

White Paper

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Are equities overvalued?

Taking an active approach to asset allocation

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Executive summary

Many analysts argue that even after recent market weakness, investors should still be cautious about the investment prospects of equities. There are two related concerns. Strategists fret that valuation metrics are stretched relative to historic norms. This implies weak future returns and investors should wait for better opportunities once valuations have mean-reverted, or become outright cheap.

Economists link the rally in equities since the financial crisis to ultra-expansive monetary policy. Corporate profits have hardly improved and, consequently, market gains are viewed as unsustainable. Once the “sugar-rush” of quantitative easing (QE) fades, equities will be forced to trade on the fundamentals of lacklustre economic growth.

We believe these arguments are based on incomplete logic. Valuation analysis is contextual and needs to be based on an assessment of the current economic environment.

Today, lower-for-longer interest rates depress future returns across risky asset classes. The good news is that given a low interest rate scenario, the reward for owning equities looks decent and not out of kilter with historic experience. Only if growth “secularly stagnates” do we find evidence of poor US equity valuations. European equities look cheap.

Thinking hard about valuation matters, but there are no easy answers. Although we do not think global equities are overvalued, challenges remain.

Volatility has been episodic and we are walking a tightrope between a more severe deterioration of growth trends on one side and better growth but a more market-hostile response from the Fed on the other. Taking an active approach to asset allocation can help.

Voting machines and weighing machines

Famously, the father of value investing, Ben Graham, likened the stock market to a voting machine in the short run and to a weighing machine in the longer run. This means that, whilst we might expect equity prices to move out of line with fundamentals over relatively short time frames, such valuation gaps are assumed to close over time.

In the minds of bearish economists, the voting dynamic has been at play over the recent past. Since the financial crisis, the total return on global equities is substantially ahead of dividend growth. This is popularly explained as a “sugar high” stemming from aggressive central bank QE. When this policy ends, the market will lose a key support. If this view of the world is correct, the equity volatility seen since the start of 2016 could be a precursor of further market weakness and volatility to come.

The idea that there should be mean-reversion back to long-run averages is typically made with reference to equity valuation metrics. Current levels are perceived to be high and therefore poised to fall back to historic norms. This is illustrated in Exhibit 1, which shows a selection of popular price ratios against their historic average readings.

Exhibit 1: US Equity market valuation metrics

	P/E	Shiller PE	Tobin's Q	Market Cap/GDP	Equity/Gold
Current Level	20.2	24.2	1.8	118%	1.65
Av Since 1980	17.4	25.9	1.3	76%	1.67
Long-Run Average*	15.6	16.7	1.1	62%	0.64
Implied Overvaluation vs LR Average	30%	45%	66%	92%	158%

*LR Averages: PE since 1971, Shiller PE since 1881, Tobin's Q since 1900, Market Cap/GDP since 1947, Equity/Gold since 1791
Source: HSBC Global Asset Management, 31 March 2016.

Many of these metrics remain well above historic averages. Using a long, 100-year time series to benchmark these readings adds further plausibility to this argument.

The “Shiller PE”, for example, is a widely-followed metric which compares the current equity price to smoothed (10-year) earnings. Numerous academic studies have evidenced a strong link between high Shiller PEs and weak future long-run equity returns.¹ Today, it is reading over 24, a situation which Professor Shiller argues has occurred only infrequently (1929, 2000, and 2007) and has each time been followed by a market collapse.

“It is entirely plausible that the shaking of investor complacency will take the market down significantly and within a year or two restore CAPE ratios to historical averages. This would put the S&P closer to 1,300... and the Dow at 11,000. They could also fall further; the historical average is not a floor.”²

After the recent market rout and rapid rebound, the S&P is trading at circa 2,050 and the Dow at around 17,500. If Professor Shiller is right, there is significant further downside to come and investors need to be extremely wary of the outlook for equities.

Exhibit 1 also shows the market capitalisation-to-GDP ratio, sometimes referred to as “Warren Buffett’s favourite indicator”.³ Whilst we do not know if it remains Mr Buffett’s preferred valuation gauge, like the Shiller PE, it is significantly ahead of historic norms.

A third measure, Tobin’s Q, is widely followed by macroeconomists and measures firms’ asset value versus current market value. Current Tobin’s Q levels are also showing an extreme reading relative to their 100-year average.

