Box 6 The equities market

Share prices in markets around the world have fallen this year, in most places by 20%-30% to the end of October. The fall in equity prices during Q1 was partly recouped in Q2 when the outlook brightened concerning an expected contraction in the US economy. However, the recovery was short-lived. Poor interim statements and widespread profit warnings this summer went hand in hand with greater economic uncertainties, and at the end of September were compounded by the impact of the terrorist attacks on the USA. Central banks in many parts of the world responded to these events with sharp cuts in their policy rates, which played some part in a general rise in equity prices in the beginning of October, after a dive during the previous month. Falling equity prices this year are widely seen primarily as an adjustment towards fundamental value. However, expectations seem to take into account the state of the US equities market, because of its impact on others. The contraction now under way in the USA has dampened demand for equities among investors worldwide.

Prices in the Icelandic equities market have broadly developed along the same lines as in the USA and elsewhere. The drop during the year, however, has been slightly less than in most other places, at 17%. Market value of equities on Iceland Stock Exchange (ICEX) has gone down by one-quarter from its peak in March 2000. Prices of shares in technology companies, which had taken on clear price bubble characteristics last year, have slumped in line with international trends. In most places prices have fallen by 60%-80% in the space of only 1½ years and are now similar to those in autumn 1998. Prices of the six companies in the ICEX technology index have followed a similar pattern and have fallen by more than any other equities in the Icelandic market. The pharmaceuticals index is the only one that has not gone down this year. Although a statistical study does not reveal much correlation between equity price trends in Iceland and other markets compared with the correlation between other European markets and the USA, there is no doubt that the Icelandic market is not as isolated as it used to be.

Equity market prices can provide an indicator about forthcoming economic developments because of the impact they have on corporate investments and on demand. The fall in market value of Icelandic companies means that this component of household assets has shrunk sharply, which may be expected to reduce demand for consumer goods.

Despite poor first-half company profits this year on the whole, operating results also showed positive trends. Many companies in fisheries and other sectors, for example, recorded improvements in EBITDA. Net financial losses, however, had a great impact on their results. Improvements in operating conditions served to push up fisheries sector equities towards the end of August and they had appreciated by one-third over the three months to the end of October. On October 3, plans for a reduction in the corporate income tax rate were announced. The following day share prices rose by more than 6%, a record figure for a single day.

Trading in Icelandic equities increased again in October after a low during the summer. Many aspects of the economy have been clouded by uncertainty and investors appear to have been biding their time and channelling their demand away from both Iceland and foreign equities. Net buying of foreign securities over the period January-September 2001 was equivalent to only one-sixth of the volume over the same period in 2000, the lowest figure since 1996. Year-on-year deposit growth has remained steady over the past 1½ years, or 10%-11% above estimated adjustments due to indexation. Of assets competing with equities for

Overview July 31 - October 31, 2001

	July 31	*Oct. 31*
Number of listed companies	75	73
Market capitalisation (b.kr.)	329.1	403.1
thereof equity funds (b.kr.)	15.6	18.0
Average monthly turnover in previous 3 months (b.kr.)	10.8	11.1
Turnover velocity (prev. 12 mo.) (%)	46.3	37.3
ICEX-15: change in previous 3 mo. (%)	-9.0	4.9
ICEX-15: change in previous 12 mo. (%)	-33.1	-24.0

investors' savings, government bonds and highly liquid instruments have been considered the most attractive options recently, and bond turnover has grown sharply. The high level of interest rates may have hampered demand for equities in the secondary market or in public offerings insofar as this would otherwise have been financed by domestic borrowing. Other factors than high interest rates, however, are probably more important in explaining the drop in equity prices this year and last year. In some sectors prices have undergone an adjustment after become excessively high, and as a rule company profitability has not given any grounds for rises. While the P/E ratio varies widely both within and between sectors, an assessment of it for the market as a whole (excluding funds) suggests that prices have been high relative to profit ever since last year. Looking at profits for the period from mid-2000 to mid-2001, and ignoring the losses posted by 47 companies, yields a very high – but also very distorted – P/E ratio. Companies accounting for only around half of the market value announced profits. An estimate of the P/E ratio based on market participants' official profit forecasts for this year likewise produces a figure of 22, which is higher than the norm in European equities markets.

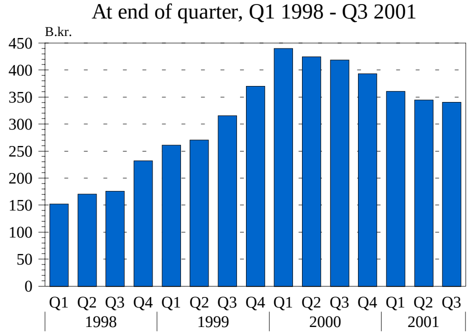
The real rate of return that Icelandic investors require from the largest companies in their evaluations appears to lie in the range 11%-16% at present. This figure may come down too if long-term interest rates drop in the near future, thereby leading to a rise in equity prices. However, investor evaluations of companies' potential for generating profits is a major determining factor in price formation. Determinants of the rate of return required by investors include the risk posed to operations by an unstable economic climate and other risk factors, and how successfully companies manage to hedge against risks. The above required rate of return suggests that the risk premium on equities in the largest companies is in the range 5%-10%.

Developments in recent weeks and the results that have been published for the first nine months of the year have, at least for the time being, boosted optimism about the equities market. Improvements in the equity market framework and its informational efficiency in recent times cannot be ignored either. Icelandic companies have been going public on a large scale in recent years, but now their number appears to have stabilised. Demand, company performance and developments in foreign equities markets will determine price trends for the remainder of the year. The outlook is that private consumption will shrink by more this year than real disposable income. Although this implies the first increase in private saving for a long time, it is not certain that this saving will be channelled into equity purchases. Changes to accounting rules and corporation taxation will make Icelandic equities more attractive for foreign investors, since the tax environment is more like that in other countries and emerges more favourably from comparisons than before. Nonetheless, it would be rash to expect that the bulk of demand for Icelandic equities will come from anywhere else than domestic parties.

Chart 1

Equity market capitalisation 1998-2001

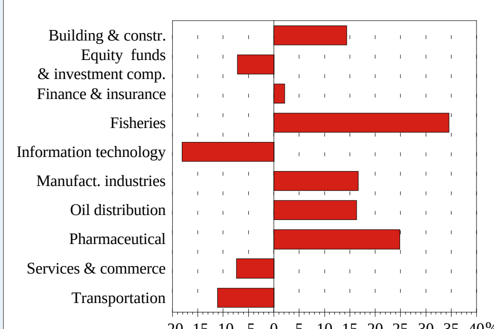
At end of quarter, Q1 1998 - Q3 2001



Source: Iceland Stock Exchange (ICEX).

Chart 2

Price change July 31 - October 31, 2001



Source: Iceland Stock Exchange (ICEX).