Investec Asset Management

Viewpoint

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August 18, 2008

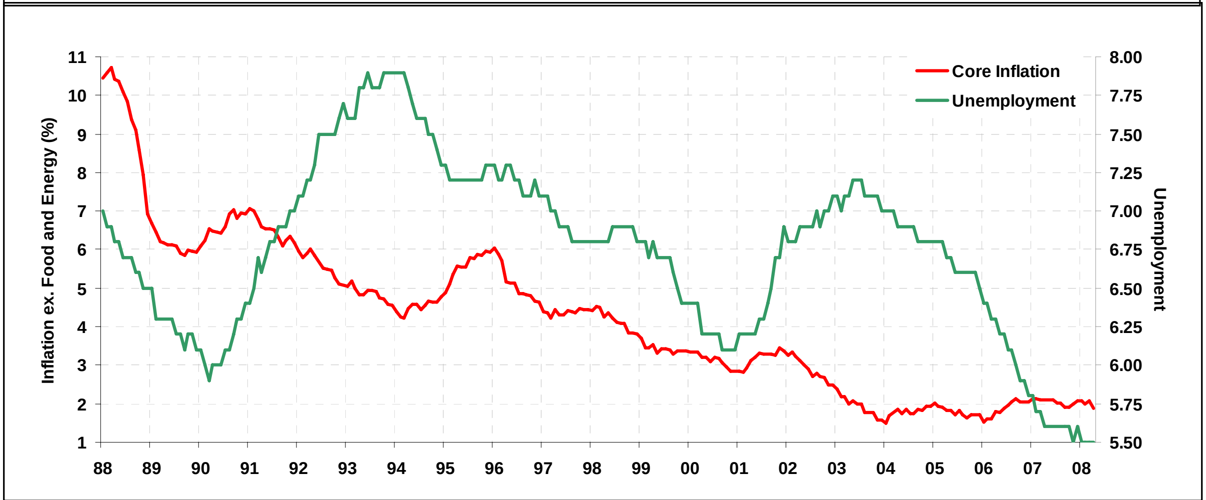
The NICE Decade for Equities

Max King, Strategist at Investec Asset Management, examines the long-term outlook for global equities.

Mervyn King, the Governor of the Bank of England, recently warned of “the end of the NICE decade.” NICE is an acronym for Non-Inflationary Credit Expansion, but it was also a nice decade for consumers and governments.

Standard economics used to take for granted something known as the “Phillips curve” which described the trade-off between unemployment and inflation. Optimists thought that labour market reforms could improve the trade-off, but the reality surpassed even their best expectations: from the mid-1990s, both unemployment and inflation fell. In the UK, unemployment has fallen from over 3 million people in early 1993 (10.7% of the workforce) to 1.64 million (5.2% of the workforce), according to the objective International Labour Organization (ILO) definition, without any increase in inflation until recently. In the OECD as a whole, unemployment has fallen from nearly 8% in 1994 to 5.5% now, despite a temporary pick-up in 2001-3, while core inflation, over 10% in 1988 and still over 5% in 1995, fell to under 2%.

OECD: Inflation and Employment



Source: Datastream

As inflation expectations fell, so did official interest rates. Rates charged by lenders fell even more, as competition reduced lending margins. In the Anglo markets, house buyers were able to borrow ever

