Monthly analysis – November

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Bull or bear market ahead in 2011?

The revival of the stock market in 2009 – with equity-market yields of more than 20% – has not been followed by a further upswing this year. Despite two lengthy periods of optimism (in February-April, when the S&P500 rose 15%, and in September-November, when it rose 17%), a breakthrough is yet to come in the stock-market indices of developed markets, most of which are fluctuating within a band of around 15% at present. This is in contrast to a number of emerging markets, which have succeeded in reaching new heights (as in the case of Turkey and Indonesia), or which have approached their highest historical values (as in Brazil, South Korea and India).
As regards the source of economic growth, no great change is expected in 2011. Developing countries will account for the bulk of growth in the global economy. Current expectations are that the BRIC countries (Brazil, Russia, India and China), following this year's 4-10% growth, may expand by a similar extent next year, while developed economies, burdened by high levels of both public and household debt, will continue to produce slower growth (1.7-3%). An expansion of 2-3.5% is expected in the Visegrád countries in 2011, falling short of the average of the developing economies.

The most recently published prognostic indicators (Procurement Managers Index, German IFO) have found renewed momentum and suggest a continuation of the upswing going forward, meaning that 2011 can begin with the hope of higher industrial output, which will in turn should be discernible in corporate results that tend to be strongly correlated with this. If we wish to define the position of the current phase in the economic cycle, then we must examine the outlook for inflation. The earlier and current quantitative easing programmes of the American central bank have so far helped the US economy to stabilize by flooding the global economy and its money and capital markets with an almost endless supply of money, leading to a significant rise in asset prices, while price inflation has thus far remained unchanged. In China, the year-on-year CPI in October rose to 4.4%, considerably above the 3% level desired by the Chinese authorities, prompting the state apparatus to almost immediately apply the brakes in the form of a reserve-rate hike, triggering criticism of the Fed's liquidity-increasing measures and setting off the struggle against "imported inflation". In my opinion, a further cooling of the Chinese economy currently represents at least as great a risk to global growth as the sovereign crisis of the eurozone members.

If we do accept a higher inflation outlook, then the world economy may be about to enter a so-called inflatory phase, which is generally better news for equities and raw materials than it is for bonds, and in which companies in the energy and industrials sectors should outperform financial companies, while the performance of stock markets in countries such as Brazil and Russia may eclipse that of raw materials importers like Hong Kong, South Korea and China.

The valuation levels of equities may provide additional support to current stock prices as these cannot be regarded as expensive either in absolute (historical) or relative terms (compared to present bond yields), but are rather underpriced compared to bonds, and average in comparison to earlier P/E ratios. Calculating with the EPS (earnings per share) expected by the end of 2011, the P/E ratio of the American market is 12.5, compared to an average value of 13, while the corresponding figure in Europe was earlier 11.1 on average, compared to the expected 10.6. In flash report seasons, companies have so far repeatedly outperformed analysts' expectations, thus strengthening the denominator in the ratio. The current level of the S&P500 of below 1200, thanks to improved corporate earnings results, can be regarded as approximately 10% cheaper than the value of the same index in April.

Looking at the amount of money flowing into global funds, there is still room for equities, as it is only in recent weeks that a modest flow of money into equity funds has become apparent. Thus far the annual flow into funds has amounted to only 2% of total assets managed, in contrast to the still appreciable flow that can be seen into hitherto favoured bond funds, amounting to 12% of total assets managed in 2010. An inflationary environment and the beginning of cycles of interest rate hikes cannot be expected to have a positive effect on the currently very depressed global yield environment, which makes bonds less attractive in comparison to real assets. While emerging equity markets have already proven to be the preferred asset class of investors (thus far justifiably, based on the fundamentals), a further increase in liquidity may lead to overheating on some hitherto strongly performing markets, with excessive optimism potentially decoupling stock prices from economic realities. In the year so far, some 8% of managed assets has flowed into developing-market equity funds, while 42% has flowed into developing-market bond funds.

All in all in 2010, it would seem, therefore, that – to borrow André Kostolany's analogy – the dog (in this case the stock market) has not been able to run ahead of its master (economic processes). Based on current macroeconomic indicators, corporate results and the related expectations of analysts, we cannot presently speak of equities being overvalued but rather as offering a good point of entry for investors. Nevertheless, the markets of several developing countries may yet fall victim to over-positioning by investors in 2011.

Prepared by AEGON Global Asset Management / AAM CEE
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