Schroders

Talking Point

Market review & outlook - and surprises for 2009

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The downward spiral in credit markets accelerated in the final quarter of 2008. Falling securities prices led to weaker bank balance sheets, making banks less willing to lend and in turn leading to the forced selling of credit instruments by cash-strapped holders. The increasing cost of credit tipped the economies in the developed world into recession, leading to panic in markets. Equities, commodities and corporate bonds suffered significant falls. Government bond prices rose and yields fell by unprecedented amounts as investors sought a safe haven. The global economy is now facing the worst conditions since the Second World War.

Actions by governments around the world to support the banking system meant that the immediate worries about a systemic collapse in the financial system were removed. However, credit conditions continued to tighten. The final quarter of the year is likely to have seen some of the sharpest falls in economic activity since the global recession of 1980. The deteriorating outlook led to a rapid fall in commodity prices. The fear of inflation that hung over markets in the summer as the oil price soared has been replaced by the fear of deflation. The US Federal Reserve cut its target interest rate from 2% to just 0.25%. Rates were also cut in the UK, Euro area, Japan and in most countries around the world.

We expect economic output in the developed world to contract by around 1% this year – the worst performance for more than 50 years. Overall global growth should be positive due to the contribution from the emerging world. But even these economies will see growth slow sharply as demand for their exports contracts. The slowdown is expected to persist throughout 2009. We are forecasting a modest recovery in 2010 due to the impact of interest rate cuts and an increase in government spending. Lower commodity prices also help by boosting real incomes. The risk remains that the credit crunch continues to overwhelm the efforts of governments and central banks to revive activity, leading to a more prolonged downturn.

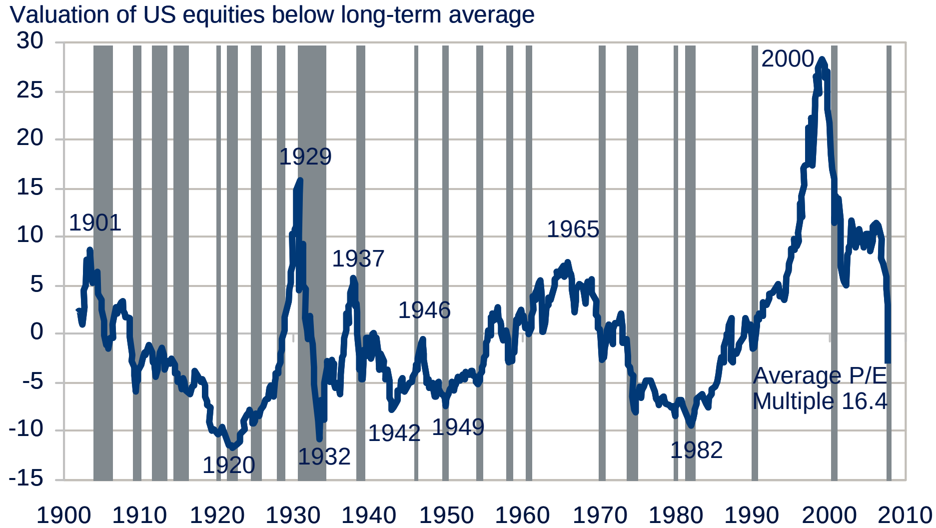
Consumer spending will remain weak. The long decline in the savings rate in the US and UK is now over and the savings rate will rise, possibly substantially. The corporate sector is responding to the squeeze on funding by cutting capital expenditure as well as employment. Government spending is expected to increase in order to offset some of the downturn in consumer and corporate spending.

Interest rates are expected to be cut further in many countries. Interest rates of zero are a real possibility in the US and Japan, and not impossible in the UK. Very low interest rates are expected to persist throughout the year and beyond. Central banks have moved beyond their normal methods in an effort to break the downward spiral in the price of credit instruments and avoid deflation. Some have increased the supply of money (in effect, printing money). Some have lowered the quality of assets that they are willing to accept as collateral from banks. Under normal conditions these measures would be highly inflationary, but in the present situation they merely act to offset the effective destruction of money caused by the unwillingness or inability of banks to lend. The risk is that these measures create the possibility of much higher inflation in the future.

The election of Barack Obama as president of the United States provides a ray of hope. The new administration will announce a fiscal package, rumoured to amount to more than 3.5% of GDP. Perhaps, just as importantly, he brings the hope of genuine leadership and renewed respect for government, both internally and externally, that has been fading over recent months and years. There is clearly considerable scope for a change in sentiment towards the US administration from current depressed levels.

