

**The impact of the new normal on equities**

**Many equity models rely on historical data and identification of cyclical patterns within the data to forecast annual equity returns. Well defined cyclical patterns do exist, but how do we know if this cycle is similar to previous cycles? It may be a much-abused adage, but it is different this time.**

**An alternative approach for unusual times**

An alternative approach can be undertaken, which doesn't involve the analysis of cycles, to determine the appropriate level for an index. Taking the S&P 500 as an example, the long-term trend rate of annualised earnings growth has been 6.1%, according to data compiled by Yale University professor Robert Shiller. But given this crisis has been preceded by a debt binge in the Western world for both consumers and governments, what is likely to happen to earnings growth as consumers and governments have to pay off excessive levels of debt? Governments with excessive borrowing have typically taken five years to bring debt levels down to acceptable levels. This reduces earnings potential amid an environment of tight fiscal policy and consumer de-leveraging.

A financial model that can capture a period of sustained lower growth is therefore needed. A multistage version of the dividend discount model (DDM) can be used to reflect this. A DDM model prices an index by the sum of its future cash flows, discounted by the required rate of return that an investor demands for the risk of owning the index. The future cash flows comprise dividends and the present value of the index. A multistage DDM applies the same methodology but has the advantage of applying varying growth rates to the dividends at the different stages.

In our multistage DDM we have assumed the consensus earnings growth rate for the first year. For the following 5 years (phase 2), representing the low growth period of widespread corporate de-leveraging, we have assumed below-average annual earnings growth of 4.5%. This figure is conservative, as growth during periods after a recession has historically tended to be higher than average. For the final stage of the DDM we have assumed that growth returns to the long-term average into perpetuity.

**Equity upside despite sub-normal growth**

For the required rate of return, or cost of equity, by which to discount these future cash flows, we have calculated an equity risk-premium of 3.6%. This is the additional return investors demand over the 'risk-free' rate, or 10-year government bond yield, for taking on the additional risk of investing in the index. A final required rate of return of 6.7% was calculated by multiplying the equity risk premium by the sensitivity of the S&P500's returns to the MSCI All Countries World index, or its beta, and adding this to the risk-free rate. As the S&P 500 has a beta of less than one, this means that for a given move in the global index, moves in the S&P 500 tend to be smaller. In other words, the S&P 500 is less volatile than the global index.

		Annual earnings growth in phase 2					
		0.0%	1.0%	3.0%	4.5%	6.0%	8.0%
Cost of equity	2.0%	1082	1133	1242	1329	1421	1552
	4.0%	1073	1123	1232	1318	1410	1540
	6.7%	1062	1112	1219	<b>1305</b>	1396	1526
	7.0%	1061	1111	1218	1304	1395	1524
	8.0%	1057	1107	1214	1300	1391	1520
	10.0%	1050	1100	1207	1292	1382	1511

Source: Bloomberg, Coutts; as at 28/07/10

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Our model suggests a 12-month target for the S&P 500 of 1305, once a lower-growth period has been factored in. This gives a potential upside of 18% from Wednesday's closing price of 1106. In order for the model to match today's index level, we would have to assume earnings growth in the 5-year low-growth period of less than 1%. This suggests that at current levels, the S&P500 is pricing in a mild recessionary period.

Multistage DDMs have their weaknesses, such as assuming the majority of S&P 500 companies continue to pay a dividend. However, our DDM suggests an overly bearish consensus, particularly given strong second-quarter earnings so far. It could well be different this time, and volatility is likely to remain high. Still, we expect moderate returns in equities for 2010 and 2011 and believe the chances of a double-dip recession remain low.

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