COLLINGS' CORNER

A VU to a killing

Although equity markets are forward looking and tend to peak ahead of actual earnings, extreme liquidity swings can result in a significant time gap between the market rally and earnings 'catch up'. We are experiencing this phenomenon currently. A classic V-shaped market, and the associated expectation of earnings recovery.

In Q4 2008, an unprecedented liquidity squeeze caused indiscriminate market selling. Some major emerging markets' stocks were losing some 30% of their market value in a single week, to trade at 2x 2009 price-earnings.

The total outflow from global emerging markets in 2008 accounted for roughly U$50bn, and mainly took place during the fourth quarter. To put this in perspective – emerging markets lost in three months almost as much money as they had attracted in the previous five years. This money flowed out of the most compelling investment markets in the world, out of sheer necessity. And irrational panic.

Ironically, I feel earnings visibility was much higher then compared to currently. Valuations were so distressed some stocks were barely discounting a real earnings growth rate into perpetuity. Frankly, the valuations were so low that if one's earnings forecasts were out by 20%, it barely made a difference to the general medium term investment case. Currently, the reverse is true.

The result is a massive rerating of debt and equity instruments across all assets classes.

The Russian stock market, for example, is the best performing major market rising 130% in USD terms. For a while, the country was hailed as bankrupt by many commentators. The intellectual ignorant have not been spared the usual embarrassment.

Brazil has been forced to introduce a 2% foreign exchange tax on any new purchases of domestic equity and debt to cool off the potential asset bubble and slow down the BRL appreciation. Again, many commentators wrote Brazil off as a beneficiary of historic global reflation and developed market growth. Remarkable what a difference a few months make to perceptions.

Many people regarded the Russian asset sales to a select few during the 1990s as the 'sale of the century'. I believe the market behaviour during the fourth quarter of last year dwarfed the Russian opportunity hands down. Given the V-shaped recovery, the rational have made a killing.

By the end of September 2009, according to Emerging Portfolio Fund Research, total funds in emerging markets' equity within their survey were already above previous absolute highs of 2007 amounting to some US$ 70bn. A massive reversal of outflows, and in a very short space of time. Is this the top, and if not, how long will this rally continue?

The Russian stock market, for example, is the best performing major market rising 130% in USD terms

It is mainly market liquidity, resulting in expanding P/E ratios, which has driven the market. The markets are discounting the economic recovery. But, sustained valuation re-rating cannot continue for much longer, since valuations in the absence of the expected growth will simply resemble what most policy makers fear. An asset bubble. The 'easy gains' are behind us. History is illustrative in this regard.

In this current cycle, the S&P 500 index is up almost 60% from its trough in March 2009, earnings are down 9%, and the P/E ratio has increased by nearly 80% to stand at 21 times earnings. This price earnings multiple suggests that it will take 21 years of historic index constituent earnings to match the current market value of the index. That is some wait. However, there is no need for anxiety. If you are 50 years old now you will still be working when this event finally occurs.

The current rally has been much faster than any previous bear-market recoveries and has taken seven months versus a 13-month average.

The market is now at the crossroads and earnings need to take over as a driver, ie P/E-led gains need to give way to earnings-led gains. Phrased differently, hope needs to make way for reality. Whether actual earnings on the S&P will match expectations is another matter, of course.

Successful investment is an art and is largely based on a pragmatic judgement of probable outcomes. Experience and education help. But so does logic.

For many emerging market equities, the visibility of earnings is high and growth drivers are compelling. Out of almost all liquid asset classes, emerging markets have the biggest potential to deliver earnings that will match current market expectations and continue re-rating in the new earnings-led environment. This is especially the case relative to developed markets. It is logical, and an allocation in this direction will probably lead to superior medium term returns.

I believe a pullback in markets is warranted and probable. During that period the current euphoria will abate and people will probably take a view on the real economy. How will the market deal with the expectation of a global U-shaped economic recovery?

At current equity valuations, probably not very well. For investors, this is a time for caution, not courage. A U-shaped economic recovery will probably result in a protracted period of range trading and elevated volatility. If you were to bet on the market making significant gains from current levels, you should bet your mother-in-law.

Bryan Collings is the managing partner of Hexam Capital