EYE ON THE MARKET
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Crisis of Confidence: Making sense of the market rout

US equity markets rebounded yesterday (August 9) after the US Federal Reserve (Fed) strengthened its commitment to accommodation. The S&P 500 index jumped 4.7% to 1,172.5, its biggest gain since March 2009, while the Dow Jones Industrial Average gained 4.0% to close at 11,239.8. Asian equity markets have also reacted positively this morning, with most equity indices up around 2-3% at the time of writing.

Comments on FOMC easing decisions

The Federal Open Market Committee (FOMC) strengthened its commitment to accommodation yesterday, indicating that overnight rates will remain unchanged at current lows at least through mid-2013 and that they are prepared to ease further depending on developments. The statement suggests to Citi analysts that all options could be on the table and are likely to be reviewed once more during the Chairman's speech in two weeks. But the announcement reinforces Citi's view that the price for quantitative easing (QE3) is extremely high given the uncertainties surrounding the costs and benefits.

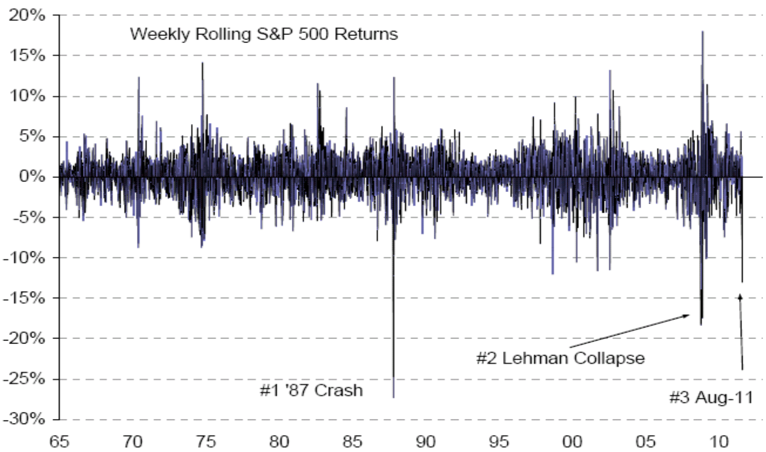
The shift appears to be a reflection of a significant downward revision to growth expectations, higher unemployment forecasts and renewed concern that inflation is likely to slow and "settle" at or below mandate-consistent levels. Although there were transitory shocks that contributed to the first half slowing, officials have concluded that there are deeper underlying sources of drag that may persist and markets should expect substantially different official projections on growth and unemployment at least through 2012.

If financial conditions continue to deteriorate in coming weeks, Citi analysts expect a move toward reserve-neutral asset purchases designed to lengthen the average maturity of the system portfolio. That could come in the form of funnelling redemptions and maturing holdings into only longer duration Treasuries or possibly by using reserve-draining operations to finance the purchases. In the meantime, policymakers confirmed that they are unlikely to back away from accommodation efforts when risks of failing on their mandates have risen significantly.

Extreme event

The recent sell-off in equity markets has been nothing short of brutal. Global stock prices have fallen by 13% over five trading days, the third sharpest pullback in global stock markets since 1965. Since 1965, there have only been two other periods where the pull back has been more extreme – the 1987 crash when global stocks prices fell by just over 25% in a week, and the pullback around the Lehman collapse.

S&P 500 Rolling Returns. Current Sell-off Third Sharpest in History



Source: Datastream, Citi Investment Research and Analysis. As of August 9, 2011.

Among the regions, the pullback has been largest in Continental Europe. Here stock prices have retraced by more than 20% this month. Citi's European strategy team notes that, in addition to soft economic momentum and sovereign risks, investors are beginning to fear further financial distress in the inter-bank market. They have consequently lowered their earnings-per-share (EPS) forecasts to 0-10% for both 2011 and 2012 and cut their market targets for end-2011 – Dow Jones Stoxx 600 now 285 (previously 315), FTSE 100 now 6,200 (previously 6,750).

Relative to Europe, the fall in Japanese stock prices has been mild. The Topix index is down about 8% in August. Citi's Japanese strategist believes the market's resilience is due to relatively cheaper valuations, solid earnings revisions, and a rapid recovery in the supply chain following the earthquake.

Meanwhile, sector performance at the global level has followed a classic cyclical/defensive split. Consumer Staples and Telecom stock prices have declined by less than 10%, whereas Industrials and Financials price falls have been twice as large. IT has perhaps been the surprise. A strong earnings season for US tech companies has helped stock prices to fall by less than defensive sectors such as Utilities and Health Care.