The point is, as Professor Shiller eloquently puts it above, that equity price ratio analysis leads many economists to conclude there are predictable further losses ahead. The assumption is that what goes up (“unsustainably”) must, eventually, come down. However, we do not believe the issue is quite so simple.

¹ For example, Campbell and Shiller (1997), *Valuation Ratios and the Long-Run Stock Market Outlook*, *Journal of Portfolio Management*

² Shiller (2015), *Rising Anxiety That Stocks Are Overpriced*: http://www.nytimes.com/2015/08/30/upshot/rising-anxiety-that-stocks-are-overpriced.html?_r=0

³ Interview with *Fortune* magazine in 2001 : “probably the best single measure of where valuations stand at any given moment”

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Simple equity ratios are poor valuation measures

In our view, classic equity-price ratios are not good measures of valuation. Using these as tools to think about future equity market direction or sustainable equity returns imposes a number of unreasonable assumptions and, fundamentally, ignores multi-decade trends in interest rates.

First, to build a diversified portfolio, investors need to assess equities relative to competing asset classes. As such, equities wrestle for inclusion in a portfolio against other risky asset classes which might include rates, credits and alternatives. The key question for investors is to determine if they are being paid for owning equities relative to the carry they can earn in another asset class. We recognise that today's high PE gives an indication as to the total return investors can expect from equities going forward. This implies that expected returns are now low compared with the returns equity markets have delivered since the 1980s. Yet this is not central to the investment decision today, which should focus on delivering the best available risk-adjusted return. We cannot ignore the cross-sectional perspective.

An implicit assumption embedded in the data of Exhibit 1 is that equity price ratios revert to a historic norm over the course of time, and that this norm is itself stable. It is an easy assumption to make and seems especially plausible with the hindsight of 100+ years of historic evidence. However, we believe this thinking is faulty and inconsistent with finance theory.

The classic Gordon growth model⁴ argues that the required return on equity reflects two components: (i) the risk-free rate and (ii), the equity premium (i.e. the additional compensation for bearing equity risk).⁵ As such, the assumption of a mean-reversion of equity ratings (or, equivalently, equity future returns), is analogous to a joint assumption that both the interest rate and the equity premium move back to their historic norms.⁶ We contend that this is a highly unrealistic view.

Exhibits 2 and 3 show the yield on long bonds in the US and the UK since the 1800s. As can be seen from the charts, government bond yields have not behaved like classic sine waves historically. Rather than mean-revert neatly, bond yields have historically alternated between phases of stability coupled with temporary mean-reversion and significant "jumps". These jumps coincide with shifts in the economic regime.⁷

For example, the 1970s jump in yields is famously related to an unmooring of inflation expectations linked to oil-price shocks and spiralling wage/price dynamics. Since the 1980s, we have witnessed a multi-decade collapse in nominal interest rates which has created a fabulously supportive environment for risky asset returns.

Exhibit 2: Historical US Government Bond Yield

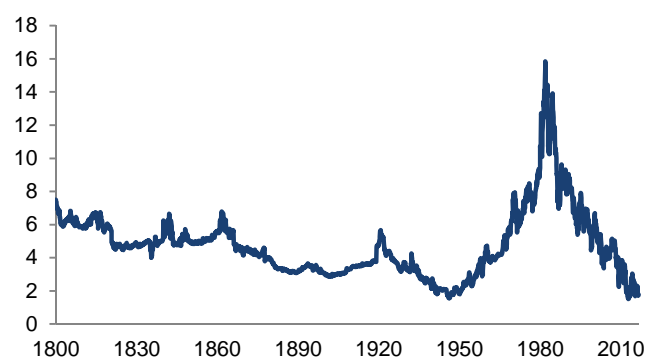
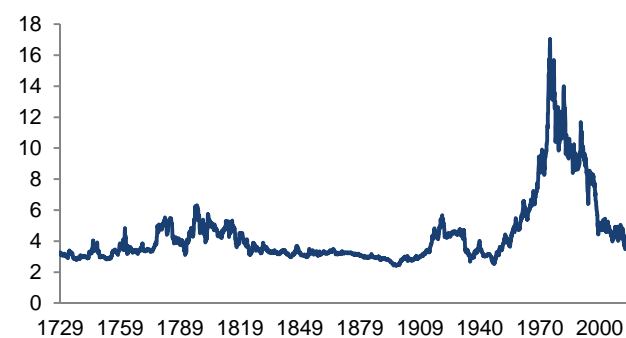


Exhibit 3: Historical UK Consol Bond Yield



Source: Global Financial Data as of 31 March 2016

Today, bond yields are in an altogether different situation. They are very low relative to the last 30 years, meaning the phase of bumper asset returns we enjoyed since the 1980s is over and, mathematically, cannot occur again from current levels.

