

This is an original article written by Philip Loh; the edited version appeared in the Business Times 8 March 2006.

Why global equity may be heading for choppy times

Low volatility in the stock markets over the past few years has whetted the appetite of retail investors. Many are coming back to the market in droves, believing that the stock market party is here to stay. The consensus among most analysts is that the global stock market would return at the high end of the single digit this year, generally in line with the projected earning growth for year 2006. However, there are some significant risks for the global market of which I would like to highlight a few:

1. US consumer demand has started to show signs of fatigue now that the housing ATM is shutting down. US consumers had capitalised on soaring house prices by extracting equity from their homes, enabling them to spend more than what they earn. The US housing bubbles ran over the past 23 years from 1982 to 2005. The factors that support that cannot be repeated. In many parts of US, housing cost is over six times of family income, while the long-term average is below four. Young Americans simply cannot afford houses at this level. Besides, a housing market slowdown in the UK and Australia shows that even a moderation of home prices could slow customer spending and the economy down significantly. The housing slowdown is likely to worsen at a time when real wages are weakening, resulting in a sharp slowdown of consumer spending which accounts for two-thirds of the US economy. The slowdown would hit the profits of both US listed companies as well as exporters in Europe and Asia.
2. Mutual fund cash positions have declined to a record low and such low readings have in the past preceded market corrections. The rationale is mutual funds are long-term investors and a high cash position would allow them to buy on market dips, hence providing some kind of baseline support for the market. Also, if there is significant fund redemption, the cash position can be used without liquidating the fund's stock holding.
3. Throughout the globe, there is a reported sharp increase of retail stock purchase, according to a number of leading dealing firms. A late surge of individual stocks investors is a clear sign of an impending top. Retail investors have been attracted to stocks by lacklustre returns from alternative investments such as bonds and real estate.
4. The Germany DAX index has recently overtaken the UK's FTSE 100 index, for the first time since 2002. This is a negative signal for stock markets as on the last three occasions that the DAX has managed to rise above the FTSE, global equity dropped sharply within a short period of time. This is because the DAX has a higher exposure to industrial and consumer cyclical stocks and hence is far more cyclically exposed.
5. The US yield curve is now completely inverted. It did in 2000 before the last recession and also briefly in 1998, during the Asian financial crisis, which was the only time in the past 30 years that an inverted yield did not precede a recession. As the stock market is a leading economic indicator, if the US economy is going to have a recession, the stock market is going to perform badly. Many investors

are saying that: "This time is different." They are predicting that it would be the same as 1998 when an inversion does not lead to a recession in US. Others believe that even if US goes into a recession, possibly from a slump in consumer spending, European and Japanese consumers would be able to pick up the slack. And with emerging spending powers in Asian and China, a global recession could be averted. This is perhaps the same confidence that pervaded in Asia during 1996-97 before the Asian currency crisis. Note that the China and Asian economies make up no more than 10% of the global economy. The economic recovery in Europe and Japan may also be too weak to withstand a sharp drop in export demand resulting from a US recession.

6. Perhaps one of the greatest risks is that investors have failed to adjust for the historical high profit margins in their calculation of PER (Price to Earnings Ratio), the main valuation yardstick for the attractiveness of stock. The bulls claimed that PERs for the global markets are near their historical average, and are far from being overvalued. What is perhaps not discounted for is the fact that profit margin, at about 8.5% is at the highest level ever reported in the last 50 years. A reversion to mean gross margin of about 5-5.5% could wipe 20-30% off current stock valuations. Some analysts are already predicting that profit margins have peaked and may be on the decline this quarter. If we believe that capitalism is still alive and doing its job, higher margins would eventually lead to higher competition and push margins down to a more sustainable level. The time for that may well be now.
7. Meanwhile, interest rates in Europe and Japan are expected to rise from their historical lows, providing additional head wind to equities. Inflationary pressures are on the rise in both Japan and Europe, forcing the EU and the Japanese government to raise interest rate probably faster than they would like to. And inflationary pressure is not likely to abate in the near term with high oil and commodity prices, and their secondary effects on prices probably kicking later this year.

It is however interesting to note that asset bubbles may well take years to burst. The highlighted risk factors may not lead to a market dip anytime soon. The bulls may well have their way again this year. But certainly, the risk versus reward paradigm is shifting and increasing pointing to a market correction. With the many hidden dangers on the horizon for the stock investor, patience could well translate to gold in a matter of months, or maybe even in a matter of weeks.