

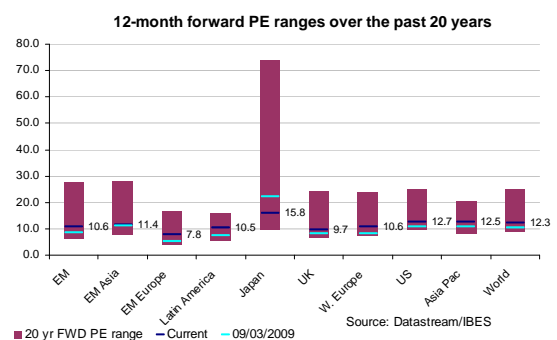
**Is there value in equity markets?**

One of the strongest rallies in equity market history was witnessed during 2009 and the first part of 2010, with a trough-to-peak gain of 84% between March 2009 and April 2010. The Greek sovereign debt crisis and fears of contagion halted this upwards march, sending stocks reeling in May. Markets may not yet have bottomed as investors get to grips with the implications of the fiscal crisis, pricing in a more realistic growth outlook for Europe given fiscal consolidation and ascribing some small probability to the risk that the crisis spreads further afield through the banking system. But at some point soon valuation will start to tempt long-term investors back into the market.

The current crisis of confidence is focused on the euro-zone fiscal problems and how large an impact European austerity measures to resolve the excessive deficits will have on economic growth. On 9<sup>th</sup> May, European policy-makers announced a rescue package which extended support to any euro-zone member facing difficulty financing its debt. This helped to allay worries about liquidity by covering vulnerable countries' funding needs, but left markets grappling with concerns about the level of fiscal consolidation needed to address the solvency of 'sinner' states with excessive budget deficits. Clearly, cutting spending in the midst of a weak recovery is likely to reduce economic activity, and there will be some countries that may well face a double-dip recession. However, we believe that the euro-zone as a whole will marginally side-step another recession, with the impact of the region's fiscal consolidation likely to trim less than half a per cent off global growth, provided the crisis does not spread via the banking system to the US and China. As a result, we retain a cautiously positive view on the prospects for world growth.

The recent correction has meant that valuations globally have fallen sharply, with the forecast global

12-month forward price-to-earnings ratios (PE) sliding from just below their long-term averages to cheap territory, at 12.3x for the MSCI World Index.



Looking at the graph, current valuations are mostly at the lower (more attractive) end of the scale showing minimum and maximum valuations over the past 20 years. While not at the lows of March 2009, markets still appear cheap, particularly when taking into account how far earnings forecasts and the economic outlook have recovered since then.

Corporate results are being increasingly supportive of markets, with around 66% of those global companies having released first quarter results beating expectations. Indeed, quarterly results have exceeded forecasts for the past three quarters. The US has beaten expectations for earnings by more than 100%, with quarter-on-quarter earnings growth of 29%. Notably, while previous quarters derived much of the recovery in global earnings from drastic cost-cutting measures, this quarter saw an increase in top-line sales growth of 9.1% over the previous quarter.

While euro-zone debt issues remain a dark cloud over the landscape, we believe the combination of economic recovery, attractive valuations and improving corporate earnings should drive equities on to further gains later this year once markets have come to terms with the full impact of the fiscal crisis.

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