Is everything rosy in the equity market?

Sophie Blanpain and Gareth Quantrill of Norwich Union Investment Management look at the world equity market and the technology revolution.

After a disappointing mid-year performance, world equity markets have recently regained ground. Were investors too pessimistic in July, when the correction began, or are they too complacent now?

The drivers

Our view of the market is derived from the analysis of three inter-related 'drivers': valuation, liquidity and sentiment. Valuation is a function of earnings and interest rates; liquidity increasingly is an international factor; sentiment is probably the most volatile element but, in the short- to medium-term, is key. It also has a strong international dimension.

Valuation is very powerful over the long term, yet sole reliance on it can affect a fund manager's performance and possibly his or her job. Valuation becomes a key driver for the market when it reaches extreme levels, as it did in 1987 and in the autumn of 1998. At other times, sentiment tends to dictate what valuation levels investors are willing to accept in large valuation ranges. Here, UK equities are well inside the acceptable valuation range. To see this, we can compare the prospective earnings yield and bond yield (*Figure 1*). The lower the ratio, the more expensive equities are relative to bonds.

On this crude but often effective measure, UK equities are fair value. Moreover, the earnings expectations, as reflected in IBES estimates, are rather conservative (14% EPS growth over 12 months) compared with other markets.

Longer term, analysts appear cautious about the UK and are only expecting 10% long-term EPS growth. This should be contrasted with 16.4% for US equities and 15.6% for France. Relatively conservative assumptions mean that the risk of serious earnings disappointment is modest.

In the short term, earnings will meet these expectations because:

- overall growth is set to accelerate next year and will be synchronised across the major economies for the first time in over 10 years. The US continues to grow fast (too fast?), but the growth differential between the US and the rest of the world will narrow. This is relevant because over the medium- to longer-term, growth differentials tend to drive relative equity market performance. The UK, along with other European markets, should take over the baton from the US; and
- inflation is the wild card. Over the past few years, a strange dichotomy has emerged between bond and equity market participants. While the bond market worries that inflation will make a comeback, the equity market has been more complacent, since increased competition and remarkable productivity improvements enable (or force) companies to absorb input cost increases. This argument is now occurring even in the UK's MPC. A lot of inflation, meaning higher interest rates, is bad for equity markets, but a little helps in that it confers some pricing power in some sectors. The range of forecasts for the UK is consistent with a bullish picture for equities.

So, is everything in the garden rosy? Unfortunately not. While valuations suggest there may be an upside, modest to low liquidity levels in institutional funds and the rising cost of credit, combined with negative prospects for some leading foreign markets, suggest that overall gains for the FTSE will be only single digit in the year ahead. The main problem is a likely correction in the US. Valuations there are stretched, although that is not a problem in itself. However, combine that with the need for a cyclical slowdown to avert massive foreign debt build-up and the picture darkens. A widening external US deficit and rising interest rates mean a correction that will probably influence London for a while.

The impact of the 'new economy'

So can investors benefit from rapid technological changes? Companies continue to benefit from technology-induced productivity improvements. However, it may be more appropriate to think of the changes as a one-off boost. The problem is that nobody really knows how significant the boost will be or for how long. We do know that no company can grow three or 10 times faster than the economy forever. Even Microsoft is growing a lot slower now.

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FIGURE 1

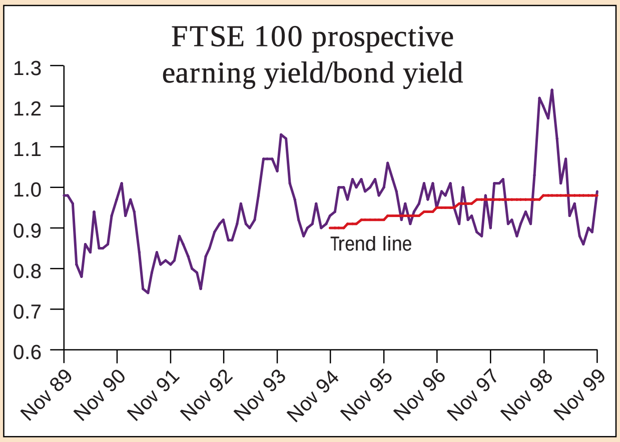
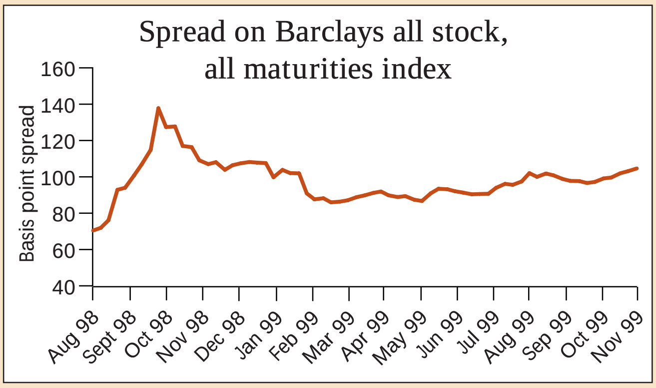