Equity markets fell sharply as the outlook for earnings deteriorated. The US S&P 500 suffered its biggest annual decline since the Great Depression while the UK FTSE All-Share Index saw its biggest annual fall since 1974 (see chart 1).

1. Ratio of S&P 500 index to 10-year average earnings in relation to long-run average

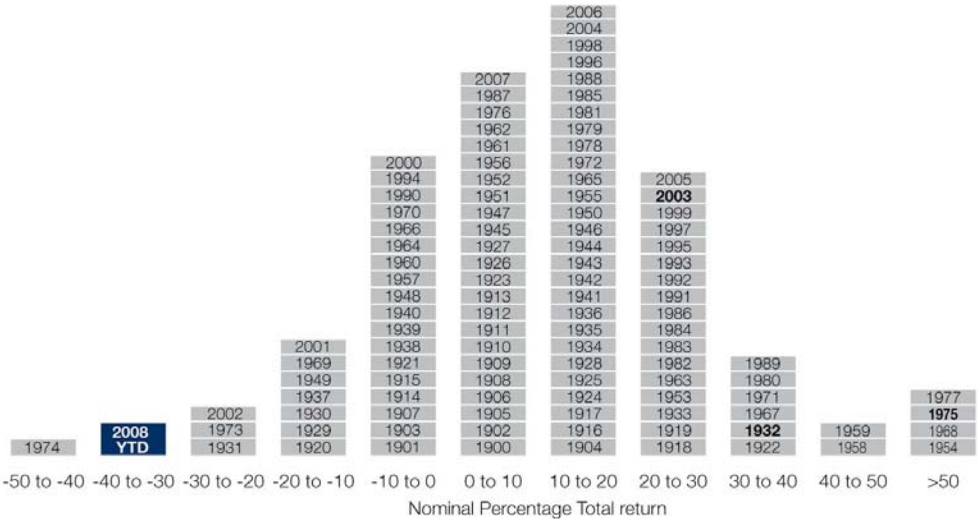


Market volatility also hit levels not seen since the 1930s. A strengthening yen meant Japanese equities provided the best returns. Emerging markets were hardest hit. Defensive sectors such as healthcare, telecommunications, utilities and consumer staples fell least while material stocks and financials suffered the biggest declines. Larger companies, that generally have greater access to capital, outperformed their smaller competitors.

The outlook for earnings has deteriorated sharply. Indeed, the economic outlook is so uncertain that companies are not in a position to provide meaningful guidance to analysts. We believe the conditions will be in place for a recovery in 2010 but there will be little evidence to either support or contradict this view for the next six months.

The fall in equity prices has taken valuations as measured by the price-earnings ratio through the bottom of the range of the last twenty years. Based on data from Yale Professor Robert Shiller going back to 1871, which looks at the price of equities relative to 10-year average earnings, the US market is trading below fair value. However, it has traded significantly cheaper during major crises, such as the Great Depression and the recession of the early 1970s and 1980s (see chart 2).

2. FTSE All-Share nominal annual return since 1900



The extent of the current crisis makes it very possible that we will trade further below fair value, but this is not a certainty. Nor is it certain that, if we are to reach lower valuations, this will happen in 2009. The US equity market price-earnings ratio averaged 16 times during the Great Depression, which was a deflationary environment. With current multiples below that level, it is possible that we have reached a sustainable valuation for the current environment. Valuations could come under pressure in future years if fears of inflation re-emerge.

A few ingredients seem to be falling into place for an equity market recovery. Market volatility has more than halved from its peak. Corporate bond spreads have stabilised over the last month. The dollar has fallen (having been a safe haven) and the gold price has rallied, perhaps indicating that the US Federal Reserve's actions have produced excess liquidity. Fears of deflation persist, however, and are unlikely to disappear while commodity prices continue to fall.

Government bond prices soared as investors fled all other asset classes, leading to an unprecedented fall in bond yields. The yield on a 10-year UK gilt fell from 4.5% at the end of September to just over 3% by the end of December. The fall in US yields was even more dramatic, declining from 3.8% to 2.1% over this period. Credit spreads widened significantly, for both corporate bonds and emerging market debt. Corporate defaults started to increase while, amongst emerging markets, Ecuador defaulted on debt payments.

The yield on the US 10-year bond can only be justified if investors expect a repeat of the decade of deflation seen in Japan. (The yield on the Japanese 10-year bond has barely traded above 2% this decade and hit a low of 0.4% in 2003.) This scenario cannot be fully discounted. The US authorities, however, have acted much earlier in the crisis and are pursuing much more aggressive policy than Japan ever did. Their determination to avoid deflation at any cost – including printing money – makes betting on 10 years of deflation a dangerous proposition. However, bonds may remain overvalued while deflationary fears persist.

