Pareto

The market and the economy in 2011

Developments in 2011 accentuated a more long-term trend: whereas commercial operators are reporting steady growth and building real values, investors are increasingly reluctant to pay for these same values. The question is whether this development has reached its limit.

For investors there is always something to worry about. The past year was no exception to this rule.

Clearly, the unmanageable Greek sovereign debt must be at the forefront of our minds, since it has repeatedly been the cause of unrest in the market. At times, attention was also focused on Portuguese, Spanish and Italian debt, which is potentially even more serious. To cap it all, US politicians, whose sovereign debt has always enjoyed a triple-A rating, succeeded in discussing themselves into a downgrade by Standard & Poor's.

There are two dimensions to the fear and unrest felt by investors. Firstly, it is clear that for many countries, and for many years to come, tight fiscal policy will be the order of the day, both out of fiscal necessity and because this represents the dominant political consensus. Pro-cyclical belt-tightening is rarely a suitable means of promoting healthy growth.

Secondly, there is concern that high unemployment and social unrest will feed a more fundamental pessimism and fear of investment that will turn Europe – and perhaps the West more generally – into an economic backwater. From this perspective, the economic significance of, for example, riots in the UK is greater than can be read from the direct damage caused.

Social unrest is closely linked to fiscal policy and economic growth. Research has shown that when budgets are tightened or when growth rates shrink, the incidence of riots and demonstrations increases. This serves to emphasise the more fundamental anxiety underlying last year's poor market performance: the fear that large parts of the West are facing a downward economic spiral.

Thus, in purely financial terms, the earthquake disaster in Japan was of less significance, notwithstanding the enormous direct damage and tragic deaths that ensued. What has been lacking is a belief in the future.

This is probably the most likely explanation for the drop in the MSCI World Index by over 5.0 per cent (adjusted for dividends) and the downturn of almost 12.5 per cent in the Norwegian benchmark index, despite very satisfactory earnings. This also explains why investors flocked to short-term government papers in countries that were presumed to be safe, while the risk premiums climbed in the case of other sovereign and corporate debt in general.

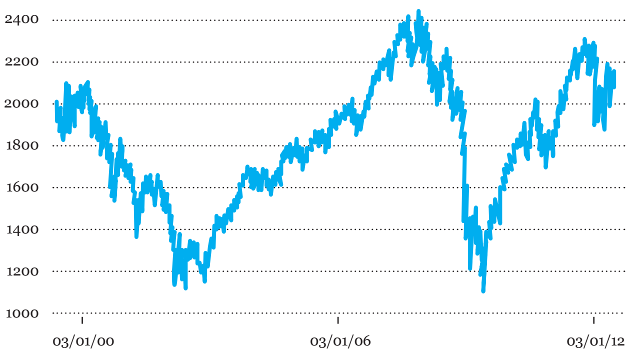
Accordingly, both the stock market and the credit market tell us the same story: 2011 was a year in which the cost of capital was high, and rising.

Depressing for investors ...

Nevertheless, the most striking feature of 2011 was not the dramatic events of the year. From an investor's perspective, the key point was that this development seems to conform to a more long-term trend.

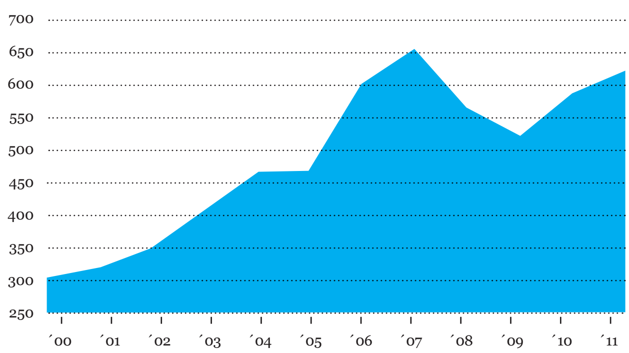
We can start by looking at the investor's bottom line: the early years of the new millennium proved to be a disappointment for the stock market. Although it is not accurate to say that equities have generated zero returns globally since the start of this new millenium, this is not far off the truth. Since New Year's Eve 1999, the MSCI World Index has recorded an average annual return of 0.7 per cent, while the US S&P 500 index has returned a miserly 0.55 per cent. Compared to the peak in 2007 both indexes are still clearly recording negative figures.

Wall Street came to a halt



S&P 500 as a total return index. Source: Datastream

Things didn't come to a halt here though



Book value of equity per share (index unit) for the S&P 500. Source: FactSet

In Norway, the situation has been better, with an average return of 5.4 per cent over the course of the same 12 years. Nevertheless, in the latter half of this period – more precisely since the first quarter 2006 – zero returns have been the order of the day here too.

