MBMG Investment Advisory Update

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Can a horse race move the markets? *Part 2*

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In this part, I look at HSBC's analysis of whether equities are overvalued if stagnant and explain my view.

The key point is highlighted by HSBC in its white paper, when it explains that 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.[1]

Yet its bearish equity-market analysis implicitly assumes normalisation of real interest rates, nominal interest rates, and of the term structure. Whilst it's reasonable to expect some degree of normalisation for today's historically low rates, HSBC – as well as the bond market – believe that a full mean-reversion is very unlikely.

The White Paper then diverts into an academic analysis of bond yield drives that I'd regarded as a red herring – unless they believe bond yields will never normalise again. They describe it as a "convergence of factors points to the rate environment remaining *lower-for-longer*, a view which markets have largely come to accept.

Concurrently, the HSBC paper goes on to say, when interest rates do start to rise, "the cycle seems likely to be *slow and low*." Such an outlook, for structurally low interest rates, impact perspective returns for asset classes across the risk spectrum. For equities in particular, it implies that what it was under higher interest-rate regimes, during the 1970s-1980s.[2]

This tends to ignore economic history dating back to the earliest records of Sumerian civilisation – it's asking for a huge leap of faith to insist on a seismic shift that totally disconnects today's world from 5 millennia of human history. HSBC also dismisses the fact that today's equity markets contain higher equity premiums, which can easily be proven measuring by e.g. Jensen's Alpha[3] and their failure to recognise the reasons behind this.

[1] http://www.assetmanagement.hsbc.com/uk/attachments/institutions/are_equities_overvalued.pdf

[2] *idem*

[3] http://www.investopedia.com/terms/j/jensensmeasure.asp

There is quite a significant body of commentary that explains how the need to generate income or growth in a ZIRP / NIRP environment has led to enforced equity re-rating. Investors who have been forced to abandon their normal risk preferences and behavioural investment studies are extremely well aware of this.

Whilst the HSBC white paper seems to start from a partial point of view, seemingly committed to defending equity valuation levels, it takes a quantum leap in its attempt to measure the prevailing market discover rate. This involves some significant assumptions: "For the US, we assume a rate path broadly in line with the Fed's forecasts,[4] 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."

They admit that this "encapsulates the notion of a "slow and low" interest rate cycle with divergence between major central banks." And that "assuming a more hawkish rate trajectory creates a larger capital loss for risky assets as they are forced to de-rate." That's as maybe, but it also assumes Goldilocks is alive and well and that *not too hot, not too cold, but just right* will manage to prevail as Macro-economic conditions for the next decade.

This would truly be a "great moderation". They also assume at 4% reverting to cyclical norms and a current dividend pay-out ratio of around 45%. They even assure a rate of 2% for European real dividends over the near term. Again, Goldilocks would be happy.

The linkage between such benign interest-rate assumptions of consistent dividend growth for a decade strikes me as wishful thinking, tempered by the authors' rejection of even more fanciful growth claims. In short this attempted analysis ignores causative relation and the possibility for any shock – it's a very elegant constructed arithmetical model, yet doesn't reflect any plausible reason.

This explains why they reach the conclusion "On this basis, in contrast to the conclusion implied in the US bonds chart (see graph above), 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."

In fairness, they do set out to answer the question *Are equities overvalued if growth is stagnant?* But in doing so, they pretty much recognise that their view owes nothing to fundamental value and everything to the freakish conditions created by policy. This undermines their own argument that prices aren't primarily just a reflection of Frankenstein's monetary policy equivalent - their view of the next decade that is ultimately contextual, admitting that as the economic environment evolves, their assessment of available market returns must also change.

[4] Fed Summary of Economic Projections, March 2016

So this 10-year view is based entirely on factors today that are hugely changeable; except that "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."[5]

The HSBC's justifications revolve around a flawed Macroeconomic understanding that ignores the role of excessive private debt in cyclical stagnation. Sadly, they fail to address this in their paper, which is its contrast flaw – if you don't identify the single greatest prevailing macroeconomic driver and capital market issue, you won't infer the right answer.

Having gone out on a limb to justify the unjustifiable, they half admit this is their conclusion "Not overvalued, but we are walking a tightrope." They state that "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." [6]

However, they sound unconvincing, admitting that the views are all based on a very short term focus. "We do not believe equity valuation can legitimately be assessed according to a fixed benchmark. It must be contextual […] 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 market."

Even though they are absent of an understanding of high debt cyclical stagnation, they admit that their roseate view may well be ignoring the dangers that the future holds. "We continue to believe that we are walking a tightrope between forces of "secular stagnation" on the other 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."

Amen to that – but I wonder why such a reasonable conclusion was preceded by such an arithmetically eloquent justification of the unjustifiable. HSBC seem to think equities aren't overvalued because looking out from very unsound foundations today we can't see the cause of a major correction happening tomorrow. But then markets rarely can, so I don't believe that is the same as saying equities aren't expensive. At some stage equities will correct.

[5] http://www.assetmanagement.hsbc.com/uk/attachments/institutions/are_equities_overvalued.pdf

[6] *idem*

Until then, whether that is tomorrow or in 10 years' time, equity returns are likely to disappoint. As a risk – adjusted value advisor, that implies to me that equities are, in general, too expensive to invest in. Most other asset classes are and valuations are both contextual and relative.

But for now I'd prefer to keep out of all the dung in the farmyard, rather than trying to pick a favourite and that's why I'll be very circumspect with my equity appetite for equities this St Leger Day.

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