Strategy Update

Investment Research – general market conditions

ESN

26 June 2013

The Outlook for Equity Markets

:

How long will it last ?

- Based on historical averages, it seems prudent to now contemplate whether the current up-cycle in economies and equity markets is close to having run its course
- However, cycles have been lengthening for structural reasons and the majority of our economic and monetary indicators are pointing to an economic up-cycle that will prove to be significantly longer than the historical average…
- …and accordingly, to a cyclical bull market in equities with still some years left to run
- Although maybe not quite as imminent as currently feared, the next major test for equity markets will inevitably be the initiation of a new monetary tightening cycle
- History suggests that the equity market will be vulnerable to significant turbulence and correction potential around this adjustment…
- ...and the start of the next tightening cycle could be all the more jarring for markets, given the unprecedented nature of the unconventional monetary stimulus currently deployed…
- …but history also shows that the underlying up-cycle in the economy and equity market can continue as monetary policy is renormalized
- In fact, over the past three expansions, the cyclical bull market in equities outlived the entire monetary tightening cycle

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Time Has Been Passing

Since 1933, the average duration of a US economic expansion has been about 59 months. The current expansion is now in its 48th month and counting.

Cycle Duration Becoming Increasingly Relevant

US NBER Recessions

Economy Troughs (Recession ends)	Economy Peaks (Recession starts)	Months of Expansion (from trough to peak)
	Aug 1929	
Mar 1933	May 1937	50
Jun 1938	Feb 1945	80
Oct 1945	Nov 1948	37
Oct 1949	Jul 1953	45
May 1954	Aug 1957	39
Apr 1958	Apr 1960 *	24
Feb 1961	Dec 1969	106
Nov 1970	Nov 1973	36
Mar 1975	Jan 1980	58
Jul 1980	Jul 1981 **	12
Nov 1982	Jul 1990	92
Mar 1991	Mar 2001	120
Nov 2001	Dec 2007	73
Jun 2009	?	48 and counting as of June 2013

Average expansion 59.4 months

* Fed Funds Rate hikes from 0.7% in July 1958 to 4.0% in December 1960
** Fed Funds Rate hiked from 9.5% in July 1980 to 20% in December 1980

Since the 1930's, the US equity market has made its cyclical bull market peak about 7 months before the peak in the economy on average.

US Equities Peak 7 Months Before the Economy on Average

S&P 500 Index Peaks (Monthly Data)	US Economy Peaks (Recession Starts)	Equities Before/ Behind (Months)
Sep 1929	Aug 1929	1 Behind
Feb 1937	May 1937	3 Before
Apr 1946	Feb 1945	14 Behind *
Jun 1948	Nov 1948	5 Before *
Jan 1953	Jul 1953	6 Before
Apr 1956	Aug 1957	16 Before
Jul 1959	Apr 1960	9 Before
Dec 1968	Dec 1969	12 Before
Jan 1973	Nov 1973	10 Before
Feb 1980	Jan 1980	1 Behind *
Nov 1980	Jul 1981	8 Before
Dec 1989	Jul 1990	6 Before
Aug 2000	Mar 2001	7 Before
Oct 2007	Dec 2007	2 Before
	Average	**7 Months Before**

* Data for these periods judged to be un-representative and therefore excluded from the average (inclusion would reduce the average to 5 months before).
Sources: NBER, Shiller

Cyclical peaks in the economy and stock market are invariably followed by recessions and cyclical bear markets. Cyclical peaks and troughs in the US, European and global equity markets have always been closely synchronised

Europe Turns When the US Turns

Cyclical Bull Market Highs for S&P 500 Index	Cyclical Bull Market Highs for Datastream E.U. Equities Index
April 2000	March 2000
October 2007	October 2007

So, “on average” it seems reasonable to contemplate whether the current economic expansion is within say 11 months of a cyclical peak that would mark the beginning of the next recession and accordingly, whether stock markets are within say 4 months of a cyclical peak that would mark the start of the next cyclical bear market.

Cycle Duration is Clearly of Paramount Importance

The duration of the current economic expansion is already in excess of that for 6 of the 13 expansions since 1933. Nonetheless, if it were to match the 73-month duration of the previous expansion (Nov 2001 to Dec 2007), the current cyclical bull market in equities might have another 18 months to run. Likewise, if it were to match the 120-month duration of the more previous expansion (Mar 1991 to Mar 2001), the cyclical bull market might have another 65 months to run and if it were to match the 92-month duration of the yet more previous expansion (Nov 1982 to Jul 1990), the cyclical bull market might have another 37 months left to run.

So, will the duration of the current up-cycle in economies and equity markets be average or relatively long?

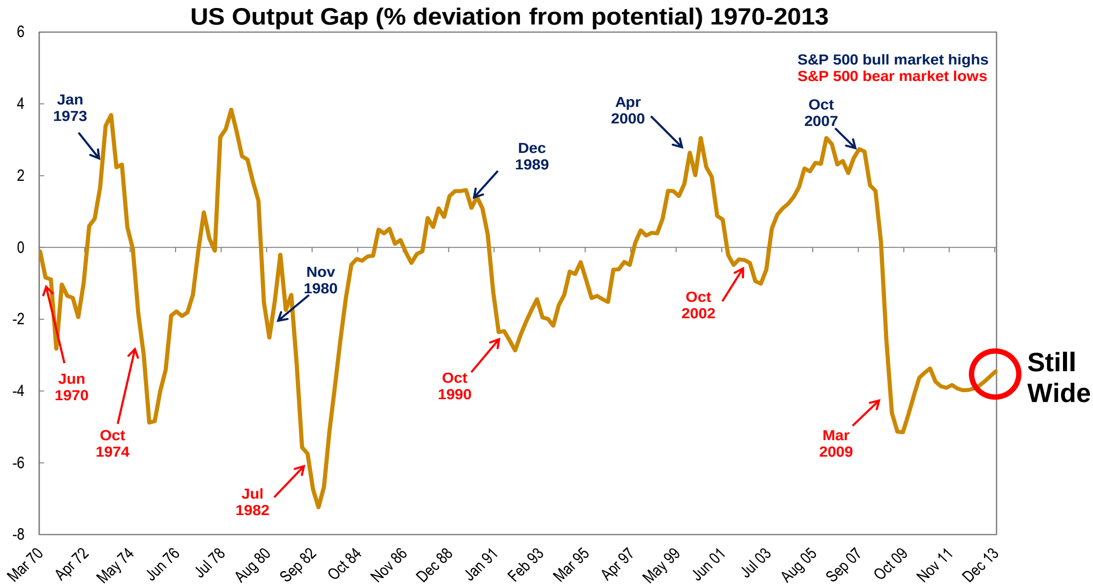
Cycles Have Been Lengthening for Structural Reasons

Of the 13 economic expansion cycles since 1933, the most recent 7 have averaged 71 months in duration, whereas the most distant 7 averaged 54 months in duration and the two with shortest durations (24 months and 12 months respectively) were characterised by unusually aggressive monetary tightening. Cycles have been lengthening structurally as movement from manufacturing towards services lessens the impact from inventory corrections. Cycles have also been lengthening structurally as global policy (monetary, fiscal, trade, security etc) has become that bit more coordinated and enlightened.

