21 October 2009

## European Equity Strategy

# The 2010 debate begins....

Although we upgraded our YE 2009 Stoxx600 forecast to 265 from 225 in Tuesday's bi-weekly we've kept our 2010 forecast at 225, just under 10% below current levels. Relative to current levels this isn't particularly extreme but relative to where we may end 2009 it does look fairly aggressive. In this note we want to expand on why the medium-term outlook still remains challenging and full of tremendous uncertainties. Clearly we may end up smoothly working our way through the aftermath of the biggest crisis in nearly 80 years but the tail risks are huge, and the structural (possibly negative) forces still significant.

For now we are in the sweet spot, or perhaps the eye of the storm. We have a cyclical recovery with some momentum with the additional advantage of it being combined with ultra low short and long-term rates. It really couldn't be any better for risk. However it's worth reminding ourselves that we've never had such accommodative interest rate and fiscal policy. If this was a good thing and a sign of strength then we could argue that we should have such a 'ZIRP' all the time. BoE rates are the lowest in the bank's 315 year history and Fed Funds are also around the lowest on record.

As we go around the world no-one truly knows whether this crisis will end up in inflation or deflation but an increasing amount of investors are thinking that it will end up with a bias towards one or the other. Historically equities have seen highest valuations in a low and stable inflation world. The fat tail risk should not be underestimated.

In this note we outline why the medium-term (6-18 months) may not be as positive as the short-term. Clearly in these uncertain times everything all of us knew prior to this crisis has to be re-evaluated. After re-evaluating and debating the themes we may find that we are in a more normal environment than we think at this point. However as we approach the time when people are contemplating their 2010 views we wanted to open up and encourage some debate around some of the medium-term themes. Some of the discussion in this short note will be a repeat of previous published views/graphs but hopefully we can start to open up debate as we start work on our annual outlook. We are trying to find a way to be more positive on 2010 but hedge the tail risks. It's these tail risks that are the main concern. The most likely scenario could be more optimistic than the weighted probability of outcomes. All feedback and comments are welcome.

**Zero Interest Rate Policy (ZIRP) - A sign of Strength or Weakness?**


*Source: Deutsche Bank, GFD, NBER*

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# Earnings

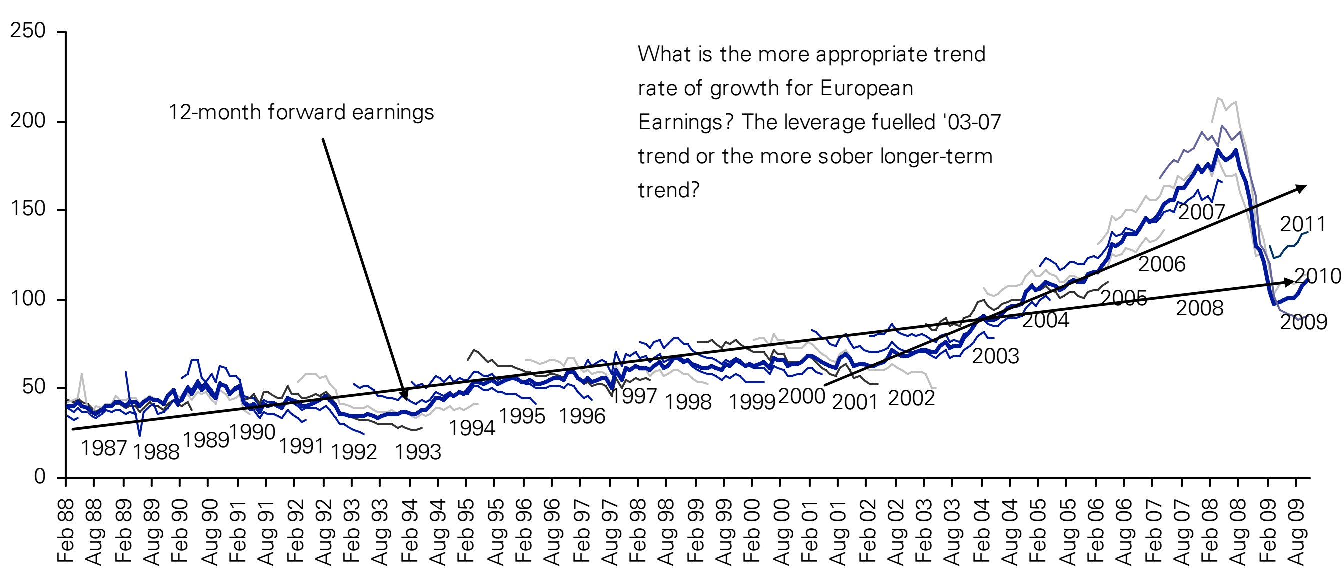
First let's look at what our forecasts mean for valuations based on earnings multiples.

