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## Are Equities Cheap? Well, that depends.

There are some pretty strong views out there as to whether equities (domestic and foreign) are cheap or not. Unsurprisingly, some commentators and fund managers are of the view that equities are a screaming buy and others are of the opinion that the market is significantly overvalued. So, are equities cheap or not?

Well, it depends.

Firstly, it depends on whether you are looking at equities in absolute terms or in relative terms. There is no doubt that one could conclude that many stocks offer good value if their normalized (middle-of-the-cycle) earnings yields are compared to bond and cash yields. This is particularly the case in developed markets where earnings yields are quite high relative to the past two decades and interest rate yields are extraordinarily low. So, if all things stay equal and earnings growth over the next two to three years is satisfactory, one could expect more and more money to flee the safer lower yielding assets in favour of equities.

Also, in absolute terms, a case can be made that at an index level, the market is trading slightly below fair value on a twelve month forward PE (price-earnings) ratio basis. According to JP Morgan, the All Share Index is on 12.6 times December 2011 earnings slightly below the average 12 month forward PE since 1994 of 12.8. This means that if the stock market generates the earnings that the analysts are forecasting over the next year, and such earnings momentum can be sustained even at lower growth rates, returns from the domestic stock market will likely be reasonable over the next few years.

Most importantly, the attractiveness (or not) of the stock market depends on your view on earnings over the next few years. The current rating on the stock market (at an index level) can be justified if a normal profit cycle ensues and interest rates stay low. A normal profit cycle will see healthy pick-ups in: consumer demand, credit extension, business investment, employment, building and other broad-based economic activity.

The bear case for equities centres on the macro-economic risks that threaten to derail the economic recovery. Many remain highly skeptical around the ability of the world's economies to commence on a sustainable growth path. Their skepticism, which gives rise to the talk of the potential "double dip", stems from a few fronts: western consumers are de-leveraging; governments have ceased stimulus packages and have an eye on reducing fiscal deficits and debt levels and raising taxes; China is attempting to slow down their economy; and some of the European economies are in a tight squeeze.

But, after the strong bounce-back in economic activity over the past year and a bit, a mid-cycle pause is normal. It has to be noted that double dips are very rare events!

The positive medium term view for equities is reinforced by the fact that global yield curves are steep – usually a strong indicator for increased economic activity.

Also, there is no sign of inflation on the horizon, despite the best efforts of various authorities to flood the market with money and liquidity. Remember, low inflation and strong profit growth is manna from heaven for equities. Low inflation means interest rates can stay low for longer which is supportive of valuations and PE ratios typically stay higher.



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It is always very dangerous to assess the cheapness of the stock market at an index level. Clearly, its constituents have a variety of different drivers and within a stock market there are always some stocks that are cheap and some that are expensive. By example, we currently view many of the domestic consumer stocks as being excessively priced, particularly when contrasted with their counterparts on developed market stock exchanges. We expect the better quality retailers to deliver poor relative returns from these valuation levels and they look to us like they are pricing in a very aggressive profit cycle. On the other hand, there are stocks whose profitability is connected to demand in markets outside of South Africa and here, the market is pricing in some very bad news. We can still find stocks that offer good value in both relative and absolute terms and are happy to stay invested in such opportunities.

In conclusion, it looks to us like equities are not excessively priced on many measures and many stocks may prove to be quite cheap if we experience a robust profit cycle. However, the macro-economic risks are significant and it is difficult to accurately predict whether investor confidence is likely to deteriorate further. This continues to suggest that a cautious approach to investing is warranted and that within equities careful stock selection is likely to pay dividends.

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