FIGURE 2



In a market, such as the UK, which is relatively short of pure technology plays, the best way to benefit from the technology revolution is by looking for companies across all sectors that are best placed to change the way they operate. Look for management teams that embrace new technologies. The effect will be particularly pronounced in sectors directly in contact with consumers. Companies that are late in embracing this challenge will find life increasingly difficult. Mind you, even the ones that do may not be big money earners. In each sector consider whether the technology raises or lowers costs of entry.

Consider how e-commerce can change the balance of power and erode traditional retailers' margins. A book shop ties up capital in two ways: premises and inventory. The cost savings of not needing a shop are obvious but the benefit of improved working capital management can be even more important. The shop will order according to what it thinks customers will want and must finance this purchase before being paid. An internet shop, on the other hand, gets paid prior to or at the same time as it ships the goods. The benefits of this, though, are unlikely to remain with the cyber-shop for long. It is easy to establish such an enterprise so the gains will be passed on to the consumer rather than to increasing margins. This means there is no alternative to research and looking at the circumstances of individual companies.

If that is true for strategic investment to benefit from technology, it is no less true tactically. Sector rotation is no longer the name of the game. Cyclical sectors have already been re-rated in line with growth expectations, financials are unlikely to enjoy a flattening of the bond market yield curve, while most investors are fully invested in growth sectors. So out-performance in the coming months is likely to be primarily from stock selection rather than allocation.

What about the capital markets?

The UK corporate bond market has a somewhat different composition to that of the UK equity market. About one-third of total issuance is from sovereigns and supra-national entities, such as the European Investment Bank, and one-quarter is from financial institutions. The remainder is largely debt issued by asset-rich borrowers, such as property companies, pub operators and utilities. Sectoral preferences are therefore more often between AAA-rated and A-rated bonds than between food producers/processors versus household goods/textiles. It seems more appropriate then to talk about the corporate bond market and the opportunities for companies to diversify their sources of capital.

The UK corporate bond market has enjoyed another strong year of expansion in 1999 with new issuance to the end of October in excess of £36bn. The corporate bond market now totals over 39% of all fixed-rate sterling assets – a percentage set to increase as government finances have tipped into surplus.

Hand in hand with this strong growth has been the rise in investor interest; spurred by the low absolute level of government bond yields and the diminished opportunity for out-performance from trading government bonds alone following the start of Emu.

This gives us a situation in which institutional investors are searching for new ways to add value for their clients at the same time as further disintermediation moves the corporate debt stock from traditional bank financing to more innovative capital market deals.

So it seems surprising that, despite supply being matched by increasing allocations to the non-gilt market, spreads are back to levels last seen during the flight to quality (as seen in *Figure 2*), following the Russian default, Asian crisis and collapse of the Long Term Capital Management hedge fund.

Nervousness over the Y2k issue and rising short rates in the UK, Europe and the US, have contributed to spread widening. As these factors fall away the demand factors will cause spread tightening of about 25bps over the next 12 months, particularly for long-dated issues. This potential will generate further interest in the market.

One feature in 1999 has been the relative out-performance of industrial credits. This reflects the dearth of issuance from this sector and demand from long-term investors in the corporate bond market for greater diversity of issuance. As more analysis resources are applied by investors and brokers so the issuer base will broaden.

The UK corporate bond market leads Europe in size, maturity spectrum possible for issuance, sophistication of investors in credit analysis and a thriving private placement market. The gyrations of international markets have not prevented two years of record issuance and investor needs suggest that demand for corporate debt will only increase. ■

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