Based on the consensus bottom-up earnings growth forecast of -20% this year and +26% next year, 2010's PE ratio would be 11.7x based on a 225 Stoxx600 forecast. Our 2009 end target of 265 would mean an end 2009 P/E of 17.4. Based on our top-down model, our earnings growth forecast is for -27% this year and +18% next year. The multiples based on this are 13.2x for 2010 and 18.3x for 2009. The long-term average for European markets is around 13x.

Based on consensus earnings our forecasts equate to a multiple compression of 28% from 2009 to 2010. This is significant but not without historical precedent. We had huge multiple volatility in the 1930s and in more recent times in the 1970s. Indeed we saw such an event between 1974 and 1976. In 1974 multiples fell 49%, then rose 91% in 1975 and then fell 17% in 1976. We are in living in extreme times more consistent with the 1930s and the 1970s rather than the more sanguine 1980s, 1990s and early part of this decade. We therefore are more inclined to believe in more extreme outcomes than our collective minds have been accustomed to in recent decades. In the section looking at structural forces we explain why multiples could be lower in the future than they have been over the last decade.

Taking a longer-term look at the trend of European Earnings we still don't know whether the long-term trend (back to 1988 in the chart below) is appropriate or whether the leveraged fuelled trend of 2003-2007 will reassert itself. We have more faith in the longer-term trend but think the market is perhaps starting to price in a return to the 2003-07 trend post 2010. At the moment forward 2010 earnings forecasts return us to the longer-term trend line and as such are not unreasonable. However on our way of thinking about the world any further upgrades will start to return us to a '03-07 type world. The bigger picture question is probably what multiple needs to be applied to earnings post crisis. Here there are some unanswered structural concerns.

**Figure 1: 12-Month Forward European Earnings Trend**

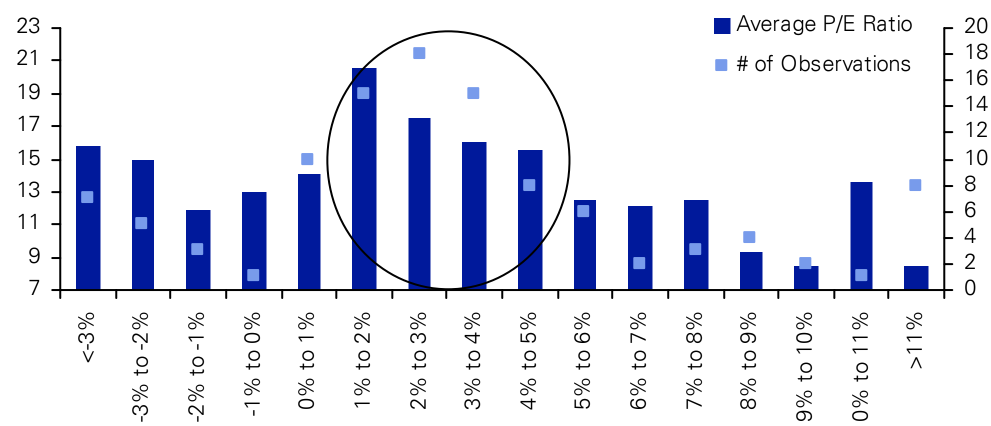



*Source: Deutsche Bank, Thomson IBES*

# Post crisis, will we live in a lower multiple world?

Over the past couple of months we've been adjusting our stance to reflect the current 'sweet spot'. Indeed 2009's market moves can perhaps be easily explained by developments in the chart below, one we previously used in 'Dropping the Anchor'.

