CREDIT SUISSE

Market Update Note – Tom Mann

Developed Market Equities

Tom Mann
Director European and EAFE Equities

Overview

- High volatility will remain a feature of markets until the sub-prime crisis has completely played out and uncertainty about growth/recession in the US is resolved
- Valuations in some markets have become extremely attractive as panicked investors sold indiscriminately
- For long-term investors who can look through the current market uncertainty, now could prove an opportune time to buy

Following the global falls in Equity markets on 21 January 2008 Tom Mann, European Equities manager at Credit Suisse, spoke to us about the recent falls and what they might mean for the future:

What lead the markets to the point we are at today?
To understand the recent falls in markets, you need to understand the history of this market cycle. After the dot-com crash interest rates fell to historically low levels (US interest rates were reduced to 1%) and remained there for a long time. These low rates drove up the value of property, as people were able to borrow more to finance the purchase of real estate.

The increase in property values enabled people to borrow further against the value of their homes. This “equity withdrawal” fuelled consumer spending, and contributed to substantial global GDP growth in 2003 through to 2006.

Because of this growth and the general perception of improved economic conditions, equity markets performed very strongly from 2003 to 2007.

What happened in markets to result in such sharp falls recently?
As the real estate boom in the US continued, lending standards declined. This meant that large amounts of money were being lent to individuals who had no means of repaying. These “sub-prime” loans were repackaged (or securitized), and sold on to investors.

At the beginning of 2007, sub-prime borrowers began to default on their loans and this fuelled a “credit crunch”, where banks would not lend to each other (as they normally do) because they feared that their counterparts would not be able to repay them.

In the second half of 2007, the market slowly came to grips with the reality that the credit crunch could send the US economy into recession.

On 21 January, there were a number of things which, in my opinion, combined to lead to a large global sell off:

- Investors panicked, taking the view that the US either was currently in recession, or was likely to go into recession
- They also took the view that a US recession would reduce global economic growth (going against the “decoupling” scenario, which postulated that increased domestic demand in Asia (China in particular) would make up for any shortfall in US aggregate demand)
- If global growth slows, then it follows that corporate earnings in Europe and the US will fall.

Is this the whole story?
No. During the period of rising markets, momentum and other style investors were sucked in. These investors do not pay particular attention to the companies they buy, instead they buy into stocks with a rapidly rising share price in the hope that the rise continues, thereby driving markets further.

Since they pay attention to price rather than valuation, these investors have been exiting markets as momentum has turned downwards, exacerbating falls.

So do you see a repeat of the bear market of 2001/2?
Equity markets are likely to remain volatile because:
- the effects of the sub-prime crisis have yet to work their way through the financial system
- there remains substantial uncertainty about when the US economy will recover

However we don't see a repeat of the situation because markets are very differently valued now.

At the start of the last bear market valuations had been driven to extreme levels by the internet/dot.com bubble whereas valuation levels in 2007/8 are much lower. In 2001/2 there was a substantial fall in corporate earnings, combined with a substantial deflation of the price/earnings multiple investors were prepared to pay for those earnings. In 2007/8, the market's price/earnings ratio is already relatively low.

Therefore, given the falls we have seen since the second half of 2007, investors have already factored in a substantial fall in earnings. Given this, we don't expect too much of a further deflation in the market's price/earnings ratio.

So is this a good opportunity to buy?
Maybe, depending on your time horizon, but there are risk factors.

Markets are likely to remain volatile for at least the near future, for reasons mentioned earlier. So, if you intend to invest for the long term and can bear paper losses and volatility in the short term, it would appear to be a good time to buy.

Many European stocks also appear "cheap" based on their dividend yield, which is often higher than the yields available on European government bonds. The last time this happened was a very strong buy signal for equities… but the question remains whether those dividends are sustainable.

Where are you investing at the moment?
As manager of the Credit Suisse Equity Fund (Lux) Dividend Europe my focus is on:
- High-yielding stocks
- With stable or growing dividends
- Companies with strong balance sheets
- And strong, sustainable cash flows

In other words, I am following the same process I have used since the launch of the fund. We believe that discipline in the application of our process is key to achieving solid, long term returns.

What is your outlook for markets?

We expect continued volatility in the short term due to the continuing questions over the sub-prime crisis and uncertainty about US growth/recession prospects.

However, this presents us with an excellent opportunity in active management. In volatile markets the importance of stock picking and careful analysis of values comes to the fore as it allows us to buy bargains – great businesses at low valuations, which is something which all successful investors love to do.

CH/E/200801