3 August 2009

S&P at 1000: a non-event or the start of a genuine bull market?

What is happening to the stock market? Despite difficult economic conditions, equity markets have posted stellar performance. This short special report sets out to highlight some of the reasons why the market rallied, why we think equities are poised to rally further and finally the best ways to profit from it by investing in Dexia AM investment funds.

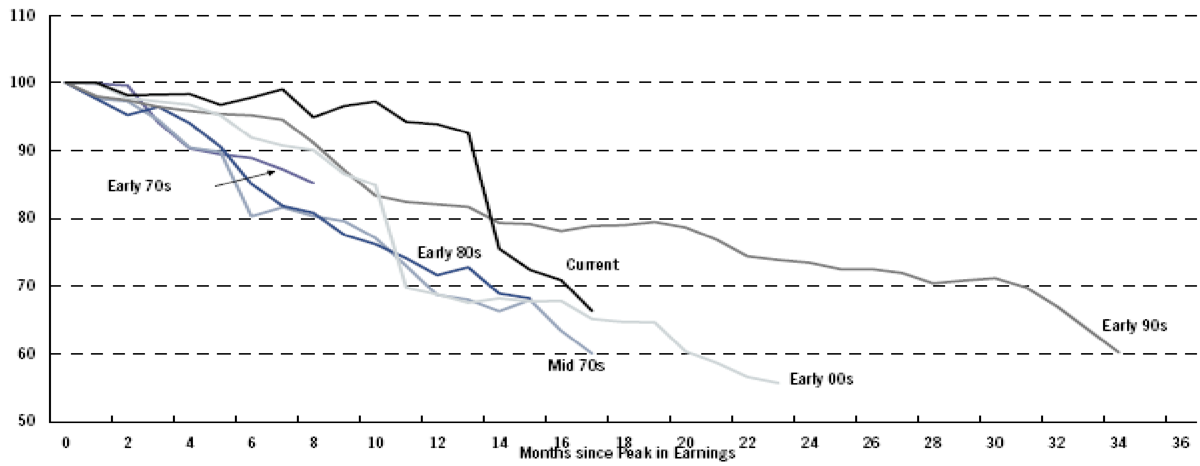
Yesterday, Monday 3 August, the S&P 500 index reached 1,000 points again for the first time since November. Buoyed by better than expected manufacturing and construction spending and China's growing factory output, the leading index has recovered by a stunning 50% since reaching an intraday low of 666 on March 9.

The questions that are raised by everyone are of course: is this rally sustainable? And what does the future hold for equity markets?

At the beginning of the year, the most alarming and depressing news haunted the markets. Facing a dire economic and financial outlook, markets tumbled. Six months later, we have to admit that these horror scenarios did not play out: companies have reacted quite rapidly and efficiently: they built off inventories, cut costs to keep profit margins up to par and manage cash.

If we compare the current recession with the profits generated in previous recessions (1970, 1990, 2000), the downturn cycle we are now in looks perfectly normal in terms of duration and seriousness.

Profit evolution in times of recession



Source: Citi Investment Research and Analysis and FactSet

This structural improvement of profits leads us to think equity valuations will rise, as they are below the historical average while visibility is improving. **We can distinguish a number of positive factors, both from a macro and micro perspective.**

- **Widespread skepticism about the sustainability of the rally: the majority of investors are still convinced that in the next couple of quarters growth will be very subdued**. We strongly believe that investors are ill prepared for a positive surprise down the road as investors are very much cautious and suspicious. We have seen recently that they tend to sell on the first sign of market hesitation and too many people were sceptical regarding the market strength to break 950 on the S&P. A moderate but higher than anticipated economic growth may not be very exciting but it may open investor's eyes. **The saying that a bull market "climbs a wall of worry" is certainly true.**

- **Ample liquidity and accommodative monetary policy until the end of 2010 at least: both the Fed and the ECB are doing everything they can to get the economic system up and running again**. Low interest rates and buying back treasury bonds should support growth while the risk of inflation is not a risk in the foreseeable future. **Maybe the upcoming inflation regime will be higher than the one we have gone through over the last decade but by no means a double digit inflation would be in sight for the next 5 years.**
- **Low valuations in historical perspective** (**European markets trading at 10 times average earnings 2010 while the average is 16 times)**. Equities have clearly not traded on fundamentals during the first half of the year but rather first on fear and then on hope. With earnings fall following now a normal pattern investors can switch to traditional valuation metrics again. What was missing so far was a lack of visibility. As soon as there is a sufficient visibility low valuation multiples can accommodate falling earnings. That's exactly where we are now and positive earnings revision would set the stage for the second part of additional positive equity performances.
- **Recovery of earnings growth: looking at the past recessions (70s, 80s, 90, 2000) global earnings in year one of a recovery have grown by an average of 20%.** This still leaves room for an upward correction. **It looks like companies are in position to see a large improvement in profits even with a muted economic recovery and this is why earnings multiple are so low**. Once again by no means are European equity pricing in a normal earnings recovery. **The earnings recovery tended to be underestimated, including by us.** The mantra "this time is different" has been prevailing for some time. Listening to several companies we are building the conviction that the operational leverage is still positively under estimated as companies have slashed cost aggressively and reduced the break even point.

These arguments lead us to think that it is becoming increasingly likely that the European indices will revisit their pre-Lehman levels, implying a potential of about 15%.

The best way to play this, we are convinced, is by a core-satellite approach. At the core of the portfolio, we propose:

- **Dexia Equities L Europe High Dividend**, composed of quality companies paying sustainable dividends. Good track record (YTD and since inception). Lower volatility than market average. 7.5% current dividend yield of portfolio.

- **Dexia Equities L Europe:** the macro backdrop for Europe is improving significantly. Europe is still the cheapest region worldwide and European equities are not priced for a normal economic recovery. This fund invests in the core of European stocks through a diversified portfolio covering all sectors.

- **Dexia Equities L Innovation**: growth will be scarce and as such will benefit from a valuation premium.

At the satellite of the portfolio, we remain bullish on Asia Pacific ex Japan, especially China, which will make or break us. The latest news from China has been upbeat in terms of economic growth and credit expansion. A good way to invest in this region is to select **Dexia Equities L Asia Premier**, which covers the entire Pacific Rim region through a diversified and risk-balanced portfolio.