MARKET STRATEGY

INVESTMENT RESEARCH

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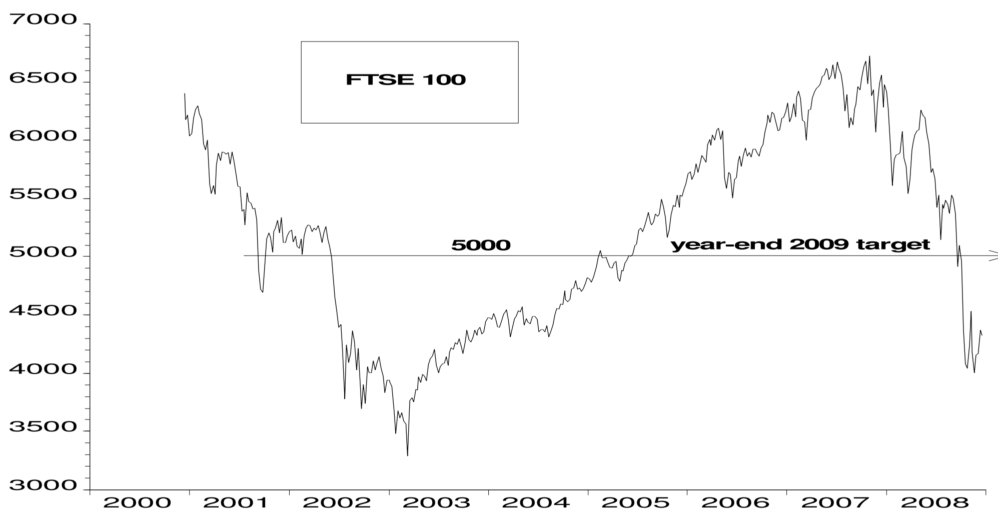
FTSE 100 – a case for a rebound in 2009.

- **Where to for the FTSE 100 in 2009? Up, down or sideways?**
- **The bad news is in the price – there is a case for a rebound which could take the index up to the 5000 area by end-year.**
- **But you always hedge your bets – watch index-linked stocks or gold bullion for any sign that the next phase of the rescue will prove reflationary.**



Source: DATASTREAM

A year of false starts, damp squibs, constant disappointment and much consternation, not to mention all that wealth destruction, is enough to make any stale bull hesitant about calling the upside to equity markets. That said, I think there is a case for thinking that equity markets could end 2009 on an upbeat note.

Here are three reasons for thinking global equity markets could pick up and that the FTSE 100 could rebound up to the 5000 area by end-2009.

First, monetary and fiscal policies are expansionary, in some cases aggressively so. Not only have we witnessed the biggest financial upheaval of our time, we are also witnessing the biggest policy response from central banks and Governments the world over.

Second, the Fed is preparing to roll out Plan C to help drive long term interest rates down by buying up financial assets. Plan B - the Fed's purchases of commercial paper and certificates of deposit - has been in progress for several months. The intention to buy up agency debt and mortgage backed securities has recently been announced by the Fed but its programme of quantitative easing remains wide open, as discussed in a recent speech by the Fed Chairman (***Federal Reserve Policies in the Financial Crisis***, December 1, 2008). The likelihood now is that it will focus its efforts on driving long term interest rates down with a view to lowering those on risk assets too, thereby pushing down the cost of borrowing and related funding costs.

