



Daily Themes

22 January 2010

Earnings now needed to drive equities higher

The continuing increase in capacity utilisation and the peak in unemployment confirm that the economy has shifted to a recovery phase, as predicted already by our recession probability model. Previous cycles suggest this will mean more muted equity performance compared to last year's extraordinary rally, as the driver of returns shifts from PE valuations to earnings growth.

Using economic variables like industrial utilisation, unemployment and trends in the output-gap (actual versus potential output) we split the cycle into five phases; early recession, late recession, recovery, expansion and slowdown. An analysis of the behaviour of changes in the price-earnings ratio (PE), earnings and equity prices over the past 5 US economic cycles shows that equity markets tend to be forward looking.

Phases of the cycle and equity performance*

Cycle phase	Duration (in months)	% Δ Real PE	% Δ Real Earnings	% Δ Real Price
Early Recession	15	-8	-10	-7
Late Recession	9	24	-5	24
Recovery	20	3	16	5
Expansion	20	21	24	29
Slowdown	9	-9	-10	-8

Source: Coutts. *S&P 500 Index

The strongest pick-up in PEs typically occurs in the late recession phase, as investors anticipate earnings improvement. This phase, which started last March, has historically been extremely profitable for equity investors as risk premiums (the additional return investors demand for taking on risk) decline in anticipation of a more benign environment for businesses. However, compared to other phases of the cycle, late recession also tends to be relatively short.

During the later stages of recession, continued economic and earnings deterioration are shrugged off by investors, as a slowing pace of deterioration

and government support programs lead them to anticipate improving profits. Actual earnings improvement follows later in the recovery and expansion phases.

Our model suggests we have now moved from late recession to recovery, when earnings tend to rebound strongly and verify what many investors anticipated during the late recession phase. However, despite strong earnings, equity returns are typically very low. Stock-price gains in the late-recession phase have made valuations more expensive (higher PEs) and earnings only "catch up" with prices during recovery.

Historically, cycles characterised by structural changes, financial crises or synchronised recessions among major economies tend to be longer. The current recovery, following a global credit crisis and synchronised global recession, looks set to last longer than the averaged noted in the table opposite.

The historical pattern also suggests that equity returns will not be strong again until the expansion phase. This won't happen until growth is above trend and the economy is operating above full capacity, which is some way off.

Still, our analysis suggests that equity markets, despite having rallied strongly, are not currently overvalued. Real trailing PEs have increased from less than 12 at the March trough in the S&P 500 to more than 17 recently. This may not seem fully justified by current economic activity and earnings, but equity markets are forward looking and higher PEs reflect an expected rebound of 25% in corporate earnings. As we move through the recovery phase we expect corporate earnings to improve faster than stock prices and equity returns to be less than the strong results seen in the second half of 2009. Despite lower absolute returns, we believe equities will outperform both government and corporate bonds.

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