

April 2012 Alvine Capital Newsletter

## Why low interest rates make equities cheap

‘We still have a long ways to go to make equities expensive’ Larry Fink CEO BlackRock (source yahoo.com 1/3/2012).

**Key Issues:** while some notable European exchanges still lag, markets have rallied since last autumn and conclusively since the ‘09 nadir. However, earnings and dividends have grown in tandem with prices, giving upon many measures favourable equity valuations.

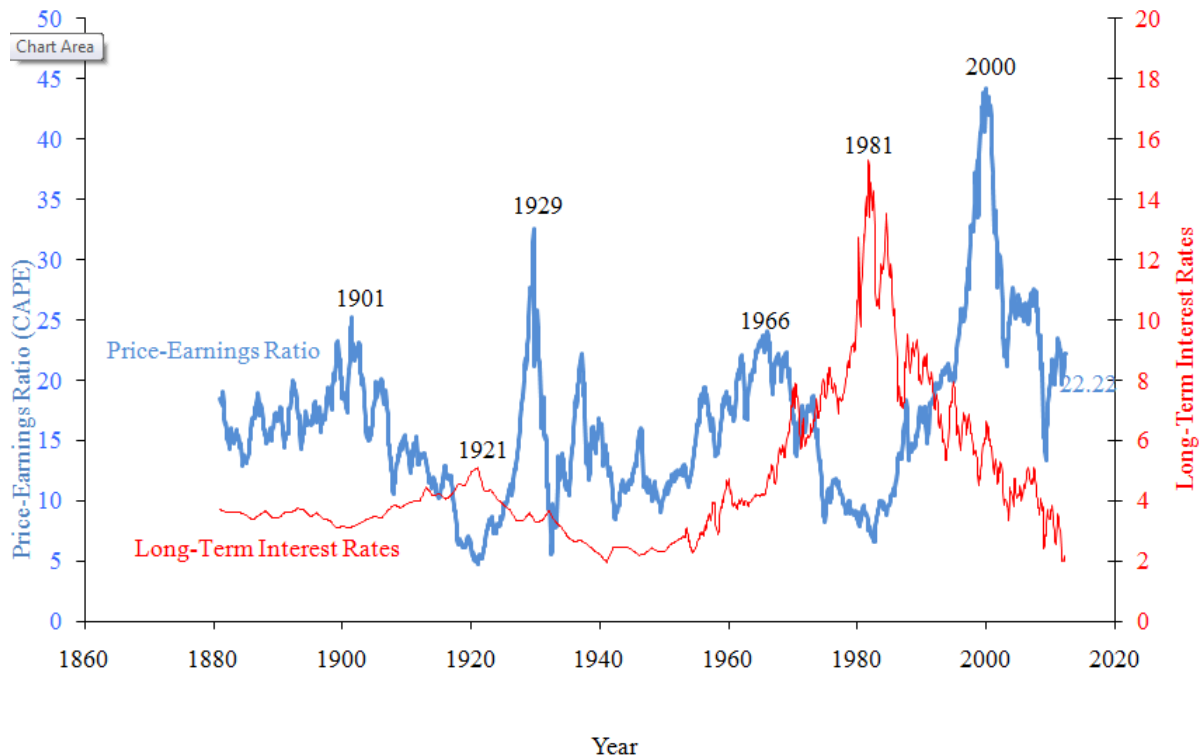
**Key Recommendations:** investors should take comfort from the both relative and absolute worth of stocks. While volatility is to be expected, favourable long terms prospects should ensue from such good relative value especially against bonds.

The art of valuing is no more scientific than the ability to judge foreign exchange rates. Depending on how deep analysis can be taken, tools used vary from discounted cash flows, ‘Q’, book value, P/E ratios, dividend yields etc. However, these models rely on a historical perspective and it is our purpose to judge which phase we are in the current market cycle.

Since the all time equity market highs of 1999 (S&P500) most measures of valuation have moderated. As long as the corporate profits that drive earnings can continue to remain at an elevated level, then prices can be seen as cheap.

**Price earnings ratios—‘when it comes to valuing stocks, the price/earnings ratio is one of the oldest and most frequently used metrics’** (source investopedia.com)

We do not intend to go into a lengthy explanation of P/E ratios, and will assume that readers of this newsletter are sufficiently experienced to follow this basic calculation.



