

## Why the recent rally has been 'low-quality'

19 August, 2009

*This week's article has been contributed by Nick Armet.*

### **Yes, markets have gone up, but why has the 'trash' been leading the way?**

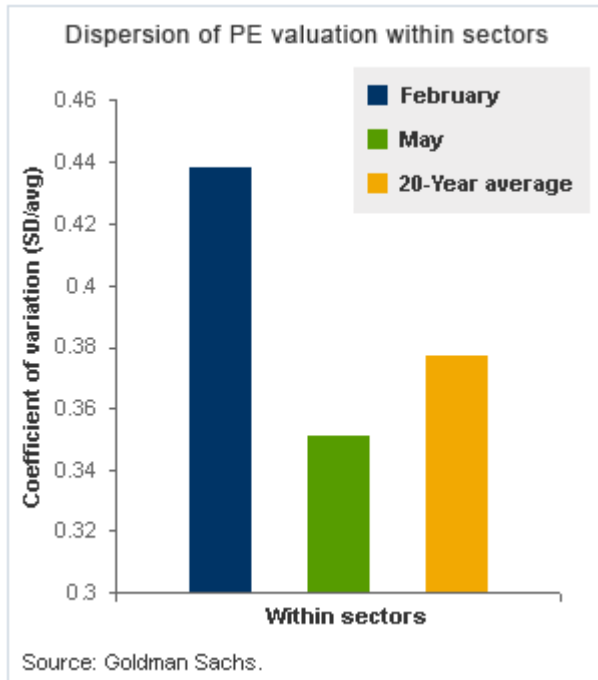
In recent months, we have witnessed a strong low-quality rally in stock markets. That is to say, markets have been going up, but the stocks that have been leading the way have typically been the most highly-indebted, or those whose earnings were most downgraded during the downturn. In other words, investors have made a 'dash for the trash'.

We can use style data from UBS to get an insight into the types of factors that have been driving market performance by separating them into fundamentally attractive and unattractive groups. Fundamentally attractive features might be high earnings growth and low valuations. Unattractive features would be the opposite. This style analysis indicates that in April, May and July, the most indebted stocks and those with low earnings growth momentum led the market rally. So, why have, essentially, the worst stocks been at the forefront of the market gains?

Intuitively, this does make some sense if we consider that the outlook for these companies was unremittingly gloomy only a few months previously. As the global economy braced itself for a deep depression in the latter part of 2008, the writing looked to be on the wall for many of these stocks. Among them were companies who were highly-leveraged and under pressure from much tighter lending conditions, as well as beaten-down industrials whose health had quickly seemed overly dependent on the high level of business activity that they had come to see as the 'norm'.

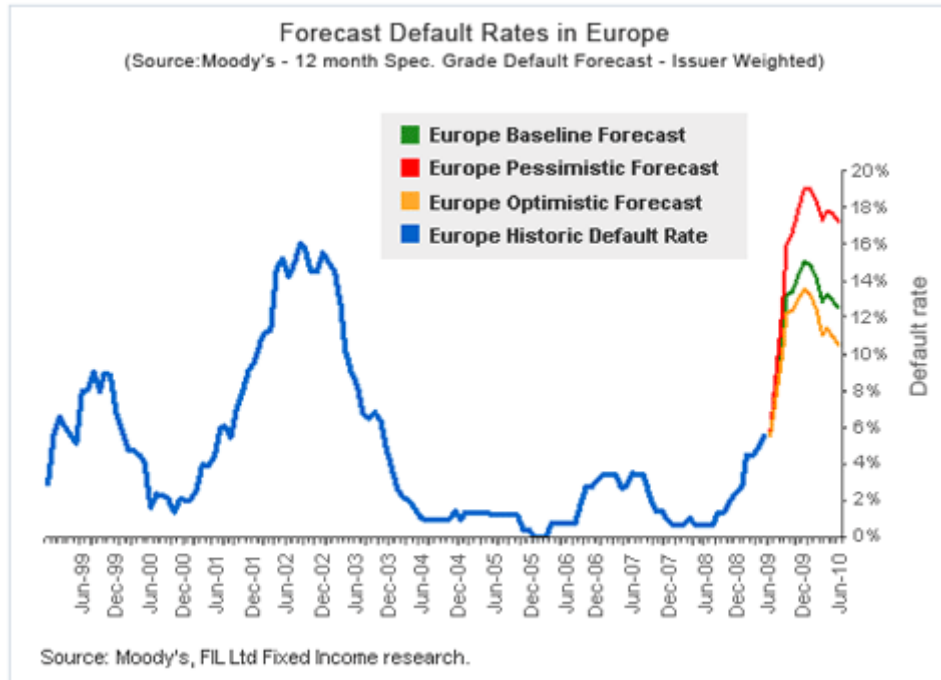
As the global economy has moved back from the brink of systemic financial failure, liquidity conditions have improved and investors' perception of the economic outlook has improved markedly from the very bleak scenarios that were painted as recently as March of this year. As sentiment has improved, the market has essentially rewarded the stocks whose prospects had previously been downgraded most severely. Highly-indebted stocks and those with the heaviest earnings downgrades have actually performed best, indicating that perhaps the sell-off in these stocks was overdone.

However, when we examine the market further, we can see that the dispersion of stock valuations within sectors (the range of difference in valuation from the best stock to the worst stock in that sector) has been lower than its long-run average. This indicates that the higher-quality stocks, the 'sector leaders' if you like, are not currently being rewarded for their better fundamental features relative to their lower-quality peers.



The chart compares the difference between valuations (using the 'Price-to-Earnings', or PE, ratio) within sectors at the end of February 2009 and the end of May 2009, against the long run average, which reflects both bull market phases (where dispersion tends to be lower) and bear market phases (where dispersion tends to be greater).

What is striking is that, even with the expected rise in defaults (see chart below) from the most exposed companies, we have seen a dramatic reduction in dispersion in a period of only a few months. In fact, in May 2009, there was less dispersion between the valuations of stocks within sectors than one would have witnessed over the last 20 years. This is entirely at odds with the still-challenging economic picture and the likelihood of rising default rates in Europe which, according to Moody's, are unlikely to peak until the fourth quarter of this year.



Naturally, a low-quality rally such as this presents challenging conditions for fundamental investors that are used to picking companies on positive fundamental factors like balance sheet strength and high earnings growth potential.

Fortunately, though, history tells us that periods of low dispersion between winners and losers do not tend to last long. As investors get more clarity on economic and corporate conditions and, importantly, as the default rate rises, investors will re-focus on fundamental factors in their appraisal of stocks to buy for the longer term.

This should trigger an increase in the dispersion of stock valuations, as higher-quality stocks are rewarded for their financial strength and their earnings resilience. In short, 'winners' will once again be differentiated from 'losers', and trash will be just trash.

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