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Second Quarter 2014

Waiting for a market correction…

By Daniel R Wessels

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

[Peter Lynch]

At the time of writing this article (August 2014) most professional investors and market commentators hold the view that local markets are expensive and offer little room for decent returns going forward. Well, local stock market investors have experienced over the past five years, and actually over the past decade, despite a sharp correction in 2008, fantastic returns.

FTSE JSE All Share index July 2004 – July 2014

Annualised Return	ALSI	ALSI TRI #
One-year	24.5%	28.3%
Two-year	21.9%	25.6%
Three-year	18.1%	21.8%
Four-year	16.0%	19.6%
Five-year	16.2%	19.5%
Six-year	10.8%	14.1%
Seven-year	8.8%	11.9%
Eight-year	11.9%	15.1%
Nine-year	14.5%	17.8%
Ten-year	17.4%	20.8%

Dividends re-invested

Source: DRW Investment Research

On face value I do not necessarily dispute the current views, actually in many ways market indicators are pointing to excessive valuations that is difficult to justify against a backdrop of a struggling economy, poor investor- and business confidence (which cannot entirely be blamed on economic fundamentals only), depressed consumer spending, indebted household levels, stubborn inflation, and rising interest rates. But, of course, many of the large cap stocks listed on the local bourse is anything but dependent on the future direction of the local economy because they derive a large part of their earnings in foreign markets and currencies. Effectively, they act as a hedge for investors against the risks of local economic woes and currency depreciation.

In that respect the global economy has turned the recession corner following the financial crisis of 2008. Many concerns, however, still exist and that is besides the geopolitical tensions present in various parts of the world. For example, will China continue to grow unabatedly its economy despite evidence of mountains of bad debt and over-investment in infrastructure? And, will China succeed to transform into a consumer-driven economy; i.e. most of the GDP growth will be driven by consumer demand than relying purely on investment spending? How will the phasing-out of quantitative easing in the USA (and normalisation of interest rates) affect economies and especially the flow of investments, fixed investments and portfolio flows, into emerging market economies? How will European economies, South Africa's largest export market, deal with serious imbalances and huge government debt in some member countries? The euro, as a single currency, effectively inhibits those troubled countries to become more globally competitive and to make the necessary structural adjustments to their economies.

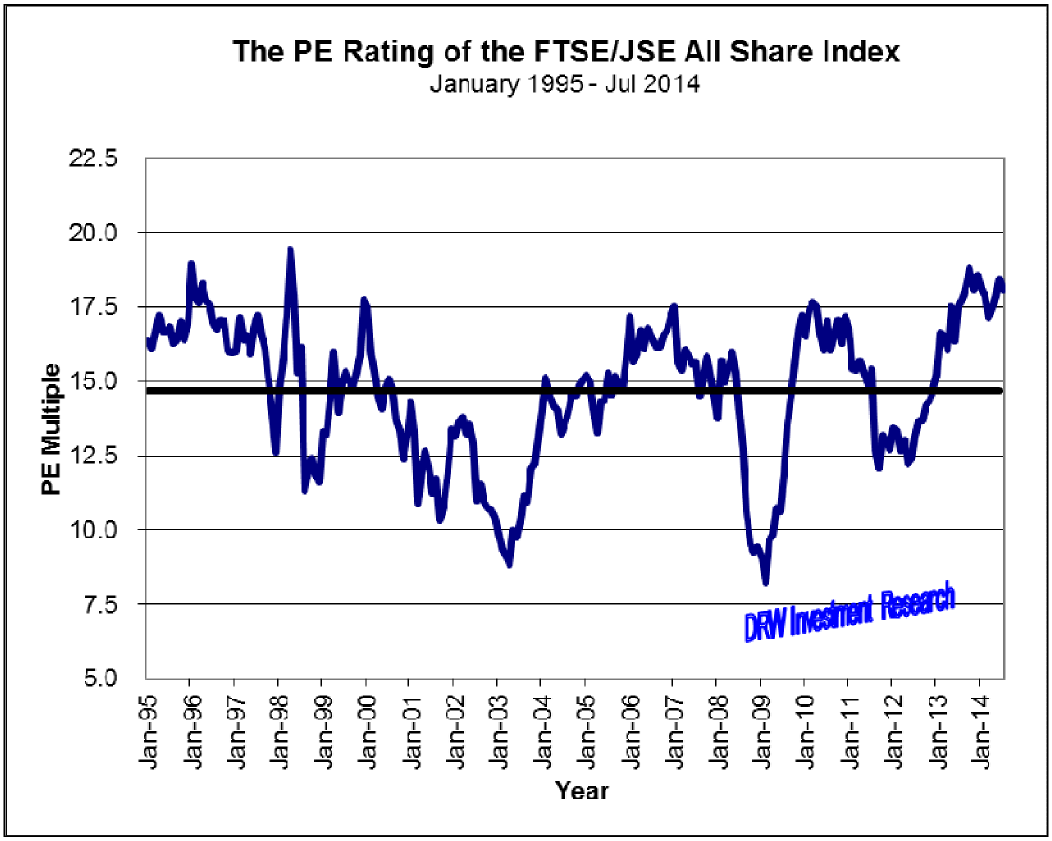
All in all, not a lot of reasons to be overly optimistic about the immediate prospects for a reasonable investment return from a South African perspective. But then again, when in history was the outlook ideal? To be sure, there are always reasons to be concerned or pessimistic, but on balance investors always made money over reasonable periods of time, despite serious economic and political issues that would have been on the forefront at times.

