

# Schroders Talking Point



## 2009 Crystal Ball

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### **Introduction: A hostage to fortune!**

As we said last year, crystal ball gazing is a hazardous occupation at the best of times, and this year more than most!

Here's what we said in December of last year:

*"As we look to the future and our baseline and alternative outlooks, the question of whether the credit markets will return to some kind of normality so that normal lending activities can resume will be key. If central banks are frustrated in their policy endeavours by a continuing lack of confidence, they will find themselves "pushing on a string" and the ordinary stabilisers will not work. This is the bleakest of all outcomes which would potentially lead the world into a long dark winter of recession, deflation and further credit losses. This is the Japan problem writ large on a global scale and, once started, it could possibly last for many years."*

**Our mistake was that at the end of the day we plumped for the "Glass Half Full" scenario where Central Bank actions to inject liquidity would ultimately be successful. We could not bring ourselves to make our baseline outlook one where the financial system ceased to function, and yet that is exactly what has transpired. We now find ourselves facing what is likely to be the worst recession since the depression. And with the normal monetary policy transmission mechanism broken we are reliant on a Keynesian style fiscal response to break the vicious downward spiral of economic activity that we are currently in.**

### **Prior recessions, earnings and equity markets**

Given that we are currently entering a recession which will see the GDP growth rate turn negative for several quarters it is interesting to see what effect previous recessions have had on the equity market and earnings. Looking at periods where both earnings and equity prices have fallen together we can begin to generate expectations about what may happen in the current crisis.



**Figure 1: Periods when S&P 500 real earnings corrected by at least 25% and the correction in real S&P 500 price occurred in the same time period (1900-2008)**

| Year (Peak to trough) | Real earnings                             |                 |   | Real market prices                                      |                     |   | After Market troughs                                     |  |
|-----------------------|---|-----------------|---|---|---------------------|---|--|--|
|                       | Duration in mths. (Peak to trough in EPS) | Fall in Earning | EPS Lead (-) or Lag (+) the peak in S&P 500 price (in mths) | Bear Market Duration in mths. (Peak to trough in Price) | Correction in price | EPS Lead (-) or Lag (+) the trough in S&P 500 price (in mths) | Chg.in EPS from trough in S&P 500 price to trough in EPS | Chg.in S&P price from trough in S&P 500 price to trough in EPS |
| 1906-1908             | 29  | -26%            | -2  | 14  | -40%                | 13  | -14%   | 42%  |
| 1911-1914             | 47  | -35%            | -4  | 43  | -34%                | 0   | 0%   | 0%   |
| 1917-1922             | 62  | -84%            | 1   | 49  | -60%                | 14  | -49%   | 26%  |
| 1929-1932             | 36  | -67%            | 3   | 33  | -81%                | 6   | -17%   | 48%  |
| 1937-1938             | 15  | -38%            | 4   | 14  | -46%                | 5   | -31%   | 20%  |
| 1956-1958             | 32  | -28%            | -1  | 20  | -20%                | 11  | -16%   | 27%  |
| 1966-1970             | 56  | -28%            | 8   | 54  | -33%                | 10  | -9%  | 30%  |
| 1980-1983             | 36  | -34%            | -4  | 20  | -30%                | 12  | -18%   | 49%  |
| 1989-1991             | 36  | -44%            | -1  | 14  | -17%                | 21  | -28%   | 28%  |
| 2001-2003             | 20  | -57%            | 5   | 30  | -47%                | -5  | 28%  | -5%  |
| 2007-2008             | 15  | -43%            | -2  | 13  | -44%                | ?   | ?  | ?  |
| <b>Average</b>        | <b>35</b>                                 | <b>-44%</b>     | <b>1</b>  | <b>28</b>   | <b>-41%</b>         | <b>9</b>  | <b>-15%</b>  | <b>27%</b>   |

Note: Even though during period of 1946 to 1948 and 1973 to 1974 S&P 500 prices corrected significantly by -41% and 53% respectively, real earnings did not have a peak & trough during this period (in fact they rose by 50% & 24% respectively). We also exclude the WW II period during 1939-1943.