Equity markets appear to be discounting a global recession

With stock prices down by more than 10% year-to-date August 9, 2011, Citi analysts think investors are beginning to price in a significant contraction in global EPS. Currently, consensus forecasts are for 15% EPS growth in 2012, which is probably too high. Citi's top-down estimate is currently 11%.

Weaker markets are a function of many well known macro concerns. The sovereign issues in Europe have recently morphed into liquidity concerns. While the European Central Bank (ECB) has been effective in lowering Italian and Spanish bond yields, market moves suggest investors have lost confidence in European policymakers being able to keep ahead of the crisis.

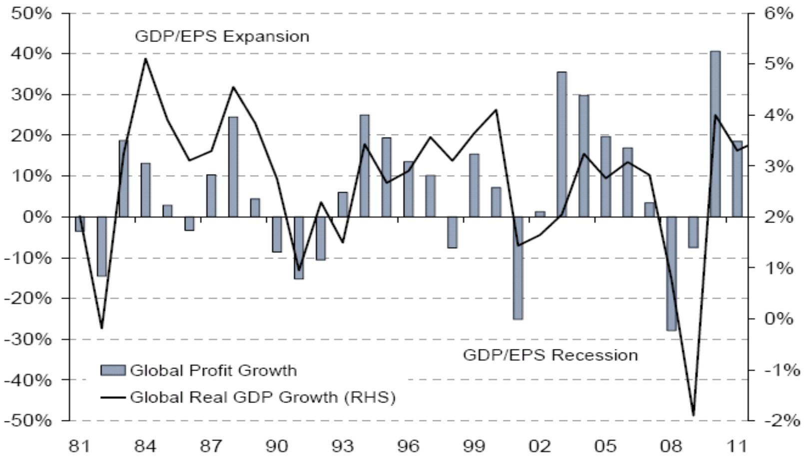
Meanwhile, the US has suffered the first ratings downgrade of a AAA sovereign this cycle. Many fear other triple AAA countries could be downgraded as well – CDS spreads for the UK and France suggest investors are beginning to price this in. Between these two countries, Citi's Chief Global Economist believes France is at a higher risk of losing its AAA rating.

Economic growth prospects

Weakening economic momentum in the US has led Citi's economics team to lower their outlook for US GDP growth. Their current forecasts are consistent with sluggish, but still positive, growth of 1.7% in 2011. For 2H11 they forecast 2.2% (annualised) down from 3.1%. Their forecast for 2012 of 2.7% could change depending on the second phase of fiscal tightening, which is still to be decided. Risks to the downside have also increased in Europe. Elsewhere, economists are more sanguine. For China, Citi analysts forecast solid growth to continue and believe any slowdown, driven by weaker growth in the US or Europe, is likely to be met with further policy easing. Globally, Citi's GDP forecasts have come down, but not to recession levels. It is generally accepted that global economic recessions occur when real GDP growth rates are 2% or less.

While many other economists are lowering global GDP forecasts, Citi analysts expect economic growth to be strong enough to support corporate earnings growth. They note that in the past, companies have usually been able to grow corporate profits when global real GDP growth has been greater than 2% – the recession threshold. Although economic forecasts could potentially come down, they are unlikely to fall into recession territory, in Citi analysts' view.

Global EPS and GDP Growth



Source: Citi Investment Research and Analysis. As of August 9, 2011.

Furthermore, companies are already cautiously containing costs and are in a position to quickly cut costs, if required. There has been little sign of companies bloating their cost base, which has previously made them susceptible to a slower economic backdrop. The combination of moderating, not collapsing, GDP growth and continued tight corporate cost control means global profits are likely to grow, not contract, as currently discounted by stock prices.

Conclusion

The pullback in the equity markets have been nothing short of brutal. We have seen the third sharpest decline in stock prices since 1965. With global equities down by 10-15%, Citi analysts think stock markets are beginning to discount a significant decline in EPS for 2012. Although economic forecasts could potentially come down, they believe it is unlikely to fall into recession territory and should remain strong enough to support corporate earnings growth. All in all, Citi analysts believe the recent sell-off has been excessive and continue to hold a constructive view on equities, especially North Asia (Hong Kong, Taiwan and Korea). Although markets are likely to remain volatile in the near term, the recent sell-off could represent investment opportunities.

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