The most important consideration, however, for investors is not to make predictions how events will unfold over time (the unknown), but focussing on current valuations (the known). How much good news is priced in today, and are there any margins for possible bad outcomes in the future?

To that end a number of yardsticks (indicators) may be used to evaluate market prices, some more useful than others, but not a single indicator on its own offers a confident assessment. Also, it is not likely to be an accurate market timing tool – when to disinvest or to invest in the market – but it is at best a guidance for assessing the probabilities of gaining decent market returns going forward.

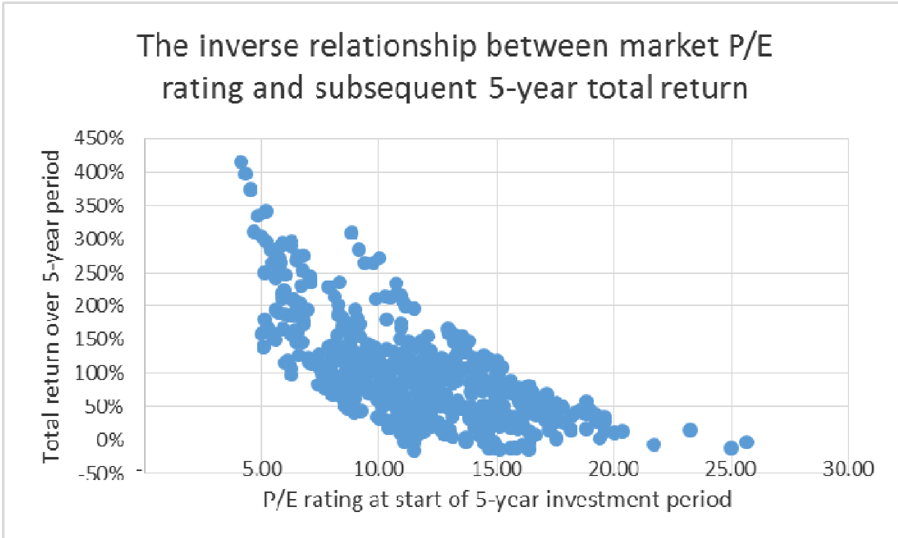
Price / earnings multiple (P/E):

Market index (price) as a multiple of the most recent historical earnings; how many years of current earnings are required to pay back today's price in full.