... but uplifting for chief financial officers

The companies included in these same indexes, however, have performed well. For example, during the course of this millennium the book value of the companies in the S&P 500 has doubled, while earnings per share have increased by over 85 per cent and dividends are up by over 90 per cent. According to the Financial Times, record margins are being reported on both sides of the Atlantic.

The companies quoted on Oslo Børs have also recorded considerable progress, but their stock prices have remained stagnant. During the course of six years of zero returns on the stock market the book value of these companies has increased by over 50 per cent, even after high – and rising – dividends have been paid. Earnings have increased by a more modest seven per cent, but the low growth rate can in the main be attributed to pro-cyclical accounting regulations that include unrealised gains in good times and unrealised losses in bad times on the stock market. Aggregate cash flow was up by 20 per cent during the same period, according to FactSet.

Low pricing – high cost of capital

Taken together these two developments are mirrored in significantly lower pricing. In the United States, the P/E level has fallen by more than 50 per cent since the start of the millennium, from 27-28 to 13-14. On Oslo Børs, the reduction has been more modest, from around 13 to 9.5, although, as we have already seen, this is measured over a zero return period of half the duration.

During this period, the earnings yield – expected earnings per share as a percentage of the share price – on the Norwegian stock market rose from 7.5 to 10.5 per cent. This represents an implicit rate of return that is no less than 7.6 percentage points above the Norwegian money market rate. In historical terms, this is very high indeed. One year earlier, this figure was in the region of 6.3 percentage points. The figure has remained consistently high ever since the financial crisis hit in 2008.

In the case of debt capital, the picture appears to be different. Norwegian government bond yields, which still deserve to be described as risk-free, have fallen to very low levels. For example, the five-year bond yield dropped from 2.93 to 1.56 per cent during the course of 2011.

However, at the same time, what is termed the swap premium rose by approximately 0.7 percentage points. The swap premium can be understood as the cost of switching between a floating and a fixed rate of interest for given periods of time, and thus expresses the price of the interest rate risk in the same periods. Accordingly it provides an addition to the interest rate, over and above the risk-free rate, to cover general interest-rate risk in the market in accordance with the market's own interest-rate expectations.

In addition to this there is the risk premium for the individual company, which in many cases has increased by a significantly greater amount.

In the case of a sound company like Orkla, the premium is modest: an increase from 1.25 to 1.6 percentage points in the course of the year. Thus overall, Orkla bondholders receive an interest-rate premium of approximately 2.3 percentage points above the risk-free rate.

For other companies the premium is of an entirely different order. Pareto High Yield Index (Series 3), which comprises companies that are rated significantly lower than Orkla, closed the year with a spread (average company premium) of approximately 12 percentage points (!). This represents a doubling – more or less – in just six months.

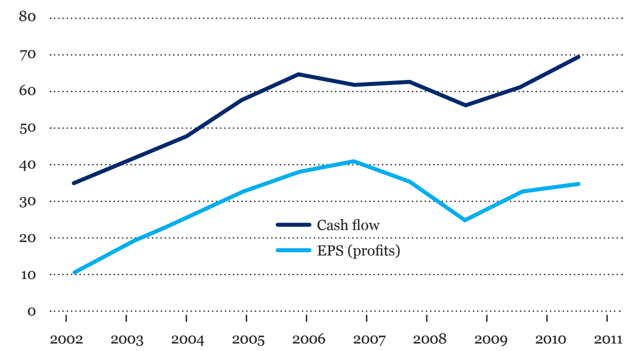
This is the irony of the market: whereas expectations of high returns meant that capital was cheap before the financial crisis, since then expectations of low returns have made capital expensive.

In essence, this means that investors will get more for their money now that they are not expecting to get so much for their money.

Six lost years?

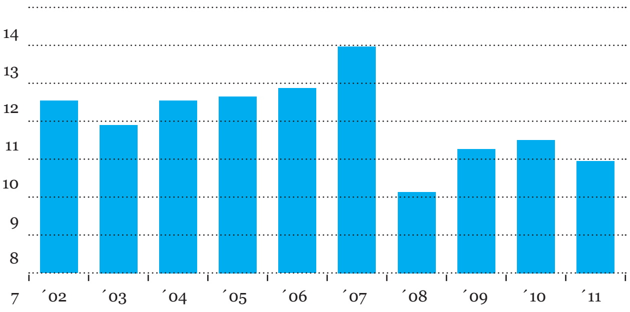
The Oslo Børs benchmark index (OSEBX). Source: Oslobors.no

King Cash still rules



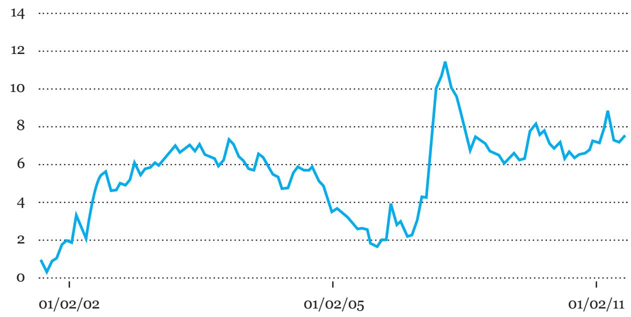
The Oslo Børs benchmark index (OSEBX), estimated value per share (index unit). Source: FactSet