⁴ Gordon (1959), *Dividends, Earnings and Stock Prices*, *Review of Economic Studies*

⁵ Mehra and Prescott (1985), *The Equity Premium: a Puzzle*, *Journal of Monetary Economics*

⁶ Based on the Gordon growth setup, one can mathematically show that the earnings yield is a proxy for future equity return.

⁷ Bansal et al (2003), *Regime-Shifts, Risk Premiums in the Term Structure, and the Business Cycle*, *Duke University Working Papers*

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Bond yields are low versus data since the 1800s for the UK and the US, and data since the 1700s for Holland. In fact, yields have only been so low on two previous occasions, both times in the aftermath of financial crises: the Latin American debt crisis of the 1890s and the Great Depression of the 1930s.

Yet the bearish equity-market analysis presented in Exhibit 1 implicitly assumes a normalisation of real interest rates, nominal interest rates, and of the term structure. Whilst it is reasonable to expect some degree of normalisation from today's historically low rates, we believe – as indeed does the bond market – that a full mean-reversion is very unlikely. Dealing with this is a key challenge for equity valuation.

The medium-term interest-rate outlook strongly depends on the economic environment. A recent Bank of England research paper⁸ has identified the drivers behind the falling bond yields of the last 30 years. The authors point to demographics, inequality, a rise in emerging market savings, reduced investment spending, and – of course – falling medium-term growth, none of which seem likely to reverse course rapidly. Meanwhile, the global inflationary environment is at its tamest since the 1960s, despite the tightening of labour markets in the US and UK over the last five years.

This convergence of factors points to the rate environment remaining “lower-for-longer,” a view which markets have largely come to accept. Concurrently, when interest rates do start to rise, the cycle seems likely to be “slow and low”.⁹

Such an outlook for structurally low interest rates impacts prospective returns for asset classes across the risk spectrum. For equities in particular, it implies that the total required return has fallen relative to what it was under higher interest-rate regimes, during the 1970s or 1980s.

In other words, the secular fall in interest rates mean that the equilibrium PE ratio ought to have increased. If we were to base our market view on the assumption that we will revert to the historic average PE under the current interest rate regime, this would already embed a sizeable margin of safety.

A possible counter-argument to this idea is if the equity risk premium has simultaneously widened, to offset the secular decline in interest rates. Whilst this would be remarkably convenient for the bears, it also seems quite implausible. Why, for example, should equities be perceived as more risky today than they were during the financial crisis, or than during the early 1980s?

⁸ Rachel & Smith (2015), *Secular Drivers of the Global Real Interest Rate*, BOE Working Papers.

⁹ Brad de Long, *The Scary Debate Over Secular Stagnation*, Q4 2015.

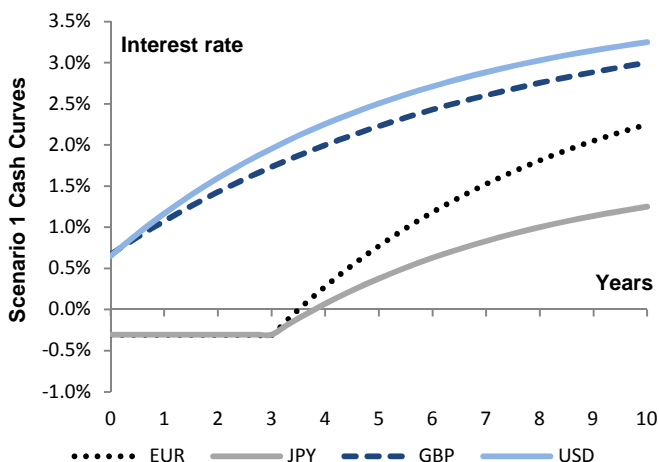
Measuring the Market Discount Rate

If equity price ratios are not a reliable measure, how should we approach valuation analysis?

