

# Equities offer reasonable value

Equity markets have not begun the year as many anticipated. **Peter Hensman** attributes the recent turbulence in the global equity market to uncertainty.

Several commentators expected a strong first half and a more challenging second half in 2010. This outlook was supposed to be for 2010, not for January! The cause of the recent market turbulence has been an increase in uncertainty. Gone are the concerns about the credit crunch; instead, investor worries are focused on how quickly the Chinese authorities will tighten policy as worries revert to expectations of too much growth and the fear of inflation. In the US, anxiety has increased with the reality of reducing liquidity support from the Federal Reserve. Equally, the unexpected defeat for the Democrats in the Massachusetts Senate election has raised the number of political unknowns, as the result means that the Democrats have lost their Senate Supermajority. This means that the Republican opposition has the ability to block legislation and increases the focus on the mid-term elections in November. The increased ambiguity has only been added to by the tribulations in Europe. Here the severity of the recession has combined with years of failure to address structural imbalances within the peripheral economies to raise concerns about the prospect of a sovereign debt default.

While each of these events has its own unique cause, perhaps a common thread as to why these issues surfaced at the start of 2010 is the dramatic shift in the cost backdrop. For much of 2009, the squeeze from input costs evaporated as the year-on-year change in everything from the oil price to interest rates was hugely negative. Now, although these costs typically remain very much lower than the levels existing prior to the credit crunch, there is no longer the same dramatic decline in costs compared to a year earlier. Indeed, with commodity costs such as the oil price having averaged US\$43 per barrel in the first quarter of 2009, the

average price in the last three months of US\$75 represents a substantial 75 per cent increase (Bloomberg, February 2010). This dramatic return to increases in operational costs perhaps explains why issues that could be ignored for much of 2009 are now returning to trouble markets.

It is equally true that policymakers remain very wary about the risk of deflation. Central bankers continue to refer to the fragility of the recovery and the risks of a renewed slump if policy is tightened too much too soon. Even in China, which appears to have been less impacted by the credit crunch than any other economy, the authorities are only seeking to temper the rate of growth. There is no desire to cause a sharp downturn in activity. This is very different from the situation in 2008, when figures such as M. Trichet at the European Central Bank sought only to squeeze inflation from the system, without any regard for the consequences of their actions on the outlook for growth or financial markets.

## Challenges

Concerns about the downside risks to growth are not unreasonable. For example, in the US fourth quarter GDP data, inventory adjustment contributed 3.4 per cent of the 5.7 per cent annualised growth from the third quarter (Bloomberg, January 2010). A very different situation from the consumer spending led growth rebounds following recessions in earlier decades. The tentative nature of the US growth recovery is also evidenced by the ongoing declines in payroll employment. Although the drop in employment is much reduced from the dramatic 750k average in the first quarter of last year, it is unusual to see payroll data continuing to contract this long after the start of a recession.

Despite these challenges, equities continue to offer reasonable value, especially in comparison to bonds. The dividend yield on the MSCI World Equity Index is 2.5 per cent (Datastream, February 2010), compared to an average of 2.1 per cent in the 2003-2007 period prior to the credit crunch. Given that most managements will have taken the opportunity to cut payouts last year (even excluding financial stocks, dividend payments have been cut by 15 per cent since their peak in 2008), the risk of further dividend reductions is low. Yet, the 2.5 per cent equity dividend yield compares to a 10-year real yield on Treasury Inflation Indexed bonds of 1.4 per cent (Bloomberg, February 2010). In the past, equity yields would have been below that on inflation-protected bonds. While there is now perhaps greater recognition of the risk of dividend cuts and a desire to gain inflation protection, this premium in equities appears large.

With events in peripheral Europe likely to be indicative of a broader investor desire for a shrinkage of government involvement in the economy and the need for governments to restore a better balance between expenditure and revenues, fiscal policy is likely to become a drag on growth, rather than a stimulus.

This is only likely to serve to increase the willingness of central banks to maintain extremely accommodative interest rates. Given this likely course of policy action to ensure that an economic recovery led by the private sector is firmly established, the recent volatility in markets is unlikely to be the beginning of a return to bear market conditions. Instead, current events are likely to prove to be the normal wall of worry that describes the ascent of an equity bull market.

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