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Downunder Daily

Decompression

One hallmark of the four-year rally in risk assets was the compression in returns and asset pricing. Never has the cliché been truer: The rising tide did lift all the boats. This year, however, has been different, with performance and pricing becoming more uneven – something I expect to continue.

It's worth remembering how unusual the rising-tide phenomenon actually is. Exhibit 1 shows global equity returns and the standard deviation of returns between markets. Historically, high returns were accompanied by greater variation between markets, but in this cycle variation between markets remained low.

This was not only a feature of equity markets. All assets classes did well through the first years of the bull market – most famously, and unusually, Treasuries, due to the Greenspan 'conundrum'. In addition, intra-asset class pricing compressed. In credit markets, for example, not only did credit spreads narrow, but the variation of pricing within each credit category was unusually small.

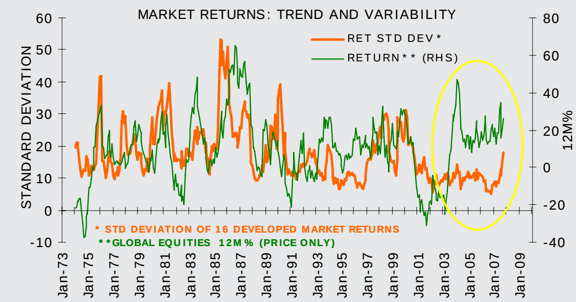
But this year divergence has returned. Clearly, credit markets have seen a serious setback, and pricing has started to reflect greater discrimination. (This all fits with a theme outlined by colleague Jim Caron on the 'renormalisation' of markets. For details, please see *Cross Asset Strategy: Risk Repricing Drives Market of One to Market of Many*, 30 August).

Likewise, equity performance has become more varied. This reflects two changes. The first is greater diversity in earnings. As Exhibit 2 shows, the variability of earnings growth between markets hit a multi-decade low earlier in this cycle – presumably reflecting the broad-based nature of the economic expansion.

Second, PE ratios are starting to diverge. This is largely due to the variation in emerging markets.

Exhibit 1

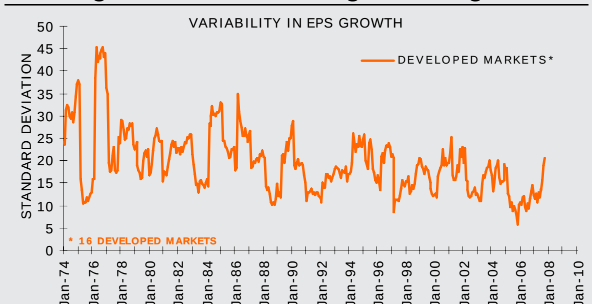
An Unusual Bull Market



Source: DataStream; Morgan Stanley Research

Exhibit 2

Earnings Growth Is Starting to Diverge



Source: DataStream; Morgan Stanley Research

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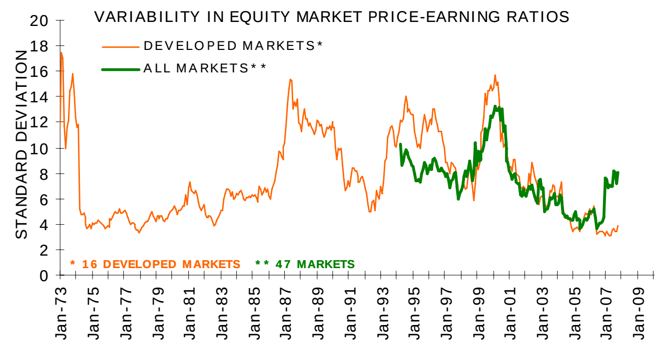
Exhibit 3 shows that the PE variation amongst developed markets remains relatively low. However, variation within the bigger basket of 47 markets (which I have a shorter time series for) is widening. History says this variation can increase significantly from current levels.

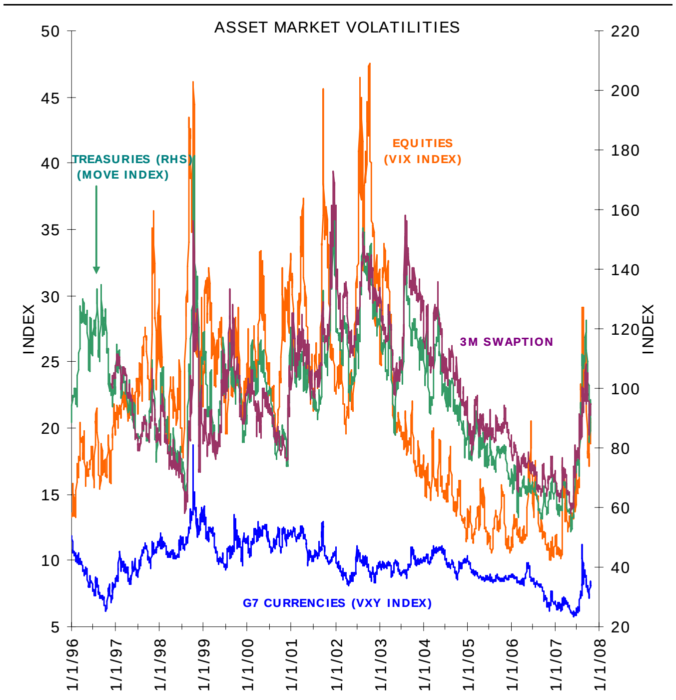
Exhibit 3
Price Earnings Also Starting to Diverge



Source: DataStream; Morgan Stanley

Associated with the compression in pricing and returns was the broad fall in volatility. Exhibit 4 shows that volatility measures fell across asset classes.

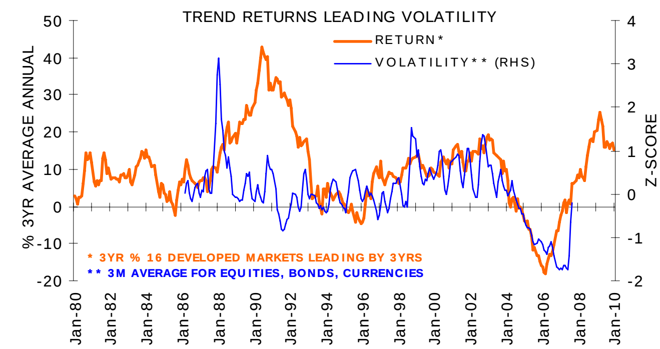
Exhibit 4
Volatility Was Low



Source: Bloomberg; Morgan Stanley Research

Volatility measures are themselves volatile, but my view is that the trend has turned here also: Just as returns will become more varied, asset prices will become more volatile. There has been a loose historical correlation between returns and volatility (Exhibit 5), so I would expect that volatility measures will trend higher.

Exhibit 5
Volatility May Also Trend Higher



Source: Bloomberg, DataStream; Morgan Stanley Research

For equity investors, the growing dispersion in earnings, pricing, and returns accompanied the end to what had been a largely themeless bull market. (The only 'theme' had been rising earnings.) Associated with the rising dispersion of returns has been the rise this year of a handful of themes:

- The relative out-performance of emerging markets
- The out-performance of stocks and sectors connected to the Asian expansion
- The divergence between industrials and financials
- American under-performance

I can't see a catalyst to disrupt these thematic trends while the current bull market stays intact. In fact, the ongoing signs of housing and lending weakness in the US support many of these themes. The problem is, however, that I'm bearish enough on growth to think that the bull market will not persist far into next year.

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