

# Now is the time for patience

There are some indications of market normalisation. But it may be still too early to make any judgement. **Peter Hensman** advises a patient approach.

The nascent improvement evident in equity markets in mid-March has continued into April, with the financial sector leading the charge. The timing of the market low on March 9 coincides with the “leak” of an internal memo from Citigroup indicating that operational performance in the early part of Q1 had been the best since Q3 2007<sup>1</sup>.

The hope this offered to investors that the worst of the credit crunch is now in the past was boosted by the release of more details on the plan from the US Treasury to stabilise the financial sector. Where the sparse detail initially proposed by Treasury Secretary Timothy Geithner on February 9 was arguably a significant contributor to the earlier equity market sell-off, investors were encouraged at the prospect of the “Public-Private Investment Plan” (PPIP) – the plan to leverage the purchasing power of private sector money by offering low cost public sector loans to those willing to acquire “legacy” (formerly known as “toxic”) assets. With a number of private sector institutions (several of whom have already been the recipients of government largesse) indicating willingness to participate in the PPIP, the market has been able to travel in the hope that the auction process will enable encumbered financials to off-load various illiquid assets at reasonable prices. Not only would this help reduce uncertainty for the financials (and investors) about the market value of what is on their balance sheets, by improving market liquidity price levels could rise above the marks currently used in accounts.

With the auction process not expected to begin until May, in order that the finer details may be ironed out and appropriate agreements with the private sector participants can be signed, the possibility that this may prove to be the

initiative that does mark the start of a new beginning for markets can continue to be held out.

Some broader signs of market normalisation are evident as after a dearth of equity Initial Public Offerings (IPO's) so far in 2009, the second and third successful US IPO's were launched in the week of April 13. While the three IPO's year-to-date pales against the 37 in 2008 and 243 recorded in 2007, that companies have been able to successfully launch a public offering is a positive change<sup>2</sup>.

Nor have economic data been as uniformly atrocious as was the case from September to February. One example of this is the widely followed Institute for Supply Management (ISM) survey of the US manufacturing sector. Where this had indicated the fastest deterioration in new orders in the 62 year history of the series in December '08, a substantial amount of this decline has reversed in the first three months of 2009. In addition, where activity indicators had consistently disappointed expectations in the latter part of 2008, more recent data points have been better than the (depressed) consensus of forecasters.

Government policy stimulus has also seen some early indications of success, notably in Germany where the initiative to offer a publicly funded cash incentive to those scrapping cars more than nine-years old if they buy a new car has helped to lift vehicle sales by 18 per cent year-on-year in the first three months of 2009. In China, the acceleration in bank lending to a near 30 per cent year-on-year rate of increase in March is also held out as evidence that the Chinese economy is also responding positively to the large public spending initiatives set out at the tail-end of 2008<sup>3</sup>.

Yet there continue to be nagging indications that there is little of substance behind these more optimistic readings – for one, the ISM new orders index, referred to above, has improved from a low of 23 to 41. But this latest reading is still consistent with manufacturing output declining at a five per cent, six-month annualised pace. This is in line with the worst points of the recessions in the last 30-years. Where in “normal” circumstances, equity markets tend to rally as the rate of deterioration in economic activity starts to ease, it is less clear that this will be the case given the extremity of the downturn we are currently experiencing. Beyond this, data points such as the improvement in the Baltic Freight index in the early weeks of 2009, or the six per cent month-on-month increase in applications to build new homes in the US in February (the first such increase since June '08) put forward as signs that conditions have been stabilising are quietly ignored as the data have worsened once again<sup>4</sup>.

Given the favourable energy cost comparison versus Q2 2008, when the West Texas Intermediate oil price rose from US\$100 on March 31 to its peak of US\$147 on July 11, the lift to disposable income and hence discretionary spending in the current quarter is substantial. This, together with the possibility that the PPIP could prove to be the turning point in sentiment toward and prospects for the financial sector could continue to underpin markets. However, given the unprecedented extent of the down turn, near-systemic collapse and uncertain consequences of the barrage of policy initiatives, a patient approach seems appropriate.

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