Economic Indicators are Consistent with a Still Immature Expansion Cycle

Wide output gaps testify to US, European and other major economies still functioning well below their potential levels and cyclical highs in economies and equity markets do not come until after the output gap closes.

Cyclical Bull Markets Don't End until after Output Gap Closes



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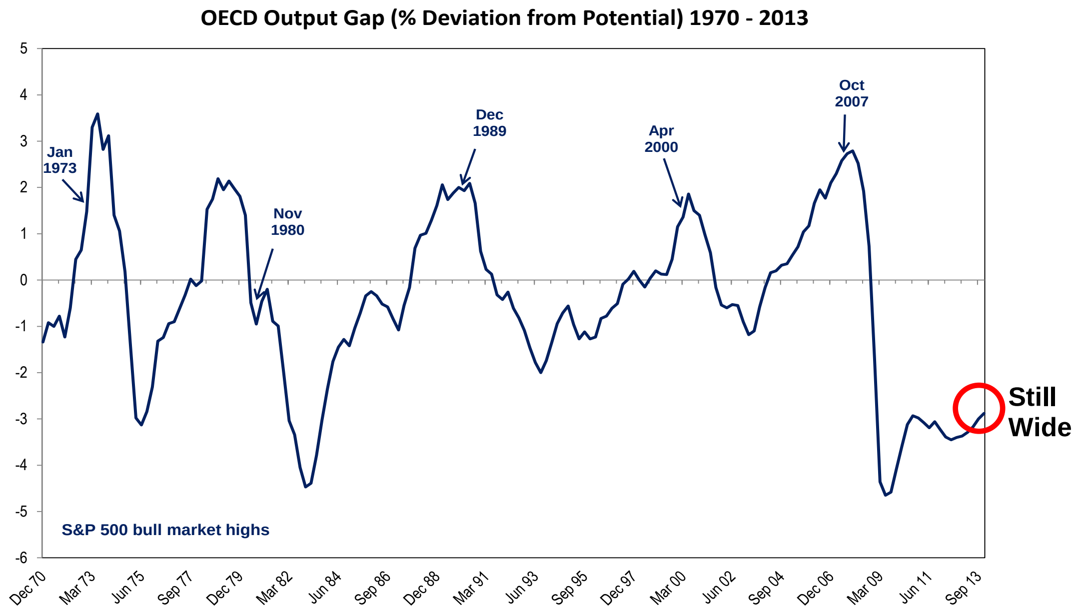
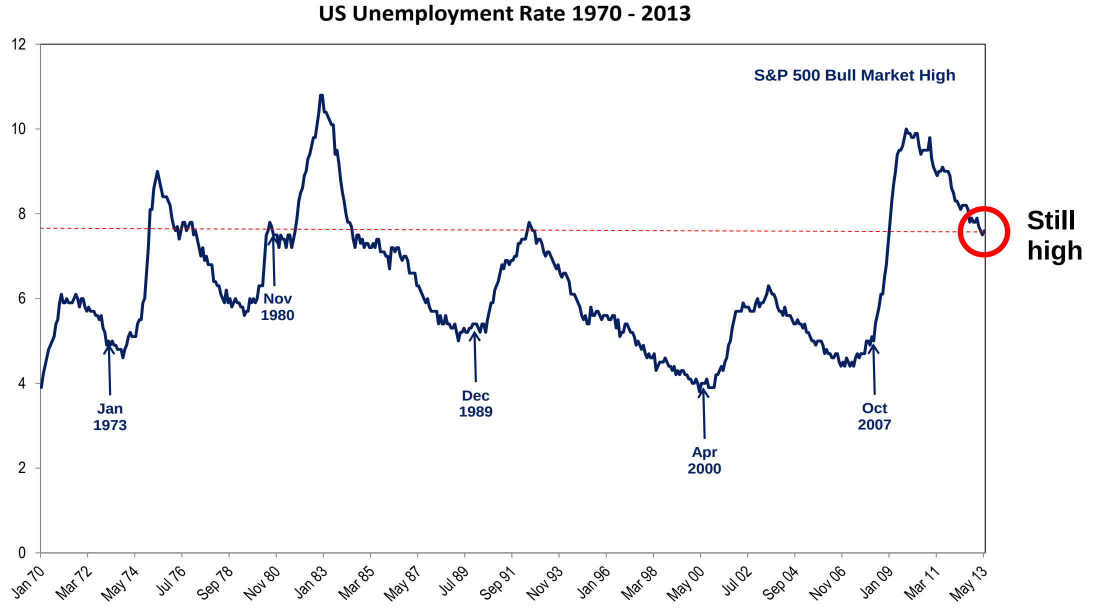


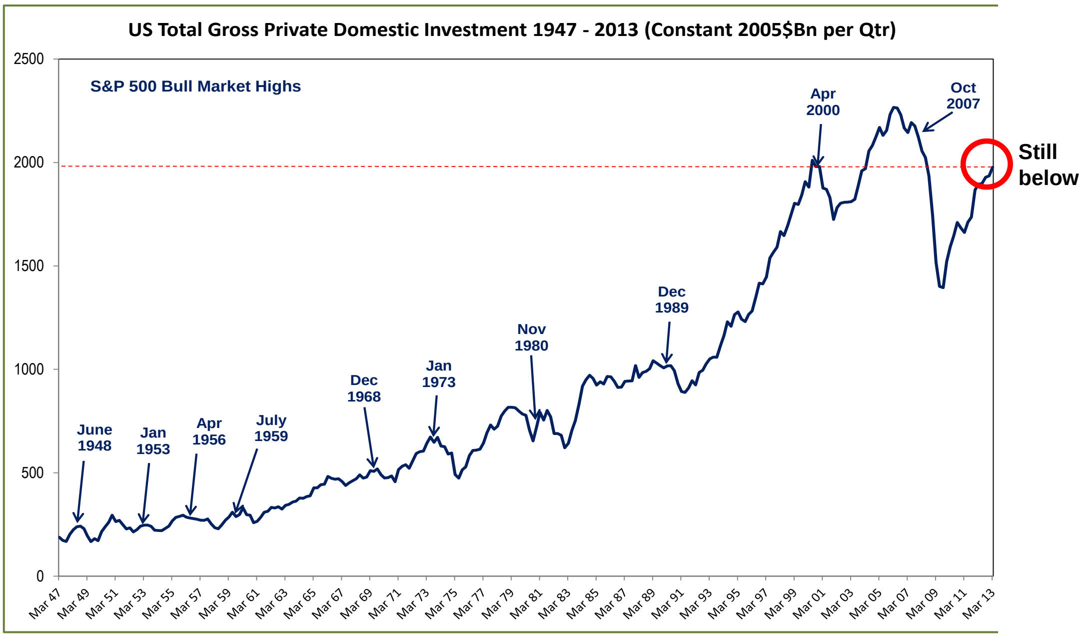
High unemployment levels in the US, Europe etc are proof of these wide output gaps and cyclical highs in economies and equity markets do not normally come until unemployment rates are considerably lower than current levels.