Source: DRW Investment Research

Currently, the market P/E is at 18.1 times. Since 1995 the average P/E ratio has been 14.7 times. Clearly, the current market rating is well-above the average market rating and therefore deemed to be expensive.



Source: DRW Investment Research

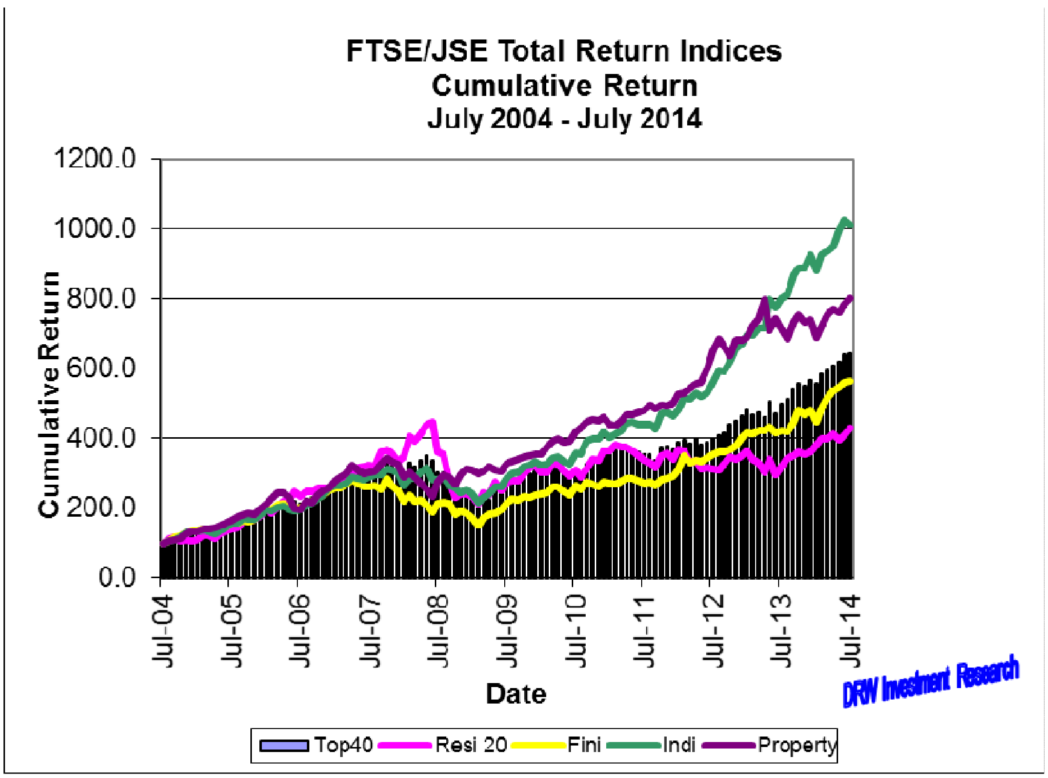
The graph above clearly illustrates the inverse relationship between market rating at the time of an investment and the subsequent total return over a five-year period; the higher the P/E ratio at the start of an investment period, the lower the subsequent returns (coefficient of significance $R^2 = 0.46$). Thus, a high market rating today does not bode well for market returns over the next short to medium term. Note, however, this is not necessarily implying a negative return, but subdued returns relatively to those when cheaper market ratings would apply.

But while this may be true for the market index, what about specific sectors of the market; i.e. resources, financials and industrials? The latter sector has run especially hard with the likes of Naspers, SAB Miller, and Richemont at the helm and leaders of equity returns in recent years.