We approach it from core principles. We start by defining a credible scenario for cash rates across relevant economies. Then, based on current equity pricing and an assumption for dividends, we calculate the “discount rate” (expected return). In the jargon, we use the “present value relationship”, a popular approach in the academic finance literature.¹⁰

Exhibit 4 shows our current modelled scenario for the US, UK, European, and Japanese interest rates. For the US, we assume a rate path broadly in line with the Fed’s forecasts,¹¹ while in Europe we assume that the ECB will persist with its current accommodative policy stance into the near term. Interest rate rises are consequently delayed, as we expect headwinds from the financial and Euro crises to continue weighing on the rate outlook into the medium term.¹²

Exhibit 4: Our current interest rate trajectories



Source: HSBC Global Asset Management, March 2016. Trajectories are based on model assumptions and are not guaranteed in any way.

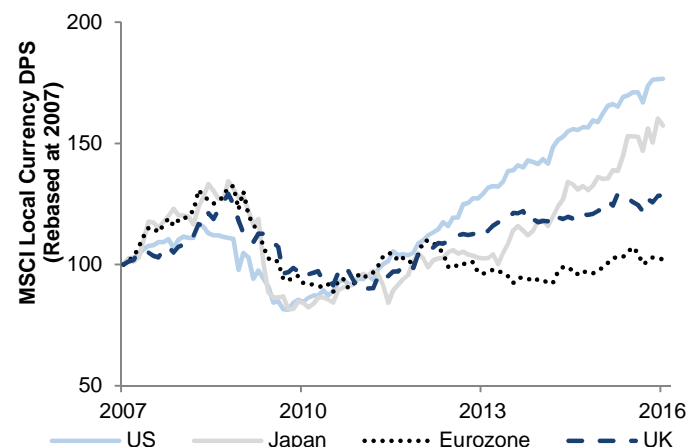
Whilst this is a relatively hawkish scenario, it still encapsulates the notion of a “slow and low” interest-rate cycle with divergence between major central banks. It also embeds a “margin of safety” in our estimate of the expected return for equities. We base our estimate of future equity returns on interest rates, the scenario for dividends, and current market prices. Assuming a more hawkish rate trajectory creates a larger capital loss for risky assets as they are forced to de-rate.

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In terms of the dividend assumption, in the short term, we base our forecast on the profitability cycle. Today we assume that US real-dividend growth will slow to 4% (versus 6% over 2008-2015 – Exhibit 5), based on current profitability reverting to cyclical norms and a current dividend pay-out ratio of around 45%. We assume a slower growth rate of 2% for European real dividends over the near term due to relatively weaker profitability and higher dividend pay-outs in the region.

More importantly, however, we assume long-term dividend growth of only 1% after inflation. This is much more conservative than the popular assumption that dividend growth tracks GDP.¹³ We believe this means that our estimated expected equity returns should be realistic rather than driven by wishful thinking.

Exhibit 5: Historic Dividend growth



Source: HSBC Global Asset Management, March 2016.

¹⁰ For example, Iilmanen (2010), *Expected Returns: An Investor’s Guide to Harvesting Market Rewards*, John Wiley & Sons

¹¹ Fed Summary of Economic Projections, March 2016

¹² This is consistent with other technical studies. For example, see chapter 14 of the OECD Economic Outlook, 2014

¹³ Bernstein and Arnott (2003), *Earnings Growth: The Two Percent Dilution*, CFA Institute.

Exhibit 6 shows our current implied expected returns for selected developed equity markets. We estimate an equity premium over cash of 3.3% for the US and 4.2% for the Eurozone.¹⁴ Relative to government bonds, the premium on US equities is higher, at 4.4%.¹⁵ Our conservative dividend scenario may leave room for some upside to this estimate. Overall, total returns on equities appear low, at 5-6% in local currency terms.

A key decision for asset allocators is to gauge whether the implied expected return (premium) is sufficient to bear the risks associated with an investment. The historic excess return of global equities versus cash has typically oscillated between 2.9% and 6.1%, with an average of 4.5%.¹⁶ Other studies have suggested between 2.4% and 4% for a normal equity premium.¹⁷ Therefore, the excess returns versus cash look reasonable in our analysis.

¹⁴ Based on January 2016 market prices

¹⁵ For brevity, we do not discuss our framework for estimating expected bond returns, but it is done in a consistent and robust way, similar to how we approach the problem in cash and equities.

