

It's not over yet...or is it?

By Neil Massie, 28 October 2009

Why are investors unfazed by the longest recession on record?

For all the green shoots emerging since the spring, you would have thought that we'd now be ready to reap a bumper harvest. But never known to be an excitable bunch, economists were content to expect that UK economic growth in the third quarter would either be flat or show a slight increase. Mervyn King, governor of the Bank of England, recently spoke of a return to "positive, if modest, growth" in the second half of this year.

Even the most humble of hopes was dashed last Friday when the ONS surprised everyone by estimating the economy shrank 0.4% in the last quarter, leaving us mired in the longest recession since records began in the 1950s. The UK is now undoubtedly the laggard of the developed world as Japan, Germany and France all left their recessions behind in the April-June quarter. The US reports its Q3 GDP numbers on Thursday and is widely expected to show an expansion of 3% or thereabouts, also drawing its recession to a close.

As the downbeat UK numbers were released, sterling fell and gilt yields also eased back as the expectation of further quantitative easing efforts to support the fragile economy weighed on investors' minds.

The FTSE 100, however, closed the day up 35 points. Why should equity investors be so unfazed by such disappointing data?

For one, economists and analysts were quick to pour scorn over the ONS data. Frequently the numbers are revised upwards at a later date. An interesting observation from Goldman Sachs showed that there is a greater correlation between the initial published data in the eurozone and the final UK figure than there is with the UK estimate itself. If that's to be believed, there are plenty of reasons still to remain hopeful. Indications are that eurozone data looks much stronger. On the same day that the UK data was released, eurozone industrial orders were reported to show a healthy rise and the results of a survey of eurozone managers indicated rising levels of confidence.

It is also hard to believe that conditions in almost every sector of the UK economy are worsening when so many of the leading indicators coming from businesses have been pointing towards an improvement. Companies are, after all, the heartbeat of our economy. The all-sector Purchasing Managers Index has been over 50 (so suggesting expansion) throughout the quarter that has supposed to have seen further decline. The services sector, which is so important to the UK economy, has been reporting particularly encouraging PMI data for months. What's more, KPMG have just released a survey which showed business confidence at its highest level in 18 months and in which one in five senior business executives were reported to consider British economic prospects for the coming year as "good" or "very good". None of that really smacks on an ongoing deep recession and so bodes well that the ONS forecast will, indeed, be revised upwards in time.

It is also useful to appreciate that so much of the earnings of our top 100 companies – more than half – come from overseas and so their fortunes are as much linked to what is happening abroad as at home. With other economies now officially on a stronger growth footing than the UK, that bodes well for the ability of international companies to grow sales organically through overseas trade, rather than having to rely upon cost-cutting efforts alone to keep the bottom-line looking healthy. Sterling's weakness (which was exacerbated by the GDP numbers) also helps out anyone selling UK goods or services abroad as our prices become more competitive.

Last week's GDP estimate may have been worse than expected and it is vital that investors remember that, while it is not the end of the recession, it is not the end of the world either. Conditions are undoubtedly better than they were in the dark days of last winter, before the spring sunshine emerged, or than they were after the collapse of Lehman Brothers last year. No one ever said that the recovery was going to be easy or that it would come in a straight line. You just have to look at the alphabet soup that is used to predict the shape of the recovery – will it be a V, a W, a VW, a square root...? One thing is for sure - whichever shape it takes, companies are telling us that the upswing is underway. That's the message investors should be listening to. That's why the Footsie was able to shrug off the GDP data and that's why many think this rally has further to go.

Performance over 5 years

	October 04 / October 05	October 05 / October 06	October 06 / October 07	October 07 / October 08	October 08 / October 09
FTSE 100	12%	19%	8%	-42%	35%

Source: Datastream. Years to 27.10.09

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