Cyclical Bull Markets Don't End Until Unemployment Rate is Considerably Lower



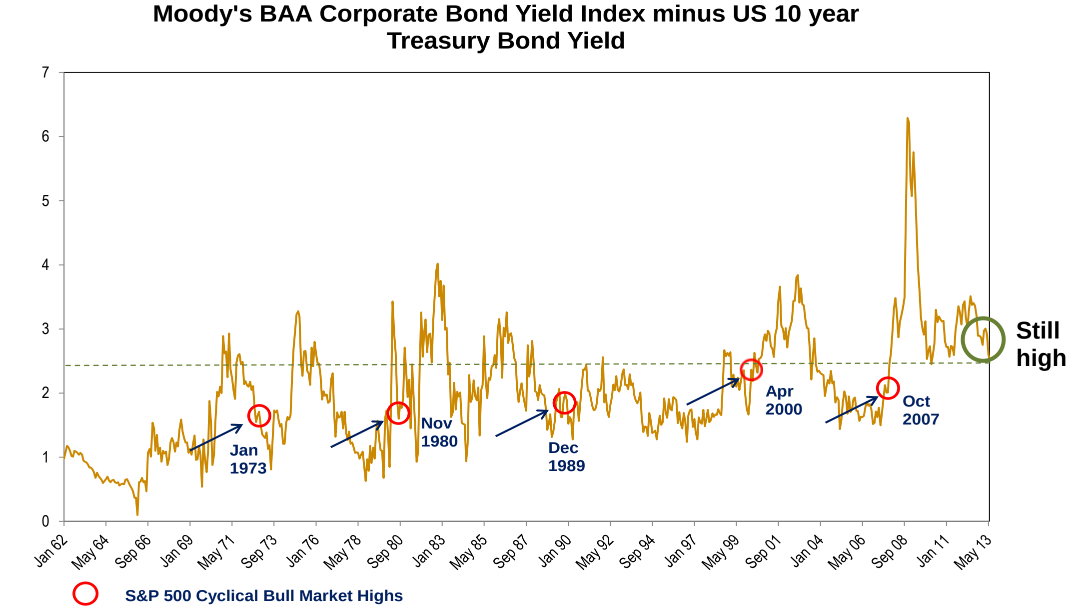
Private sector investment remains depressed in the US and Europe as corporations and individuals remain in cautious mode. US total private sector investment spending is still below the previous two cyclical peaks in real terms. Cyclical peaks in the economy and equity market do not usually come until after private sector investment makes a new cyclical high.

Cyclical Bull Markets Don't end until Real Private Investment Spending makes a New High



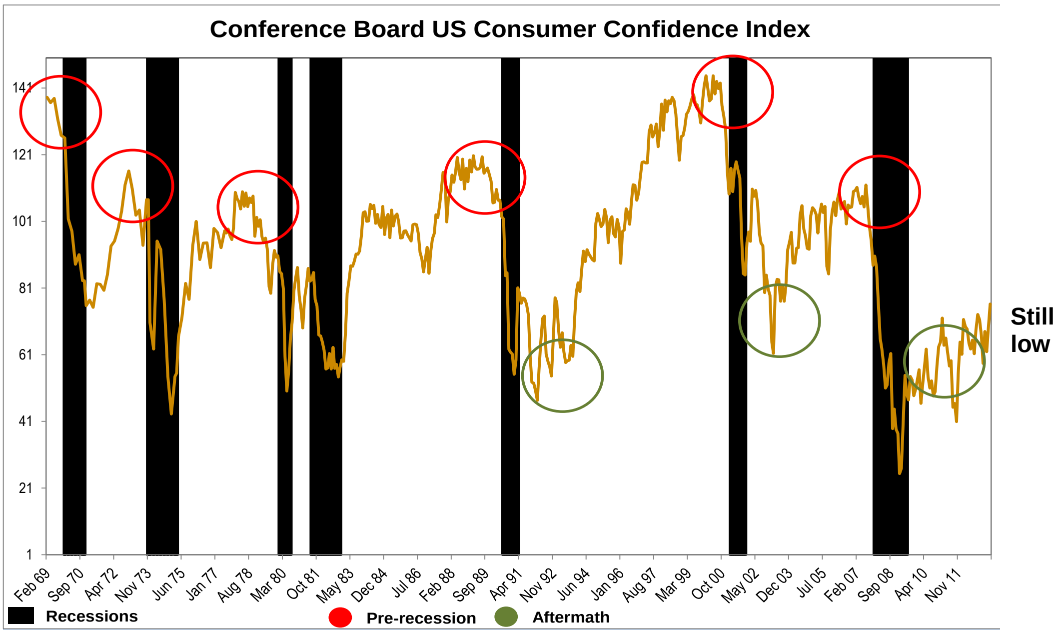
Spreads on corporate bond yields (over government bond yields) have not yet dropped to the lower levels that precede cyclical highs in the equity market.

