

Equity valuation in a non-equilibrium

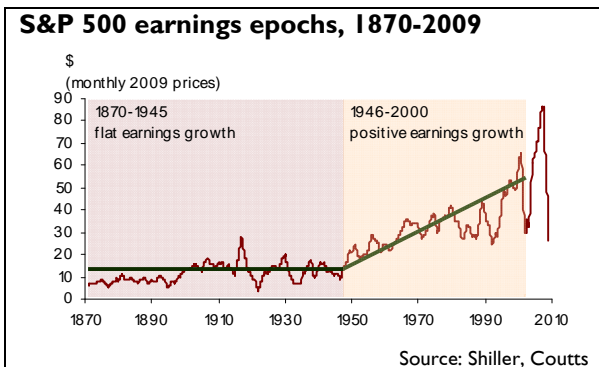
The past decade has proved an eventful but ultimately unfulfilling experience for equity investors. Over the past ten years, UK equities, for example, have produced an average annual return of -1.3%. Back in 1999, equities were very expensive and so, first and foremost, this is a lesson in the importance of valuation to long-term returns. But how much comfort should we take from today's more attractive valuations?

Over a ten-year holding period, the most significant driver of total equity returns is the valuation at the start of the period. As well as being statistically significant, the argument makes intuitive sense. Indeed, it borders on the self-evident: equities should be bought when they are cheap and sold when expensive. Today's Graham & Dodd price-earnings ratio (using 10-year average earnings as the earnings) is 13.5 times, consistent with an average annualised return of around 10% for the next ten years. The historic probability of an outright loss is zero. As always, however, there are a number of caveats to this statistically rosy picture.

First, valuation offers inconclusive guidance to short-term equity performance. For example, current valuations are consistent with a 65% chance of positive returns over the next six months – encouraging, but of scant reassurance to already traumatised short-term investors.

Second, current valuations offer long-term investors reassurance only to the extent that they believe the real economy is in equilibrium and that past trends and relationships will persist. In this week's *Global Markets Weekly*, we discuss this assumption in the context of the cross-sectional Fed model of relative equity/bond valuations, but it also holds for a time-series valuation of equities. In particular, expected returns calculated from current valuations assume that earnings will continue to grow at trend and that valuation is mean-reverting – in other words, valuations don't

follow a 'random walk', and today's low valuations mean that valuations are more likely to rise in the future than fall.



Few investors today will have any recollection of anything other than nominal earnings trending upwards. The upward earnings growth since 1945 was the result of increased real GDP growth. For the 75 years before the end of the Second World War, however, trend earnings growth was close to 0%, because of a combination of two major deflations in the 1870s and 1930s and volatile real growth. More recently, earnings growth has become very volatile. Today's deflation risk and the possibility that increasing savings rates will lower trend rates of growth are the economic mechanisms through which this recent volatility could come to mark a break in the post-1945 trend.

Finally, how confident should we be that valuations will mean-revert from their current low historical levels? There is statistical evidence to support this assertion, but other factors – such as demographics – also appear to have an impact on long-run valuation trends. In particular, the older a population, the more likely it is to be a net seller, rather than a net buyer, of financial assets. This could become a significant driver of valuations in many developed economies over the coming years.

We will return to these topics of long-run earnings and valuation expectations in future *Daily Themes*.

Carl Astorri
+ 44 20 7753 1612

Richard Batley
+ 44 20 7753 1576

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

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