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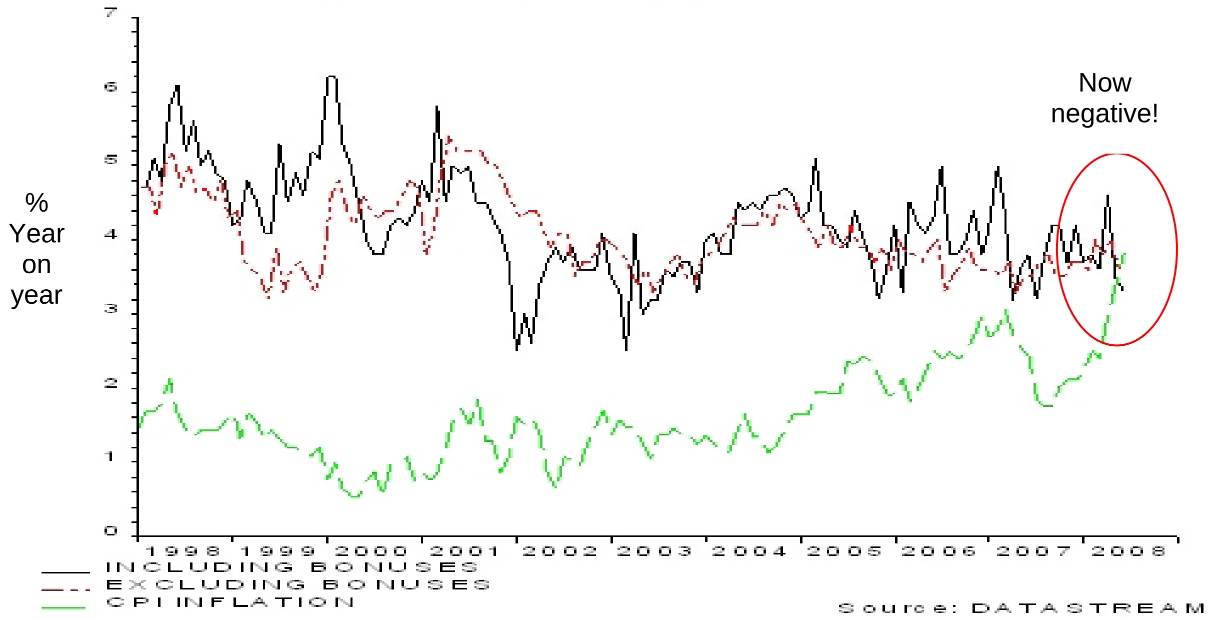
higher multiples of their salaries and to lock in rates for the long term. The easy availability of commercial borrowing enabled companies to grow, banks loosened consumer credit restrictions and re-mortgaging released equity to fuel the spending boom. As economies expanded, salaries rose and a virtuous cycle of credit expansion and prosperity ensued.

Low interest rates and bond yields encouraged governments to borrow more, increasing public spending without regard to value for money. Rising tax revenue meant the deficits never seemed to get out of control. In the UK, the devolution of the setting of interest rates to the independent Bank of England committee enhanced the credibility of monetary policy and helped underpin sterling, so often in the past the weak point of the UK economy and the acid test of government credibility. In Europe, the process of convergence before the switch to the euro and the subsequent record of the European Central Bank have had similar effects.

As Mervyn King says, all this has now changed. Lenders have stopped lending, forcing consumers to stop borrowing and therefore to spend less. The threat of a ballooning budget deficit is forcing the UK government to restrain public spending. People are now howling at every proposed tax increase while tax revenue is being undermined by weakness in corporate profits, spending and the property market. Lower mortgage availability is causing house prices to fall and preventing mortgage equity withdrawal. With property prices falling, people are no longer able to claim with hopeless optimism that their house is their pension. Higher savings will mean even lower consumer spending and less tax revenue. The virtuous economic cycle has gone into reverse, compounded by the spiralling cost of commodities.

The reversal of fortunes is best illustrated by the disappearance of real income growth as rising inflation catches up with stagnant earnings growth. With taxes rising, the squeeze on net earnings is even greater.

Growth in UK average earnings less inflation



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The picture in other countries is not very different: taxes might not be rising, but the picture of rising inflation and stagnant earnings is the same. Credit growth in Germany has been restrained, largely due to much lower levels of home ownership, but other parts of Europe more than compensated. The introduction of the euro meant a bonanza for consumers and governments in Portugal, Italy, Greece, Spain, and Ireland as the introduction of the euro saw a seismic shift downwards in interest rates. The pattern in the US has been very similar to the UK, except that it has already seen the currency devaluation that, in the UK, inevitably follows boom turning to bust.