Corporate Bond Yield Spreads Typically Rising from Lower Levels before Equities make a Cyclical High



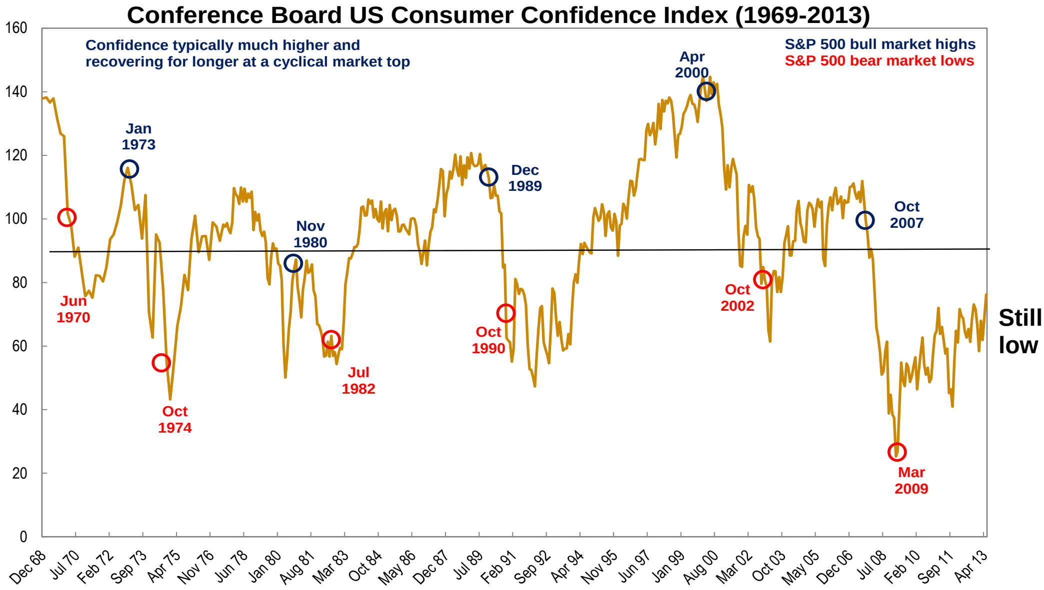
US consumer confidence remains at historically depressed levels and more typical of the aftermath of a previous recession than the prelude to the next recession. End of cycle recessionary risk typically only rises after confidence has risen to and sustained significantly higher levels than currently.

Consumer Confidence Falls from Strong Levels Before Recessions



Similarly, consumer confidence is typically much higher than currently and recovering for longer before the equity market reaches a cyclical peak

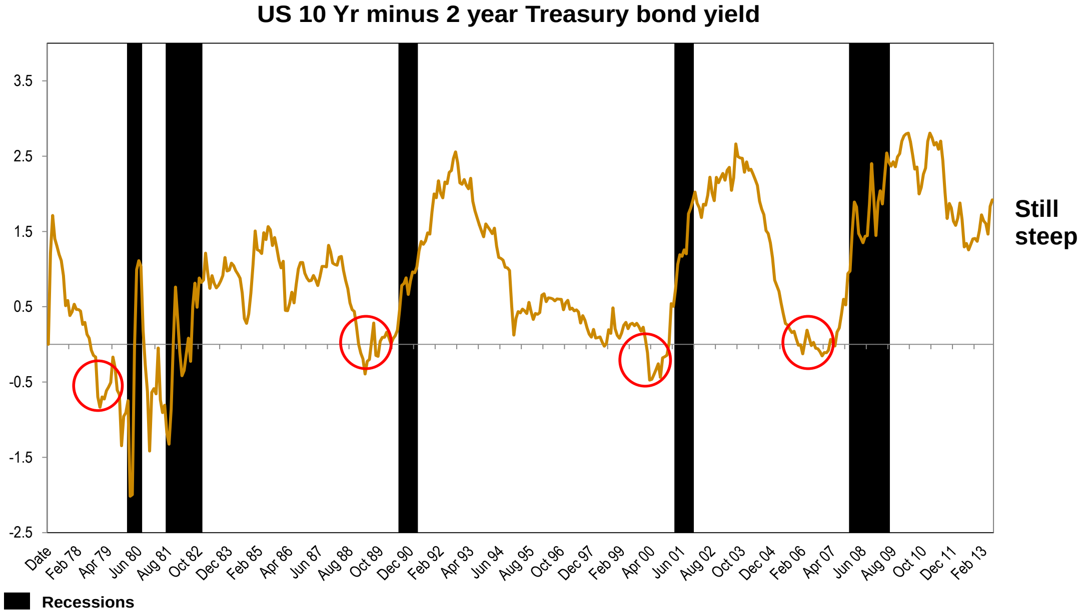
Confidence Still too Low for a Cyclical High to be Close



Monetary Conditions are also Consistent with a Still Immature Expansion Cycle

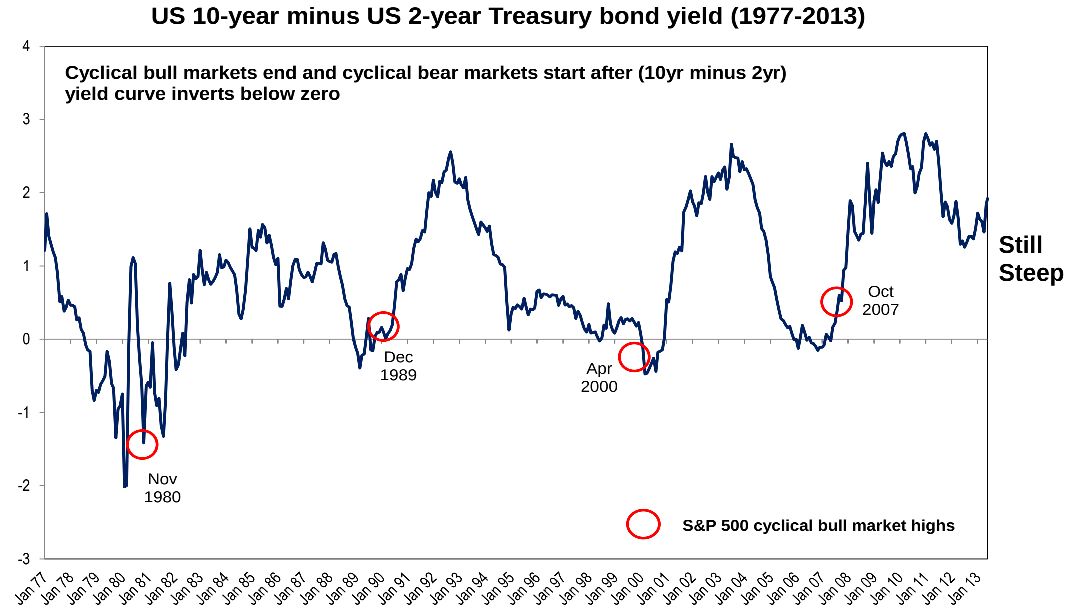
Typically a maturing economic expansion does not give way to recession until the yield curve (difference between ten-year and two-year government bond yields) inverts (turns negative) under the influence of sustained central bank monetary tightening.

