The Global View: Will the year-end equity rally repeat this year?

Dec. 2, 2011

- Historically a good month for stocks, this December is starting off on a fairly upbeat note
- While a number of factors feed into year-end rallies, this year macro seems likely to dominate
- The weeks ahead will see two main macro forces to watch: the U.S. Congress and its decision on fiscal stimulus into 2012, and European policymakers in terms of their next steps to stabilize EMU
- We are relatively more optimistic that the ECB will at least meet market expectations in the days ahead but remain nervous about the other two policymaker focal points
- With that in mind, income-oriented equity strategies remain attractive, both near- and more medium-term

The year-end rally for cyclical assets – and notably equities – has started right on schedule. The first two days of December have seen, so far, equity gains (with the S&P 500 up a bit over 1% and the FTSE 100 up about 0.3% (Bloomberg data as of midday Friday ET). Such moves are in line with Decembers of the past. Going back to the end of WWII, the S&P has gained an average 1.8% in December, the largest monthly median gain of the year and a positive performance in nearly 80% of those years.

There are various theories for the year-end rally: a better investor mood given the holidays, year-end book closings motivating traders to push for positive performance. Whatever the case, it is worth asking if it will repeat this time around?

Attractive equity valuations and market positioning are generally supportive for a 2011 year-end rally. But as investors well know, those factors have been overshadowed for the last several months by macro – economic data and policy surprises in particular.

This past week has been a positive one on the macro front. U.S. economic data – ranging from improving U.S. non-farm payroll trends to better-than-expected consumer and manufacturing business confidence and extremely strong car sales. In addition, markets cheered a monetary ease from China and a coordinated central bank step to cut the cost of U.S. dollar loans (50bps cut in the cost of borrowing via dollar swap lines). Finally, hopes re-emerged that European policymakers may be getting closer to a more comprehensive solution to the peripheral EMU crisis.

That all said, the month still has a long way to go. In terms of macro, we would focus on two main issues that could make or break this year’s December rally: the U.S. Congress and Europe.

Congress hopes to start its year-end recess on Dec. 16. So basically it has two weeks to decide whether it will extend fiscal stimulus into 2012 or let programs lapse. So far, the two parties have been unable to agree. Late Thursday, the Senate voted down both Democratic and Republican versions of the payroll tax holiday extension. However, media reports Friday suggested that the two sides still were talking and that a deal could still be reached. A deal, all else equal, would suggest a slightly firmer tone to the U.S. economy into 2012, and would likely support cyclical assets including stocks. (The opposite obviously holds true as well – no deal, less likely the rally can endure as growth hopes fade somewhat.)
Meanwhile, Europe has a number of key events in the weeks ahead that will shape markets, most notably the European Central Bank (ECB) meeting on Dec. 8 and the European leaders summit on Dec. 9.

The market is already expecting a lot, so the risk of disappointment is there if European policymakers act but do not provide enough – similar to market trends before and after the July and October “big bang” European announcements (buy the rumor, sell the fact).

What combination of European events would we want to see to keep equities rising into year-end?

From the ECB, our wish list would include:

1. **Lower policy rates (now 1.25%).** The market already expects a 25bps ease, so steady rates would be a big disappointment. In his press conference, we would hope to see ECB President Draghi argue that a “floor” for rates could be well below 1%.

2. **Further liquidity provisions for banks.** The ECB, trying to help bank funding markets, could extend unlimited liquidity for different tenders and/or offer even longer maturities (2-3 years). It might also consider easing collateral requirements in certain areas.

3. **Increased buying of Spanish and Italian bonds** (the so-called Securities Markets Program, or SMP). We do not think this is likely to be enacted on Dec. 8, but will be discussed during Draghi’s press conference. We would hope to see him open to the concept as long as Italian and Spanish governments can sufficiently show commitment to austerity programs.

4. **ECB loans to the IMF,** which in turn could be used to help peripheral countries in need. This also seems unlikely to be enacted on Dec. 8, but as with an enlarged SMP effort, could be discussed. Whispers around such an action suggest ECB funding of around EUR 300bln.

From the European policymakers, we believe markets would rally on – details. What has upset investors over the last year has been grand pledges made by Euro zone leaders that subsequently withered – the EFSF expansion, new Greek bailouts, bank recapitalizations. All provided big “headline” numbers and sound bites but little in terms of execution and timing. We remain somewhat skeptical that Dec. 9 will be different – comments from different EMU states suggest there is not a broad agreement yet on what a “grand bargain” could look like this time around or how quickly it could be implemented.

What sort of details will we be looking for?

1. **Governance reforms.** To get Germany and some other northern EMU members to agree on further aid for the periphery, there will likely need to be something – in writing – that EMU members agree to. This might include a more-binding Growth and Stability Pact, or even some broader European body that would help oversee “badly behaving” countries’ budgets.

2. **Timeline for any Treaty changes.** If leaders believe that a stronger EMU over the long term requires changes to the Maastricht Treaty, we would hope to see some details on when talks would occur and how long the whole process would be seen to take. After all, the financial pressure on some of the EMU states, together with the scale of debt maturing in 2012, suggests that years for a treaty change may be a non-starter.

French President Sarkozy and German Chancellor Merkel are due to meet Monday in Paris and could start outlining their thoughts for the summit. Also Monday, Italy’s new Prime Minister, Monti, is due to present new austerity measures – most likely a necessary condition before receiving any more ECB/IMF/EU aid. Along the same lines, Spanish Prime Minister-elect Rajoy is set to speak Thursday about his plans for austerity in the years ahead.
So back to equities, what does one do? If all three issues are resolved positively, this could shape up to be a great December. Of the three, we are relatively more optimistic that the ECB will at least meet market expectations.

But if it’s just the ECB, or no positive market surprises at all, the last several days’ rally could falter. The uncertainty reminds of a reason we keep focused on high-dividend equities. We get exposure to capital appreciation, but have a "cushion" from dividend yields if equities end up staying in a choppy, sideways pattern. As a reminder, we do not just focus on the firms with the biggest dividends but the firms that offer above-average yields AND below-average payouts, a low payout ratio suggesting a more disciplined use of capital by management.

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