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Whither equities?

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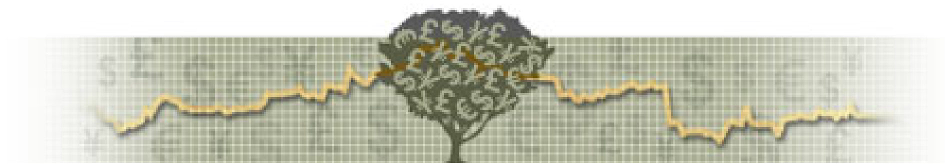
Stockmarkets have more to fear from a spike in the oil price than from a terrorist attack



AFTER last Thursday's blasts, it is business as usual in London this week—or so we are pretending. For those who lost family or friends, things will never be "usual" again. Buttonwood for once found a reason to be glad that her teenaged daughters sleep the morning away during the holidays. When the bombs went off, they had yet to put a foot out of doors.

But what is business as usual in today's markets? After the initial skid, as investors retreated into traditional havens such as gold and Treasury bonds, share prices showed rude good health. London's FTSE 100 index took a day to recover, as did most European shares. Wall Street stumbled and caught itself within the day. By close of play on Monday July 11th, the Dow Jones Industrial Average had gained about 350 points from its post-London low; NASDAQ hit a six-month high; and the Russell 2000, which tracks small-cap shares, closed at its highest level ever.

This resilience was unexpected only in its ebullience. Unlike Madrid, which took the hit in 2004, London knew that it would eventually be a target. And, once a terrorist event does happen, stockmarkets recover more quickly than they used to anyway. A number of academic studies suggest why.

Take, for example, the 2004 work by Andrew Chen of the Cox School of Business at Southern Methodist University and Thomas Siems of the Dallas Federal Reserve. Looking at 14 acts of terrorism or military attack, beginning with the torpedoing of the *Lusitania* in 1915, they found that over time fewer trading days were needed to return the Dow to its level before the event. When Hitler invaded France, the Dow took 795 trading days to recover. After the attack on the World Trade Centre on September 11th 2001, it took just 40. For that, thank a healthy financial system, a central bank that was quick off the mark in supplying liquidity, and improved technology that had expanded the flow of information, brought more participants into the market and increased its efficiency.

But there is weirdness at work these days. However stiff the upper lip, no reminder that global terrorism is alive and kicking can be good news. Yet now the market mood seems almost euphoric, whereas before the attack it was one of muted gloom. In a year coruscating with conundrums, the direction of the economy—and corporate profits—has rarely been so disputed. Is the "soft patch" history, or are we teetering on the edge of the abyss?

The flattening yield curve, high oil prices, the string of flat or negative leading indicators from the OECD and competition from China all suggest that things will get worse for America and Europe, and it's just a question of how much worse. Yet the slowdown is mostly concentrated in manufacturing; service sectors are reasonably upbeat. Consumer spending has slowed in Britain but not in America. Unemployment in the United States is a mere 5%. Companies have ample access to capital. Many expect American GDP growth of between 3.25% and

3.5% this year, down from 4.4% in 2004 but far from horrible.

Against this disputed background, dwindling corporate profits are the issue *du jour,* as the reporting of second-quarter results begins in earnest. For the past year and a half, America's stockmarket, though soggier than many in Europe and the developing world, has been driven by surging earnings. Company profits were growing at rates of 20% and more year-on-year, but they are no longer. In the first quarter of 2005, profits increased by about 14%. Analysts reckon they will grow by only about 7.5% this quarter, says Thomson Financial. It doesn't do to take this guidance too seriously: company bosses prefer to surprise on the upside and have been doing so in aggregate since 2003. But the go-go years would appear to be over. Does that mean that share prices are set to crash?

Not necessarily, says Richard Batty, global investment strategist at Standard Life Investment, a fund manager. Earnings and the stockmarket are moderately correlated. In America that relationship has sometimes been overridden by particular situations: the second world war, for example, and inflation from the mid-1960s to the mid-1990s. For the past ten years, however, corporate earnings have again been an important driver of the market.

To the normal ebb and flow of profits over the business cycle must be added other factors that influence earnings: most recently, oil's sharp spike upward and the dollar's stealthy rise against the euro, which reduces the value of American companies' earnings in the single currency. Mr Batty models the sensitivity of operating earnings in 2005 and 2006 to an immediate 50% increase in oil prices and a 10% decrease in the dollar (old habits die hard), along with plausible monetary policy that these changes would be likely to provoke. The Japanese stockmarket takes the greatest hit from both changes in both years; Britain's takes the smallest, because global energy firms are a big component of the FTSE. America benefits from the weaker dollar only in the first year, before the Fed raises rates to boost the currency.

Mr Batty then looks at the impact different real GDP growth rates in 2006 might have on earnings. If the American economy were to return to 4% growth, the year-on-year increase in operating earnings would fall from roughly 15% in the first quarter of 2005 to 5% by the end of 2006, thanks to slower growth this year and the lagged effect of oil prices and the dollar's recent appreciation. If the economy grows steadily at 3%, earnings perform about the same, but for different reasons. And if GDP were actually to shrink, operating earnings would collapse.

Something to bear in mind is that investors seem to be remarkably tolerant of weak spells. Even if operating earnings grow by only 5%, well below the S&P 500's trend of 8.3% since 1945, shares will increase in value—and by more if earnings growth is on an upward trend. Only if earnings actually fall do investors hammer the shares. With almost all European equities looking cheap relative to bonds, investors are pricing stocks for minimal earnings growth. Not so in America, where only hyper-low bond yields can make equities look a reasonable buy at current valuations.

What all this suggests is that while investors may be able to throw off risks that they have no way of quantifying (ie, that of terrorist attack), they are, in fact, reasonably clear-eyed about the likely impact of tangible things like sharply dearer oil. Where oil spikes and repeated acts of terrorism coincide, however—other than in the Middle East—is in tending to produce slower economic growth. And that is one thing that even brave London's spirit of endurance can do nothing to fix.

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