¹⁶ Elroy Dimson (2011), *Equity Premiums Around the World*, CFA Institute.

¹⁷ Respectively: Arnott and Bernstein (2002), *What Risk Premium Is Normal?*, CFA Institute; and Damodaran (2015), *Equity Risk Premium: Determinants, Estimation and Implications – The 2015 Edition*, Stern School of Business.

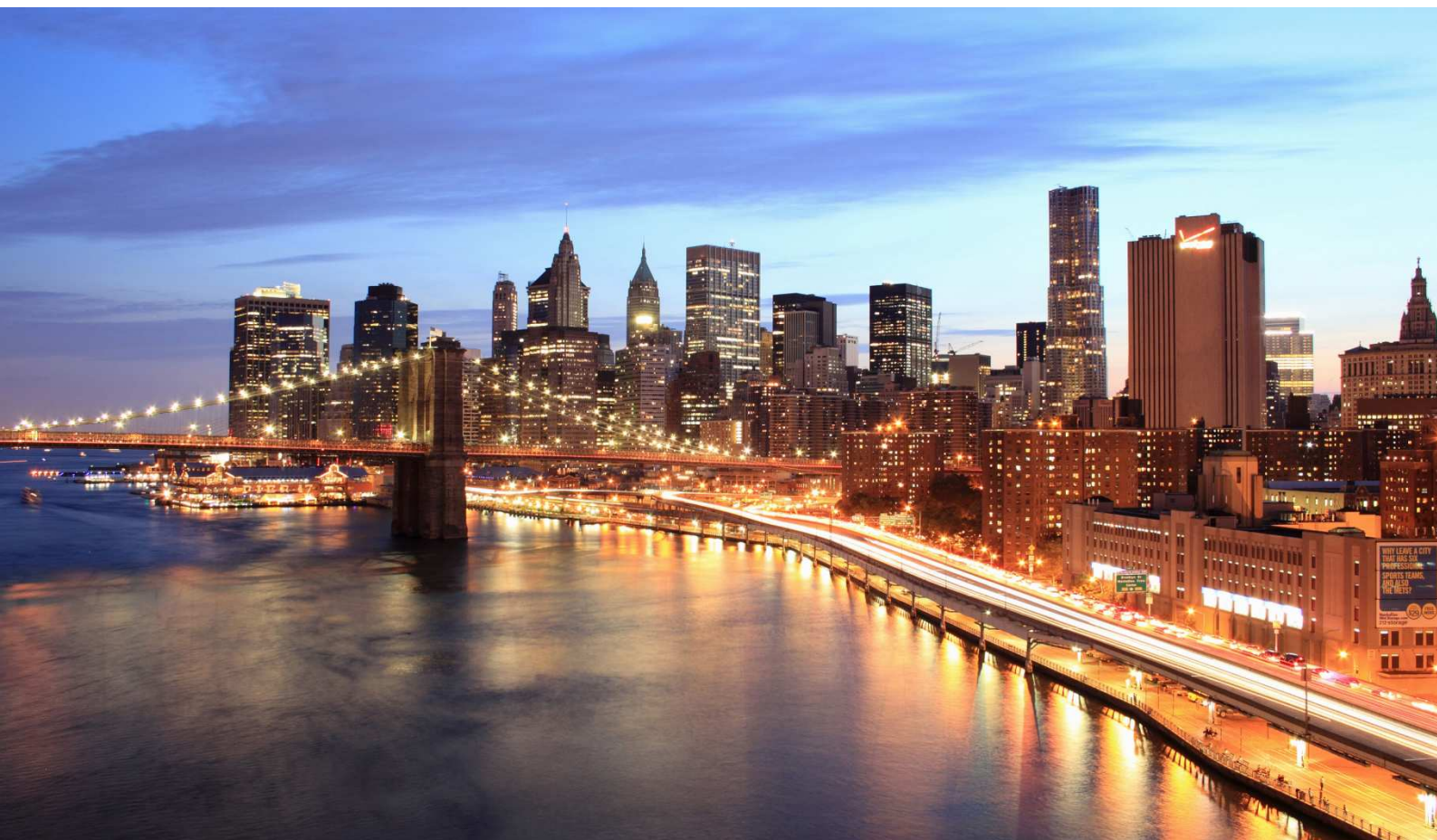
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Exhibit 6: Nominal, local, annualised implied returns based on a 10-year horizon model with end-March 2016 prices.

