Aviva Investors - Equity Market Review

Q4/09 Update

Philip Kearney

Presenter: With his outlook for the equity markets over the next few months, I'm joined now by Phillip Kearney, Senior Equity Fund Manager at Aviva Investors. Phillip, you stood up in January this year very publicly at your Focus Conference and predicted what was going to happen to the equity market, has that prediction been borne out?

Philip Kearney: Well at the time of our Focus Conference equity markets were in freefall. We found that many of our clients were concerned that we might be on the cusp of another great depression, and they were certainly fearful that equities would continue to plummet. At that time we put forward the view that though we were in a severe global recession, we wouldn't reach such a depression-like extreme as policy makers were going to do whatever it takes in order to avoid such an awful scenario. Against that backdrop, we presented a history of previous bear market crashes and, more importantly, their aftermath in order that we might get a sense of what would happen this time around. And the conclusion of that analysis was that equity markets would trough substantially before the recession would end and more than six months before company earnings reached their low, all of which pointed at equities troughing and moving higher by Q2 '09. In fact that's exactly what has transpired, with equities reaching their lows by mid March and since then the S&P has rallied by more than 50%.

Presenter: But if earnings are falling and equity prices are going up, surely valuations are getting expensive?

Philip Kearney: Well the fact that the market has rallied while profits are continuing to fall means that P/Es have more than doubled over the last six months, so on the face of it equities no longer look cheap. But we shouldn't be too concerned about that because it's normal for the market to experience such a re-rating at this point in the cycle. In fact the magnitude of that re-rating is very similar to what's occurred in the aftermath of all previous bear market crashes.

Presenter: Given we're near the bottom of the corporate earnings cycle, what happens next?

Philip Kearney: Well that's right; earnings should trough by year end and begin their recovery shortly thereafter, and if we continue on with this historical analysis idea then we should get a clue to what the future will hold. On most previous occasions the biggest gains in the equity market occurred between the equity market low and the earnings trough, so this time around that's between March '09 and effectively now. Equity markets do tend to find it tougher going once the earnings trough has been reached. If you like, some of the easy money has been made by the time earnings actually start to recover. But equity market returns, while no longer spectacular, do tend to be positive when the absolute increase in company profitability starts.

Presenter: So are you suggesting the rally's now over?

Philip Kearney: Well no, some of the spectacular gains have already occurred but rebound rallies don't tend to end until we get a turn in the interest rate cycle. So if previous experience is anything to go by then the current market rally should have something left. The trigger for the end of that phase tends to be the first Fed rate hike, or at least the first signs that the tightening in the cycle has begun. We still think that that's some way off and our economist doesn't believe that rates will rise until the second half of 2010 at the earliest.

Presenter: Phillip Kearney, thank you.

Philip Kearney: Thank you.