GLOBAL VALUE
INVESTORS

EQUITY MARKET UPDATE AND OUTLOOK

The benchmark Stoxx Europe 600 Index dropped 6.1% this past week to its lowest level since July 2009 The gauge, whose decline for a fourth week was led by banks and carmakers, has now sunk 23% from its February peak, amid concern that policy makers are failing to tame the debt crisis.

National benchmark indexes fell in every western market except Iceland last week, with the S&P falling 4.7%, Germany's DAX Index declining 8.6%, the U.K.'s FTSE 100 Index down 5.2% and France's CAC 40 Index dropping 6.1%. Compounding investor concerns, statistics released Aug. 16 showed the German economy, Europe's largest, almost stalled in the second quarter.

There are several questions that are pertinent to investors at the moment.

1. What are the risks of a double dip? - Clearly, markets tend to under and overshoot and whilst a 45 ISM data number is already expected by *the market* in early September that does not mean that we are going into a recession. However, the market is already there. Institutions are basically positioned for the worst outcome with Merrill Lynch's monthly Fund Manager Survey which shows managers have record levels of cash and retail investors are withdrawing cash at rates not seen since September 2008. On the flip side, company directors are buying their own company stock at levels last seen in Q4 2008 (FT and Dealogic data last week).

   The Philly Fed manufacturing index reading last week of -30.7 (from July's 3.2) is the first real sign that a US recession is possible. But this measure is not reliable and is very volatile. It gave false recessionary signals in 1995 and 1998. It significantly overestimated the extent of the downturns in 1970,1974,1980,1990 and 2001. It may be doing the same again. Remember the headline figure is derived from a question on "general business conditions" and can be greatly influenced by general sentiment. If one looks at the index from the five more quantitative questions of new orders, shipments, employment, supplier deliveries and inventories, which is used in the ISM data, then the figure is around -12. Based on current data, the ISM is suggesting a fall to 49 in August. It needs to fall to 46 or below to signal a recession (remember, the market is currently assuming a 45 reading). We are still of the view that slower than normal growth in the US, Japan and UK over the next 12-18 months is probable with the risk that there could be one or two quarters of negative growth during this time.

2. Will valuations sustain equities?- Basically, if one feels that the market can fall further, then you need to believe that US earnings are going to fall below $85 over the next 12 months. Whilst this is obviously possible, one has to believe that that the current economic environment is likely to deteriorate to a greater degree than that seen in 2008/9. That is, the greatest economic contraction seen since the depression? $85 puts the US market on a P/E of 13x.

   Here are the numbers for the index levels and possible earnings targets for the current year (next four quarters) until June 2012.

S&P level	EPS($)	P/E
1300	100	13x
1200	90	13.3
1100	80	13.75

Based on these numbers, the US is cheap. The picture is even better for the UK and of course Europe but the structural issues of the latter have been covered in (4) below.

Even using the Graham & Dodd cyclically adjusted P/E ratio (CAPE) for equities, Global equities are trading on 20.5x; the US is 18.5x; UK 13.8x and Europe 13.5x compared to the 30 year average of 20x. Around here should therefore be the base for equities unless we are going into another severe recession/depression which we do not believe to be the case at the moment.

3. History as a guide to likely future equity price movements – The recent fall in equities has put equity yield above bond yields in the UK, US and European stock markets. This valuation phenomenon is rare and in the case of the US has only been seen 5 times in the last 30 years. What is even more impressive is the twelve month return from equity markets post this phenomenon. 1 year forward returns from the US, UK and European markets have been 38%, 29% and 18% compared to an overall average return of 11% in each region. In other words, history suggests that there is an above average chance of better than average returns at current valuation levels and it is better to Buy rather than Sell equities!

S&P price correlation – Once again skyrocketing

Source: Bloomberg

The chart above shows the recent spike in stock correlations as both value and growth stocks become indistinguishable in terms of performance. The market moves as one amorphous body driven by ETF's, futures and program trading and underlying volumes accordingly diminish.

4. Impact of a European banking crisis? – For the last two years European politicians have essentially 'been asleep at the wheel' in terms of showing any sort of political leadership to solve the underlying issues relating to European debt and the knock on effect it is having in the euro zone. It must be remembered that whilst Angela Merkel *et al* discuss their frustrations with the way in which the 'market's' have been trying to paint them into a corner, the fact is that all of the euro zone countries (including Germany) have been happy to use the bond and equity markets when it suits them. They have all raised enormous amounts of money via bond issuance for years and Germany has been happy to let domestic manufacturers export to southern European countries, knowing full well that there was massive risk being taken by their banking system via export trade guarantees etc. But for as long as it reflected positively economically, they were happy to bask in the political 'glow' of economic strength and wellbeing. The moment things started to go wrong, like spoilt children, they blamed the 'system'. Sure, it is not perfect but it is still a lot better than the alternatives! Recession is probable.

   We are still of the belief that European markets are likely to continue to underperform the US, UK and Japan. They have serious structural issues that are going to take many years to overcome and to this end we continue to lighten our exposure to these markets and increase our US exposure (currently 35% compared to c15% three months ago).

5. Can emerging markets rescue the world from a slowdown? – The short answer is No. Whilst emerging markets are still expected to grow by an average of 6% pa over the next few years they are also running large current account surpluses. This is mainly a function of China and the Middle Eastern oil producers where there would need to be a massive rise in imports to these countries to run down the surpluses. Huge domestic stimulus programs would be needed and given the already high levels of inflation in these countries that seems unlikely to happen. Ultimately, the inextricable link between demand and supply between developed countries and emerging countries means that if the US and Europe go into recession there is simply insufficient domestic demand to absorb the huge manufacturing capacity of these latter countries.

Summary

Based on the above, we do not at this stage believe that the US is going to fall into a sustained recession. It is more likely to be a low growth environment for the next 12-18 months. There may well be one or two quarters where GDP data records a negative number that will rattle markets, but by and large, we feel this is the right fundamental level to buy equities and that the probability is on our side for higher prices 12 months time.

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