For corporate bonds, defaults will rise significantly further. However, a very bad outcome is already priced into markets. Our next change in policy is likely to be to favour corporate bonds over governments. We expect supply to increase significantly for both corporate and government bonds.

Commodity prices fell sharply. Leading the decline was the oil price, which fell to $37 from a July high of $147 (see chart 3).

3. Oil Price Back to 2004 Levels (Brent Oil USD)

Every commodity future in the Dow-Jones AIG index fell over the quarter. Gold bullion managed a small increase over the quarter, which contributed to a record eighth annual gain.

The combination of falling prices and tightening credit conditions meant that major cutbacks in production were announced. Many mines and wells are unprofitable at current market prices. Indeed, some metals are trading at levels that mean that half of the producers are operating at a loss. While the outlook for demand has worsened, the scene is being set for recovery.

Gold provides a hedge against the risks that governments go too far in their efforts to reflate economies through unconventional – and untested – means. In particular, excessive money growth without coincident economic growth would be an attractive environment for gold.

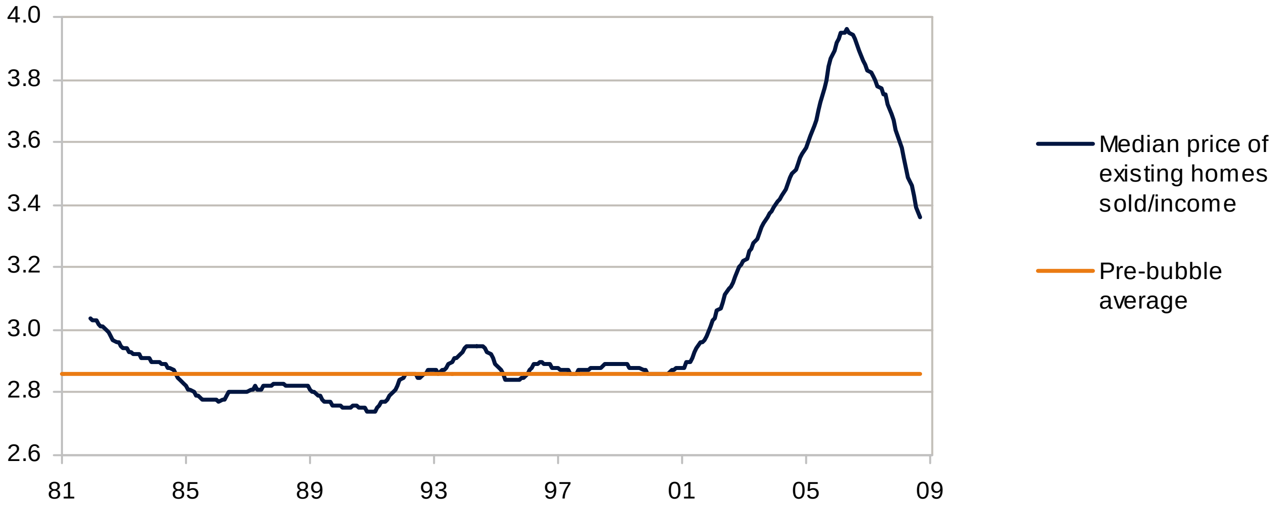
Hedge funds produced poor returns. The rise in the cost of borrowing impacted all strategies and, in some cases, forced managers to reduce exposure to illiquid investments at distressed prices. Convertible arbitrage managers produced the worst returns while macro trading and merger arbitrage managers finished the quarter in positive territory (using HFRX index returns). The industry saw large outflows of capital and we expect these to continue in 2009. This will mean that many managers will remain reluctant to commit capital to illiquid markets, which could hamper returns. Further out, the reduction in the number of hedge funds and less competition from the proprietary trading desks of banks should translate into more attractive returns. The ability to go both long and short a market or security remains an attractive attribute in the current environment.

The listed hedge fund sector was hit particularly hard as discounts to underlying net asset value increased. Most vehicles will trigger continuation votes in 2009, meaning a number of funds will be wound up with cash returned to investors at net asset value. We see significant value at current prices.

The fall in equity prices means that the private equity deals done over the last three years will struggle to achieve positive returns and will need to be held for many more years than planned. The volume of deals done between 2005 and 2007 is said to equal all the investments prior to 2005. This will destroy the long-term record of the industry and lead some investors to question the rationale for the strategy. We believe there will be plenty of attractive opportunities for funds with cash to invest to find attractive opportunities. The obvious areas of attraction are the many areas where there are distressed sellers, including the secondary market in private equity funds.