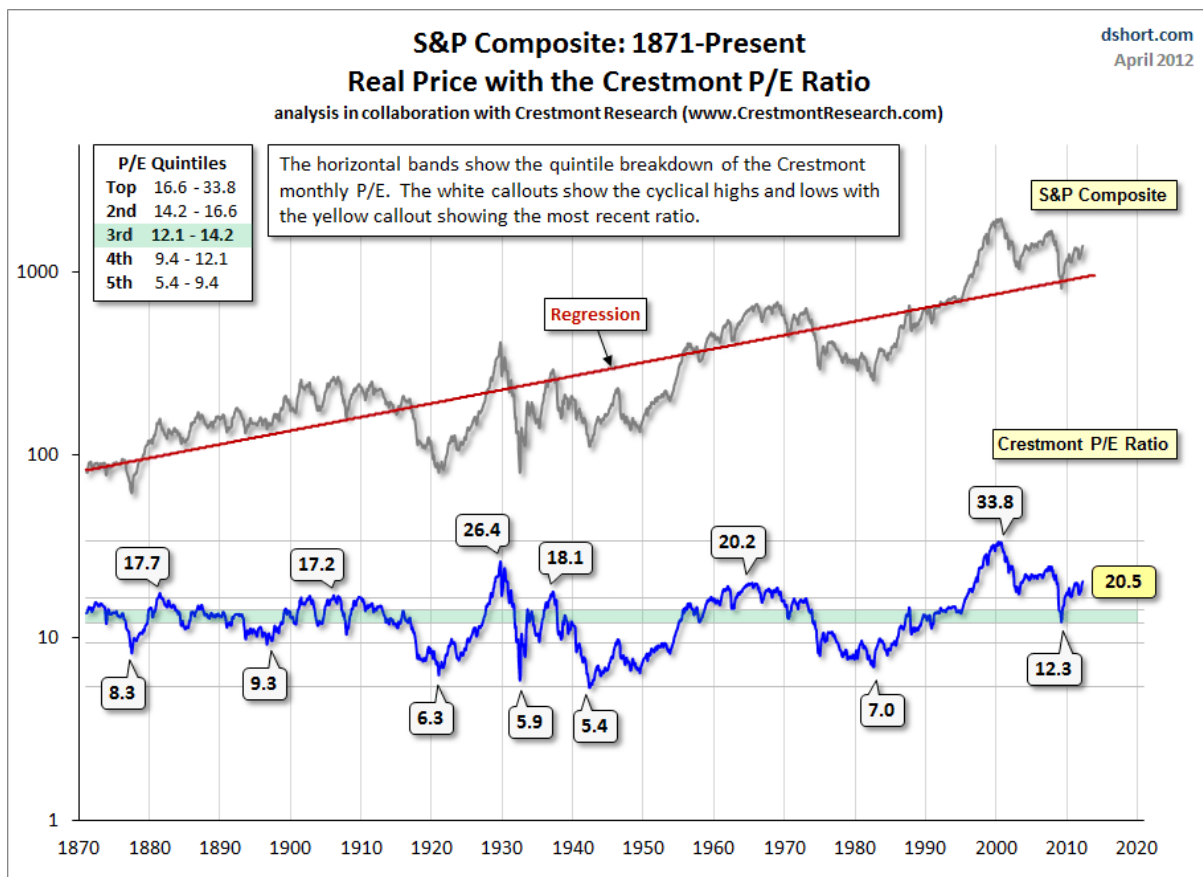
S&P 500 P/E and Long-term interest rates (Source RobertShiller.com)

This chart provides a good visual means of comparing historical P/E ratios, and from this we can see that the current levels of 15.98 (source Birinji Associates 26/4/12) are broadly in line with the long term. 'It seems reasonable to believe that prices are not likely ever to drift too far from their normal relationship to indicators of fundamental value' Robert Shiller (source The Journal of Portfolio Management.) So this old fashioned measure does not help us greatly, except to show that valuations are neither excessively cheap nor expensive.

### Cyclically adjusted P/E ratio (CAPE)

In an attempt to refine further value it has now become popular to go beyond a single year's figures and try and define over an entire economic or corporate cycle. While there are many ways in which this could be defined probably one of the best is the 'Shiller P/E. This uses an average earnings figure for the last ten years -roughly one full business cycle' (source [www.moneyweek.com](http://www.moneyweek.com)).

