Is the FTSE 100 over-priced versus resource stocks?

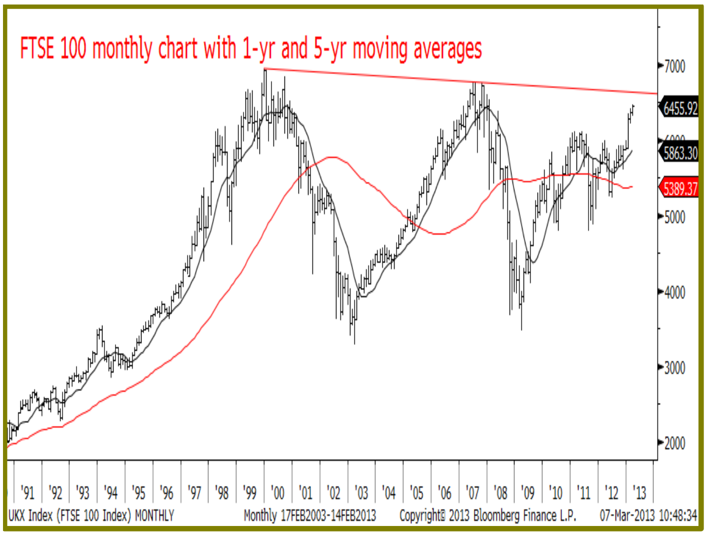
Trade Idea

08 March 2013

Summary

- The FTSE 100 posted new cycle highs (since 2009) this week above 6400
- Investors have not reacted to Moody's downgrade of the UK's credit rating to Aa1 from Aaa
- A relatively soft GBP is helping to bolster shares despite the drag from the fall in metals and oil prices
- Investors have become used to the view, especially over the last 10 years, that as commodity prices rose (such as oil, copper and gold), the FTSE 100 would generally rise as well. This is not happening right now
- While the FTSE 100 investors could be right (and WTI Crude, HG Copper and gold should be bought) the divergence picture in the FTSE 100 14-day RSI cautions excessive optimism in the index

The FTSE 100 extended its rally this week and posted new cycle highs (from the 2009 trough). The bull run since November 2012 has accelerated despite Moody's downgrading the UK's credit rating to Aa1 from Aaa and relatively sluggish economic growth outlook. The FTSE 100 daily chart below shows the rapid rise since the 2009 'credit crunch low' (an increase of 86%). A warning sign for bulls is the 14-day RSi (Relative Strength Indicator) which has fallen away from overbought levels and is showing signs of 'bearish divergence', which in technical terms can indicate a downward move. The monthly chart opposite highlights the 'range' that the FTSE 100 has been in since the peak in 1999. A simple line from the 6950 and 6754 peaks (which occurred in 1999 and 2007 respectively) comes in near 650 now, which may be worth keeping in mind.

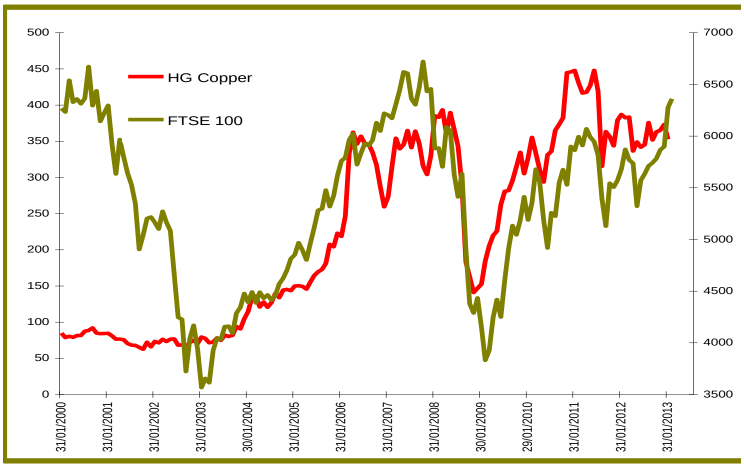


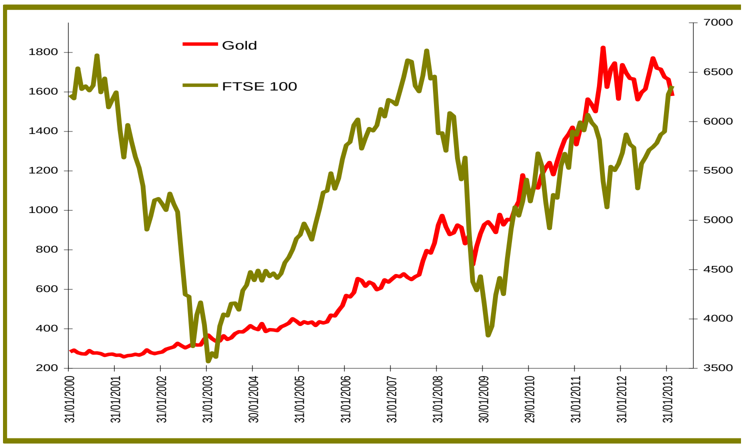
The FTSE 100 has a relatively heavy weighting to mining (basic resources; with the 'headline' focus on gold and the investor focus on copper and other industrial metals) and energy (oil and gas). This can be between 25% to 30% at times, and makes watching the movements in the underlying shares – and underlying commodities – useful at time.