As at the end of July 2014

Performance over	J210T Resi 20	J212T Fini	J211T Indi	J253T Property
1 Month	5.1%	0.6%	-1.4%	1.9%
3 Months	4.1%	5.3%	6.6%	4.0%
6 Months	12.9%	26.0%	14.7%	16.7%
12 Months	33.9%	32.8%	26.3%	12.7%
24 Months *	17.5%	26.2%	34.2%	11.1%
36 Months *	8.5%	27.5%	32.0%	18.5%
48 Months *	8.6%	20.8%	29.6%	17.6%
60 Months *	9.4%	21.3%	28.4%	19.5%
84 Months *	4.2%	11.5%	19.7%	14.9%
120 Months *	15.7%	18.9%	26.0%	23.1%

Source: DRW Investment Research



Source: DRW Investment Research

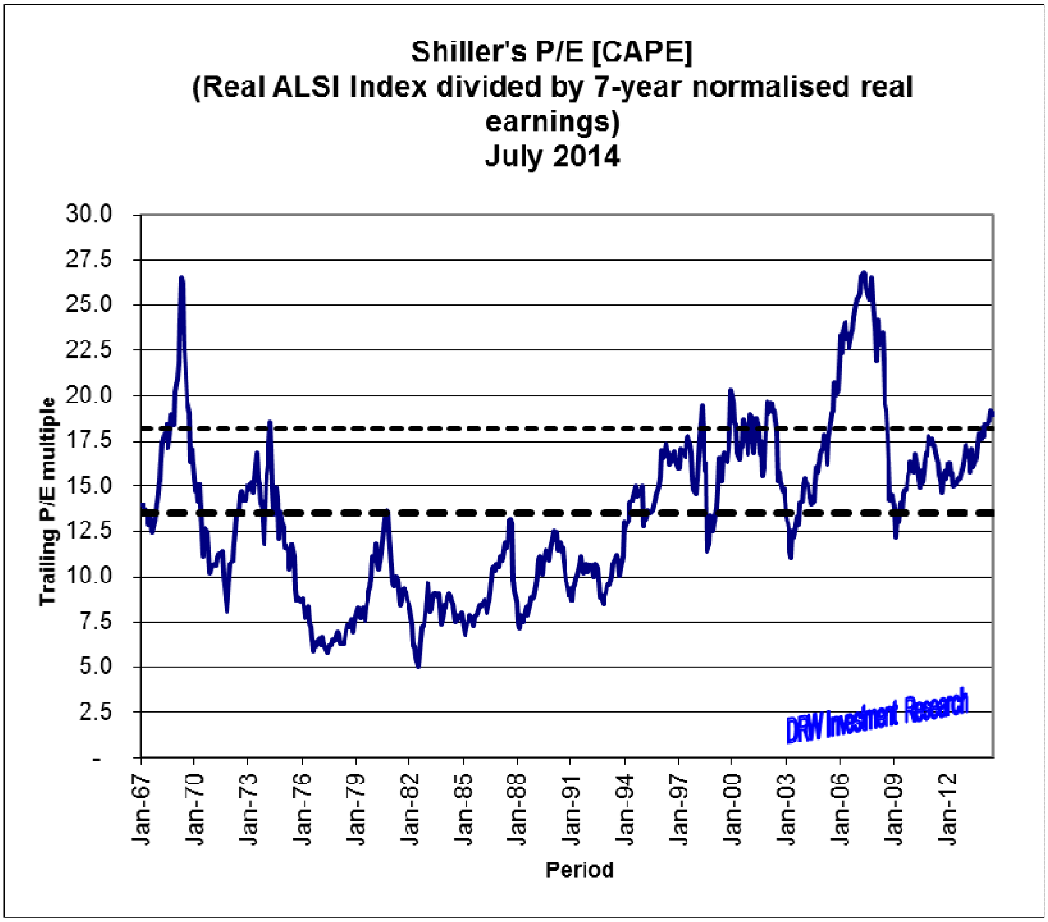
Currently, the top 25 industrial shares has an average P/E rating of 22.1, the top 15 financial shares (banks, insurance, asset management) are rated at

15.2 and the top resources companies are valued at 14.5 multiple. If anything, it seems the latter two sectors are not as expensively priced as the industrial sector.

A caveat, however, exists in that earnings in the above formula only accounts for the last reported set of financial data and does not disclose anything about the earnings trend. Therefore, a better method is to smooth out earnings over time and then to establish how the current price is rated against the smoothed or normalised earnings. This measure is known as the cyclically-adjusted price earnings multiple or CAPE.