Lowest since the financial crisis



Average estimated P/E throughout the year on Oslo Børs. Source: FactSet

High share premium



Earnings yield OSEBX less 3 month NIBOR. Source: FactSet

When the alarm bell sounds

It could be argued that the securities markets can perform badly even if the companies quoted on these markets are reporting growth. For example, increasing correlation has made it more difficult to reduce risk through diversification and to steer the portfolio in the direction of safer assets.

Firstly, correlation increases in times of unrest, as a cyclical phenomenon. In August 2011, when share prices plummeted, there was a monthly correlation between Oslo Børs and the S&P 500 of no less than 0.995. The long-term average is around half of this. In the same way, the correlation between shares that, more or less by definition, should move in opposite directions, such as oil producer Statoil and oil consumer Royal Caribbean Cruises, shot up. In addition, we have seen increasing correlation between different classes of assets. When the alarm bell sounds, everyone heads for the exit at the same time, even if the building isn't on fire.

Secondly, there is a longer-term trend towards greater correlation as a structural phenomenon. Here, of course, there is no escaping increasing globalisation. Normally, world trade grows at a faster rate than GDP. Investment increases across national borders. Regulations are coordinated and investment barriers are dismantled, not least in countries that previously had poorly developed markets. And moreover, media coverage is globalised, with the result that we all nervously follow the same key figures.

Increased correlation between individual shares can be attributed to factors such as algorithmic trading (software-controlled order placement) and increased indexation, both direct (index funds, ETFs) and indirect (benchmarking). The latter will increase correlation more or less by definition. And you thought that indexing would reduce risk ...

In addition, we have been given a lesson in sentiment risk. The mood generally swings from one extreme to the other, and at present the market is suffering the after effects of the unbounded optimism that prevailed five years ago. Once bitten, twice shy, as the saying goes. Unfortunately, the market behaves in precisely the same way.

The upside to this is that it creates opportunities.

Record results

No new margin records were set in Norway, but for business and industry in mainland Norway, EBITDA has never been higher. The provisional figure of NOK 614 billion represents an increase of 13.6 per cent in two years and almost 45 per cent of the gross product produced by business and industry.

Figures reported by the oil sector were down on 2008, although this in no way provides grounds for claiming that times are hard. Gross operating profits are now approaching 90 per cent of the gross product of this sector. Even though the government takes a sizeable chunk, there is, literally, plenty of money left over.

At first glance it appears that the companies quoted on Oslo Børs have some way to go before they reach the levels recorded in 2006 and 2007, but this can largely be attributed to accounting effects – typically the recognition in the income statement of unrealised losses on securities or the writing down of fish in accordance with the accounting standard IFRS. Cash flow has never been higher. Last year alone, cash flow was up by 13 per cent, according to FactSet.

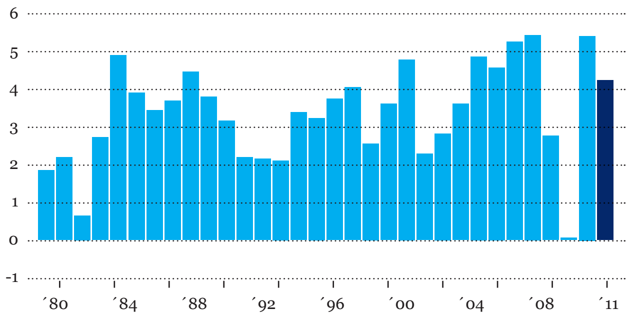
Over time, earnings have grown faster on Oslo Børs than in the Norwegian economy as a whole. This could be a function of selection, with the best-run companies finding their way to the stock market. But it could also be an indication that profitable sectors – especially oil-related companies – are over-represented on the stock exchange. Furthermore, some listed companies are domiciled outside Norway.

That being said, results fluctuate more on Oslo Børs than they do outside the exchange. Even so, fluctuations are not greater there than in the US stock market. It probably helps that three such key drivers as the oil price, the rate of exchange of the dollar and the price of salmon rise and fall entirely independently of each other – with a correlation that is as close to zero as it is possible to get in practice.

For the purposes of this calculation, all three prices have been measured in kroner to facilitate comparison and because the point is to measure the NOK earnings per share. Furthermore, this allows us to eliminate the misleading exchange-rate waltz between the dollar and an oil price quoted in dollars.