The charts below show the FTSE 100 and HG Copper and gold prices since 2000. The general view would be that as copper prices rise (as a proxy for the other industrial metals) or gold prices rise (as a proxy for 'risk preferring sentiment' and the 'headline' metal that retail investors focus on), the FTSE seems to rise as well. This has not been the case over the last few weeks though, as HG Copper and gold prices have fallen but the FTSE continues to rise.

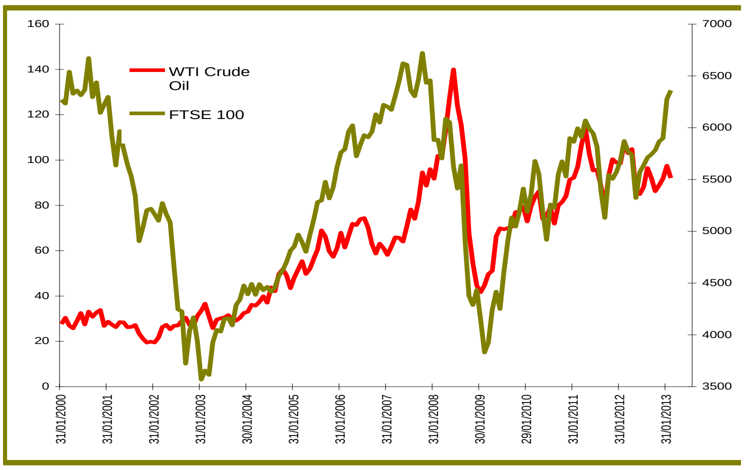
* Source: Boost, Bloomberg. The prices used for the returns are primary market closing prices from Oct 18th 2012 to March 07th 2013, and are given in the base currency of each index. The returns may rely in part on back-tested prices prior to the inception of some ETPs. Past performance and back-tested performance are not indicators of future performance. Back-tested prices are those which precede Dec 4th 2012 for ETPs referencing the FTSE 100, Dec 7th for the DAX, Dec 10th for EURO STOXX 50, Russell 1000 or NASDAQ-100, and Dec 17th for the commodities.
** Calculated as annualised standard deviation over the past 3 months of daily returns (some of which are based on back-tested prices.

While the impact of HG Copper and gold price moves may in the 'absolute' view (big moves in times of crisis or shift in sentiment on a short term basis, or long term moves) have an impact on the FTSE 100, on a day to day trading view, there are other factors in play.





The impact of oil prices on the FTSE 100 is similar. The chart below shows a casual relationship that on the face of it is pretty compelling as the lines do tend to rise and fall together. Here too, the daily return data shows that there is a negative correlation at times, and the general correlation is too close to zero to be very useful.



However, the 'big picture' view is important to keep in mind in this case as well. It seems that in general WTI Crude oil prices and the FTSE 100 track each other up and down, and there are very instances on the 'broader' view where they diverge for any meaningful period of time. This is making the last run higher in the FTSE 100 look a bit isolated. This is not a 'valuation' view as the FTSE 100 can swing away from asset prices (much like the DJIA can from gold prices) for long periods of time. But this is a 'directional view'. Namely, investors have become used to the view, especially over the last 10 years, that as commodity prices rose, the FTSE 100 would generally rise as well. This is not happening right now, and while the FTSE 100 investors could be right (and WTI Crude and HG Copper should be bought) the divergence picture in the FTSE 100 14-day RSI cautions excessive optimism in the index.

Chart support levels to watch are at 6400 and then 6260/6200, with further support layered at 6000 ahead of 5827, the 250-day moving average. At the moment though the FTSE 100 is pushing to new cycle highs, and is starting to 'stand out a bit' against the trend moves in the commodity markets that are important for many of the index members.

Investors who believe that the FTSE 100 may fall in line with the recent losses in HG Copper, gold and WTI Crude oil may wish to consider the Boost FTSE 100 3x Short Daily ETP (3UKS) which will offer a leveraged return if the FTSE 100 does fall. Investors who believe that the recent moves in the FTSE 100 are justified and that it will continue to rally may consider the Boost FTSE 100 3x Leverage Daily ETP (3UKL) which will offer a leveraged return if the FTSE 100 does rally further. A leveraged return is one where the return is magnified through the use of leverage so that the investor will profit by a greater amount if the correct decision is made. However, losses are also magnified accordingly.

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