Cyclically-adjusted price earnings multiple:

Earnings is smoothed out over the long-term, in this case seven years. Both historical prices and earnings are adjusted for inflation to compare the current ratios with those in the past on a like-for-like basis.



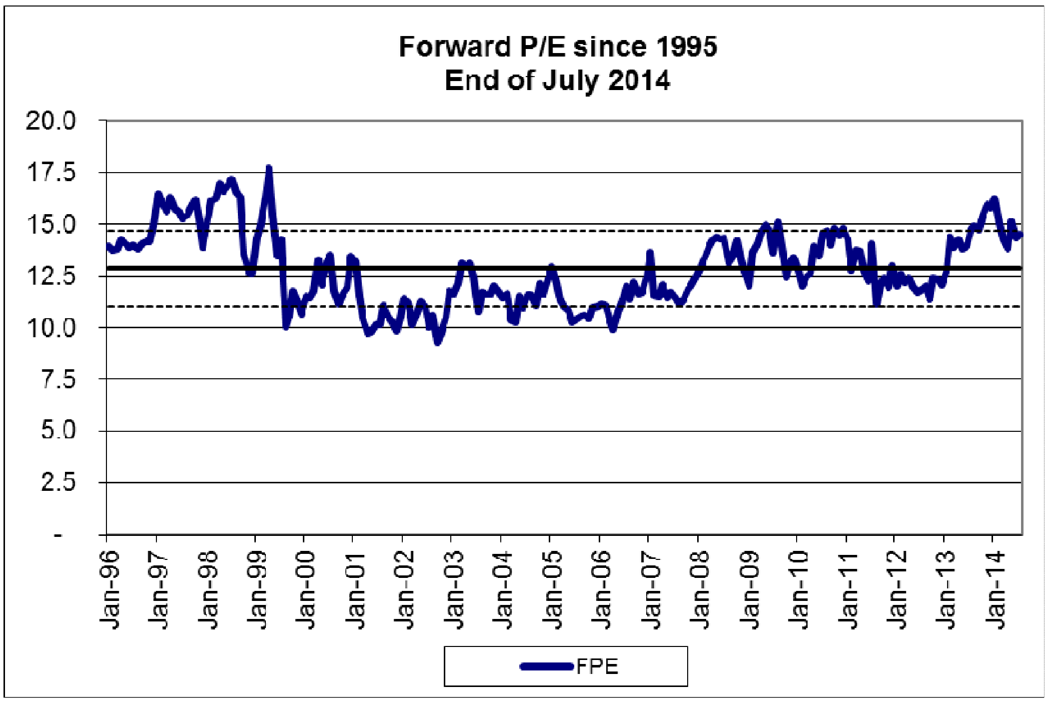
Source: DRW Investment Research

The current CAPE multiple (19.0) is well-above the long-term historical average (13.5) as well as trending more than one-standard deviation above the mean (18.2). Clearly, current ratings are deemed to be on the expensive side. Note, however, it is nowhere near the peaks reached in late 2007 and early 2008.

Next, I consider another alternative indicator where I evaluate how well the market is predicting earnings growth. While earnings tend to be cyclical over time, the market obviously knows this and one could argue that today's price is the best estimate of future earnings, given what is known today of the prospects of earnings growth going forward. If the market is expecting a period of high earnings growth, one can expect the current P/E ratio to increase to reflect this bullish view.