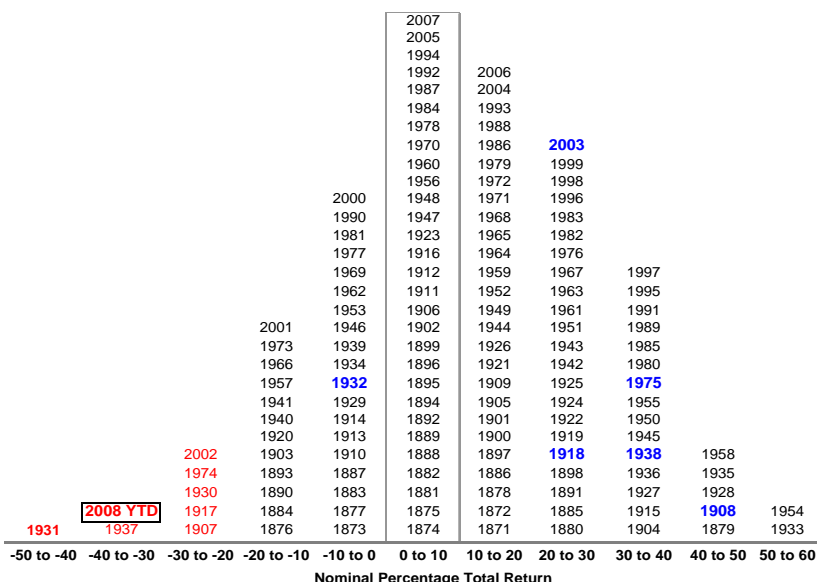
Source: Yale University/Shiller, DataStream, Schroders, Updated 26/11/2008

We can observe on average:

- Earnings fall 44% and share prices fall 41%
- Prices begin to rally nine months before earnings recover. Equities tend to rally strongly during this period on average increasing 27%. The 2001-2003 recession was the first time that this trend reversed and equities rallied 5 months after earnings recovered.

In 2008 we have experienced a very sharp correction in both earnings and equity returns; equities have delivered a return of approximately -40% and earnings have fallen by 40%. Year to date the S&P 500 has suffered its second-worst annual return since 1871. However, markets tend to rally strongly after such large falls. Over the seven years in which the S&P returned less than -20%, five of them were followed by strong returns in the next year. This optimism must be tempered with the fact that 1931 was followed by 1932 (equities returned -43% followed by -9%), and 1973 was followed by 1974 (equities returned -15% followed by -27%).

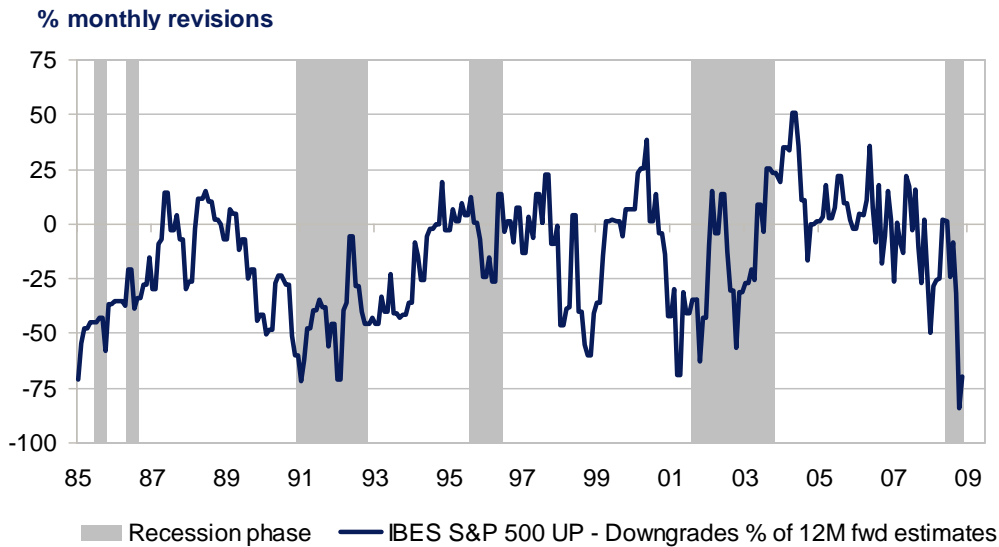
**Figure 2: Distribution of S&P 500 annual nominal total returns since 1871**



