

Take care not to be misled in the search for the bottom Print

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Have equity markets reached fair value?

Some eminent investors, such as Warren Buffett, would appear to think so. And certainly, the time to pose the question is when the prevailing mood is as glum as it is today.

But in seeking the answer, we should be aware of its limitations. Fundamental analysis is an absorbing topic, but only occasionally relevant to market reality. And since equities were so overvalued at the top, we would normally expect them to be well below fair value by the time they hit bottom.

Indeed, the fundamentals are particularly elusive. Equity markets today have little to do with the outlook for corporate earnings, being rather the public expression of a much deeper unease emanating from the world of credit.

And that outlook is in any case deeply obscure. Sector analysts, such as economists, are no good at turning points. The world's fund managers, according to the latest Merrill Lynch survey, have given up on analysts' forecasts completely, agreeing only that corporate earnings are tumbling.

By how much? Most strategists say by 30-40 per cent in total. But that is merely the average of the past few earnings cycles. This cycle might be average, but it scarcely feels like it.

How then to proceed? I think the best method in the circumstances is one championed by Professor Robert Shiller of Yale, which involves taking today's price as a multiple of average corporate earnings over the past decade, adjusted for inflation.

This provided damning evidence of gross overvaluation in 2000 and was used by the UK consultant Andrew Smithers in recent months to argue that the markets were still overvalued.

And now? Mr Smithers says the US market has finally reached fair value, defined as the average level for the Shiller price/earnings since 1900.

The same is true, he says, by another yardstick known as Tobin's q, which compares market value with equity book value.

A similar exercise from Merrill Lynch shows the earnings multiple for Europe is at its lowest since the early 1980s. This is interesting but perhaps less relevant.

Back then, confidence in equities had been shattered by the inflationary 1970s. In 1982 it became clear that that inflation was finally coming under control, and this kicked off one of the longest and strongest bull markets in history. It is hard to see any such golden horizon today.

Indeed, from some perspectives the idea that we are at the bottom of a real bear market seems fanciful.

For instance, BAT, the UK tobacco giant - which is a classic defensive stock - is now trading on a price/earnings ratio of 13.6 and a yield of 4.7 per cent. In the trough of the 1974 bear market those figures were reversed - a p/e ratio of 3.4 and a yield of 10.3 per cent.

Granted, those were strange times, with UK inflation at more than 20 per cent. However, they are strange enough today. Back then, the market was spooked by a false rumour of National Westminster Bank going bust. Now that same bank, along with its parent Royal Bank of Scotland,

is being part-nationalised to stop it going bust in reality.

Another pressing concern is the amount of forced selling by leveraged funds. Among the hedge funds, for instance, this has been going on for months, as lenders have required funds to post daily collateral. Added to that now are actual redemptions by investors.

Since the amount of stock held by those funds is finite, this effect will dwindle over time.

It will end either when the last hedge fund folds or when the survivors have both shed their leverage and convinced investors they can do a good job without it. But we are not there yet.

It might perhaps be argued that the worst was past with the series of international bank rescues. That rather depends on whether the series is over.

The Institutional Risk Analyst thinks bad debts in the US will peak next year at double their 1990 level of 2 per cent - indeed, some banks are at 2 per cent already.

On that basis, it expects the US government to end up controlling Citigroup, JPMorgan and perhaps Bank of America.

Taken all round, it is not hard to argue that even if the market is at fair value now, it has further to fall. As to how much, Andrew Smithers is not sanguine.

Since 1920, the US market has hit six real bear market bottoms - in 1920, 1933, 1942, 1949, 1974 and 1982. These bottoms have averaged precisely 50 per cent below fair value by the Shiller method, the range being 39-68 per cent.

There is, of course, no saying when such a bottom might arrive. There could be all kinds of spectacular rallies in the meantime. Still, tin hats all round, I fancy.

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