Recessions Follow Yield Curve Inversion



Similarly, the cyclical bull market in equities does not give way to a cyclical bear market until after the yield curve inverts.

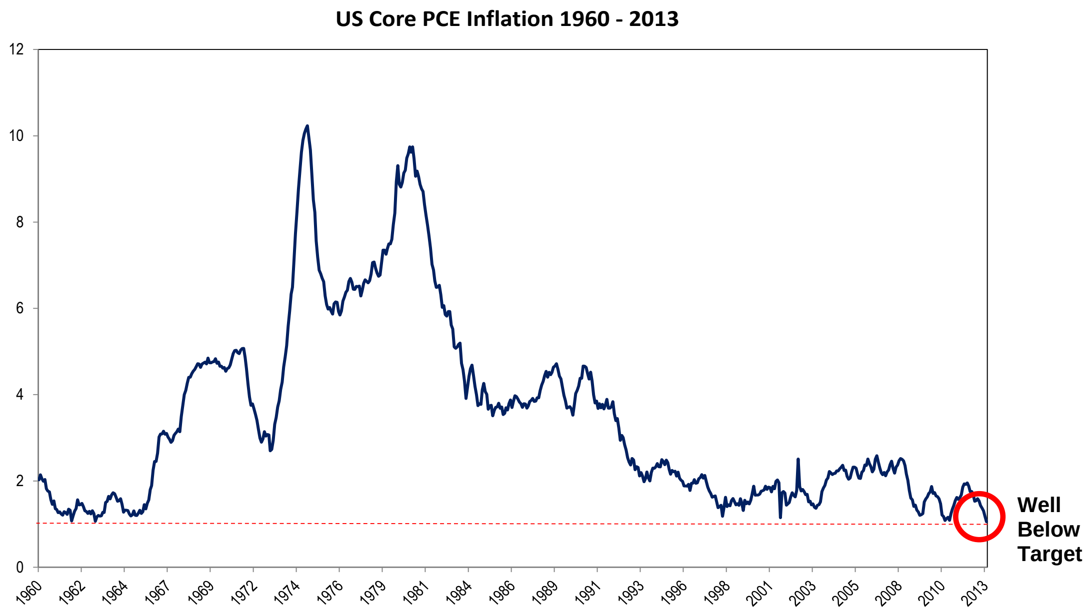
Steep Yield Curve Consistent with a Continuing Cyclical Bull Market



Yield curves in the US and Europe remain quite steep and the monetary tightening cycle has not yet started, suggesting that cyclical highs in economies and equity markets are in no way imminent.

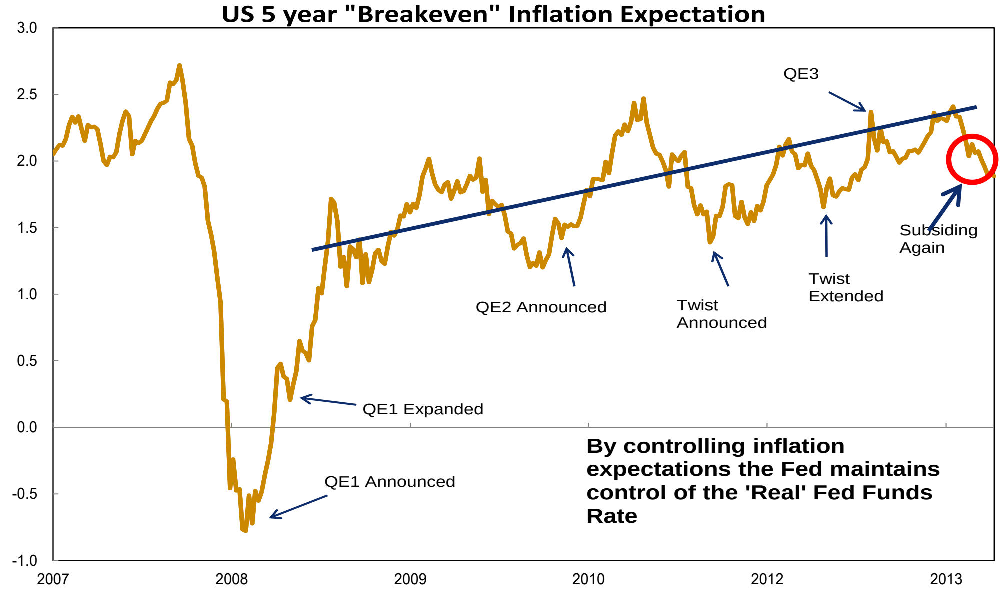
It is inevitable that a new monetary tightening cycle will start at some point as a positive consequence of an increasingly established and self-sustaining economic expansion. However, the US labour market remains relatively lacklustre and the renewed downward momentum in core inflation from historically low levels cautions the Fed that the deflationary threat has not yet been seen off.

Record Low Core Inflation keeps Fed Wary of Lingering Deflationary Risks

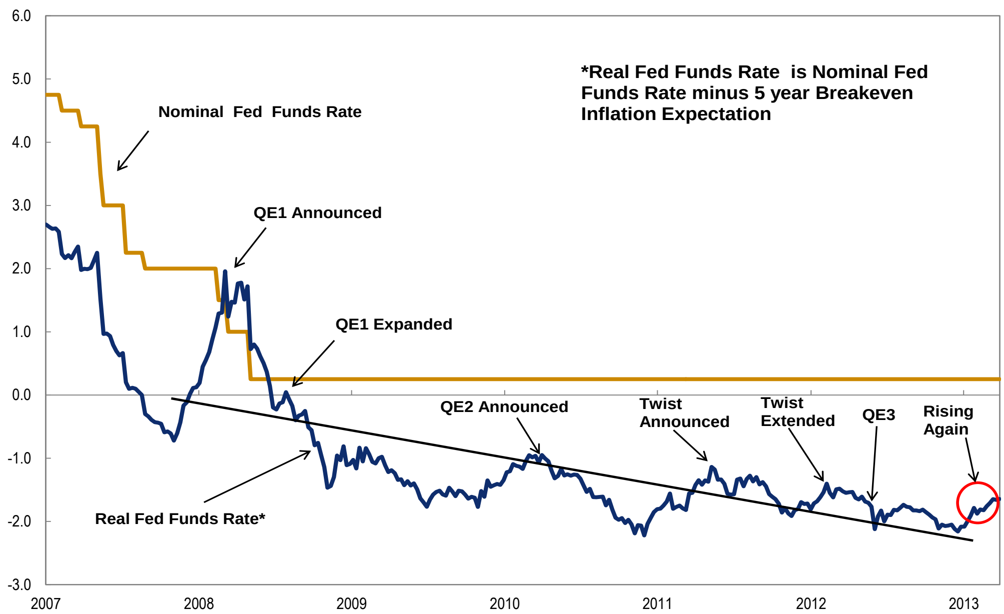


In the “zero-bound” world, the Fed maintains its ability to cut the all-important real Fed funds rate (when appropriate) by using QE to increase inflation expectations. So recent subsidence in inflation expectations is in itself a form of unintended monetary tightening and anticipation of imminent significant “tapering” still seems a bit premature. In Eurozone, the prospect of monetary tightening is significantly more remote and further easing still seems more appropriate.