For governments and consumers, the party is over, but equity investors missed out on the party, and should avoid the hangover. In mid 1998, profits were growing rapidly, Asia and emerging markets were booming, the technology sector was starting to take off and every mega-cap merger was greeted with soaring share prices. Only Japan and small caps were left behind. By the millennium, an Asian crisis had not infected developed markets and even small caps and Japan were joining in the fun. That, however, proved to be only the first leg of a ten year roller-coaster. Over the last ten years, the 3.5% annualised return of the UK's All Share index and the 2.5% annualised return of the S&P 500 index scarcely kept up with inflation. The annualised return on the MSCI World index has been only 2.8% in Sterling and 4.7% in Dollars.

Real returns: S&P 500 10 year total returns – CPI 10 year (annualised)

Source: Merrill Lynch

Bond investors have done rather better, with UK gilts returning over 5% annualised and global government bond indices a little less. So much for the notion of equities outperforming in the long term, and for the long-term evidence of excess equity returns averaging 4%. The actual figure in the last 10 years has been -1.7% for the UK, -2.8% for the US and -1.8% globally.

Warren Buffett once commented that "the mistake that investors repeatedly make is that they are habitually guided by the rear-view mirror and, for the most part, by the vistas immediately behind them." This should serve as a warning not to extrapolate the past 10 years into the next. The economic outlook now is as gloomy as it was rosy in 1998, but investors then never believed that the good news was sustainable. Equity markets were progressively de-rated to the lowest multiple for over 20 years even though the sustainable rate of real long-term profit growth has almost certainly improved.

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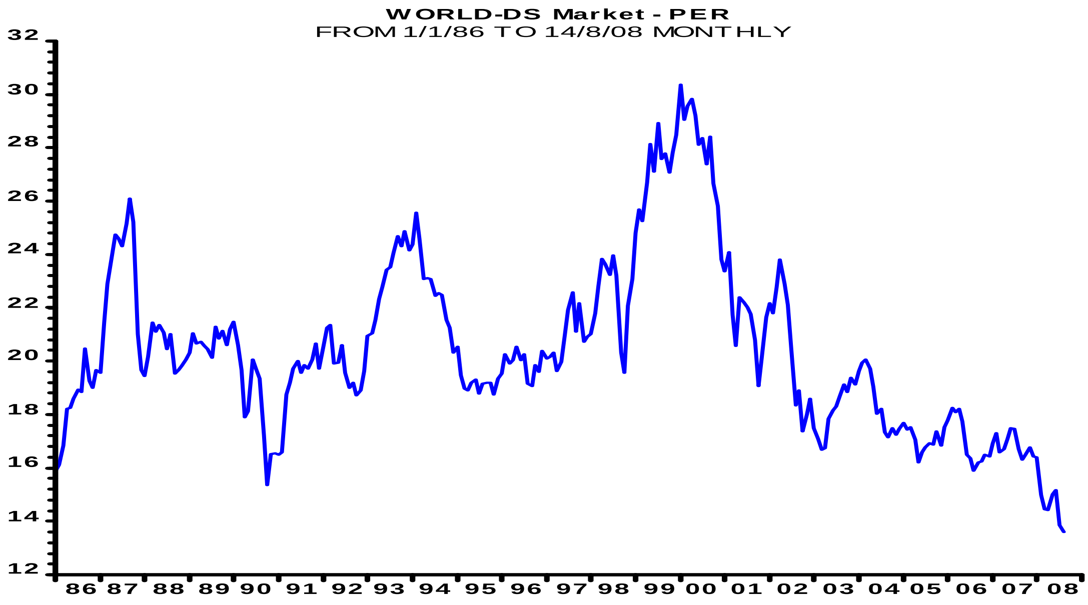
It is interesting to look back at the 10 year outlook at similar points in earlier decades. By the middle of 1988, historic 10 year real returns on the S&P index, according to the Merrill Lynch chart, had compounded at over 10%, but stock markets had recently crashed, economies were over-heating, inflation pressures rising and a recession was expected sooner or later. Most investors thought that the best of the bull market, if not all of it, was in the past. The exceptional returns of the next 10 years were forecast by almost nobody.