House prices continue to decline in the UK and the US. Prices remain above long-term fair value (see chart 4) and are expected to fall further. We expect further downside to commercial property prices in the UK, Continental Europe and America. Here too, distressed sellers will present buyers with attractive opportunities in 2009.

4. US House Price-Income Ratio



Finally, 2008 will prove to be a year that forces investors – including ourselves – to question their strategic asset allocation framework. This does not mean we are about to abandon our investment philosophy. We remain committed to a multi-asset approach. However, even investors who thought they would never have to worry about liquidity, such as the US endowments, have been faced with liquidity issues this year. Many of these liquidity issues will persist. Therefore we will be asking ourselves whether the return premium for illiquid strategies is sufficient.

We start 2009 knowing that the economic outlook is as bad as any of us have faced in our careers. We also know that this is well understood by the markets. We are convinced that there will be good opportunities in the year ahead to buy assets at very attractive prices from distressed sellers. We also expect that these opportunities will persist for some time. We will continue to be highly selective in increasing exposure to risk assets.

Surprises for 2009

Here are eight events that could upset consensus next year. They range from the distinctly possible to the more improbable.

1. Economic activity collapses

Despite economists spending the last six months slashing forecasts, the dysfunctional banking system leads to a sharper fall in activity than expected. The US economy shrinks by 5% while growth in China slows to 4%. The Chinese devalue their currency in an effort to sustain exports, creating trade frictions around the world.

This would see many of the trends of the last six months repeated, with risk assets suffering, commodity prices falling and the yen the likely beneficiary within currency markets. Government bond yields fall as deflation becomes a reality.

2. Agricultural commodity prices rises hit the headlines again

The combination of falling commodity prices and tight credit margins has led to cuts in production. It has also meant less investment in new capacity. While energy and industrial metals are suffering demand destruction, the same is not true for many agricultural commodities. Smaller harvests push prices higher.

This is bullish for agricultural futures and agricultural equities.

3. Hedge fund assets under management halve AGAIN

Funds under management fell from around $2tr to around $1tr in 2008. The events of the last quarter trigger more investors to reduce exposure. The Madoff fraud proves the final straw for some. Many investors, committees and trustees rethink their strategic asset allocations at the start of the year and exposures to illiquid investment strategies are cut.

Expect more constraints on liquidity to manage the outflows. The impact of hedge fund selling on broader markets will be less than experienced over the last six months. Future returns should eventually be boosted by the reduction in competition for hedge fund strategies.

4. Banks are nationalised in UK, US and beyond

Banks are only half way through the deleveraging process. Lending continues to shrink. The need for additional capital remains. The Obama administration follows the example of Roosevelt, temporarily closing banks while their balance sheets are examined and nationalising those with insufficient capital.

With banks now effectively capitalised and incentivised to lend, credit risk falls. Equities recover and high yield bonds lead returns in the fixed income area.

5. Low quality stocks outperform

Earnings prove as bad as expected in 2009. The downturn, however, is particularly painful for companies that have proved defensive to date. Global consumer staples companies suffer as customers in emerging markets return to cheaper domestic brands. For pharmaceutical companies, the shift to generics again exceeds expectations. In contrast, leveraged companies that manage to service their debt recover strongly.

Consumer cyclicals and industrials outperform consumer staples and healthcare. The US market has been seen as the safe haven and would prove a laggard in this environment.

6. UK house price declines accelerate

The housing market peaked in the summer of 2007 and fell sharply in 2008, with transactions drying up. While further falls are expected, few investors are fully aware that studies of historic housing busts around the world show that downturns typically last four to six years. Rising unemployment leads to more forced selling, accelerating the rate of decline.

Other housing markets around the world will experience similarly prolonged downturns. This is negative for consumer sentiment and therefore consumer sensitive stocks.

7. A major financial firm fails

The key risk in the aftermath of the failure of Lehman Brothers was a systemic failure of the global financial system. This fear subsided following various government measures to support major banks around the world, as well as the absorption of the broker-dealers into the banking system. However, the dealing rooms of many of the largest hedge funds are indistinguishable from those of investment banks. The collapse of a major hedge fund causes chaos through the complexity of the derivatives market.

This would again favour defensive investments over risky assets. It would accelerate the flow out of hedge funds.

8. Equities rally strongly

The sharp declines in markets and expectations of global recession means 2009 starts with sentiment at rock bottom. The combination of actions by governments and central banks around the world together with a recovery in commodity prices eases fears of deflation, reducing the risk of holding equities. US earnings peaked last year and usually bottom within two years. Investors start to look towards recovery in 2010.

Commodity related equities would be expected to lead any rally associated with an easing of deflationary pressures. Government bond yields would rise.

31 December 2008