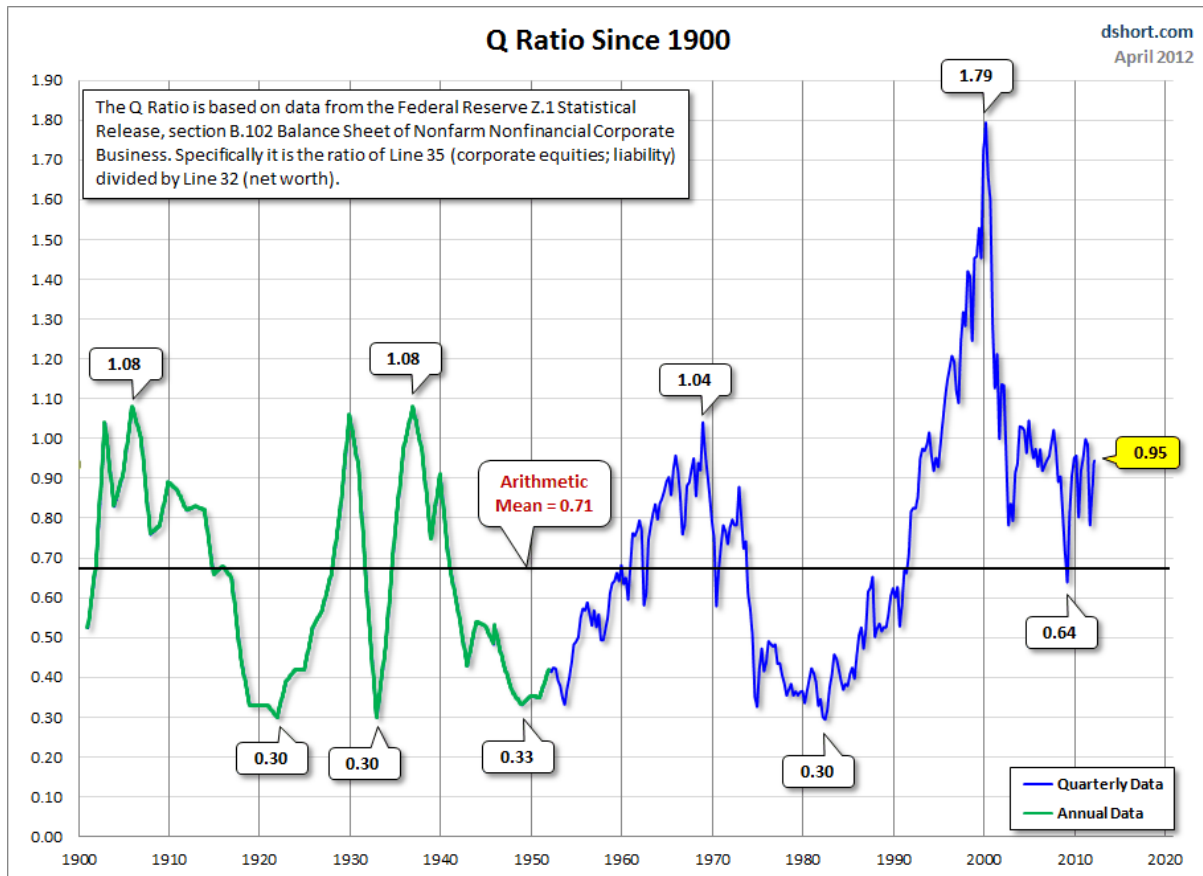
Many measures of CAPE are showing a far more extended level of P/E ratios for stocks. Corporate profits have increased substantially during the last ten years, so keeping the crude P/E ratio down, if you distrust these enhanced earnings then the CAPE levels can make the market look far more expensive.



This is another measure of CAPE, showing at over 20 in 2012.

### The Q ratio ---replacement value

Invented by Noble Laureate James Tobin, this is a simple concept of the total market capitalisation of a stock divided by the replacement cost of all the assets made up from that entity. The below chart supplied by the Federal Reserve covers the entire US stock market.



This relationship of value, not unlike P/E ratios, does show that we are approaching a level of over valuation but as in the late 1990's this may not mean the market is ready to fall.

### Discounted cash flow—a question of judgement

This is a model designed to count the expected future cash flow of a business, or a market, and discount those funds at an appropriate rate (generally either the current funds rate, or 10 year Treasuries). This rests upon an understandable assumption that at some stage or other, all businesses need cash rather than other measures of growth such as earnings (which often include intangibles like future sales or stock re-valuation).

**‘The advantage of this method is that it requires the investor to think about the stock as a business and analyse its cash flow’** - Jae Jun (source old school.blog.com 14/12/08). However, there are many problems with this approach for example how does one forecast these very future cash flows?

As James Montier explained ‘while the algebra of DCF is simple, neat and compelling, the implementation becomes a minefield of problems.’ (source stockopedia.com.)