On the other hand, the outlook in mid-1978 was terrible. Historic 10 year real equity returns were negative, the expectation of dismal growth and high inflation was embedded in popular psychology and the world was heading for the second oil shock and second recession in 10 years. In fact, the next ten years were excellent for both equity and bond investors. In mid-1968, it was the reverse: equity returns had been excellent, growth was strong and inflation was modest. Returns in the next ten years were awful.

Just as an analysis of returns over the past 10 years and a consensus assessment of the macro-economic and corporate outlook over the next ten years was a rotten guide to the future prospects for equities in 1968, 1978, 1988 and 1998, so it is likely to prove now. 10 year returns have been poor and the global economy is suddenly beset by problems; a credit crunch, soaring commodity prices and consumers under severe pressure in most of the OECD. The outlook does not appear promising, but short term impressions are deceptive, because valuations are exceptionally attractive.

The global price earnings ratio, now standing at 13.8 on a historic basis according to Datastream, is at the lowest point for more than 20 years by a significant margin.

Global market price-earnings ratio



Source: Thomson Datastream

With the Institutional Brokers' Estimate System (IBES) consensus forecasts predicting 5.6% growth in corporate earnings this year and 16.4% next, the prospective price-earnings ratio is significantly

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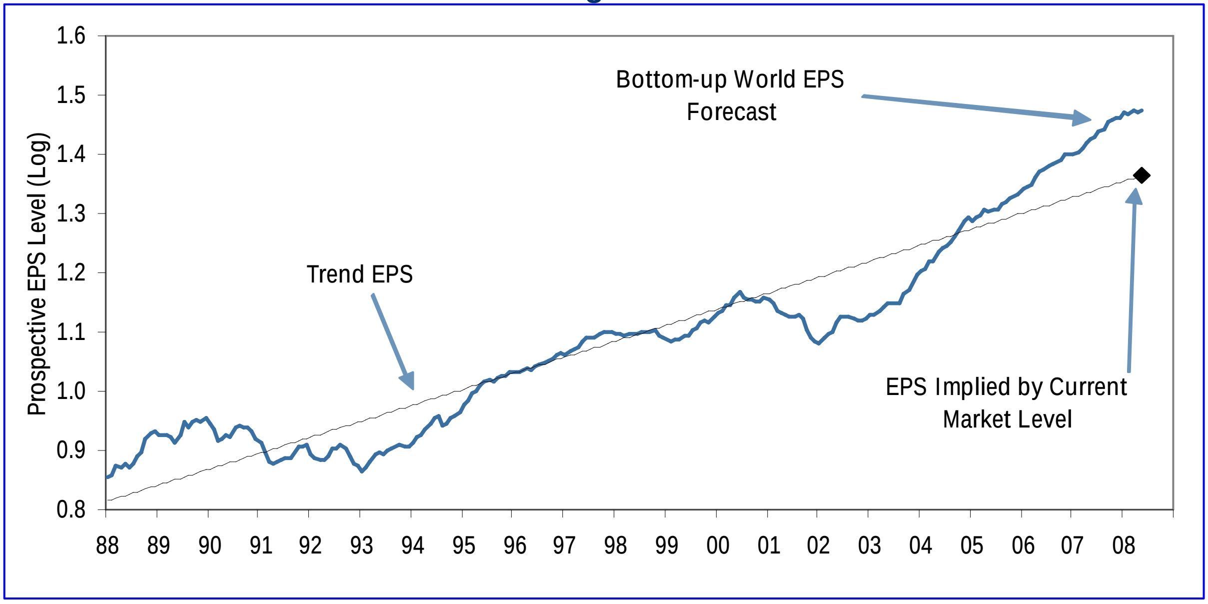
lower. In July, the Merrill Lynch survey of fund managers showed an extraordinarily high 83% of respondents believing that consensus estimates are too high, but current valuations discount not just a dramatic drop in profits, but an absence of any subsequent bounce-back.

