Oldfield Partners

Gravity in Financial Markets

Recent headlines in the financial press have been dominated by the yield of 10-year US Treasury bonds hitting a multi-year high of 4.7%. Using Bloomberg data, such yields were last seen in 2006 and 2007, just before the outbreak of the Great Financial Crisis.

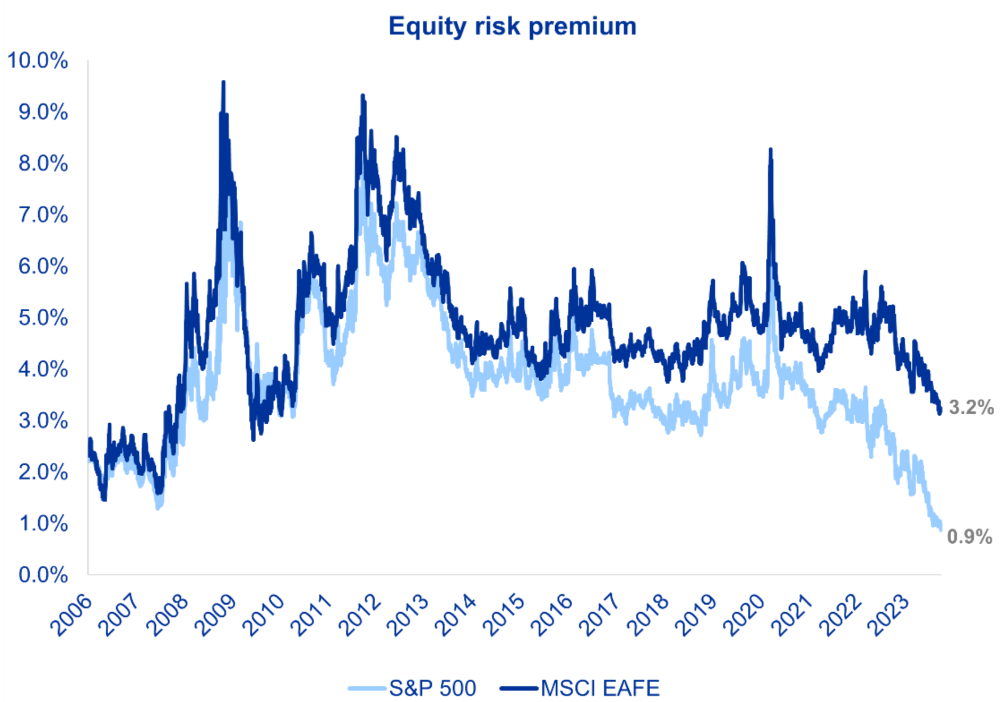
Source: Bloomberg

US government bond yields are an important yardstick for pricing financial assets. Warren Buffett said that "*interest rates are to asset prices what gravity is to the apple*". The relationship between US government bonds and equities is a simple one: anyone can buy a US government bond and receive a 'safe' 4.7% over 10 years, hence riskier assets like equities need to deliver a higher prospective return. This incremental return is known as the "equity risk premium". In general, the higher the premium, the more attractive stocks will be (and vice versa).

A rough-and-ready measure for the prospective return on equities is the inverse of their price-to-earnings (P/E) multiple, the so-called earnings yield. On that measure the S&P 500 yields 5.6% (i.e. trading on P/E multiple of 18x) while developed markets outside North America are yielding 7.9% (i.e. trading on P/E multiple of below 13x).

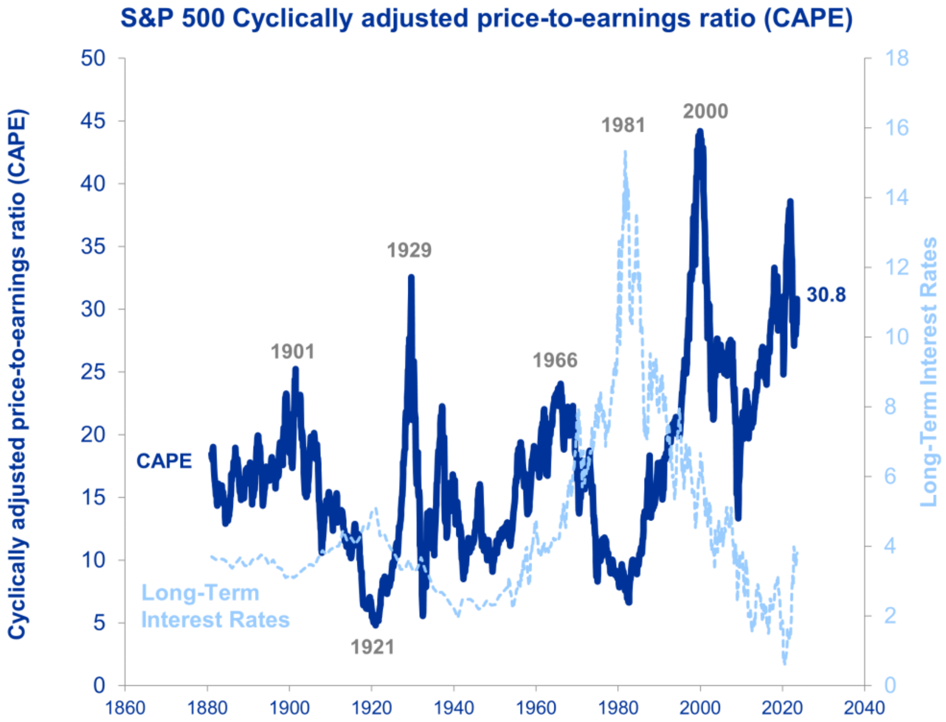
Based on inverse of 12 months forward price-to-earnings ratio
Source: Bloomberg

This suggests that US equities are offering an equity risk premium of just 0.9% over the 10-year US government bond while international equities provide a 3.2% premium. This higher equity risk premium provides a larger margin of safety.



