

Should I stay or should I go?

By Tom Stevenson, 7 October 2009

The next phase in the market might not match the first six months of the rally but investors should stick around.

"It's better to travel than to arrive" is an old investment adage derived from the tendency of markets to predict economic movements rather than move in synch with them. It's why the share prices of companies sometimes fall back on the day when they announce excellent results.

It is also why markets were able to turn upwards in March despite the outlook being bleak at the time and why they continued to rise despite broadly negative economic data over the spring and summer.



"Is a 48% rise in the FT All Share index in just seven months as good as it gets?" Tom Stevenson

Now that the hopes of an economic recovery are being matched by real evidence that an improvement is on its way, many investors are asking themselves whether it's all in the price. Is a 48% rise in the FT All Share index in just seven months as good as it gets?

With the market seeming to lose momentum in recent weeks, self doubt is starting to kick in. Those who have made paper profits are wondering whether to take them off the table while those who have missed the upturn are finding it hard to join the party at what they think might be too late a stage.

An indication of how many people are in this latter boat is provided by the still high levels of cash sitting on the sidelines and the fact that what money has come back into risky assets has largely been directed at the bond market. Most investors have simply not believed in the market recovery this year.

The good news is that arriving at the first economic stop (the beginning of recovery) does not necessarily mean that the enjoyable journey (the stock market rally) must come to an end. Think of the return to growth as just an intermediate station and not the destination. The train may slow a bit from here (it could hardly continue at that pace) but it could still move ahead at a decent pace.

Citigroup put it another way this week in a research note that described the past six months as a "twilight zone" in which equity prices rise sharply even though corporate earnings are still falling. It thinks this period is now over and that we are on the brink of entering a new phase in which an earnings recovery begins and during which share prices will continue to rise, albeit at a slower pace than during the initial rally.

There's another stock market adage which could be relevant in today's market: "don't fight the tape". It means that as long as the market is still moving ahead, investors should go with the flow. There's a lot of merit in this argument, not least because most investors are hopeless at spotting the tops and bottoms of markets.

There's plenty of historical precedent for the market continuing to grind higher from here. If you plot the stock market movements around the turning point for corporate earnings during earlier recessions you often see a similar picture – a strong rise in prices in the year to six months before earnings hit bottom and then a flatter but

still upwards trajectory.

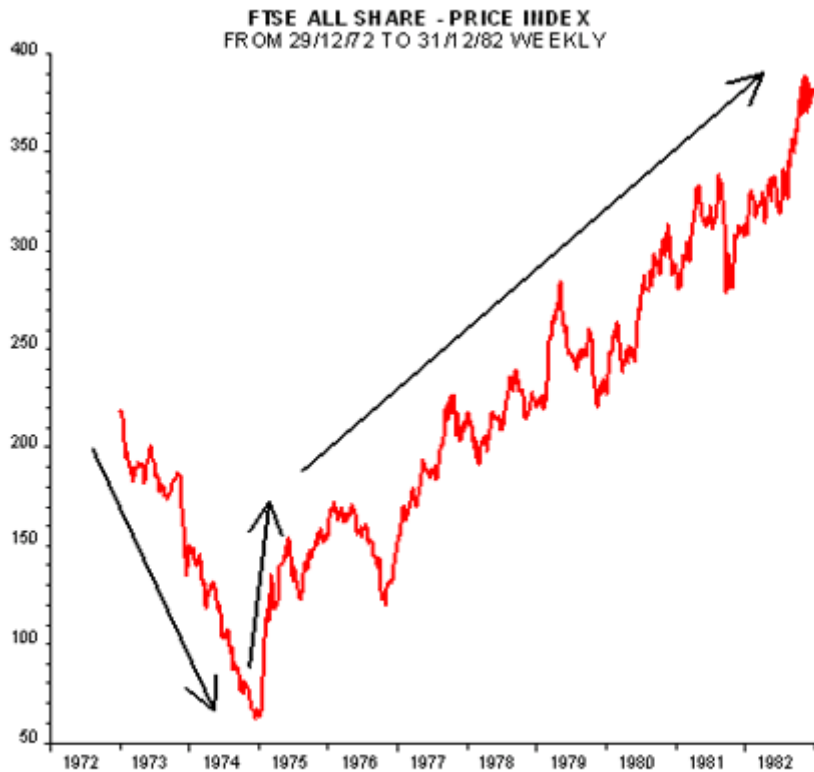
There are two further reasons why equities could continue to rise. First, the earnings recovery this time around could be sharper than in previous recessions. That's because they have fallen a lot further and because the speed of cost-cutting of many companies means that even a modest pick-up in revenues could lead to a bigger than expected bounce in profits.

Goldman Sachs, another vocal proponent of the bullish case for stocks at the moment, is looking for operating profits in Europe to grow by 40% next year, well ahead of the average forecast among their peers (around 25%).

The second reason is that despite the rise in equity prices since the spring, shares are still not too expensive. There are lots of different ways to measure the cheapness or otherwise of shares but, looking at average earnings over a 10-year period, Citigroup estimates that shares are cheaper than they have been since the early 1980s.

One final stock market adage. Bull markets, it is said, "climb a wall of worry". This means that share prices tend to rise when most investors are worried about the future. By contrast, when everyone thinks that the outlook is set fair, most people who are likely to buy shares have already done so and there is no new money to fuel further rises in the market.

Judging by the prevailing gloom in the media and among many investors, we are certainly nowhere near that point yet.



HIGH 389.17 12/11/82 LOW 61.92 13/12/74 LAST 382.22

Source: Thomson Datastream

Performance over 5 years

	Sept 04 / Sept 05	Sept 05 / Sept 06	Sept 06 / Sept 07	Sept 07 / Sept 08	Sept 08 / Sept 09
FTSE ALL SHARE	20.9%	11.1%	8.7%	-25.1%	6.1%

Source: Datastream, years from 30.09.04 to 30.09.09

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