According to other Merrill Lynch research, the level of earnings is cyclically high, and likely to revert to trend. The low level of the p/e ratio supposedly discounts mean reversion.

Global earnings versus trend



Current valuations discount a fall in earnings far below trend. IBES consensus data (according to Societe Generale research dated 11 August) shows the world market on a 2008 p/e of 12.7 and a 2009 p/e of 10.9. The Datastream long term average historic p/e ratio is 17.2, but the prospective p/e ratio would be lower. Applying a fair value p/e of 15 – 16 on 2009 earnings suggests that the market is discounting 2009 earnings being between 27% and 32% below forecasts, enough to bring earnings well below the Merrill Lynch trend.

A similar study by Credit Suisse First Boston (CSFB) shows that real earnings in the US are now below trend, but in Europe still 15% above. On a global basis, real earnings might be 5% above trend, but there is no reason why reversion to trend need be imminent.

Gavekal argue that the global p/e ratio, though low, is actually understated, not overstated. They argue that reported earnings are less reliable than profitability according to national accounts, because the latter are based on tax returns, which provide no incentive to maximize earnings and are less volatile. From 1998 to 2000, reported earnings in the US continued to rise while profits according to the national accounts were falling. The puzzle was later resolved when it was discovered that reported profits for many companies had been overstated.

In the current cycle, national accounts suggest that US profits are understated, largely due to aggressive provisioning for credit losses. This means that the US p/e ratio according to the national accounts is actually lower than the reported figure.

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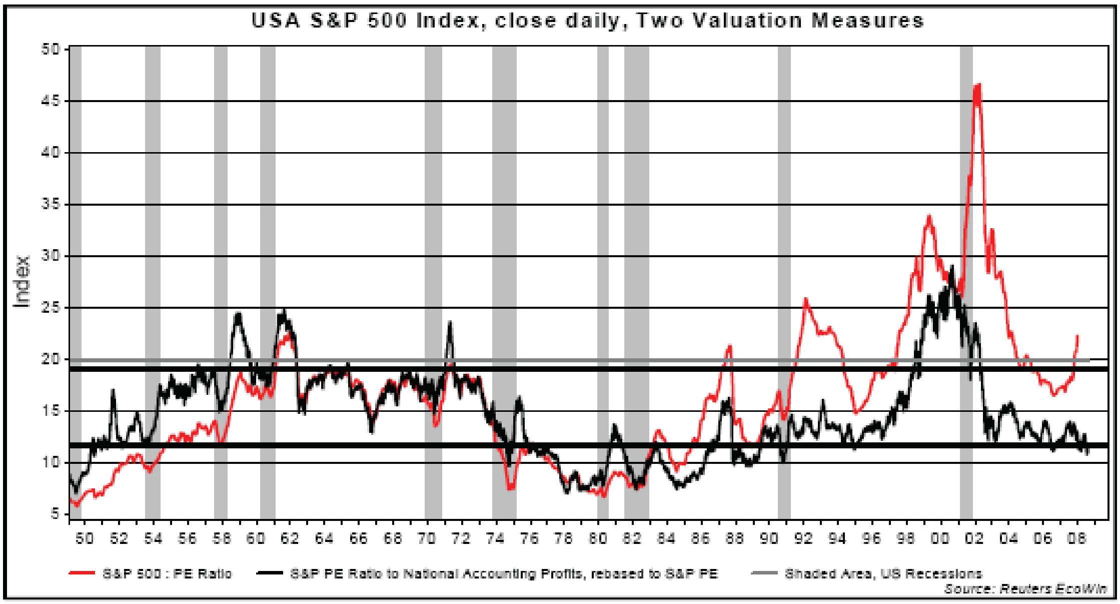
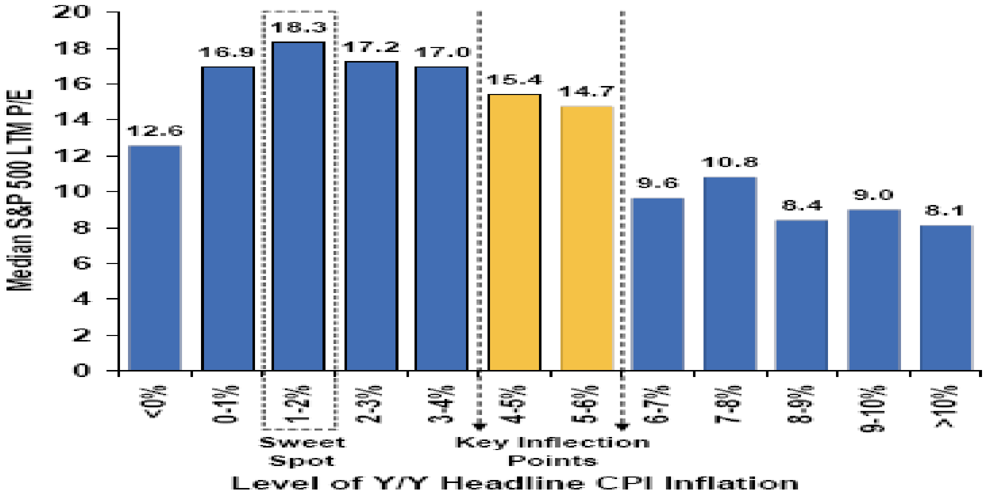
P/E ratio according to S&P reported earnings and national accounts profits



Gavekal calculate that the UK and Japanese markets are even more undervalued than the US, while France and Hong Kong, "will soon be there as well." The gap is likely to be filled both by the crystallisation of losses and by the write-back of provisions, but the point remains that the global p/e ratio may be being overstated due to the impact of one-off losses.

Just because markets are cheap by historic standards does not mean they are certain to be re-rated. Research by Morgan Stanley shows a strong correlation between high inflation and low market ratings.

S&P 500's median trailing P/E multiple in different inflation environments, April 1953 – June 2008