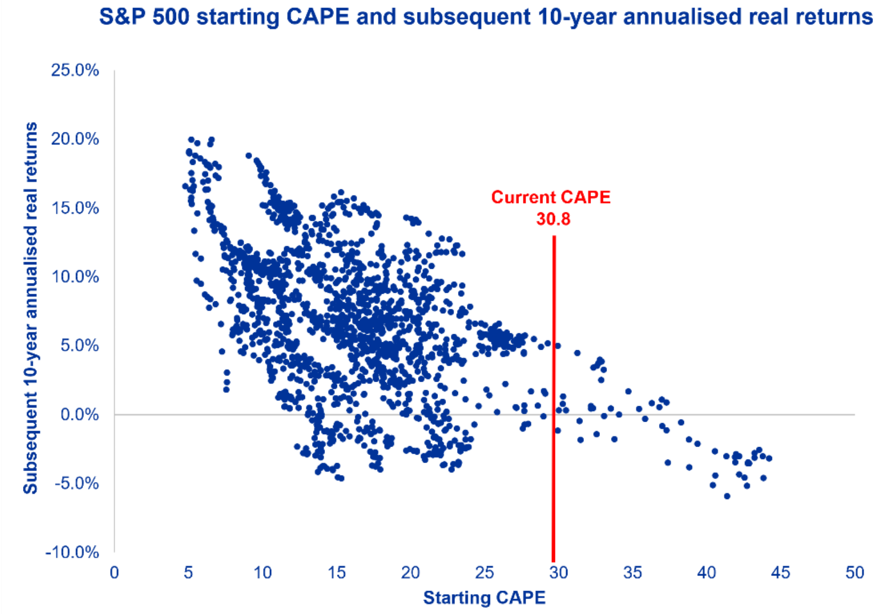
Calculated as 12 months forward earnings yield, less yield on 10-year US treasuries
Source: Bloomberg

We last saw such low levels in the US equity risk premium before the outbreak of the Great Financial Crisis, but even then they remained at above 1%. Today, we have reached this point as a result of bond yields rising and the valuation of the S&P 500 remaining almost unchanged. This situation, looking at history as a guide, seems unlikely to persist. In a goldilocks scenario this is resolved by bond yields falling and (or) earnings growing. Investors in the S&P 500 may then receive positive, but probably low returns. We believe a less rosy scenario is more likely given sky-high valuation levels. The chart below shows the cyclically adjusted P/E ratio ("CAPE") for the S&P 500. CAPE is a measure of price to rolling 10-year earnings.



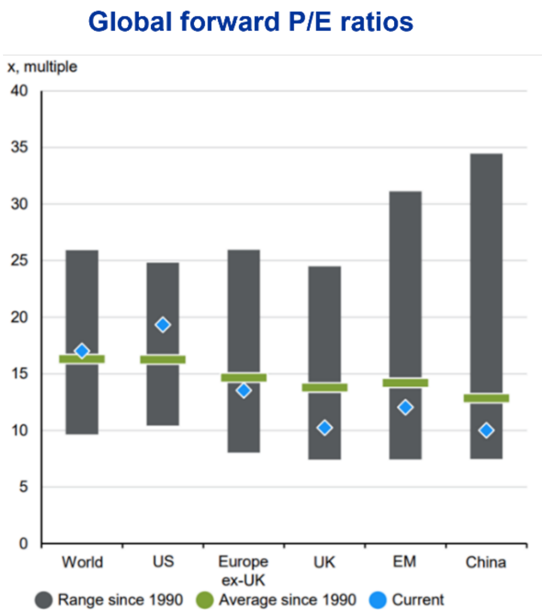
CAPE based on moving average of historical 10-year real earnings.
Source: Robert Shiller via http://www.econ.yale.edu/~shiller/data.htm

Over periods of 10 years or more, this metric has proven to be a highly predictive indicator. The S&P's CAPE is currently at 31 times. When CAPE hit such levels in the past, it was followed by 10-year annualised real returns of below 5%. History may not repeat itself, but current valuations in the US market leave little margin for error. Having had a very strong run, we believe US equities in aggregate cannot defy gravity forever and will deliver poor returns from current levels.



CAPE data from 1920 to 2013.
Source: Robert Shiller via http://www.econ.yale.edu/~shiller/data.htm

In our view international value stocks offer attractive upside potential for investors willing to research and risk-assess stocks to ensure they provide a margin of safety. We believe fundamental analysis of intrinsic worth combined with the patience to wait until this value is realised will deliver compelling long-term performance. Now is the time to reconsider international value equities.



Source: IBES, MSCI, Refinitiv Datastream, S&P Global, J.P. Morgan Asset Management. Forward P/E ratio is price to 12-month forward earnings. MSCI indices are used for all regions/countries (due to data availability), except for the US, which is represented by the S&P 500. Range and average for China is since 1996, due to data availability.

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Richard Garstang & Christoph Ohm

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance