BREWIN DOLPHIN

Market Strategy

INVESTMENT RESEARCH

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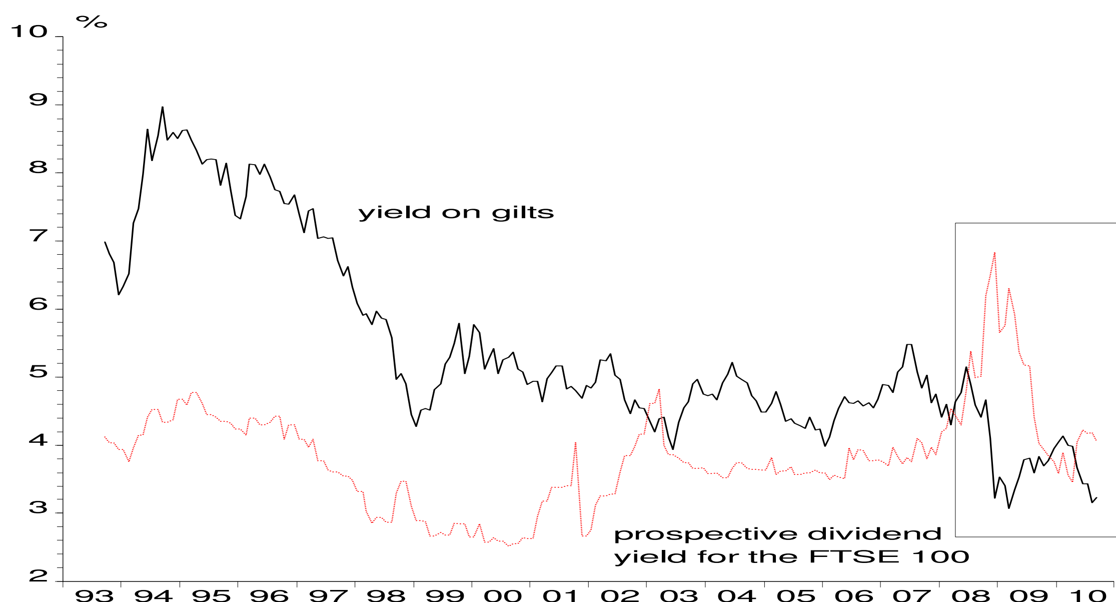
Bond markets take their cue from the developed economies, equities from the developing.



Source: DATASTREAM

There was a time when the dividend yield in the UK equity market was indicative of value and also when high yielding equities used to outperform. This was especially so in cases where the high yield reflected a 'falling-out-of-favour' with the shares, say because the operating environment for the company had disappointed or because the company had gone ex-growth – or was perceived to have done so.

In time patience was rewarded through capital growth in addition to the big up front return via the high yield. Typically, a re-rating would come through a takeover or management change that transformed a company that had gone ex-growth into a new growth vehicle. Alternatively, it might have come from an improvement in a company's operating environment during a recovery from recession.

Today's high yield in the UK equity market is partly a product of the recession. But more than this, it reflects what was widely recognized from the outset, namely a recovery and process of adjustment from a financial crisis that was never going to be easy.

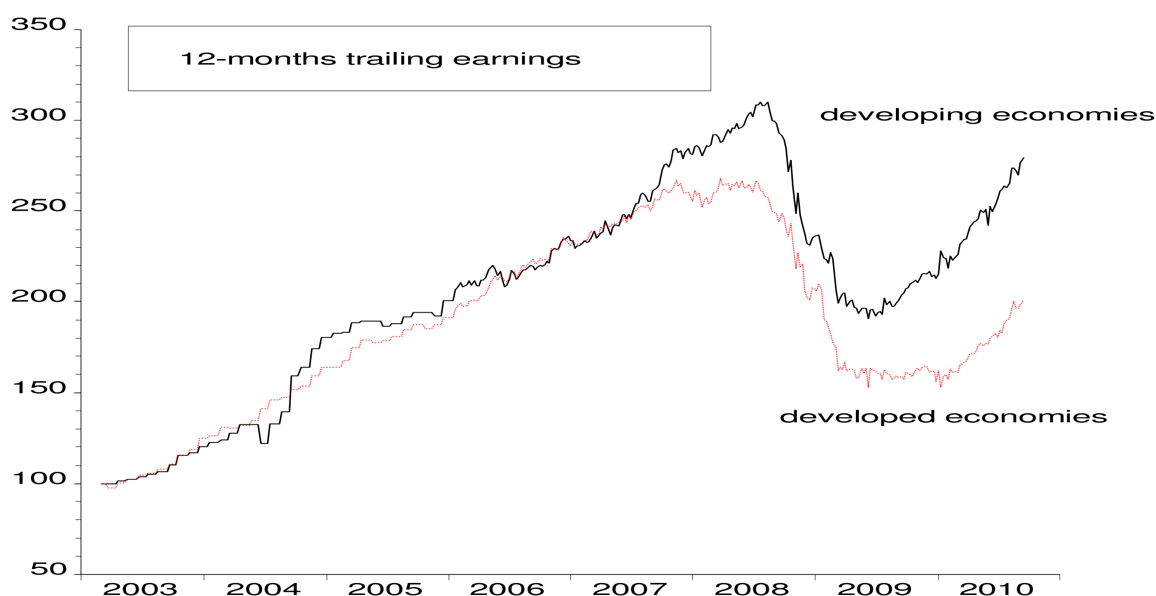
As the chart shows, the prospective dividend yield on the FTSE 100 lies above the yield available in the gilt market. For some the development is not just symptomatic of a difficult period of adjustment. It also reflects how the legacy of the financial crisis in its various manifestations is affecting sentiment – adversely in the case of the equity market and beneficially in the case of the bond market. Examples are the eurozone's sovereign debt crisis earlier this year, the loss of recovery momentum over the past months and the concern more recently over the success of the reflationary effort to support the global economy.

In this context, a dividend yield in excess of the yield on gilts is not indicative of value but of lingering economic duress. A high yield on equities and a low yield on government bonds are part of what might be expected in a world characterised by slow growth with a disinflationary, if not ultimately, deflationary tendency.

But there are two worlds out there and, for one, the relevant backdrop is not that of slow growth with a disinflation or deflationary tendency. That combination fails in representing what the developing economies are all about. Not only are the latter growing strongly but also expectations for growth are still being revised up, albeit with a few exceptions – like China where expectations have been trimmed a little after months of steady upward revision to the forecasts. For emerging Europe where the outlook remains fairly grim, forecasts for GDP growth are, nonetheless, being revised up too.

In the developing economies inflation is modestly on the rise – in some instances not so modestly, as in India's case. Monetary policy is tightening. While this does not apply to emerging Europe, it does for much of emerging Asia, Latin America and parts of the Middle East. The issue of whether the reflationary effort is succeeding is generally not in doubt in the developing world.

As the chart below shows, corporate earnings are growing far faster in the developing economies than in the developed.



Source: DATASTREAM

Moreover, for the FTSE 100 the share of revenues derived from the developing world has increased rapidly in recent years. Around 76 percent of FTSE 100 revenue is generated overseas but we estimate that something in the neighbourhood of 34 percent of all FTSE 100 revenue now comes from the developing economies. At the turn of the millennium, our estimates indicate that the proportion was of the order of 15 percent, if that. While the composition today of the FTSE 100 differs from what it was back then, the present structure of the leading index is partly a response to the changing influence of the developing world on earnings for the large internationals – the Mining sector being the obvious example.

The proportion of revenue derived from the developing world is set to climb. Instead of bringing in 34 percent of total FTSE 100 revenue, as now, the contribution in five years time is more likely to be closer to 40 percent and possibly even in the 45 to 50 percent range.

The growing importance of the developing world to the top line for the big internationals might help account for why, despite plenty of reason to sell off to much lower levels, equity markets have managed to hold their ground. The swings and roundabouts aside, 2010 is proving to be a year of consolidation following last year's big rebound.

Also, while equity markets are attractively valued, they are not really, really dirt cheap viewed from the stand point of where dividend yields have been historically. In the case of the FTSE 100, the dividend yield does lie above the yield on gilts but this is largely because the major bond markets are taking their lead from what ails the developed economies. Meanwhile, the big internationals are focusing increasingly on the developing world and this is helping to make equity markets increasingly beneficiaries of the faster growing regions of the global economy.

Shares derive their value from growing dividends. If companies can't grow their profits and they lose the capacity to grow their dividends then maybe the cult of equity has ended in every sense of the word. But that is not where it's at. In time, I would expect to see a re-rating of the shares most geared to the faster growing regions of the global economy and since we're talking of a growing proportion of such exposure for the major indices and especially for the FTSE 100, this suggests a prospective re-rating for the indices themselves.

What lay the ground for the cult of equity was recognizing that the return from growing dividends gave equities their value as an asset class of choice for long term growth. Today's yield in the equity market is likely to be indicative of what it has been in the past, namely a guide to value and, where it is high, a guide to the uncertain return for risk associated with that value and not a dead end ally.

IMPORTANT NOTES

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