For the purposes of this article it will be hard to go beyond certain opinions from leading stock market operators. Warren Buffet likes DCF but this may not help us to judge the market now.

### **Market capitalisation as % of GDP**

The percentage of total market cap (TMC) theory assumes that a nation’s total worth will have some relationship to the value a market may ascribe at any time. ‘Probably the best single measure of where valuations stand at any given moment’ - Warren Buffet (source gurufocus.com 26/4/12). **At current levels the total US market index is at \$14,549.4bn which is about 97% of the last reported GDP.** This leaves the US market again at a frustratingly average historic level.

However this tool may be of less relevance in future as an increasing number non-domestic companies list on international exchanges. This explains much of the anomaly between the UK (119%) and Germany’s (41%) TMC levels. For the British market there are now many companies that have very little to do with the domestic economy; this tool may no longer work in a modern economy.

### **Dividend yields in a low interest world**

***‘Do you know the only thing that gives me pleasure? It’s to see my dividends coming in’ - John D Rockefeller*** (source [www.brainyquote.com](http://www.brainyquote.com)).

There is something rather neat about this quote. While it is of academic interest to use models/cash flow/Q/P/E ratios etc to value stocks, the whole bedrock of value must eventually rest with the payment of dividends. While the greater fool theory may allow in certain circumstances an ability to flip a security to another punter, **we need and like an income stream.**

The other important factor about any valuation matrix is to consider the alternatives. Nothing is cheap or expensive in isolation; all investments must have some sort of relative value. Yields elsewhere have been in a bull market for thirty years, driving government and corporate rates to all time lows. It is on this basis that equities stand out.

**‘Low rates are pushing investors into stocks’** Eddie Lampert Texas Pacific Group (source CNBC.com 5/4/12). With two year treasury yields barely into double figures,

and when IBM can issue a bond with a coupon of less than 1%, a fat dividend must be compelling. After all, if you need duration, are not equities the ultimate undated bond?



Pink line, cash, blue, Moody investment grade bonds, green, S&P dividend yield (source Bloomberg). An unprecedented gap.

### Corporate earnings---conclusion - can they last?

Does this all look too easy? While most of the measures we have looked at do not show any great measure of cheapness, the power of dividend yields looks compelling. As prices have risen since 2009 corporate profits, and hence payouts, have kept pace keeping simple P/E ratios low.



Source: U.S. Bureau of Economic Analysis

### **The worry here is how can this level of corporate profits be sustained?**

Several factors impact here. Technological progress and the globalisation of markets have all given companies the opportunity to grow even in a tough overall environment. A slack labour market has also given companies pricing power in relation to employee compensation. It may well be that these trends can be sustainable giving capital the edge in the 21<sup>st</sup> century.

### **Cost of capital—it is all about interest rates**

The really significant issue remains the historically low level of interest rates, and hence the cost of capital. This has reduced interest cost for solvent corporates, enabled economical investment and hence inflated profit margins.

‘We think the Fed is going to keep the cost of capital low for corporations’ Neel Kashkari Pimco (source cnbc.com 12/4/12.)

**In a prolonged low interest world dividends look cheap, giving stock prices a catch up game over the remarkable decades’ long performance of fixed income securities.**

### **Conclusion—we are back to Fed watching**

Readers of this newsletter know that the much repeated mantra of Fed, and general Central Bank watching, have been our primary focus. For an understanding of how cheap equities are, we need once again, to base our conclusion of an understanding of interest rates.

On a few occasions in April natural profit taking coincided with fears of the future direction of the US interest rate cycle.

Fed Governor Yellen reassures - 'I consider a highly accommodative policy stance to be appropriate in present circumstances' (source cnbc.com 12/4/12). It is our overriding belief that this ultra easy policy will continue hence allowing companies to enjoy the benefits of a low cost of capital. Rising earnings and dividends will flow. It is on this basis that we call equities to be cheap.

## **Model Portfolio**

### **The banality of money printing**

The Bank of Japan continued its recent policy of coming back to QE at latest policy meeting. While the market reaction was muted to what had already been expected, it is worth standing back and digesting what was **another \$60bn** plus-injection into the world's third largest economy.

With the UK now back in recession, and the US's growth figures stalling back nearer to 2%, what price for the notoriously 'easy' central banks reaching for the print gun?

Once the egregious policy of monetary printing is started we have little doubt that ever larger sums will be 'thrown at the problem.'

For this reason we remain positive on risk, and will continue to hold extended equity exposure, as well as gold in our portfolio.

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