	Equity Return (local ccy)	Excess Return over Cash	Excess Return over Bonds
World (DM)	5.5%	3.6%	4.7%
US	5.6%	3.3%	4.4%
Eurozone	5.0%	4.2%	5.3%
UK	6.2%	4.1%	5.2%
Japan	5.4%	5.0%	6.2%

Source: HSBC Global Asset Management, March 2016. Trajectories are based on model assumptions and are not guaranteed in any way.

On this basis, in contrast to the conclusion implied in Exhibit 1, it seems difficult to argue that equities are very overvalued today. Even in our conservative scenario, US equities look fairly valued, whilst European equities look cheap – as do global equities relative to government bonds.



Are equities overvalued if growth is stagnant?

Our view is that valuation is contextual, rather than a fixed absolute. As the economic environment evolves, our assessment of available market returns must also change.

Today, one of market participants' crucial concerns is of a long-term stagnation in economic growth going forward, which is also likely to create problems for the corporate sector. A lacklustre macro picture would make it difficult for corporates to generate decent free cash flow and dividend growth to reward shareholders.

Such concerns are not unfounded. US economist Larry Summers has argued forcefully that we are in the midst of experiencing a "secular stagnation",¹⁸ contending that markets are facing a generational shortfall in aggregate demand relative to the available aggregate supply. Advanced economies are consequently doomed to underperform.¹⁹ As Summers recently reflected, a key implication of this view is that interest rates will remain very depressed into the medium term:

"The core idea behind secular stagnation was that the neutral rate had for a variety of reasons fallen and might well be below zero a substantial part of the time going forward. The inference was that economies might be doomed to oscillate between sluggish growth and growth like that of the 2003-2007 period that rested on an unstable financial foundation."

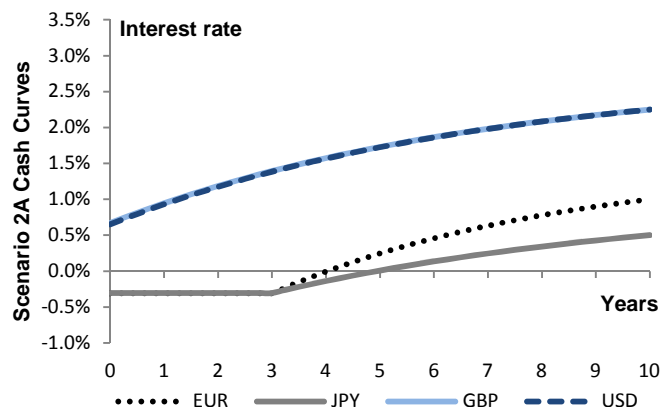
Recent market worries about the US and Chinese cyclical outlook can be viewed as part of a larger concern around multi-year global growth. The precise macro challenge varies across countries, but the deleveraging of debt burdens clearly also acts as a headwind for many advanced economies. As Keynes would have said, we have "magneto trouble".²⁰

To understand the implications of a "secular stagnation" on our equity valuation approach, we must revisit our assumptions. We first adopt a stylised interest-rate scenario based on current bond market pricing, whereby rates rise slowly to only 2.25% in the US (Exhibit 7). Results of our valuation model are shown in scenario 2A (Exhibit 8).

As a second step, to reflect the effects of stagnant growth on corporate profits, we force our dividend growth assumption down to 0% after inflation for the next ten years, keeping our assumption of 1% dividend growth thereafter.

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Exhibit 7: Stylised rate scenario based on bond market expectations



Source: HSBC Global Asset Management, March 2016. Trajectories are based on model assumptions and are not guaranteed in any way.

This effect is shown individually in scenario 2B. The combined effects of both lower growth and lower rates are shown in scenario 3 (Exhibit 8).

Based on a combination of stagnant growth and lower interest rates, the premium on developed equities is now 3.1% (scenario 3). This is at the lower limit of what an investor might regard as reasonable compensation. However, it is interesting that we still don't find a clear signal of over-valuation (i.e. a premium below 3%). The only way to obtain such a signal is to assume an inflation-adjusted persistent decline in dividends. Such a scenario could yet emerge, but there is little fundamental justification for holding this forecast today.