Controlling Inflation Expectations is Fed's Weapon in a 'Zero Bound' World



Fed must keep Control of the 'Real' Fed Funds Rate

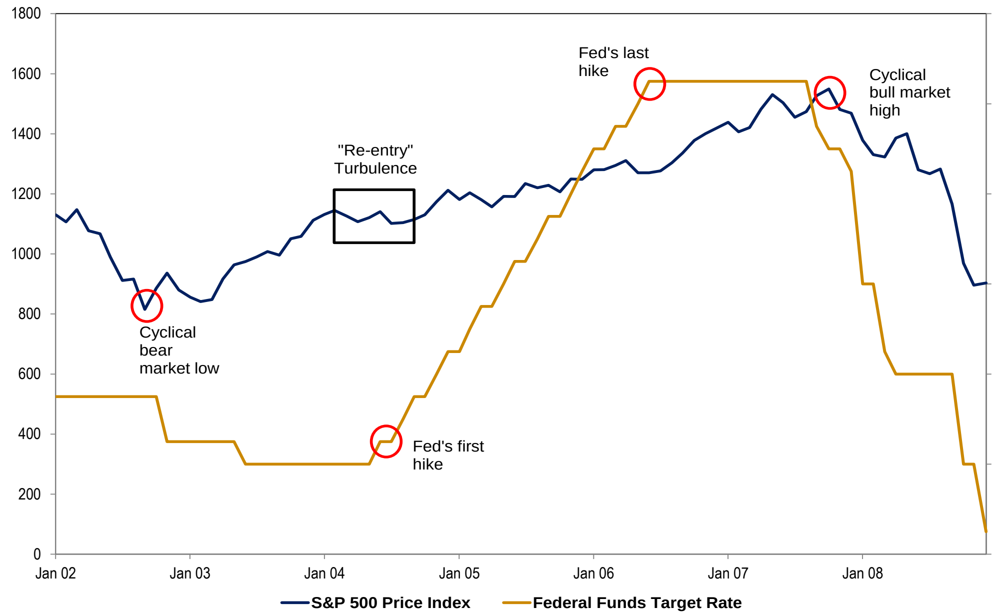


A Cyclical Bull Market Typically Outlives the Full Monetary Tightening Cycle

When the new monetary tightening cycle does begin, this is typically consistent with the on-going cyclical expansion in the economy and stock market still having some years left to run. The equity market tends to be particularly vulnerable to turbulence and correction at the start of a new tightening cycle before settling into the view that renormalisation of monetary policy reflects a healthy renormalisation of economic growth. Given the unprecedented nature of the unconventional monetary stimulus currently deployed, the start of the next tightening cycle could be all the more jarring for equity markets. However, the underlying cyclical bull market can be expected to resume after this period of adjustment.

The most recent Fed monetary tightening cycle started in H1 2004 and the on-going cyclical bull market in equities continued for about another three years from that date.

A Cyclical Bull Market Usually Outlives the Monetary Tightening Cycle



The previous Fed tightening cycle started in early 1994 and it was over six years later before we saw the cyclical high in the equity market.

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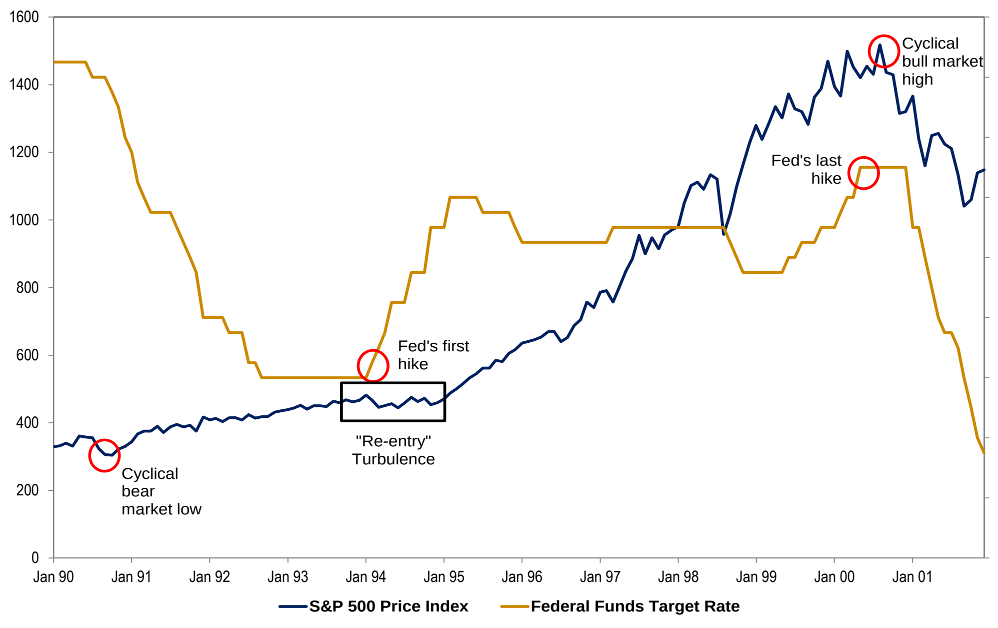
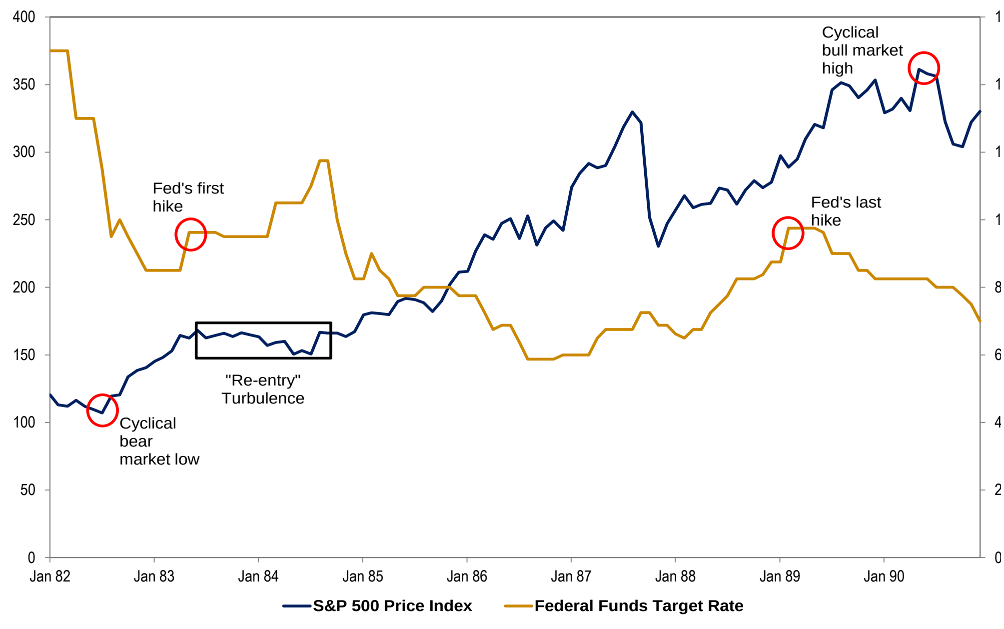