Forward P/E multiple:

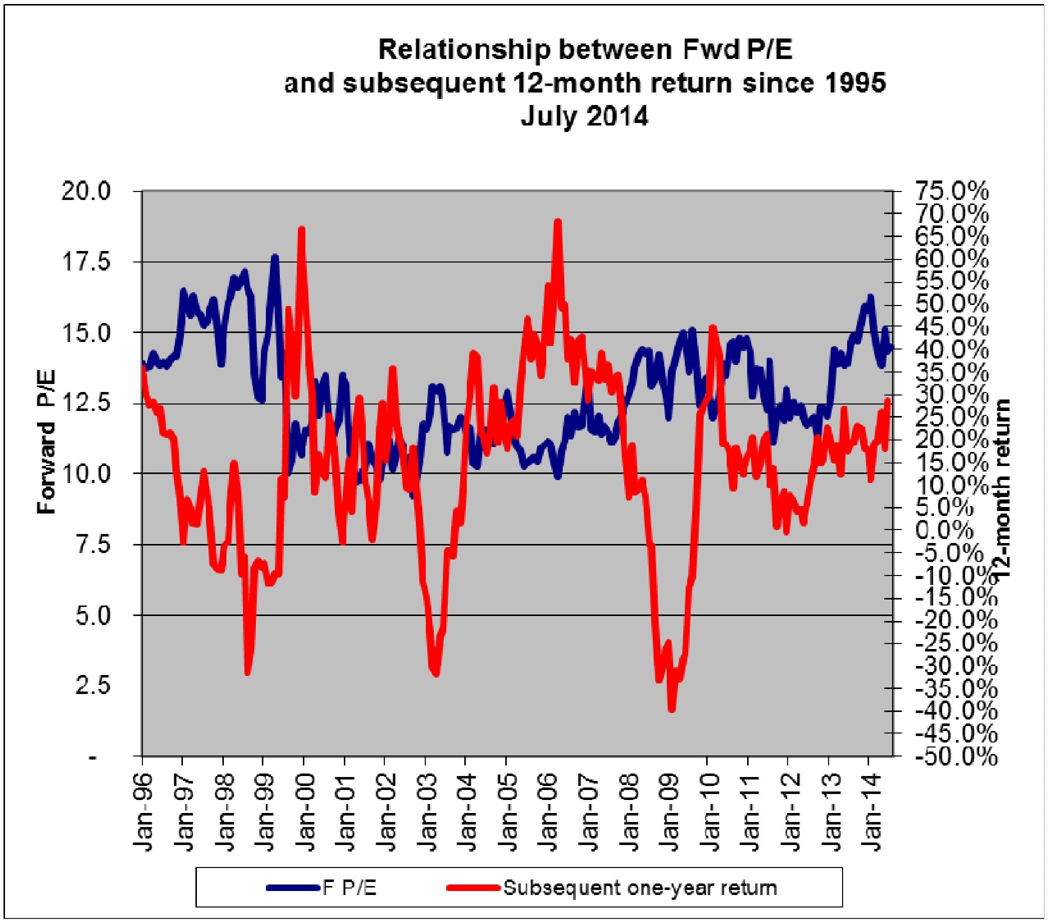
This indicator measures the accuracy of the market in predicting the earnings growth of companies in the market index over a twelve-month period. It is done by comparing the index level (price) twelve months ago with the earnings growth achieved over the following twelve months – thus how effective was the market in setting the price levels a year ago in anticipation how earnings growth of companies would play out today.



Source: DRW Investment Research

Typically, the market is predicting earnings growth quite effectively in a narrow range of between 11.0 and 14.7 forward P/E multiple and with a mean forward P/E multiple of 12.9. At the end of July 2013 (one year ago) the market index was at 41,293 with a P/E multiple of 17.5 at the time. Over the next twelve months earnings growth of more than 20% materialised that resulted in a forward P/E multiple of 14.5 – at the high end of forward P/E multiples, but still within the normal range.

At the moment (July 2014) the P/E multiple is at 18.1 and for the stock market rating to be in line within the typical forward P/E multiple range, earnings growth of 20% to 30% is anticipated over the next twelve months. If that growth is not going to materialise, some market correction can be expected.