Under scenario 3, the premium on US equities falls to 2.5%.²¹ We would regard this as a low premium. Nonetheless, the assumed profit scenario is extreme – equivalent to the profitability (ROE) levels experienced at the worst of the financial crisis.

Outside of the US, the valuation position looks clearer. Current market pricing implies that, even under a scenario of low growth and low rates, European equities still offer a premium of 4% (scenario 3). Similarly in Japan (4.3% premium).

¹⁸ DeLong (2015), *The Scary Debate Over Secular Stagnation*: <http://delong.typepad.com/milken-review-secular-stagnation-34-51-mr68.pdf>

¹⁹ Larry Summers (December 2015): *My Views and the Fed's Views on Secular Stagnation*: <http://larrysummers.com/2015/12/22/my-views-and-the-feds-views-on-secular-stagnation/>

²⁰ John Maynard Keynes: *Essays in Persuasion*, 1931

²¹ Because our initial dividend growth assumption for Europe was only 2.4% (Exhibit 6), the growth haircut is less severe than in the US.

Exhibit 8 – Scenario analysis: implied returns for major equity markets under different economic assumptions

	Scenario 2A		Scenario 2B		Scenario 3	
	“Lower Interest Rates”		“Lower Dividends”		“Lower Rates & Lower Dividends”	
	Equity Return	Excess Return over Cash	Equity Return	Excess Return over Cash	Equity Return	Excess Return over Cash
World (DM)	5.4%	4.1%	4.6%	2.7%	4.4%	3.1%
US	5.4%	3.7%	4.5%	2.2%	4.2%	2.5%
Eurozone	5.0%	4.7%	4.3%	3.5%	4.3%	4.0%
UK	6.1%	4.5%	5.9%	3.7%	5.8%	4.1%
Japan	5.3%	5.3%	4.4%	4.0%	4.3%	4.3%

Source: HSBC Global Asset Management, March 2016.
Trajectories are based on model assumptions and are not guaranteed in any way.

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Conclusion

Not overvalued, but we are walking a tightrope

A lack of generous market pricing across conventional asset classes implies that we are currently in a low-return world. However, our research does not indicate that equities are overvalued, even under stagnant growth assumptions. Relative to the low returns available on cash or government bonds, we believe equity markets continue to offer fair-to-attractive compensation for risk.

We do not believe equity valuation can legitimately be assessed according to a fixed benchmark. It must be contextual. As discussed in this paper, the assessment of equity fair-value relies heavily on how interest rates and corporate fundamentals will evolve. Our approach to valuation is based on the “present value relationship” linking current prices and economic fundamentals to extract an implied premium (excess return) for equity markets.

In our calculations, the current US equity premium versus cash is just over 3%. It is not very generous, but nor is it obviously expensive. Relative to government bonds, we find that US equities are even cheap. In Europe, the valuation signal is clearer; equities are cheap relative to “safety” assets and we would need to assume meaningful, persistent declines in dividends to challenge this view.

We continue to believe that we are walking a tightrope between forces of “secular stagnation” on the one hand and a combination of better growth and higher US interest rates on the other, with market volatility likely to remain episodic. This combination of heightened macroeconomic uncertainty and low asset-class returns poses a challenge for investors. In this context, we believe that a focus on active asset allocation has never been more relevant.

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Chris Cheetham joined HSBC Global Asset Management in 2003 as Global Chief Investment Officer and has worked in the industry since 1978. Prior to joining HSBC, Chris was Global Chief Investment Officer of AXA Investment Managers, where he also held the position of CEO AXA Sun Life Asset Management. Chris began his career with Prudential Portfolio Managers (now M&G), where he worked in a variety of investment management roles, ultimately as Director of Investment Strategy and Research. He holds a First Class honours degree (BSc) in Economics from Hull University (UK) and a Masters in International Economics from Warwick University (UK).



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Joseph joined HSBC's Asset Management business in 2007. He is currently Chief Global Strategist, responsible for leading our work on macroeconomic and multi asset research, and for developing the house investment strategy view. He was previously Chief Strategist for Strategic Asset Allocation and a Fund Manager working on Tactical Asset Allocation strategies for an absolute return strategy. Prior to joining HSBC, he worked as a Global Economist for JP Morgan Cazenove. Joseph holds an MSc in Economics from Warwick University and is a CFA charterholder.

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