

30 October 2008

WEEKLY RESEARCH NOTES

1873 and all that

On May 8, 1873, the Vienna stock market crashed. Big falls followed across Europe. Curiously, like the current credit crunch, most historians point to the US as the source of the trouble. The first factory farms in the mid-west ploughed by 70 horse teams had undercut global agricultural prices. A new economic power had emerged. This undermined European confidence and pricked a land and property bubble. The contagion spread across the continent and ultimately back to its source.

UK banks cut their lines of credit to conserve capital and interbank lending costs soared. This precipitated the collapse of Jay Cooke and Company in the US on September 19, 1873 and a stock market panic (the Lehman Brothers failure occurred in the same week, 135 years later). The New York Stock Exchange closed for ten days. Over the next four years 40% of railroad companies, then the biggest component of the stock market, defaulted on their debt.

The parallels between the 1870s and the current crisis are intriguing, though not necessarily informative. There were no powerful central banks acting as lenders of last resort to prop up the banking system, policy tools were limited and long-term pools of capital very rare. It was a world of *laissez-faire* globally-connected capitalism, but one in which the infrastructure of the market economy was rudimentary at best.

What is potentially of greater interest is to compare prices and valuations in the wake of previous dislocations in attempt to get a sense of how this current bear market stacks up. It is now the case that the decline in global equity markets since October 2007 is among the worst in the last forty years (see Chart 1). But in spite of this sharp correction, the P/E multiple for US equities based on reported earnings is still above its 147-year average.

Looking at simple averages is misleading, however. Though leverage does not change the value of a company it does distort the P/E markedly because higher interest payments generally reduce earnings. This complicates the issue of comparing P/E's across time and is one reason why many fund managers use valuation methodologies such as Enterprise Value, which is capital structure neutral. Using this approach allows the adjustment of P/E's for leverage. Cyclicity of earnings should also be adjusted for because extremely high or low P/E's are generally unsustainable. This can be achieved by estimating an underlying earnings growth trend by relating it to changes in GDP.

With these two adjustments in place, the US multiple is 26% below its 147-year average. These are levels seen only in periods of extreme distress, such as the Great Depression, World War II and the 1870s (see Chart 2). The lowest ever reading was in 1877 four years after the panic of 1873. That year saw labour unrest on a scale unprecedented before or since in the US. Unfortunately it is not possible to make such a long-term comparison for global equity markets as the data does not exist. Using the MSCI World Index back to 1970 suggests global equities are 39% cheaper than their long-term average. These are levels last seen in the early 1980s recession.

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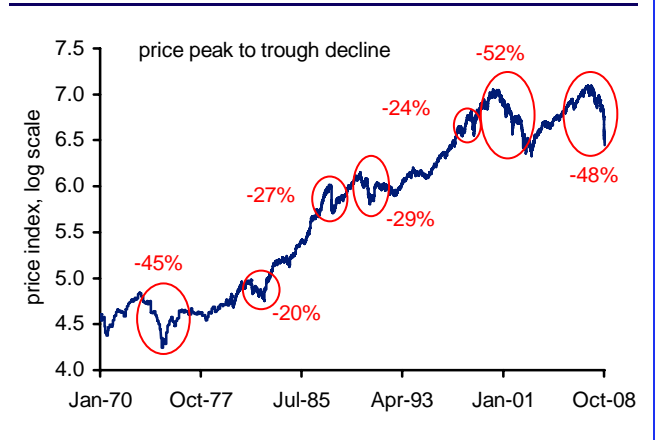


Of course, valuation is a poor guide to the timing of any rally. The volatility witnessed across markets since the Lehman Brothers collapse is keeping investors on the sidelines. State Street Global Markets' measure of cross-border institutional investment in developed equity markets remains at a record low in the past month. But at these levels it is not difficult to make a long-term argument for equities. The world is not at war, policymakers have surely learnt the lessons of the 1930s and Japan's lost decade, the soaring inflation of the 1970s is not going to return against the backdrop of a deflationary credit crunch and labour is in abeyance.

But perhaps the greatest difference of all is the rising of power of institutional investors. In 1946 pension funds, mutual funds and insurance companies owned just 6% of the equity of US corporations. By 1980 this had risen to 30%. The 50% barrier was breached in 1996. Now, according to one recent report, the figure stands at 76%. In absolute dollar terms institutional ownership of the US equity market has risen ten-fold to \$27 trillion since 1980.

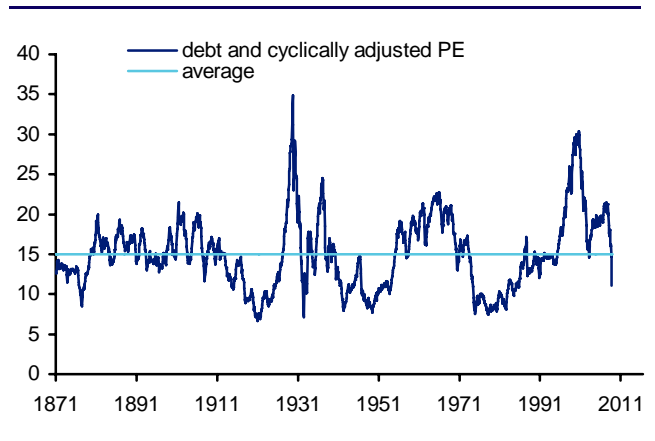
These long-term allocators of capital are already the biggest players in equity markets, though flows suggest they are not yet adding to their holdings. But, intuitively, they seem much less likely to sit on their hands and see valuations driven to irrational levels than the individuals that lost personal fortunes in earlier market crashes. The point at which institutions start buying may mark the turning point in the current market crisis. There have been false dawns. State Street Global Markets' measures of investor behaviour are already proving a better guide than prices, urging caution through the rally this time last year and since July. When sentiment of institutions turns we will be ready with the news.

Chart 1: The current decline in global equities is among the largest in 40 years



Source: State Street Global Markets

Chart 2: The US P/E multiple is approaching historically low levels



Source: State Street Global Markets

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