BREWIN DOLPHIN

Market Tactics

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INVESTMENT RESEARCH

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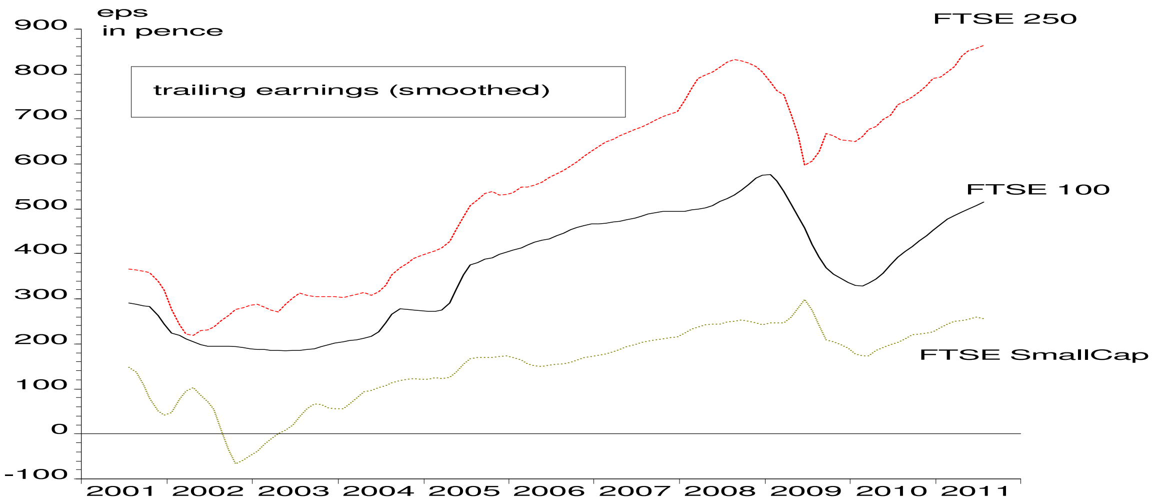
Value and earnings make equities a better buy than bonds.



Source: DATASTREAM

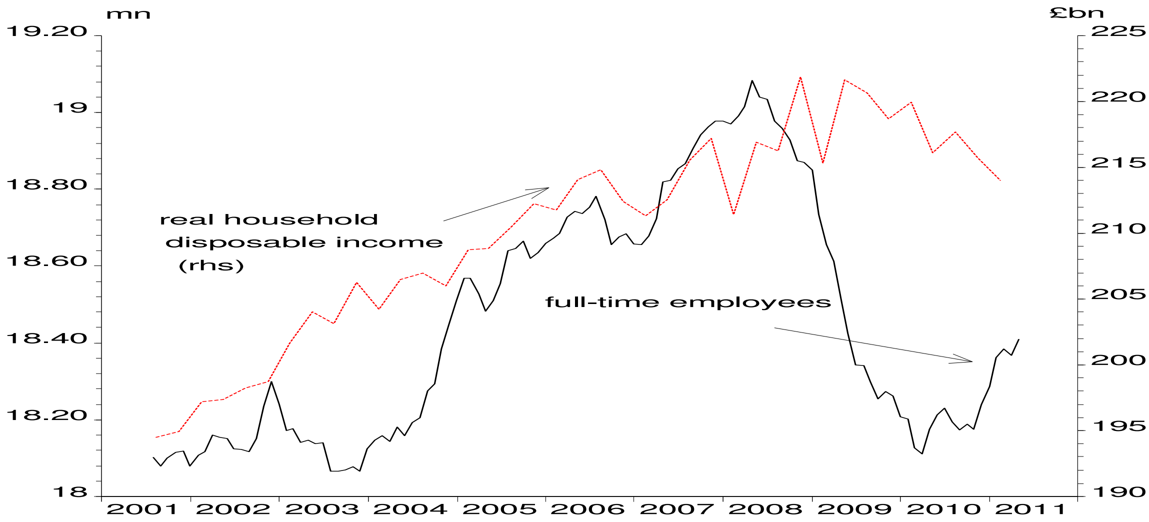
Bond and equity markets start another week with President Obama and the Republicans still gridlocked, deadlocked, stalemated and log jammed over differences on what it will take to raise the debt ceiling in a week's time. With the prospect of a default drawing nearer, gold may be the short term winner but a sell-off in equity markets will only improve what are already favourable valuations.

Otherwise, it will be another busy reporting week for company earnings – in the UK as well as in the US – and a busy week for economic news including figures for second quarter GDP growth due tomorrow for the UK and on Friday for the US. Weak numbers will not surprise given the loss of recovery momentum in the developed world but the question remains: how weak?