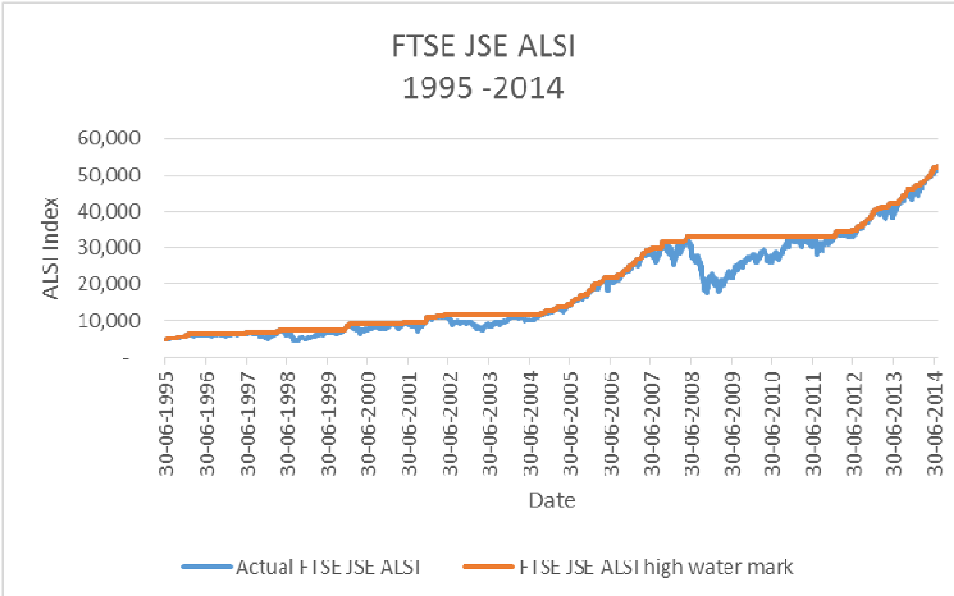
Source: DRW Investment Research

The above graph illustrates the relationship between forward P/E multiple and subsequent twelve-month market return. Typically, but not always, if the forward P/E multiple was at the higher end of expectations (left-hand vertical axis) a subsequent poor return was likely over the next twelve months (right-hand vertical axis) and vice versa.

All three indicators discussed above are pointing towards expensive market ratings, but not necessarily solidly in excessive territory which would raise definite red flags. Thus, to my mind it is not a foregone conclusion that the stock market is priced for corrections going forward.

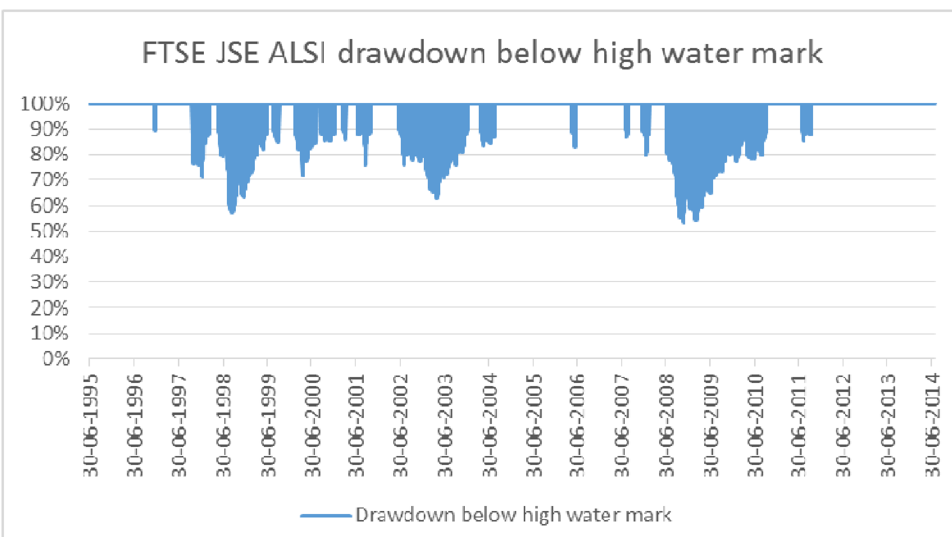
There is a chance that earnings growth on average would surprise on the upside over the next year (20%-30% earnings growth), and of course, many of the locally listed large cap stocks derive a substantial portion of their earnings in foreign markets and currencies. If the current index level (51,000) remains more or less in the same range over the next twelve months, the current P/E multiple of 18.1 will decrease to about 14.5-15 this time next year, which is actually in line with the long-term average rating of the stock market. But if local and global economic woes continue to surface the possibility of upside earnings surprises will quickly evaporate and market prices and ratings will reflect the new reality; i.e. expect significant market corrections.