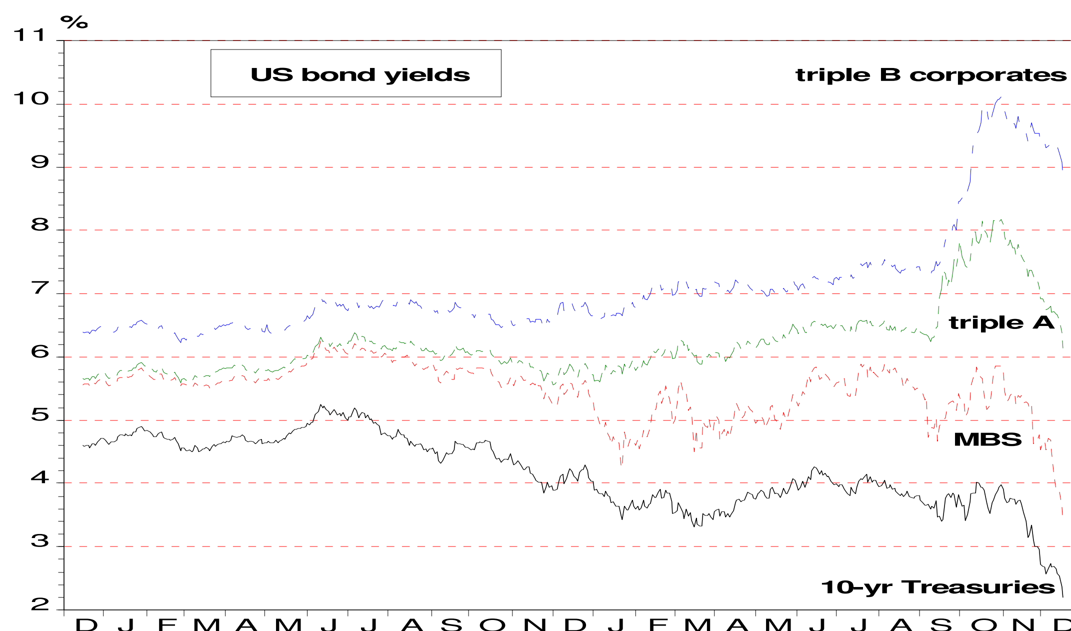
The further this development goes, the more likely it is to give rise to **an expectation of a recovery in economic activity and to a better outlook ahead for corporate earnings**. This should also help support **valuations in equity markets, which are more attractive today** than at any time since the recessions of the early 1980s. It should also **help the spreads in the credit markets narrow** and, once this starts happening, **a sustainable recovery in the equity markets is likely to follow.**

Third, falling inflation worldwide will boost real household incomes and this should provide something of a boost to the growth of consumer spending - worldwide. On the corporate side, commodity deflation should help profit margins - worldwide. Commodity price deflation could end up being a powerful stimulus for global demand growth. By the middle of next year, sentiment towards risk assets could be improving.

Note 1

Falling yields

It is worth developing, only briefly, the point about falling yields on financial assets and the stimulus they can be expected to provide for global growth. With the major economies in recession and inflation now falling like a stone, yields are tumbling in government bond markets. As the chart below shows, in the US yields on mortgage-backed securities (MBS) are coming down as are the yields on investment grade corporate debt.



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In the statement that accompanied its latest decision to target the federal funds rate in a range of zero to a quarter point, the Fed said it 'will continue to consider ways of using its balance sheet to further support credit markets and economic activity.' This is as formal a statement of intent as is likely to come out of a central bank. Not only does it suggest that the Fed will extend its direct purchases of financial assets but will do so with the express purpose of bringing downward pressure on yields across the entire spectrum of risk assets including yields in equity markets. Getting those yields down, narrowing the spreads and reducing funding costs directly through force feeding money into the economy, should hopefully stimulate growth.

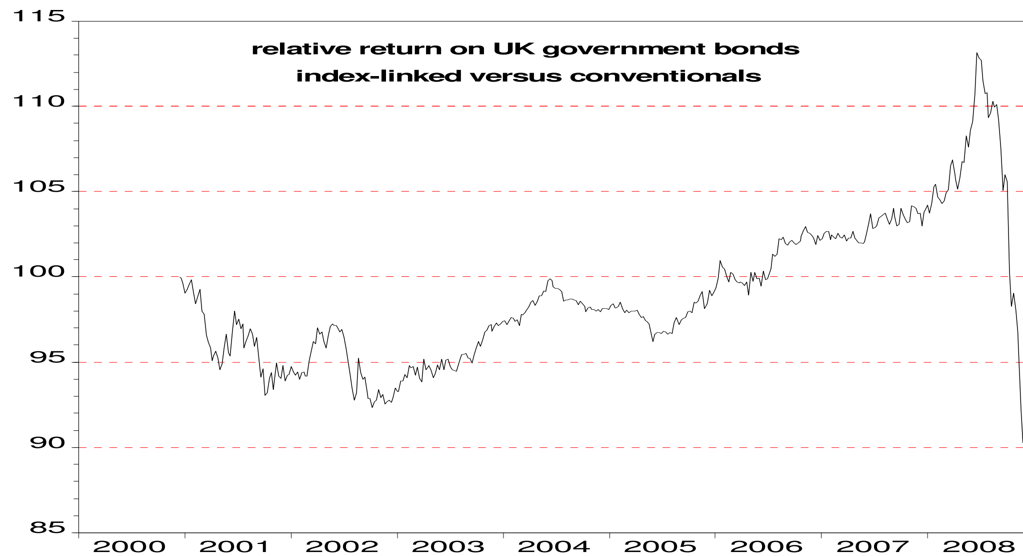
Note 2

What are the risks? And Defensive strategies

So what is the risk to this view? Deleveraging compounds the contractionary forces of recession but recession further enforces deleveraging, which sets in motion the forces of deflation. This is the 'death roll' and equities would plunge to new depths, thereby inflicting even more wealth destruction than has occurred thus far. There remains a place for defensive assets in portfolios, notably government bonds - though it makes sense to balance this holding between conventional and index-linked stocks and higher investment grade corporate bonds.

