

Current Market View

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At the back of the latest Eden View, we summarise, as usual, our view of the market. This is based on the conclusions of our Asset Allocation Committee, which met on October 27th. In the light of the recent market volatility (a euphemism for dreadful market conditions) and the somewhat changed circumstances, it is worth providing more in the way of explanation.

On the face of it, the asset allocation recommendation is unchanged. However, market falls would have reduced equity weightings in October, so an unchanged allocation implied some rebalancing towards equities and corporate bonds. We saw a high chance of a very sharp snap-back rally, and the subsequent week may have represented the beginnings of one. We did not rule out further weakness back to the lows of 2002/3 (about 10%) but the last week makes this less likely. The rally could be followed by an extended period of consolidation lasting most of 2009, during which corporate bonds could out-perform equities, so after the rally we expect to reduce the latter in favour of the former.

A sustained equity bull trend is unlikely to start until six months before the low of the economic cycle is reached and corporate earnings turn up. At the earliest, the low point looks like the end of 2009, implying that equity exposure will be raised again in the second half of 2009. However, it is important to take one step at a time, and hence our view was that the first priority for investors was to be positioned for an equity rally.

One of the precedents for our thinking is the 1970s. UK equities lost 70% of their value in the 1972-4 bear market (80% in real terms) but then doubled in the first quarter of 1975. The rally was so sharp and sudden that it was virtually impossible to buy on the way up; by the time liquidity appeared, the rally was over and the market then had an extended period of consolidation while the bad economic news worked its way out. We are not expecting markets to double this time, but we envisaged 35% - 40% from the lows, recovering about half the fall from the peak (as in 1975).

Equity markets around the world now appear to offer good value. Historic price earnings ratios are at least 40% below the average for the last 25 years. In the words of CSFB, who use a methodology (Holt) based on cash-flow, "we are either staring an extraordinary buying opportunity in the face or facing a world where returns fall to their cost of capital and remain there."

Value relative to government bonds is also at an extreme; the equity risk premium in all markets is huge. Bonds have outperformed equities heavily over the last 18 months, and also over 10 years, but it cannot be right to say that the higher risk of equities is compatible with a lower rate of return. Either equities are extremely cheap relative to bonds or their relationship has not just broken down but inverted. Meanwhile, government bonds are expensive, but with economic growth slowing, inflation falling and interest rates likely to be cut further in Europe, the UK and elsewhere, there is a good chance that yields in these markets will fall further. So the valuation disparity between equities and bonds should be corrected by equities rising, not by bonds falling in price.

However, the pace of earnings downgrades has accelerated sharply. Forecast earnings growth for 2008 fell 4% in October and for 2009 it fell 4.3%, which means actual forecasts fell 8.3%. Analysts have capitulated to the downturn, but there is a huge consensus that forecasts will fall further. To put that in context, 2008/9 earnings growth would have to fall from the +12% currently forecast to -40% to give a 2009 p/e of 16, a somewhat cautious estimate of a fair rating at the low of the earnings cycle. It implies that investors are prepared to discount no more than trend earnings growth of 6% per annum thereafter (i.e. a permanent 50% loss of earnings over 2008/9). So, falling earnings forecasts are likely to dent valuations, but valuations discount a negative outlook.

Market charts look terrible, but markets are oversold and the downward momentum is excessive, all major markets are more than 30% below their 200 day moving averages. Sentiment is at a negative extreme. Volatility has only once been higher in living memory, at the time of the 1987 crash, and

then only briefly. Risk aversion is huge, advisers are very negative, cash holdings are high, insiders are buying and retail investors piling out. These are all positive for markets.

There is now a strong consensus among institutional investors, according to Merrill Lynch's monthly survey, that the market is cheap but this indicator tends to work because investors do not put their money where their mouths are. Investors do nothing because they are intimidated by losses, uncertainty and the selling pressure. This pressure mostly comes from forced sellers – those facing redemptions from hedge funds and mutual funds, or instructions from Trustees to sell. However, there is good anecdotal evidence that investors have anticipated far more redemptions than will materialise, that some of those demanded by year end will be withdrawn, and that some of the money (together with money sitting on the sidelines) will be reinvested. As this becomes apparent, investors may rush to reinvest, but find no sellers. Hence our expectation is of a sharp and sudden rally.

With regard to regions, the US market is currently out-performing as it is expected to be the first to emerge from the downturn, but other markets are significantly cheaper. The phase of US out-performance is nearing its end, hence our neutral recommendation but focus on sectors (such as pharmaceuticals and technology) where America has a competitive advantage. Japan's economic and market performance has been disappointing for a country which has scarcely been affected by the credit crunch other than to see a surge in its currency, so we remain neutral. Europe will be very attractive soon, but not yet. Asia and Emerging markets held up well as developed markets fell, but then collapsed. Value is excellent, earnings growth continues at a brisk though reduced pace and the economies are nearly all far stronger than at the time of the 1998 crisis. These markets are attractive.

This leaves the UK market, which has ignored the benefit of the fall in Sterling, despite the significant support it gives to earnings. This makes it one of our preferred markets even for non-UK based investors. Within the market, naturally, we favour overseas earners. These include resource stocks (energy, base metal mining and precious metals), which have been hit hard by falling commodity prices, though there is evidence that companies are, at last, getting to grips with costs and output bottlenecks. We will be producing a write-up on the energy sector soon. We also favour consumer staples, both because of their overseas sales and because sales are relatively insensitive to the economic cycle.

There is excellent value in small and mid caps, and in industrials, which are also beneficiaries of lower Sterling. We are back to being sceptical on the UK banking sector, as the terms of the recent fund raisings from government and Middle Eastern investors are extremely onerous and dilutive for existing equity investors. The banks that have taken money from the government may be forced to sacrifice profits in favour of broader economic and political objectives (there is already evidence for this) while increased government interference and regulation will tie the hands of everyone.

We also favour corporate bonds, especially once equities have rallied. The spread of corporate yields for investment grade bonds over government yields in the US is the highest since 1932. European yields are at least as high. High yield (i.e. junk) bonds are not yet at that extreme, and face the likelihood of a sharp rise in defaults, but the yields are huge. There is also some excellent value in emerging market local currency debt, and for the recklessly brave, Dollar denominated Argentine government debt yields 60%!

Within alternatives, the IPD index continues to show falling values for commercial properties, but this is discounted in the prices of shares and Reits. The prospect of lower interest rates makes gold attractive, and gold shares are exceptionally cheap relative to the gold price. Obituaries for the entire hedge fund industry are being written, but the pessimism has been grossly exaggerated. Performance this year has, on average, been very disappointing, particularly since many funds almost promise positive returns in all circumstances. There have been a lot of terrible performers, and money is being taken out of the industry. Nevertheless, there are also many funds which have performed well and the dislocation of all markets offers huge opportunities. As in all markets, the winners of the future will not necessarily be the winners of the past, so this is a time to choose funds carefully, not to desert the asset class.

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