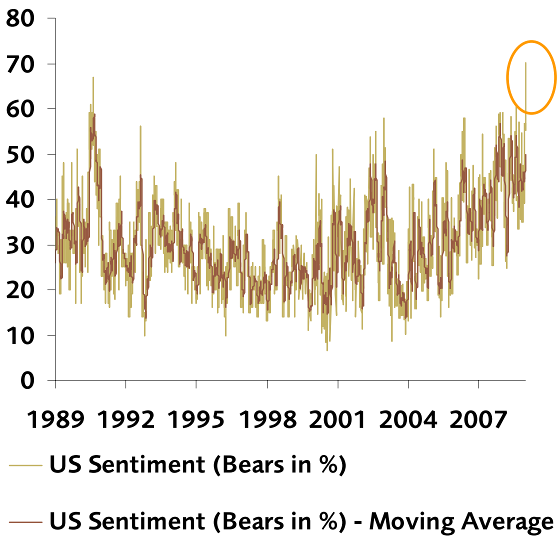
Source: VP Bank, Bloomberg

After having traded close to the upper end of that corridor at the outset of the year, the market then took a nosedive of roughly 20% and the channel was penetrated on the downside several days ago. We believe the reason for that penetration of key support is investors' doubts about the ultimate effect of the announced fiscal measures. A particular burden in this regard stems from the perception that many politicians are sitting on their hands. In the USA for example, the announcements of concrete measures have not been followed by action, and the Europeans have disappointed due to the failure to support their new EU member states. The lack of clarity in terms of the de facto nationalization of Citigroup also weighed heavily on financial services stocks.

Sideways channel penetrated

In parallel with the break below the lower end of the horizontal trading range, investor sentiment and the market in general plunged to a level that now clearly reflects an oversold condition.

Investor survey: Percentage of bears



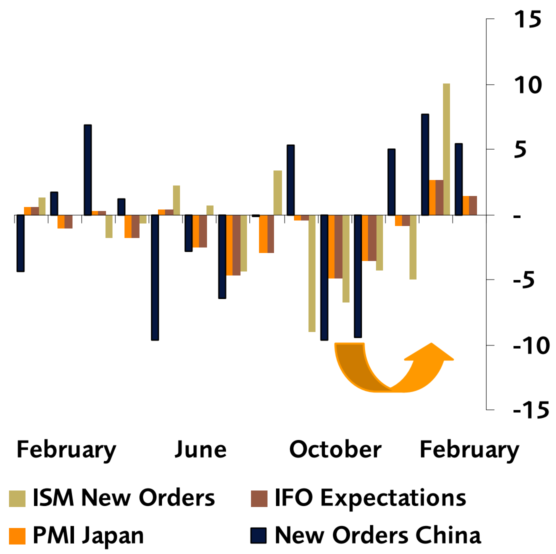
Source: VP Bank, Thomson Datastream

Many investors have turned a cold shoulder to stocks, at least for the time being. As a result, the liquidity parked in money market funds now exceeds the volume in all equity market funds.

We are sticking by our positioning
To our way of thinking, the deterioration in investor sentiment, as well as the oversold condition in the marketplace, sends out a "hold" signal (in contrarian terms). For example, an investor survey that has now been conducted for more than two decades reveals that there have never been so many bears than reflected in the current reading. If, as is the case at present, 70% of all private investors anticipate a further deterioration in stock prices, it is obvious that expectations are in the cellar. However, in the past it has been shown that such a miserable mood, in combination with an already oversold condition in the markets, can brake the downward dynamic. In other words, the worse the sentiment, the less any negative news reports can burden the markets further. As we saw yesterday (Tuesday), such a setup can result in a sharp countertrend move when positive news actually comes out.

Leading indicators are signaling stabilization
The concerns of equity investors are not being confirmed at present by the leading indicators. As the past year drew to a close, key purchasing managers indices stabilized and that provides a good indicator for future business activity. In January, estimates for new factory orders rose for the first time in months, and that level at least held up for February.

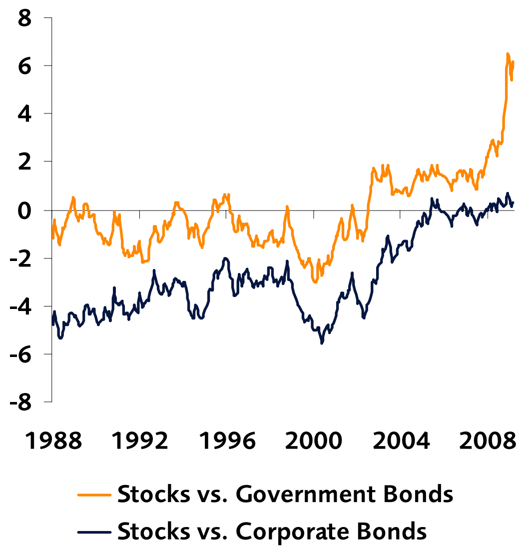
Change in leading indicators



Source: VP Bank, Bloomberg

Current valuations argue in favor of stocks
Many critics state that, even though current absolute valuations are low, they are not (yet) low enough. That is true if one views shares solely from a personal standpoint: (profit)cycle-adjusted, stocks were cheaper at the start of the '80s and end of the 20's. But in comparison to other asset classes such as government bonds, equities are favorably valued. Even though the fundamental environment for companies is very difficult at present, select shares are already very attractive from a long-term standpoint due to their valuation.

Risk premiums (USA)



Source: VP Bank, Thomson Datastream

If one compares the earnings yield of companies (i.e. the inverse of P/E) with the return on government bonds, there is also a sizeable discrepancy in favor of stocks. For accepting a significantly higher risk, shareholders are rewarded with a potentially higher return even though a drop in profits has been anticipated. The related risk premium is at a record high. If the central banks now start to buy bonds (quantitative easing), that premium will increase even further because the bond yields will sink.

Moreover, the yields on corporate bonds are roughly the same as equities at current levels. But because at present we do not anticipate a sustainable, drawn-out upsurge in the equity markets and still consider the risks to be very high, we recommend taking a wait-and-see attitude in terms of equity investments and continue to prefer that new positions be taken in corporate bonds rather than stocks.

Uncertainties remain
Despite all this, corporate reports on prior-year earnings remain a drag on stocks. That news arrives with a lag and may thus continue to place a burden on the markets. In addition what continues to be analysts' fainthearted changes in earnings estimates add to the downbeat mood in the marketplace.

The bottom line
We are going on the assumption that a countertrend move will evolve in the equity markets, one that should take US shares back into their previous horizontal trading range. Afterward, we expect to see a volatile, directionless trading pattern in the indices. Moreover, it has to be borne in mind that the markets are being hassled by enormous uncertainties, thus the risks involved in an equity investment are unusually high at present.

We are therefore leaving our trend assessment at "sideways" for now and will remain with our neutral equity allocation in discretionary accounts. For clients who, during the sideways movement, brought equity exposure back to their original strategic level, we suggest that they maintain their existing positions.