Equity Strategy and the Economy

At the beginning of 2010 equity markets had benefited from almost a year of positive returns. At the beginning of 2009 it was clear that it would be fairly easy to make money in the market given the degree of pessimism in the market at the end of 2008 and how much equity markets had been sold down. The market unexpectedly turned around in March 2009 and began an almost year long rally. At the beginning of 2010 market direction was a lot less clear. Equities which were cheap in early January 2009 were no longer cheap given the sharp rally in 2009.

MSCI Earnings Yield Gap, Jan 2010.

Equity markets have been volatile in 2010 falling sharply in early 2010 then rallying hard into the Spring before falling sharply again on fears of sovereign default in Europe and renewed economic weakness in the US. Valuations, however, have improved, as corporate earnings improved while markets traded sideways with volatility.

MSCI Earnings Yield Gap, Sep 2010.

The prospects for equities remain attractive. Investors do not dispute the robustness of growth in the emerging markets, particularly in China, India and Brazil. Germany has been a bright spot in Europe relying on its export industries to support economic growth. The big question is once again economic growth in the US. Employment numbers have been poor and housing data has been dismal. Economist fear a double dip recession in the US, fixed income markets are pricing in Japan style deflation and markets have sold off once more. However, ISM data is indicative of economic recovery and there are reasons to be optimistic about this. ISM PMI data while softer in July remains above 50, indicative of expansion. More importantly, the data is supported by strength in exports. A similar pattern is exhibited in the ISM NMI (non-manufacturing).

The US is shaping up as an export economy. Current account as a percentage of GDP has recovered in the wake of the 2008 financial crisis. One thing to note here is that this series will be volatile in recovery as import volatility is higher than export volatility on account of the US being a more open economy than her trading partners. The trend in the current account is clear. Recovery.

US Current Account as a percentage of GDP

Economic growth is cyclical and this is a consequence of any dynamic system. Within the broader long term cycle there are shorter term gyrations. It is likely that the current weakness in employment data is volatility along a longer term trend of recovery. The ISM data is a very strong indicator of economic performance, more so than labour data. The current account data provides some insight into the source of that growth, namely, a newfound export competitiveness in the US.

In terms of the relative performance of markets, we see the largest yield gaps in the US, followed by HK and H shares. Europe, Australia, Canada and India look like the least value. The risk to this approach of valuations is of course that the basis of earnings calculations is course and open to gaming. Also, the yield gap is boosted by treasury yields which are at historical lows. A spike in inflation or higher rates could change the picture significantly. Putting these aside we have the following picture:

Experience tells us that you can have a rising equity market when economic growth is weak or even in recession. Conversely, it also tells us that equity markets can fall when the economy is growing. The lags and autocorrelations are not stable enough for us to measure econometrically, but it is sufficient to understand that fundamentals drive markets through psychology.

Markets have been driven by macro factors since the great financial crisis of 2008. They will likely continue to do so. Weak economic data is likely to precipitate further economic stimulus which the market is likely to take positively. On the other hand the underlying economy is healing and will drive longer term returns going forward. What presents today is a convex payoff to the intrepid equity market investor.