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Stock markets: growth in sight?

So far this year, stock markets in western industrial nations have been marking time. After above-average performances in the last two years (over which time the US S&P 500 index gained almost 39%, the Swiss SPI 26% and the German DAX 40%), this shouldn't come as much surprise (see Table 1). So does this mean we're about to see a protracted period of consolidation? Not really. If you compare things over a longer horizon, or start the comparison from a different date, they look rather different.

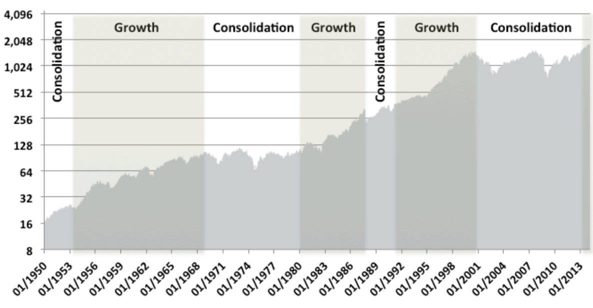
Table 1: Development of the international stock markets

	Performance since March 2012	Performance since financial crisis low	Years since low	Performance since pre-financial crisis high	Years since high
S&P 500	39%	178%	5.0	20%	6.4
Eurostoxx 50	26%	71%	5.0	-32%	6.7
SPI	46%	124%	5.0	5%	6.8
DAX	40%	155%	5.0	15%	6.7
Nikkei 225	60%	117%	5.0	-16%	6.7
MSCI World	32%	144%	5.0	0%	6.4
MSCI Emerging Marktes	-7%	113%	5.4	-28%	6.4

To 7 March 2014; source: Bloomberg and own calculations

Take a look back and you see that there have frequently been phases of consolidation – for example following the collapse of the London Gold Pool in March 1968, or after the dot.com bubble burst in March 2000. But these phases have always been followed by periods of powerful stock market growth (see Graph 1).

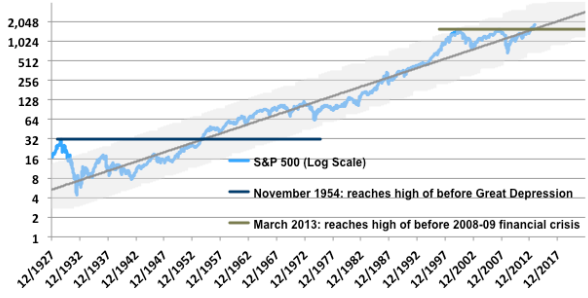
Graph 1: Growth follows consolidation (S&P 500, logarithmic)



Source: Bloomberg and own calculations

Another historical observation suggesting that share prices are set to rise is the S&P 500's recovery in November 1954 to its highest level since the Great Depression. Even though share prices had already surged back up after their low in August 1932 in the midst of the depression, the rally continued uninterrupted after that (see Graph 2).

Graph 2: Great Depression vs 2008-09 financial crisis



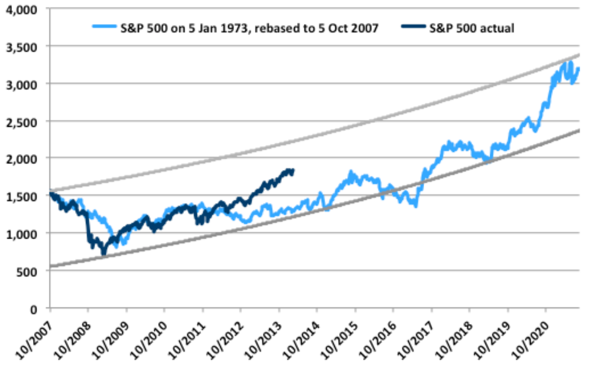
Source: Bloomberg and own calculations

It may well be that we're also seeing a repeat of this pattern in the wake of 2008-09 financial crisis. In March 2013, share prices recovered to their pre-crisis high in nominal terms, and even though the markets have seen an upward correction since their June 2009 low, prices are likely to continue to rise in 2014.

The third historical correlate is the market highs seen before the collapse of the Bretton Woods system in 1973 and the most recent financial crisis. In both situations it was several years before the S&P 500 had recovered and reached its nominal pre-crisis high. During both periods, governments tried to combat the effects of severe economic crisis by means of devaluations or ultra-loose monetary policy.

If the stock markets were to develop along the same lines now as they did after the 1970s consolidation, we would see the index climb to around 3,000 points within the next five years. What sounds incredible would merely be history repeating itself (see Graph 3).

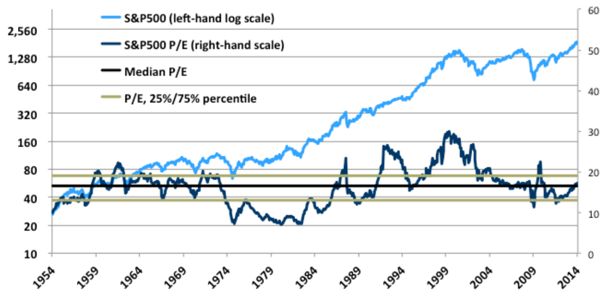
Graph 3: A comparison of the Bretton Woods crisis and the 2008-09 financial crisis, S&P 500



Source: Bloomberg and own calculations

With a P/E ratio currently running at 17.20x, the S&P 500 is still way below previous highs in terms of price to earnings multiples as well (see Graph 4). The P/E ratio shows the relation between the share price and expected earnings per share for a specific period. A high ratio suggests that the share is relatively expensive. But seen in terms of a long-term median of 16.45%, the current figure gives no grounds for concern.

Graph 4: Price to earnings for the S&P 500



Source: Bloomberg and own calculations

There are also tactical reasons why share prices look set to rise in industrialized countries. For example, with the normalization of US monetary policy, increasing amounts of money are likely to flow back to the US and Europe from emerging economies. Since the first announcement by former Fed chief Ben Bernanke in May 2013 that the US central bank would start tapering, many western investors have taken their leave of emerging markets.

And most recently, a growing number of private investors have returned to the equity markets, suggesting that a “Great Rotation” from bonds into stocks is beginning.

So is all well on the stock markets? Basically, yes. Naturally there will be setbacks, as we are seeing right now in the midst of the political crisis in Ukraine. But the trend in the next few years will point up. We realize these forecasts may seem bold and very optimistic, but only if you limit your horizons and fail to look far back enough into the past. Take a long-term view of the financial markets, and these expectations no longer look unrealistic at all.

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