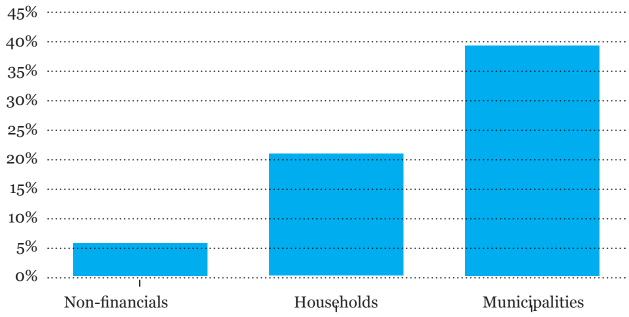
On the other hand, fluctuations in the pricing of Norwegian shares are far greater. Swings in P/E are more than three times as great for the OSEBX as for the S&P 500. When compared with the Eurozone the difference is less, but even so it is pronounced. In other words, Norwegian shareholders are far more reliant on

The world keeps on growing



Global GDP growth in percentages. Source: IMF

Debt bubble? Not the corporate sector.



Growth in domestic credit December 2008 – December 2011. Source: Statistics Norway

the interpretations and reactions of the stock market.

For Norway, this makes the distinction between movements in prices and the underlying operations far more important.

Unheeded risk elements?

The next question is: what can we say about underlying risk? The danger of international recession is the chief hazard, but it is also the one that is both obvious and has been talked and written about at endless length. There is little point in rehearsing this discussion here, beyond acknowledging that for the foreseeable future there will be a very real danger of poor macroeconomic performance amongst our trading partners.

Nevertheless, this only represents a serious problem for investors in equities if and to the extent that the market has not priced it in. The low pricing suggests that the market is very aware of – and fears – a development of this nature. Hardly surprising, given the massive attention devoted to this issue by the media.

Similarly, it should be noted that listed companies will not necessarily have their heaviest exposure to Norway's trading partners. The high percentage of commodity-based stocks listed on Oslo Børs suggests that developments in emerging markets are of greater importance, in relative terms, for sales volumes and, not least, prices.

At the same time, there is no doubt that, on the whole, Norwegian companies are well equipped to take on new problems. Costs have been cut and the debt ratio has been reduced. If you have been reading about a Norwegian debt bubble you should take a look at these figures: over the last three years Norwegian business and industry (excluding the financial services sector) increased its overall debt by a meagre 5.3 per cent, compared with 20.9 per cent for households and no less than 39.8 per cent in the municipal sector. The paucity of attractive investment projects has resulted in a higher proportion of liquid assets and equity.

A further point worth noting is that an increasing number of Norwegian companies have introduced defined contribution pension schemes for their employees. It is unlikely that this transition will have any major effects in the short term, but in the longer term it will lead to a reduction in risk, strengthening the impression of an increasingly well-adapted and lean commercial sector. The Norwegian economy is not necessarily the oasis in a world beset by problems that many people would have us believe, but at the same time it is not necessarily business and industry that will face the greatest problems adapting.

Adaptation is also a question of time. Many commentators have expressed frustration over the time it is taking to clear up the sovereign debt problem. Politically and economically this frustration is understandable. However, in purely commercial terms there are advantages. Every single quarter the accounts reveal that losses are being absorbed and money is being earned. Most of the estimated losses resulting from the financial crisis have already been absorbed in the accounts, and the closing of the last financial year provided an excellent opportunity to digest a big chunk of the value reduction of European sovereign debt. In the meantime, companies continue to make money. Taken as a whole, the companies in the S&P 500 have never recorded a loss in all the years that this statistic has been compiled, i.e. as far back as 1871. And even if it is no longer the case that the gross operating profit of the Norwegian mainland economy has increased every single year since 1970 – revised figures now show a reduction of 1.4 per cent in 2009 – the statistic provides a timely reminder of the robust health of Norwegian business and industry.

It also provides a reminder of the real foundations for returns on equity and debt capital alike: that companies earn money. The statistic shows that they are doing just that – in spades.

Which means that it can only be a matter of time before this will be reflected in the returns generated on securities.

2011 in a nutshell

• OSEBX	-12.5%
• S&P 500 return	+2.11%
• MSCI World net	-5.5%
• 3-month NIBOR	from 2.60% to 2.89%
• 10 year Norwegian Treasury	from 3.68% to 2.41%
• Share turnover Oslo Børs (value)	-15.6%
• Brent Blend	from USD 94.70 to USD 106.87
• USD/NOK	from 5.86 to 5.99
• EUR/NOK	from 7.81 to 7.75
• GDP growth global	4.2%
• GDP growth Norway	1.0%
• GDP growth Mainland Norway	1.9%

***Sources:** Oslo Børs, Standard & Poor's, MSCI Barra, Norges Bank, FactSet, IMF, Statistics Norway, Pareto. GDP growth is updated with revised estimates after the respective Pareto annual reports were published.*