For corporate earnings the good news is that economic growth remains surprisingly robust in the developing world. In contrast to expectations for GDP growth this year in the major economies, expectations for growth in the emerging economies have barely altered. Strong emerging economies have had much to do with the earnings recovery for the big internationals, but then the recovery has been very much about the corporate sector and little about the personal sector, that is, strong growth in profitability and not about jobs or growth in real household incomes and consumer spending.

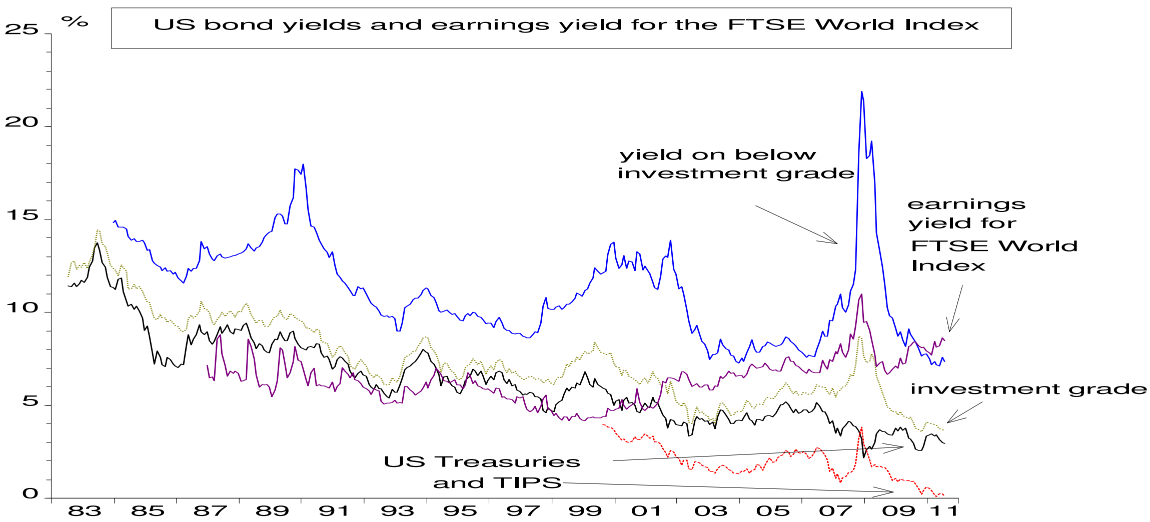
Interestingly, the corporate recovery has not been limited to the big internationals. As the chart above shows for the major components of the FTSE All-Share index, earnings for the mid caps in the FTSE 250 now exceed their former cyclical peak. For the smaller caps in the FTSE SmallCap index earnings are very nearly back to their former cyclical peak, much like the large caps in the FTSE 100. Yet this is for companies far more geared to the domestic economy than the large multi-nationals. So the performance is all the more impressive considering the weakness of an economy that is also burdened by fiscal austerity.

Even more surprising for an economy struggling to sustain a recovery is the growth in UK full-time employees. As the following chart shows the trend has been up for over a year. If profitability is what it is for the mid and smaller sized companies, which typically provide the bed rock for job creation, then this might explain the job growth. A weak economy doesn't create jobs. What's weak about the UK is spending but this is because inflation is eroding real income growth, as the following chart also shows.



Source: DATASTREAM

Do equity markets offer value? Equity markets may not be dirt cheap but they are not expensive and, indeed, something of an anomaly exits. The following chart shows two things; firstly, that the gap between the prospective earnings yield for the FTSE World Index and yields on both US government bonds and US corporate debt have continued to open up, and secondly that the earnings yields for the FTSE World Index now exceeds the yield on below investment grade corporate debt.



Source: DATASTREAM

Expressed in terms of bond-equity earnings yield ratios, that ratio is at its lowest for the period shown with one exception; against US Treasuries when it was only marginally lower after the collapse of Lehman Brothers at the end of 2008. Aside from this, equity markets have not been more attractively valued against the bond markets for the period shown, including against US Treasury Inflation Protected Securities as well as against investment and below investment grade corporates.

As the chart shows, the crossover of the earnings yield with the yield on junk bonds has been underway for almost a year. This is a first for the life of the two series and may well reflect the recovery story which is one of profitability across the corporate sector. But it shows how far all bond markets have run and suggests that value lies with the equity markets.

Equity markets have had every reason to sell-off over the past months but have chosen instead to trade sideways in a relatively narrow range. You wonder what they have been waiting for. A US default? Or a Greek default? Or an opportunity to move upwards and onwards? The leaders in the FTSE World Index not only offer solid earnings growth but also more of it from the faster growing developing economies. This means growing dividends and makes equities at current valuations a better buy than the fixed income markets.

IMPORTANT NOTES