Let me explain what I mean by a "significant correction". Typically it refers to situations where the stock market drops more than ten percent from its previous highs (highest index level).



Source: DRW Investment Research

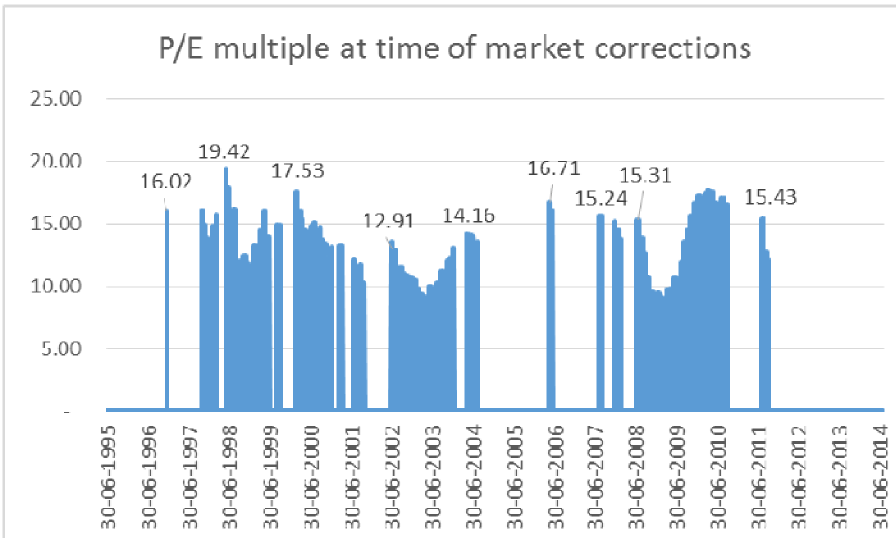
The graph above shows the FTSE JSE All Share index movement since 1995 to date (blue line) and the new highs (high water mark) reached during this period (orange line). It illustrates the extent of market corrections (drawdown) from previous record index levels that occurred at certain periods over the past two decades.



Source: DRW Investment Research

All significant market corrections larger than 10% (from the previous record index level) over this period is illustrated by the graph above. The worst sustained drawdown periods happened in 1998, 2002 – 2003 and 2008 – 2010.

Now, was all these significant market corrections preceded by high market ratings (P/E multiples) at the time?



Source: DRW Investment Research

No, clearly not. Actually, only the correction of 1998 and to a lesser extent that of 2000 happened when market ratings were in expensive territory; other corrections happened at times when P/E ratings were deemed “normal”!

Thus, as always, it is not an easy game to make absolute predictions where markets are going in the short term. Most market experts and experienced investors will attest that they have met at one time or another their nemesis, Mr (Ms) Market during their investment careers. Remember, “investment losses” should also include the opportunity costs of missing out on investment returns when one has made definite calls on the short-term direction of the market. Likewise, ordinary investors should not start playing guessing games, but remaining mostly true to their investment strategies.

What have we learned from the predictive power of expensive market ratings? Perhaps that it is not a great indicator whether investors will experience significant market corrections (negative returns). It does tell us, however, that the likelihood of decent returns from that point onwards is less than if the market ratings were more favourable.

It would make sense, therefore, to employ phasing-in tactics with lump sum investments at times of high market ratings since the odds are stacked against reasonable returns going forward. By spreading the investment allocations over time investors can acquire assets hopefully at more reasonable valuations that will increase the probabilities of securing decent returns going forward.