The yet more previous Fed tightening cycle started in H1 1983 and it was about seven years after that before the equity market made its cyclical high.

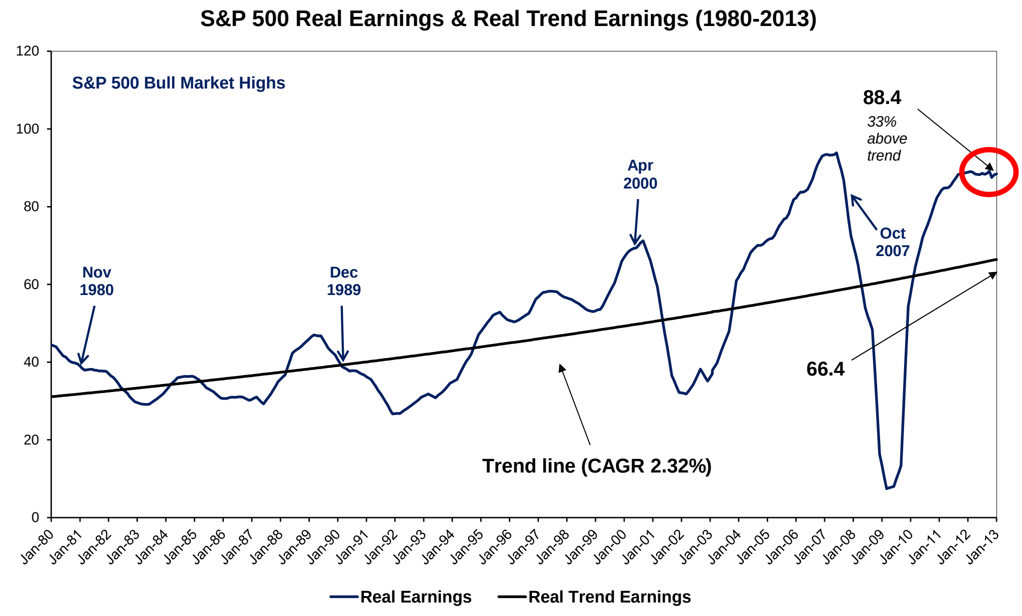
A Cyclical Bull Market Usually Outlives the Monetary Tightening Cycle



The Indications from Earnings are More Ambiguous

US earnings well above the underlying trend level look to be more consistent with a maturing cyclical uptrend in the economy and equity market and if the recent peak in earnings marks a cyclical peak, this would certainly not be consistent with optimism about potential remaining duration for the cyclical bull market in equities.

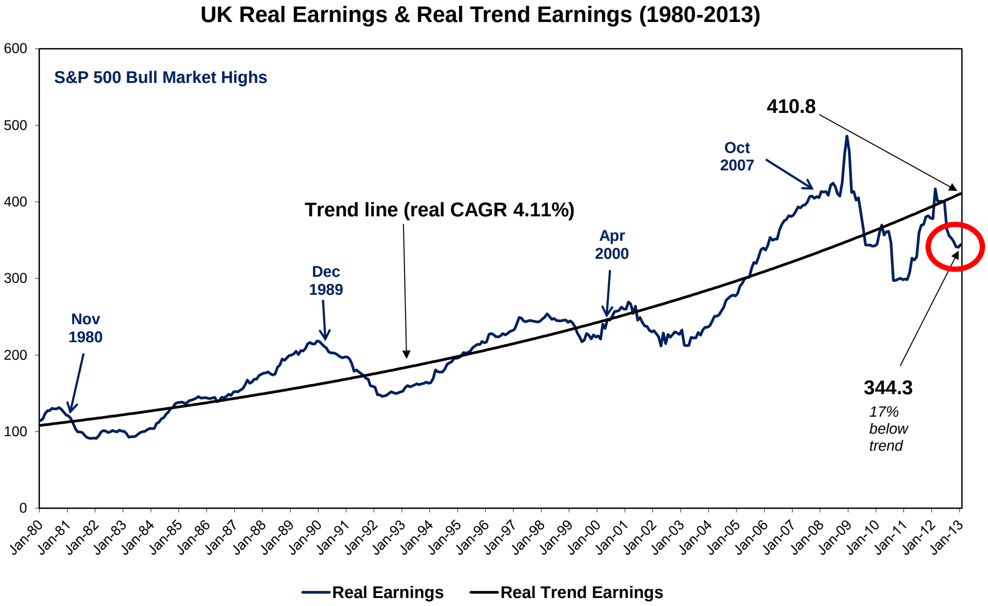
US Earnings Open to Ambigious Cyclical Interpretation



However, corporate profitability has for quite some years now been boosted by structural factors related to globalisation and the pricing power of capital relative to labour. The forces for structural mean reversion of profitability and margins still look to be absent, although likely to be an inevitable eventual structural headwind for equity markets over the medium to longer term. In the meantime, improving cyclical growth in the economy can yet take earnings to new cyclical highs as top-line revenues re-accelerate. Reassuringly, recent downward revisions to earnings expectations were driven by disappointing top-line performance as margins held up well.

