AQUILA

Flash

Are equities about to crash?

8 out of the last 10 equity bear markets were triggered by a recession. In 5 cases, very high stock prices also played a role. Experts have linked 4 cases to a sharp rise in commodity prices as well as aggressive interest rate hikes on the part of the Fed. For the world economy next year we see a continuation of the current trend of moderate growth and we also expect that commodity prices will remain low. While we think that the Fed will be a bit more aggressive in raising rates than the market currently expects, our US interest rate expectations are not such as to suggest that equity markets will crumble. Given also that many valuation metrics suggest equities are fairly valued, a crash seems unlikely. Equities remain our preferred asset class.

8 out of the last 10 bear markets were triggered by a recession.

J.P. Morgan has published a study of the circumstances of the last 10 bear markets – starting with the Great Crash of 1929 and ending with the global financial crisis which began in 2007. According to this study, 8 of the last 10 bear markets were triggered by a recession. In 5 cases, very high stock prices also played a role. Experts have linked 4 cases to a sharp rise in commodity prices and aggressive interest rate hikes on the part of the Fed. Given that investors are always concerned as to the chances that equities might crash, it is worth considering the factors associated with previous crashes and the extent to which these factors are present today.

We expect that the world economy will again experience moderate growth next year.

Obviously, an analysis as to the chances of a bear market involves a consideration as to the likelihood of a recession. In late summer, stock markets were buffeted by investor anxiety that the world economy might suddenly lose momentum. At the time we felt that such growth fears were exaggerated and this is still our view today. Following a phase of increasingly negative reports and comments on China, a consensus now seems to have developed that the Chinese economy stabilized in the second and third quarters and that the government has enough room for maneuver – in fiscal and monetary policy as well as in terms of regulation – to put China back onto a higher growth path. The US economy has now been in an expansion phase for 74 months and is thus in the top third of the 13 post-1945 expansions in terms of length. The longest post-1945 expansion was 120 months, or 10 years. Moreover, the present expansion is the least robust of all the post-WW2 expansions in terms of the growth rate, and this could well be a factor behind its longevity. For next year, we forecast a growth rate for the US economy of between 2% and 2.5%, not least because the recently agreed Budget should boost GDP by around 0.3%. So far as the Eurozone is concerned, the data suggest that this this year’s growth rate – around 1.5% - can probably be sustained next year. Even though Japan is unlikely to grow faster than 0.5% pa. next year and Russia and Brazil may well remain in recession, the world economy probably has enough momentum to achieve a 3% growth rate in 2016. Such an outturn could not be characterized as particularly robust growth, suggesting markets will continue to be intermittently fearful as to the health of the world economy.

A big run up in commodity prices is unlikely in the near term.

The well-diversified CRB Commodity index rose from 120 to 473 between 1999 and 2008. It now stands around 200. Commodity price series tend to show long cycles. The strong upward trend during the decade to 2008 encouraged a massive general expansion of capacity. This, together with reduced demand growth from China, has resulted in large supply overhangs – in particular for iron ore, copper and coal. Meanwhile in the oil markets the big growth in shale oil and gas production in the US has triggered a change in behavior on the part of oil producers in other countries. Saudi Arabia in particular has opted to defend market share rather than the oil price. The result is an excess of supply of oil of the order of 2 to 3 million barrels a day. For some time commodity markets have been engaged in the process of finding prices which will balance the markets in this new environment. It will take time for the necessary reductions in production capacity to take effect and thus a run up in commodity prices is unlikely in the near future. Given the theory that commodity prices tend to move in long cycles, the next upturn could well be as far away as 2018.

The Fed might feel itself forced to raise interest rates by more than the market currently expects.

Most investors believe that the Fed will only raise interest rates slowly. But our inflation forecasts suggest otherwise. "Core" US consumer price inflation is already 1.9%, and thus corresponds broadly with the Fed's long-term inflation target. The Fed's preferred measure of inflation is the price deflator for consumer spending which currently stands at 1.3%. From November, the big fall in oil prices will no longer impact year on year rates of inflation. As a result, broad – as opposed to "core" – measures of inflation will rise strongly over the next few months. If wage inflation increases as well, as some experts expect, the Fed might feel itself forced to raise interest rates faster, and by more, than the markets presently expect. By itself, this should not cause a steep fall in equity values. In the past, even aggressive interest rate hikes on the part of the Fed did not, on their own, cause equities to crash.

Equities are "fully valued", not "overvalued"

In terms of their history equities seem fairly valued. At current prices, prospective returns from holding equities are somewhat below historic returns in both Europe and the US. Meanwhile the Shiller P/E, which compares US equity prices with the average of US inflation-adjusted earnings over the previous 10 years, is just below levels which are generally viewed as expensive. Thus equities seem fully valued. They are not extremely overvalued.

Equities remain our preferred asset class.

While aware that financial markets can always move in unexpected ways, we nevertheless think an equity market crash is unlikely in the near-term, even though some of the factors which may in time contribute to a crash are already in place. With this perspective, we continue to favor equities over other asset classes.

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