Source: Yale University/Robert Shiller, DataStream, Schroders. YTD – 17/11/2008

In previous recessions we have seen businesses increase their share of GDP. This increase helps to counter balance the fall in earnings due to negative economic growth. It appears that in the current crisis we are going to suffer from both a declining share of earnings and negative growth.

**Figure 3: Revision in IBES S&P 500 forward earnings**



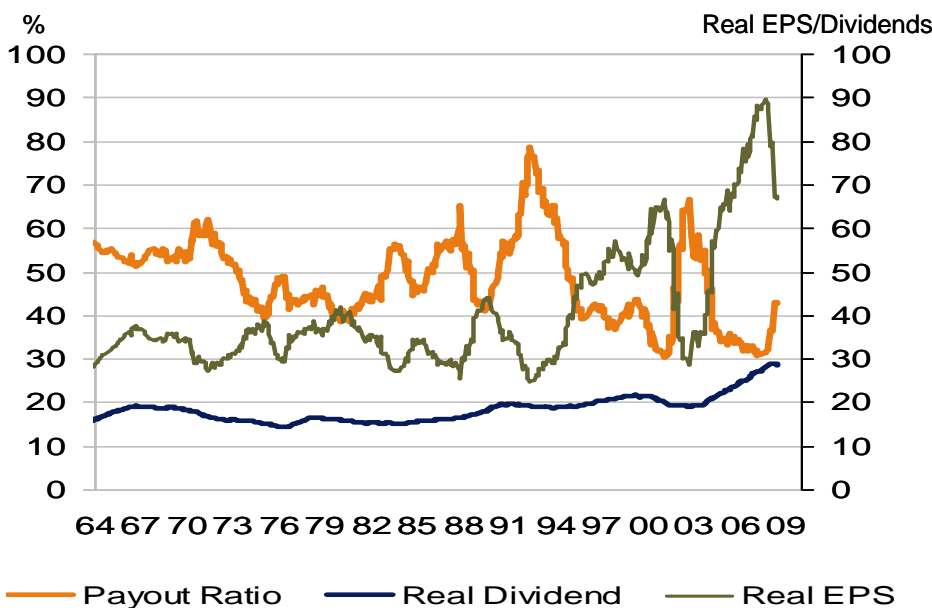
Source: DataStream, Schroders

This potential for a large negative decline in earnings is reflected in the substantial downward revision in broker estimates for 12 month future earnings.

Although the outlook for earnings remains gloomy it is important to try and gauge the extent to which markets have priced this in. Once markets have fully priced in the expected future earnings decline they can begin to look beyond this and see the positive growth in the future. This is why we tend to observe a rally in prices 9 months before earnings actually trough.

While stock prices can fluctuate wildly during recessions as markets are uncertain how to assess future returns, dividends tend to remain fairly stable.

