

# Where are we in the equity cycle

By Nick Armet, 10 February 2010

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In recent weeks, investors seem to be increasingly questioning the sustainability of the current upswing in the equity cycle. There are a number of risks they think could spoil the party. Sovereign debt problems in Greece; the Chinese government making moves to curb bank lending; and Obama's plans to limit risk-taking in the banking sector. Taken together, do these factors mean that the equity upswing is breaking down?

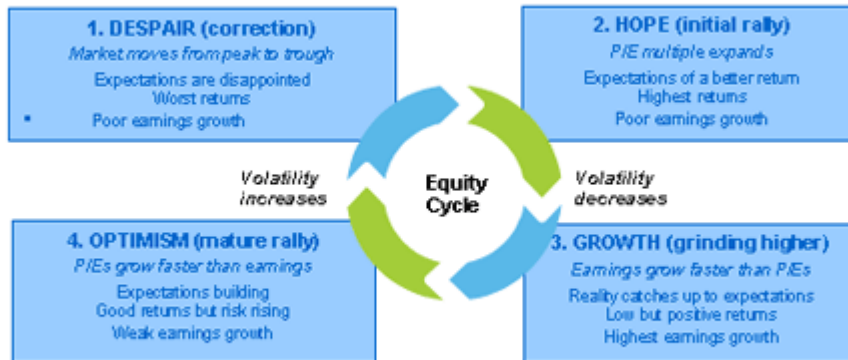
The most likely answer is probably not. Of course, a major sovereign default would be a shock to the global economy and could stall the market advance. But, the vast swathe of historical evidence suggests otherwise. The greater likelihood is that what we are experiencing is a normal corrective phase within a longer upswing. In every new bull market, investors must climb the wall of the worry, hoping that anticipated economic and corporate improvements are not derailed.

Most investors have short memories, particularly when it comes to recalling how bull markets develop. Because losses hurt more than gains are enjoyed, bear markets stick in the memory much longer. Investors may remember the last phase of the bull market when making money seemed relatively straightforward. They are less likely to recall the nervous way in which that bull market developed, the unlikely conditions from which it sprang and the hurdles that it had to overcome before it could achieve the much-vaunted tag of 'sustainable' - a description that commentators are not yet willing to apply to the current cycle.

We can find some comfort by looking at history and the nature of the equity cycle. Although the speed and extent of the correction and the rebound were extreme, the market's behaviour has been straight out of the textbook. When we look at history, four distinct phases can be identified within equity cycles. Moving from one peak of the cycle to the next, these phases can be described as: Despair, Hope, Growth, and Optimism.

Researchers from Goldman Sachs used historical data to break down these phases by average price return and whether those returns are driven by valuation factors or company earnings growth. They found that despite the fact that most corporate earnings growth occurs in the third 'growth' phase of the cycle, the best returns are made in the second 'hope' phase when investors anticipate the prospect of earnings growth coming through in the near future.

## THE FOUR PHASES OF THE EQUITY CYCLE



Source: Goldman Sachs Global ECS Research, October 2009.

## Moving into the growth phase

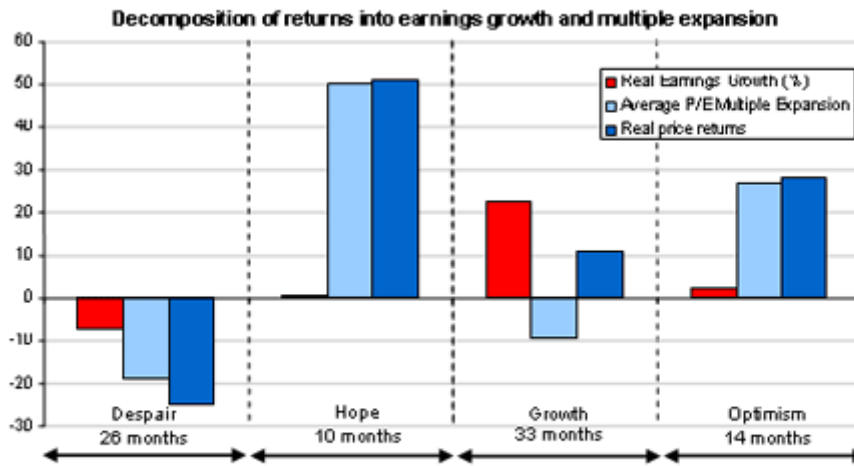
Generally, the 'despair' phase is associated with recession or the prospect of recession and lasts around 26 months on average. This is when the equity market moves from peak to trough. In the recent context, equity markets troughed in March 2009 after peaking in mid-2007.

More attractive valuations combined with the expectation of better conditions ahead eventually cause a rebound in markets in the 'Hope' phase. This short phase is typically when the highest returns are available; we witnessed a sharp rally in equities in the months following March 2009.

As you can see from the chart, the 'hope' phase is when earnings growth is discounted by investors in advance and cheap valuations drive returns. The cumulative effect of sustained economic and earnings growth eventually brings about a last phase full of 'optimism', that is often characterised by high levels of retail investor buying. This is when confidence can run ahead of itself and equity markets peak as valuations become too rich.

The evidence now points to equity markets being in transition from the 'hope' to the 'growth' phase. There are no 'hard and fast' milestones that symbolise such a shift but the balance of historical evidence suggests that PMI surveys typically move back above 50 (which they have) and unemployment shows signs of peaking (which, it could be argued, is the case in the US).

## THE FOUR PHASE DECOMPOSED INTO RETURNS AND DRIVERS OF RETURNS



Source: Worldscope, Haver Analytics, DataStream, Goldman Sachs ECS Research, October 2009.

## The growth phase

An interesting aspect of the 'growth' phase is that it typically begins with a great deal of investor uncertainty. Strangely enough, although conditions have improved from the trough, investors begin to perceive equities as more risky at this point in the cycle. In their view, they have already been paid for future earnings growth in the 'hope' phase and that growth may or may not materialise. A certain amount of nervousness over the threat of central banks tightening too soon or governments regulating too harshly so that they kill off economic growth is only natural. However, the corporate earnings outlook is encouraging as profits come off a low base in 2009 and leading indicators of activity suggest an ongoing expansion of global economic growth. Earnings growth is likely to come through, like it has done in previous equity upswings. Stock markets are likely to grind higher as a result, offering the prospect of moderate, positive returns to investors before a more rewarding gain in the final phase of the cycle.

## Conclusion and investment implications

Earnings growth drives equity markets over the long term, but it is rarely paid for when it occurs. The last decade, in particular, saw some of the strongest earnings growth in modern history, but also some of the worst returns. This was due to the inflated valuation of shares at the start of the decade after a period when investors became over-optimistic.

At this point in the cycle, valuations are fair and reasonable given the economic outlook. Equities and particularly commodities and commodity-related equities tend to perform well in the 'growth' phase of the equity cycle. Sector calls are less important in this phase; in fact, Goldman Sachs found that that the 'growth' phase offers the least potential for sector selection. Bottom-up research, insightful stock selection and the ability to identify those companies that can beat earnings expectations become paramount.

*Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.*