European earnings are below the underlying trend levels and are therefore more unambiguously consistent with a relatively immature up-cycle in the economy and equity market.

European Earnings still Consistent with an Immature Up-cycle



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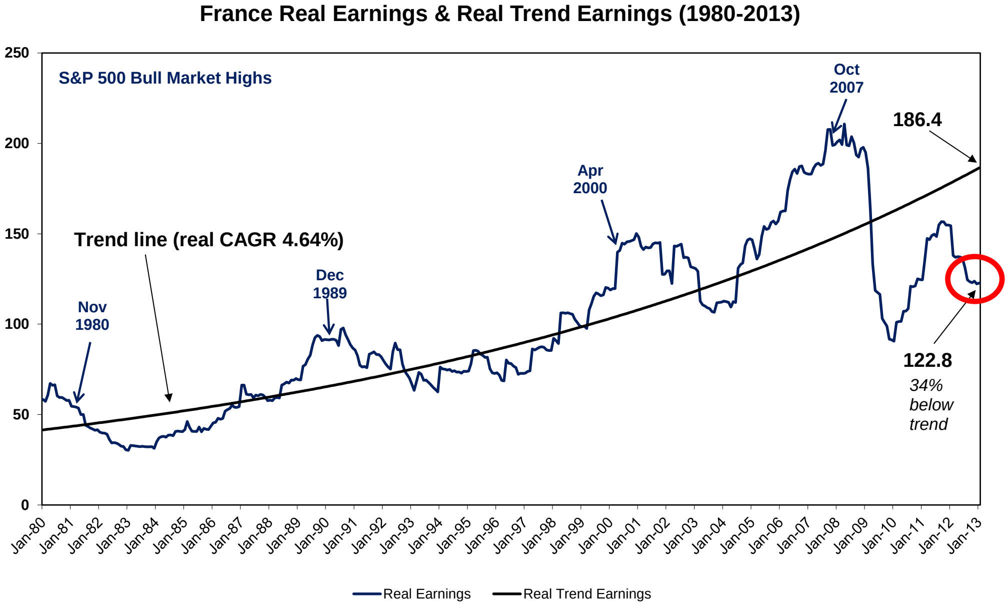

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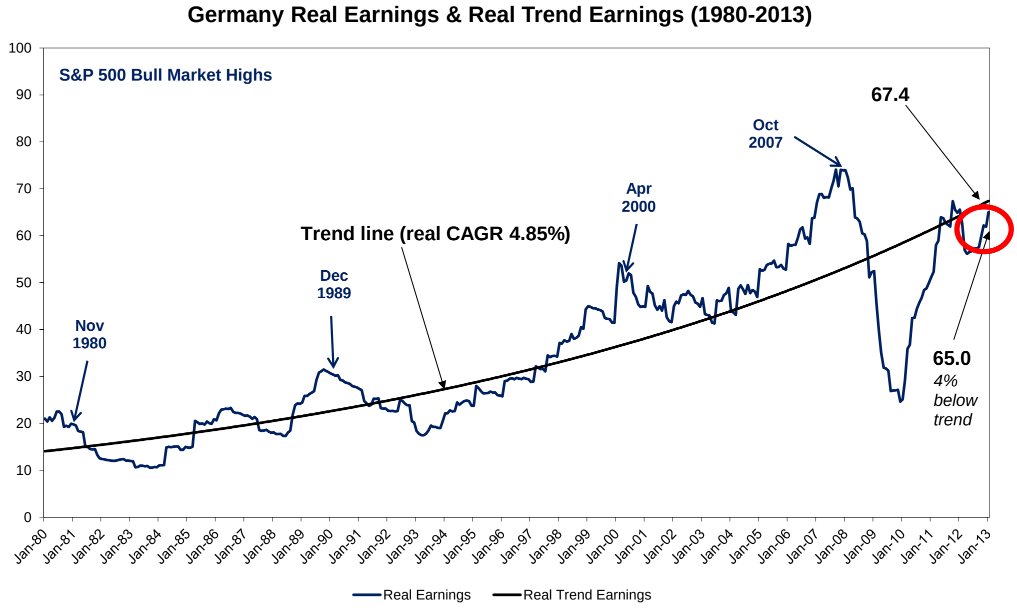

Conclusion

Looking at historical averages, it seems prudent to now contemplate whether the current up-cycle in economies and equity markets is close to having run its course. However, cycles have been lengthening for structural reasons and the majority of our economic and monetary indicators are pointing to an economic up-cycle that will prove to be significantly longer than the historical average and accordingly, to a cyclical bull market in equities with still some years left to run.

Although maybe not quite as imminent as currently feared, the next major test for equity markets will inevitably be the initiation of a new monetary tightening cycle. History suggests that the equity market will be vulnerable to significant turbulence and correction potential around this adjustment and the start of the next tightening cycle could be all the more jarring for markets, given the unprecedented nature of the unconventional monetary stimulus currently deployed.

However, history also shows that the underlying up-cycle in the economy and equity market can continue as monetary policy is renormalized. In fact, over the past three expansions, the cyclical bull market in equities outlived the entire monetary tightening cycle

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Meaning of each recommendation or rating:

- **Buy**: the stock is expected to generate total return of **over 20%** during the next 12 months time horizon
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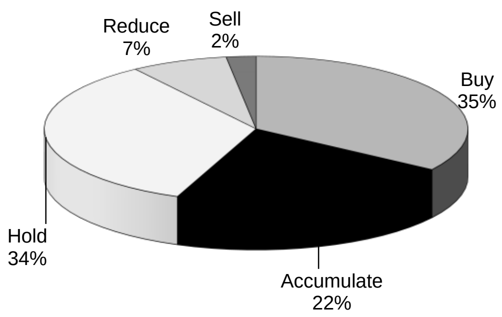

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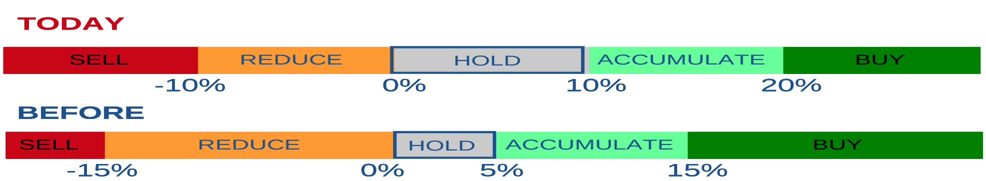
- Time horizon changed to 12 months (it was 6 months)
- Recommendations Total Return Range changed as below:



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