

Different this time? Investors no longer seem to think so

By Tony Jackson

Published: February 11 2008 02:00 | Last updated: February 11 2008 02:00

Whatever happened to the bounce in equities? A week ago the UK's FTSE 100 index, for instance, was in fine fettle, up 450 points from the low and back through 6,000. Then it lost two-thirds of that in three trading days. Some rally.

One explanation may be that too many big brokers - and this column, for that matter - had warned that a bear rally was in order after an atrocious January, but was not to be trusted.

So investors believed the second bit and gave the whole thing a miss.

Much more important, we seem to have entered a new phase of global apprehension. Last week's unnerving drop in US non-manufacturing activity was taken as further confirmation of US recession.

The biggest market reactions, however, were elsewhere.

While the S&P fell only 3.2 per cent on the news, Japan's Nikkei was down 4.7 per cent and Hong Kong 5.4 per cent.

In Europe, spreads on credit derivatives soared to new highs, prompting Nomura to comment that "the macro story is progressively taking over from the credit story".

In other words, ripples of concern are spreading from the US round the world. The decoupling argument is losing ground.

Investors no longer seem to believe it is different this time, that a US recession no longer has the same power to harm the rest of the world.

We do not yet have the data to resolve that. But work by Citigroup's strategy team sheds light on the probabilities.

Citi points out that no US recession since 1970 has caused a contraction in world output. But all have caused a sharp fall in corporate earnings worldwide, the effect being typically more severe outside the US than in it. On average, the fall in share prices has been steeper than the fall in earnings.

Further, it would appear that whereas recessions over the period have grown milder, the peaks and troughs in earnings have grown more extreme. So much for the Great Moderation.

These remarkable findings need to be unpicked a little. Citi has calculated world GDP on purchasing power parity exchange rates, thus giving more weight to high-growth emerging nations than would result from market rates.

Nevertheless, it is striking that even in the deep US recession of the early 1970s, the world still managed 2 per cent growth on that basis. And yet corporate earnings outside the US plunged from 40 per cent growth to a 20 per cent decline. In this context, today's more bullish forecasts on world growth may be not so much wrong as irrelevant.

In the much milder US recession of 2001-2002, ex-US GDP growth held up at 5 per cent.

Yet ex-US earnings collapsed from 60 per cent growth just ahead of that recession to a 40 per cent fall in its wake.

The corresponding figures for US earnings were around 20 per cent and 35 per cent respectively.

In all this, we must recall that no two recessions are wholly alike. For instance, that of the early 1970s came at a time of very high inflation, so the fall in corporate earnings was to that extent understated.

We must also recall that the 2001-2002 recession was mainly due not to the usual fall in consumer demand and so forth but to the bursting of a bubble in capital expenditure, in high tech especially.

This resulted in an absolute drying up of orders, and a particularly sharp fall of more than 50 per cent in world share prices.

That was not helped by the fact that prices were on sky-high multiples of earnings. Today, by contrast, multiples are a lot lower.

It might also be argued that this recession will be of a more familiar consumer-led variety, and thus less harmful to earnings.

Maybe, but given the continuing chaos in the credit markets, we may be in new territory in other respects.

What does this all boil down to? Citi's work suggests that a typical fall in world share prices in response to a US recession is in the range of 20 per cent to 30 per cent. So far we are down around 15 per cent.

So if this recession were typical - a big if - we would not have that much further to go. But there remains one danger to which I have drawn attention in the past.

Analysts' forecasts for individual company earnings, though coming down, are still far too high. And when companies fall short of those forecasts, they get punished.

As Citi puts it: "If we were to see the normal fall in earnings associated with a US recession, then analysts' forecasts for 2008 US and global earnings growth could be 30-40 per cent wrong. This is very worrying."

There, for now at any rate, the case rests.