**Figure 2: Average P/E Ratio Based on Different Inflation Buckets**



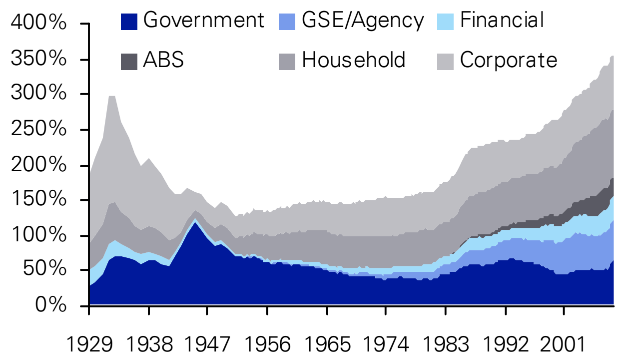

*Source: Deutsche Bank, Bloomberg, Irrational Exuberance (Second Edition) (Robert Shiller), S&P*

In this chart we show that equity valuations (using over 100 years of US data) are highest when inflation is low but positive. In Q1 of this year the fear was that we'd break out on the left hand side of this 'sweet spot' and towards deflation. However unparalleled and extraordinary intervention has taken us back into the sweet spot that has dominated the macro-economic landscape for nearly 30 years.

When you read books on how bubbles are formed you tend to find that long, sustained periods of macro-economic stability are often an accompanying backdrop. Historically such a backdrop has steadily led to higher valuations, until finally investors get so confident that they extrapolate out the prevailing conditions far into the future, thus laying down the conditions for chronic over-valuation. For us this has been the story of the last decade and a half in Western equity markets. From the mid-1990s investors started to sense something special with regards to the macro backdrop while later finding a new technology to be the bubble cheerleader. When you consider the favourable demographics often discussed in our research (and briefly mentioned later), the perfect conditions for a bubble had formed.

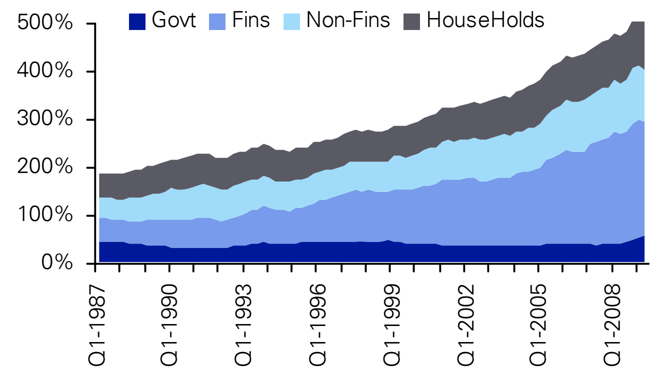
Why all of this is important is because the authorities responded to the savage post-2000 correction in a way that ensured that we stayed in this macro-economic sweet spot while the bubble deflated. The short-term stability of the economy/financial system was seen as the priority. However the consequence of maintaining this macro economic stability and still historically high equity valuations has been ever higher debt burdens in the Anglo-Saxon world. Indeed the charts below show the cost of sedating the volatility of macro-economic variables (mainly growth and inflation) in the UK and the US. The period of 'The Great Moderation' was increasingly sustained by ever larger Global imbalances, without which macro-economic volatility would likely have been far higher.

**Figure 3: US Debt to GDP back to 1929**




Source: Deutsche Bank, Federal Reserve, The Statistical History of the US , from Colonial Times to the Present, by Ben Wattenberg