Source: Morgan Stanley

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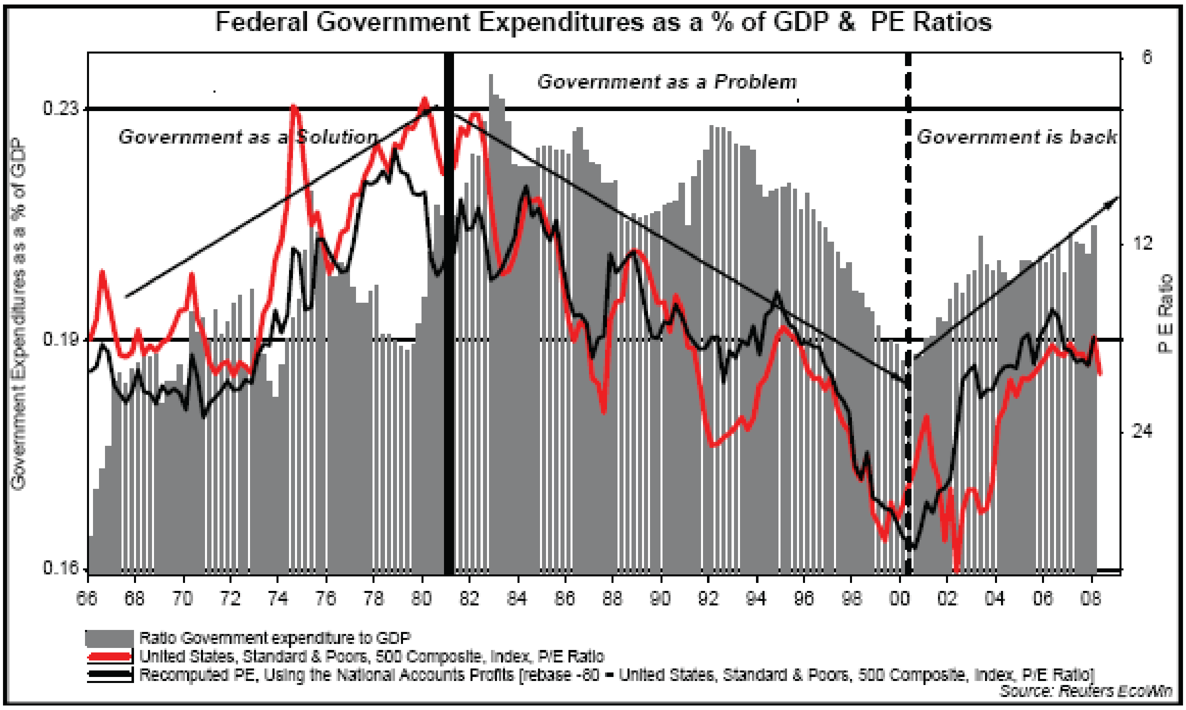
In Europe, Morgan Stanley estimates that a 1% rise in inflation reduces the p/e ratio by 1.6. In the UK, data since 1927 show a sweet spot of inflation in the range 2% - 3.5%. The de-rating of equity markets could be discounting a structural rise in the inflation rate, as borne out by recent data. However, government bond yields provide no support for the assumption that long-term inflation pressures are rising and the recent fall in commodity prices indicates that inflation is likely to fall back in the short-term. Morgan Stanley conclude that lower inflation could lead to a 25% rise in the p/e ratio.

Gavekal provide an additional explanation by charting the changing role of government. They argue that rising government spending as a percentage of GDP leads to a falling rate of return on invested capital, with share prices following.



From 1966-1982, when governments were “the solution” to national problems, and again since 2000, p/e ratios fell. From 1982 - 2000, when big government was seen as a problem, its share of GDP fell and p/e ratios rose. The cycle in other developed markets is similar.

The US outlook may be affected by the presidential election, but not necessarily. Under Clinton, the Federal budget was in surplus and welfare was reformed while Bush has been an interventionist big spender. McCain would not necessarily be an advocate of limited government, and Obama may not turn out to be similar to Clinton. In Japan, Europe and the UK, the tide of public opinion is now running strongly against big government while the boom in emerging markets has been closely associated with a decisive move away from centralised government control to laissez-faire market friendly policies.

Individually, the arguments are imperfect, but taken together there appears to be strong support for higher market ratings and sustained earnings growth. We believe that global economic growth is

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likely to remain strong, helped by globalisation, technological change and the consequent growth in productivity, and a political environment which is likely to become more rather than less market friendly. We also think that inflation pressures are likely to recede and see no reason to expect a secular decline in corporate profitability. If this is right then low valuations are indeed the bargain they appear at first sight.

We believe it is highly likely that, in contrast with the last decade, equity returns will handsomely beat both inflation and the returns from government bonds over the next ten years. Of course, there is no magical reason why the middle of the eighth year of the decade should be an inflection point; but the combination of pessimism about current economic prospects, a widespread belief in a seismic turn for the worse in the outlook for investment returns and very low market valuations suggests that optimistic contrarians might not have long to wait. The nice decade for the economy may be over, but the nice decade for equity investors could be just about to begin.

Further Information

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