The judgement call for policy makers is deciding how far to go in responding to the forces of contraction. The effectiveness of conventional monetary policy has been greatly diminished by a failure of the lending channels to transmit lower interest rates through to households and businesses. The risk of deflation may have increased as a result.

Having responded with vigour to the credit crunch and depleted its conventional arsenal, the Fed in particular has now indicated in no uncertain terms its readiness to force feed money into the economy. I think its likely focus on reducing yields on long term assets will dispel any notion about deflation in the sense of it affecting investment and consumption decisions. If anything, the effort should have the opposite effect, namely that of stimulating demand and inducing a reflationary expectation. You will know which way the markets are thinking if and when index-linked stocks start to outperform conventional government bonds once again (top chart below). Or maybe when gold bullion resumes its upward trend (bottom chart below)!



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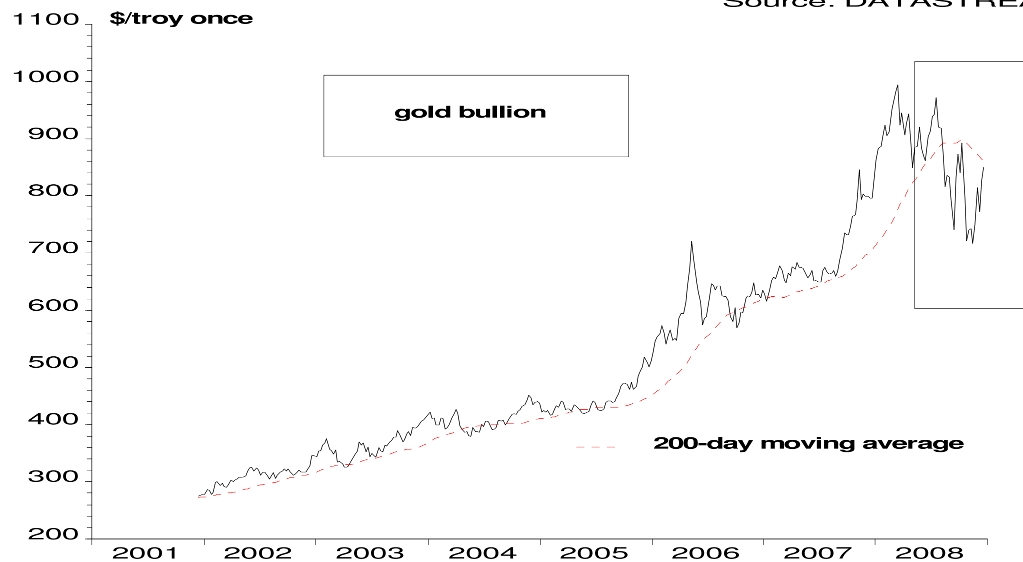

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Note 3

Forecasts in Previous Years – Mike Lenhoff

This time last year I set my FTSE 100 forecast at 7200 for end 2008 and offered three reasons for that fanciful expectation. The first was interest rates. I hadn't imagined zero interest rates but I thought they would be lower sooner rather than later. Commodity prices - oil especially - got in the way. They pushed inflation to levels beyond central bank targets, although as a policy consideration, this was more relevant in the UK and the eurozone than in the US.

Second, I thought that by the middle of 2008 we would be looking across the valley to an economic recovery with better times ahead for earnings. Third, I felt valuations would be underpinned by the much lower interest rates and the thought of improving earnings expectations. Together, they would feed momentum and push equity markets onwards and upwards, but it was not to be. Enough of that!

Looking ahead, my initial thought for end 2009 was 4750 for the FTSE 100 - a bit wimpish I know. It was my end-2003 forecast for where I thought the FTSE 100 would be by at the end of 2004 (***Building on the recovery – the outlook for 2004!*** 11 December 2003). I had a bit of luck with that one so I was tempted to give it another go. But then I thought the market could have a decent run in the latter stages of the year, perhaps to the 5250 area. That was my end-2004 forecast for where I expected the FTSE 100 to be by the end of 2005 (***UK equities – looking back, looking forward!*** 23 December 2004). That wasn't such a bad call either so I thought I'd try that one again too.

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