**Figure 4: UK Debt to GDP Ratios**



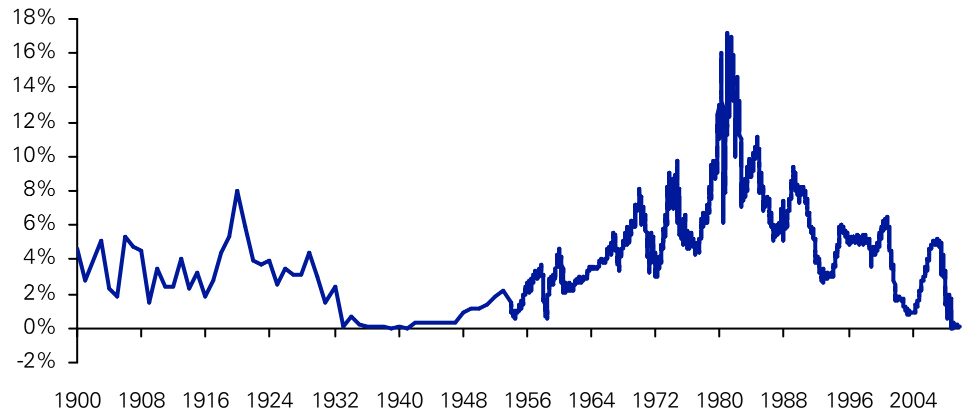

Source: Deutsche Bank, Office of National Statistics

So the longer we can stay in a world where the market is convinced that we will see positive (and firm) growth with low but positive and steady inflation, the longer equity market valuations can stay above their long-term averages. With the huge conflicting inflationary/deflationary forces currently at work it does take a big leap of faith to believe that the authorities will keep us perfectly and permanently in the sweet spot. The more likely scenario is that they won't do enough or probably more likely they will try to do too much. In 2010 the debate could move on to when inflation becomes a concern for markets, or when the bond market bear will start to wake from its near 30-year bull market. However any pulling back of stimulus and deflation will be back on the agenda. It really is that delicate a balancing act and the decisions that will eventually determine the outcomes have probably yet to be made.

So there is a compelling reason for equities to trade above their long-term valuations as long as bond yields fail to see any inflation risk on the horizon. We were slightly uncomfortable that the deflation risk had been completely priced out of markets in recent weeks. With such huge forces operating on both sides, it's too early to declare a winner; if indeed there will be one. Overall we feel that in a fiat currency world the medium-term risks are more inflationary given the authorities determination to avoid a debt-deflation spiral.

We also still find it puzzling that there is such a strong consensus suggesting that Zero Interest Rate Policy (ZIRP) is a positive. An alternative theory could be that this reflects a very weak underlying system. The most obvious examples of ZIRP in modern economic history are the 1930s and 1990s- Japan. There is an argument that ZIRP has been put in place earlier than in those circumstances but the uniqueness of this situation should not be underestimated. Again the early response could be inflationary or we could still be in a liquidity trap that characterized the 1930s Global Economy or 1990s- Japan.

