Daily Themes

11 March 2009

Picking equity ideas in a deflationary environment

Selecting equity sectors that will outperform in a deflationary period is a bit like quantitative easing: it's all theoretical, as the only historical parallel is Japan and that, for a variety of reasons, doesn't really work. Yet there are still some lessons to be learnt about where value is to be found in 'value' stocks and how deflation affects some of the so-called defensive sectors.

The problem with Japan as an example is that its period of deflation was a slow, long-drawn-out process. And, despite the misery of the 'lost decade', growth did not collapse entirely, because the global economy was coming out of the recession of the early 1990s to enjoy a period of strong, if not unbroken, growth and unprecedented prosperity. That background made it far easier for export-oriented industrial sectors than the current global recessionary environment where, to take one example, Japan's exports have all but halved over the past year.

Relative performance of Japanese sectors 1997-2005

Best four		Worst four	
Consumer Goods	+28%	Telecoms	-34%
Technology	+27%	Financials	-20%
Industrials	+20%	Consumer Services	-9%
Health Care	+20%	Utilities	-5%

Source: Datastream

It is still possible to garner some useful information from the Japanese experience, especially when we analyse other themes, such as 'value' versus 'growth' stocks, momentum, and large versus small. That can provide a greater understanding of drivers of performance in a deflationary environment.

First, to reiterate the obvious, the traditional defensive sectors of consumer goods and health care still outperformed during the Japanese deflationary period, as they do in normal recessions – and, indeed, as they have done so far in the current recession.

Financials, including banks, underperformed during the Japanese deflation. Although this might appear self-evident, it contradicts the normal experience of recessions, where the financials sector generally gets a positive boost from cuts to interest rates. Another underperformer was consumer services, including retailers. So deflation may mean that the current 'normal' outperformance proves to be unsustainable.

Beyond sectors, the key thematic drivers for performance in the Japanese deflationary environment were the outperformance of 'value' stocks. So, even when valuation measures for equities as a whole are not acting as a useful guide for short-term asset allocation, valuation can provide a good indication of the relative performance of sectors and individual shares. The other key driver was short-term momentum, which was very negative. So investors could consistently make returns from selling shares that had outperformed and reinvesting in underperformers.

Some questions remain unanswered. In Japan, small caps outperformed large caps, as the big banks weighed on the large-cap end. However, bottom-up analysis suggests that small caps should be more vulnerable, given their higher gearing and their dependence on funding from those same banks. Partly as a result, we have taken a negative view on small caps, even though we recognise that the historical record does not support this conclusion.

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