**Figure 4: Growth in real dividends of the S&P 500**

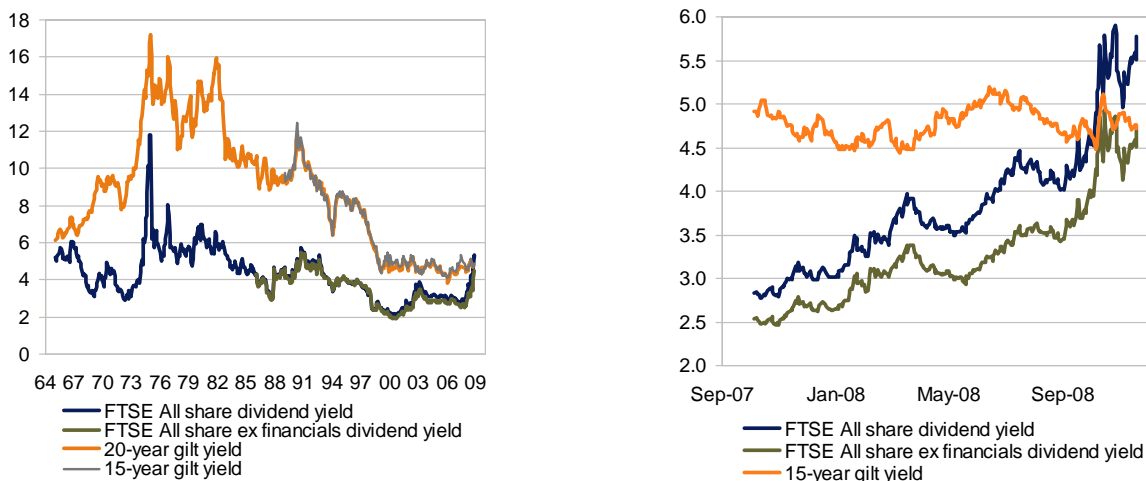


Source: Yale University/Shiller, Schroders

In fact dividends have grown at a reasonably steady pace since the 1950s. The annualised growth rate has been 1.7%, despite large fluctuation in earnings.

If companies continue to try and protect dividends, then we can begin to build a yield argument underpinning the equity market. The difficulty with this is that companies are experiencing a substantial reduction in the availability of credit. In addition, with monetary policy currently ineffective, the extent of the earnings downturn is going to be very dependent on whether the Keynesian stimulus package works and pulls us out of the current downward spiral in economic activity.

**Figure 5 The FTSE All share yield gap**



Source: DataStream, Schroders

Nonetheless comparing the dividend yield of the FTSE All Share index to the long-term government bond yield we can begin to gauge the relative attractiveness of the two asset classes. Historically the dividend yield on equities has been far lower than the yield on 15 and 20 year government bonds.

Due to the sharp fall in equity prices we have seen a dramatic increase in the dividend yield of equities. Notionally at least the dividend yield of the FTSE All Share is now actually higher than that of a 15 year Gilt. The “reverse yield gap” has reversed! However this overstates the case for equities as it is likely that only a few banks will pay dividends in the next few years. Looking at the dividend yield of the FTSE All Share (ex financials) we can see that the gap has closed significantly but the gap has not yet reversed.

**Government debt**

One concern about the burgeoning government deficit is the growth in government debt this implies. In a recent speech, Mervyn King recounted an anecdote about the first television interview with a governor of the Bank of England in 1955.<sup>1</sup> The topic of discussion was the national debt.

|                     |  |
|---------------------|--|
| Cobbold (governor): | The National Debt represents the sums of money which the government have over the years borrowed from the public, mainly in this country and, to some extent, abroad. That is really the amount of expenditure which they have failed over the period to cover by revenue. |
|---------------------|--|

<sup>1</sup> Mervyn King to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire. Tuesday 21 October 2008

|          |  |
|----------|--|
| Day:     | Have we paid for World War II?           |
| Cobbold: | No                                       |
| Day:     | Have we paid for World War I?            |
| Cobbold: | No                                       |
| Day:     | Have we paid for the Battle of Waterloo? |
| Cobbold: | I don't think you can exactly say that.  |

What this anecdote highlights is one of the key features which differentiates a government's ability to borrow from individuals is that governments, in theory, last for ever. This means provided the economy continues to grow, the value of the government debt relative to its tax base will decline. The economy also has a small inflationary trend since as the government issues the majority of its debt in nominal terms its real value will decline over time. Provided government borrowing is a substitute for private sector borrowing, then the overall debt burden of the economy is not increased. What will be key is the ability of the government to rein in the deficit to avoid crowding out the private sector when the economy begins to pick up. At the same time, the Bank of England will need to reverse today's easy money policy to avoid a surge in inflation. Getting these judgements right is going to require the wisdom of Solomon!

## Conclusion

The dividend yield on equities is approaching a level where, provided dividends are not cut savagely, a long-term investor will be well compensated for the volatility in equity prices with a yield approaching that on a long-term government bond. There will also be the potential for material upside once the market sees through the earnings trough. Historically the market has generally bottomed around 9 months before earnings begin to recover. This optimism must be tempered with the observation that the average length of S&P 500 price falls from peak to trough has been just under 2½ years and the S&P 500 only peaked on 12 October 2007.

We are expecting the UK economy to shrink by about 2% in 2009, and the US economy by about 1.5%. For 2010, we are pencilling in a weak recovery. But this recovery is based on an act of faith that the financial system will gradually get back to business-as-usual and the potency of monetary policy will be restored. *(There we go again. Just can't bring ourselves to believe that the financial system is broken for the long-run!)*

If our faith is justified then on say a 50% decline in earnings and 25% decline in dividends, the market would still be very attractively priced. However, if the UK economy posts another 2% decline in 2010, and earnings shrink by 80%, as has happened at least once before (1917 – 1922), then all bets are off. What will be the signs that the concerted efforts of central banks and governments are working?

One key indicator to watch is the Libor spread as this reflects the cost of bank funding much more closely than official rates. A return to spreads of less than 25 basis points will be a clear indicator that the banking sector is getting back on its feet allowing the normal monetary policy transmission mechanisms to function once again. Another series of linked indicators will be keeping an eye on the expansion or contraction of central bank balance sheets, the monetary base and the multiplier (money supply/monetary base). Shrinking central bank balance sheets and a declining monetary base, and a rising multiplier would all indicate that the period of quantitative monetary easing is coming to an end and credit is beginning to flow again.

Second, we need to see signs that tax cuts are being spent and not saved, and that expanding fiscal deficits are providing enough demand to break the downward spiral of activity. We should monitor closely indicators such as consumer confidence and retail sales to watch for early signs of a pick up.

Looking closely at the 1930s leaves us with a strong sense of optimism that the current crisis will not approach the horrors of the Great Depression. A combination of the gold standard and the poor design of

the Federal Reserve created severe constraints on its use of monetary policy. This led to a large contraction in the money supply when the Fed should have been expanding it. In the 1930s depositors were not protected; banks went bust. In the 1930s protectionist policies exacerbated problems globally. With Bernanke, an expert on the Depression, in the driving seat we are confident that the same mistakes will not be made. What is less clear though is whether the policy prescription will actually work. A recent IMF study (November 2008) of 42 banking crises since 1970 shows that the policy measures being used today (provision of liquidity, depositor protection/guarantee, recapitalisation of the banks and fiscal stimulus) have been commonly used in the past. It is hard to draw conclusions from this without a counterfactual to a crisis resolution where we can look at policies employed which haven't worked. Fortunately there are not many examples to draw on (and that's good news!) but there is possibly one with Japan and its lost decade. It is arguable that the slow response of the authorities contributed greatly to the onset of persistent deflation and this may well explain the rapid response of the Federal Reserve and the Bank of England this time around. We also have to recognise that we have no precedents on the scale of today's crisis to guide us. Ultimately we must simply wait and see.

When the indicators we have outlined begin to turn in the right direction, that is likely to indicate the beginning of the end of this particular financial crisis and may well herald a sizeable recovery in risk assets of all forms credit, equities and property. Let's hope that we don't have to wait until 2010!

For a fuller discussion on Policy Responses Available in a Financial Crisis please go to [www.schroders.com/talkingpoint](http://www.schroders.com/talkingpoint)

### **Important Information:**

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