**Figure 5: US 3-month Government Yield – ZIRP a rare and troubling event?**



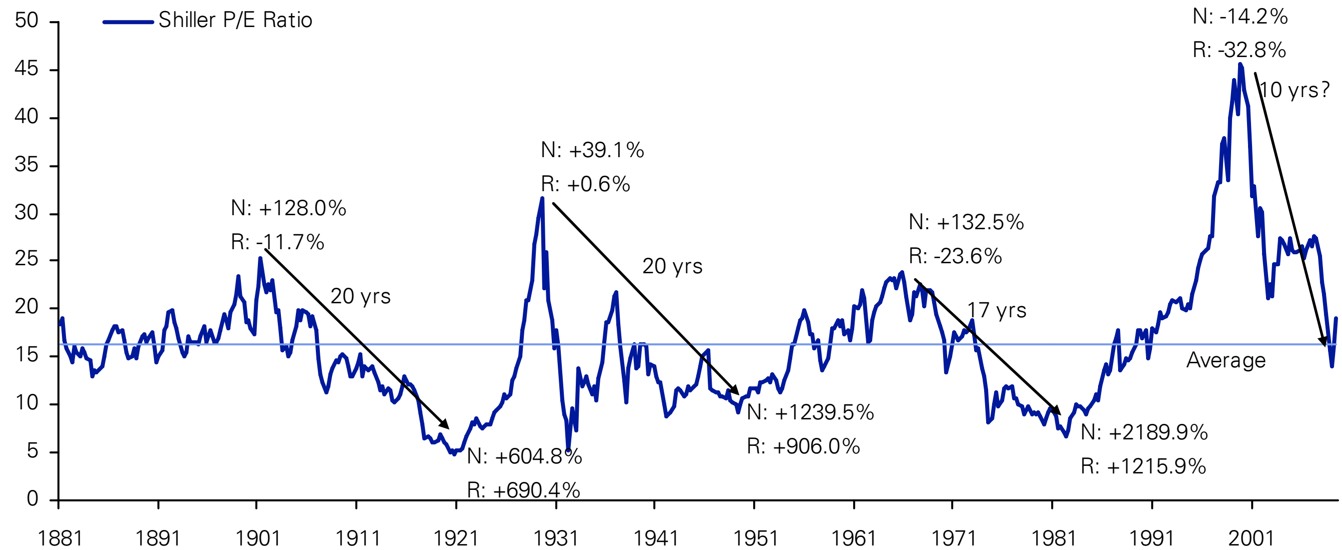

*Source: Bloomberg, GFD, NBER*

What the 'ZIRP' has done is prevented the Global Economy from rapidly adjusting in a chaotic way post crisis. This doesn't mean the adjustments won't eventually have to be made but it does mean that the problems can be masked. Over the last two-three months we've written about how the authorities have engineered a 2007-lite Economic system. So instead of making painful structural adjustments they have pumped money and energy into restoring the old and arguably fatally flawed system. The problems of too much debt in the West have been solved by more debt. Auto and Housing subsidies are examples of this. It may be that when these and other stimulus programs expire, the end demand is still lacking. The authorities may have to continue to offer up these incentives to keep activity higher. This will then raise the discussion on whether Government bond markets will be as willing to finance these deficits in the future as they have been in a QE driven world.

## Structural concerns that may lead to lower multiples

We are not yet sure whether the structural decade long bear market in equities has been fully resolved. There is little argument that equities are in the ball park of long-term fair value (probably just on the expensive side) but history tells us that averages rarely hold. In fact long-term sweeping cycles tell us that investors fall in and out of love with equities over a generation which tends to swamp short-term economic cycles.

**Figure 6: Shiller P/E Ratio and Total Returns in Nominal (N) and Real (R) Terms covering Structural Bull/Bear Markets**

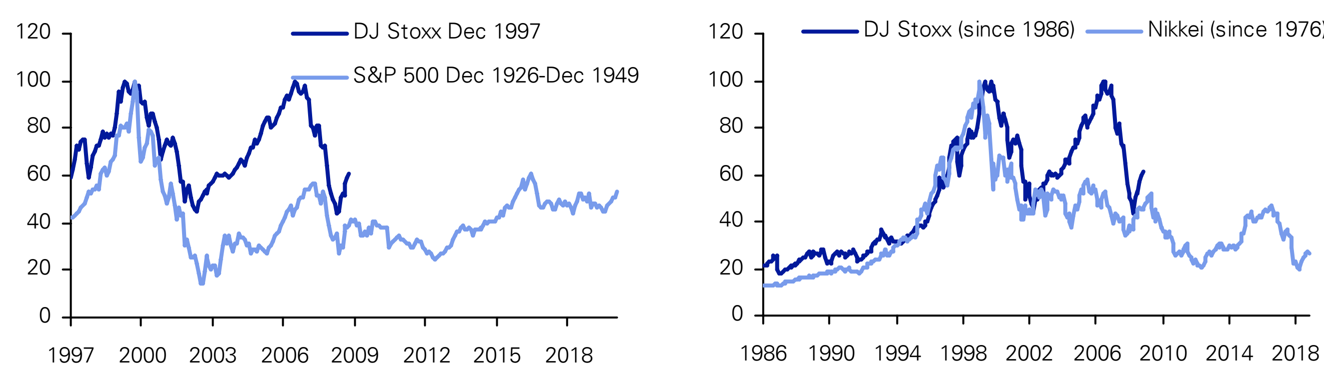



*Source: Deutsche Bank, Bloomberg, Irrational Exuberance (Second Edition) (Robert Shiller), S&P, US Bureau of Labour Statistics*

So can we wholeheartedly say that we won't get lower than average multiples after a long period of chronic overvaluation? History would at least suggest we shouldn't rule out the possibility over the next few years.

When we plot this decade long bear market against the two most famous structural bear markets of the last century (the 1930s and Japan post 1990) it is hard to say that we have completely decoupled from history. In the charts we simply rebase the DJ Stoxx600 at 100 at its peak in 2000 with the equivalent peak in the US in 1929 and Japan in 1990 (both also rebased at 100 at the peak).

**Figure 7: Current DJ Stoxx 600 vs US 1929- (left) and Japan 1990- (right). All rebased to 100 at respective peaks**

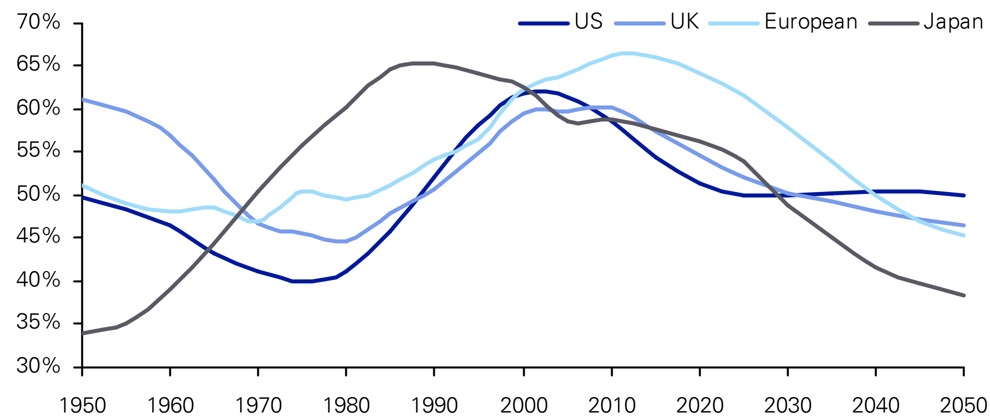



*Source: Deutsche Bank, Bloomberg*

Could equity markets from 2000 onwards still be broadly tracking the same big picture pattern as seen after 1929 in the US and Japan after 1990. We simply do not know but there are some remarkable similarities, especially in the timings of the peaks and troughs. If we are still a hostage to history we still could have a few years of range trading markets, albeit with the possibility of large cyclical ranges.

Finally while we are on structural themes its worth remembering that Western World demographics have been utterly supportive for equities and risk assets in general until this decade. In Japan this demographic support peaked in 1990, the exact same point that their equity market peaked. We can't rule out that an aging Western population will have a similar reluctance to be as aggressive in equities as they were when they were a surging society of baby boomers. This may mean a period of lower multiples ahead. We simply don't know how an aging Western population is going to feel about a volatile asset class that has provided a decade of negative returns. They perhaps should now be looking at the renewed value in the asset class but they instead may irrationally keep a lighter weighting in equities reflecting a more risk adverse mentality.

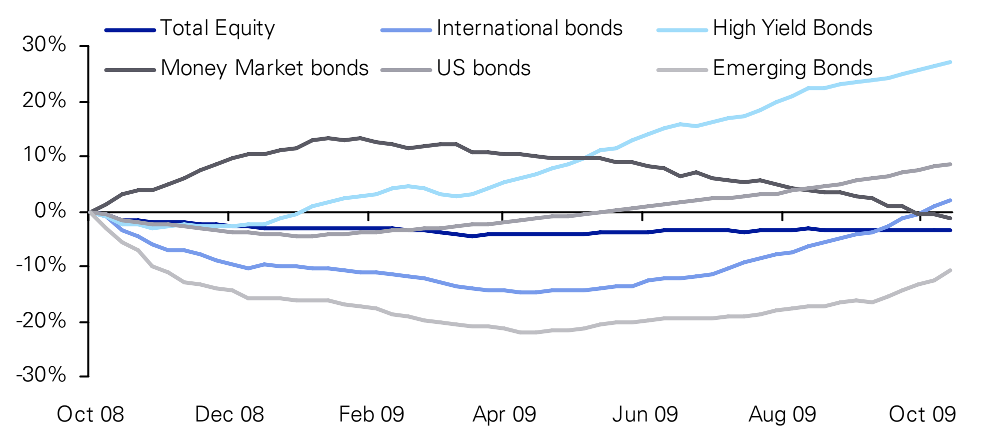
**Figure 8: Global 35-54yr Dependency Ratios**




*Source: Deutsche Bank, UN Population Division*

Indeed the flows we've seen since March in some way backs this up. Since this point Fixed Income flows seem to have recovered in a more positive manner than equity flows. There are huge risks to this if the authorities allow inflation to be unleashed, however flows are not always rational and could be a reflection of the patterns/performance seen for most of this past decade. The flows into Fixed Income could also be linked into the demographic transition Western economies are now undergoing.

**Figure 9: International Asset Allocation changes since October 2008**




*Source: EPFR / Deutsche Bank Calculations*

## Reason for Stoxx600 2009 YE Upgrade

Outside of the well versed discussion on the "sweet spot", there is increasing evidence that we are in the early stages of a strong reporting season on both sides of the Atlantic and although the bar has been raised since Q2, it does seem that shocks are unlikely to materialise in earnings over the next few weeks.

According to our analysis, which tracks the results from Bloomberg, of the 100 companies that have reported so far in the S&P 500 (since October 1st), 81% have beaten expectations, relative to 18% who have missed. In Q2 the final number of beats to misses was 76%/23%. In Europe, only 32 of the Stoxx 600 have reported and 21 (66%) have beaten with 11 (34%) missing.

On revenues Q2 saw 51% beat and 49% miss in the S&P 500 with the comparable numbers being 49% and 51% for Stoxx600. So far in Q3 66% have beaten in the US with 56% beating in Europe. We also show Q2 for comparison.

**Figure 10: Q3 09 US and European EPS and Revenue vs. Consensus Estimates**

| | | EPS | | | | Revenue | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Count | Percentage | Average Beat | Median Beat | Count | Percentage | Average Beat | Median Beat |
| S&P 500 | Beats | 81 | 81% | 13.0% | 8.5% | 66 | 66% | 4.5% | 2.4% |
| | Misses | 18 | 18% | -12.2% | -6.3% | 34 | 34% | -2.9% | -1.6% |
| | In Line | 1 | 1% | N/A | N/A | 0 | 0% | N/A | N/A |
| | All | 100 | | 8.2% | 6.1% | 100 | | 2.0% | 1.0% |
| DJ STOXX 600 | Beats | 21 | 66% | 10.7% | 6.4% | 18 | 56% | 4.0% | 1.4% |
| | Misses | 11 | 34% | -18.2% | -15.9% | 14 | 44% | -5.5% | -1.8% |
| | In Line | 0 | 0% | N/A | N/A | 0 | 0% | N/A | N/A |
| | All | 32 | | -0.9% | 1.1% | 32 | | -0.2% | 0.1% |

*Note: In calculating averages and medians we have excluded outliers (i.e. all EPS/revenue data that beat consensus by more than +50% or miss consensus by less than -50%. Source: Deutsche Bank, Bloomberg*

**Figure 11: Q2 09 US and European EPS and Revenue vs. Consensus Estimates**

| | | EPS | | | | Revenue | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Count | Percentage | Average Beat | Median Beat | Count | Percentage | Average Beat | Median Beat |
| S&P 500 | Beats | 374 | 76% | 13.28% | 10.17% | 252 | 51% | 4.86% | 2.33% |
| | Misses | 115 | 23% | -10.04% | -4.82% | 240 | 49% | -5.57% | -2.95% |
| | In Line | 6 | 1% | N/A | N/A | 2 | 0% | N/A | N/A |
| | All | 495 | | 7.75% | 5.80% | 494 | | -0.29% | 0.03% |
| DJ STOXX 600 | Beats | 272 | 58% | 14.92% | 11.53% | 235 | 49% | 4.72% | 1.98% |
| | Misses | 195 | 41% | -15.00% | -11.33% | 246 | 51% | -4.44% | -2.22% |
| | In Line | 4 | 1% | N/A | N/A | 1 | 0% | N/A | N/A |
| | All | 471 | | 2.81% | 3.45% | 482 | | -0.15% | -0.17% |

*Note: In calculating averages and medians we have excluded outliers (i.e. all EPS/revenue data that beat consensus by more than +50% or miss consensus by less than -50%. Source: Deutsche Bank, Bloomberg*

## Conclusion

The short-term outlook is boosted by the favourable macro environment and the current positive earnings season. However as we gaze into the crystal ball for 2010, many of the Global imbalances remain. It's debatable whether the market has fully appreciated the impact of a potentially more volatile macro-economic world going forward and the structural forces that may lead to lower than average multiples in the future. None of this is set in stone and the uncertainty level is high, however we think it's dangerous to think that the 6-18 month outlook is as rosy as the 3-6 month one dominated by extra-ordinary intervention.

# Appendix 1

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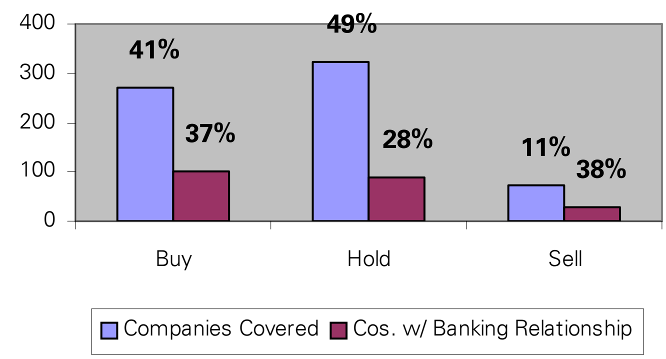

European Universe

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