

## Equities: Is the Bull Market Under Threat?

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**Keith Wade, Chief Economist and Strategist at Schrodgers, gives his views on equities as an asset class in the current economic environment:**

"Equity markets have experienced a setback recently and this has led many strategists to question the longer term case for the asset class. However, we remain positive on shares and believe that equities can still generate an attractive premium for investors.

There has been a change in the relationship between the global equity index and sovereign bond yields, from one where both moved in the same direction to one where the two have parted company. Some see this as setting up a battle between bond and equity markets: falling bond yields are often associated with expectations of weaker growth, which is a bad outcome for corporate earnings and thus equity prices. Since global growth expectations have been falling this year, the argument goes that equities will soon start to track bond yields lower, and the correlation between the two will become positive again.

While it may well be that bond markets are correct about global activity, we should bear in mind that equity markets also benefit from falling interest rate expectations. Equity prices reflect the discounted value of future profits and so can be boosted by a lower discount rate as bond yields decline. This suggests that the question as to whether it is equity or bond markets that are right is far more nuanced than a straight call on growth. Equity investors may well judge that global growth and earnings prospects are subdued, but still see shares as attractive assets given the low discount rate, or to put it another way, the low returns offered on bonds.

Our seven-year return forecasts show equities making single digit returns, but outperforming cash and bonds. On this basis, absolute returns may not be as high as in the past, but global equity markets still offer a risk premium over bonds on our projections. Arguably, this risk premium (which ranges from 1% to 6% depending on the market) is too low to compensate for the risks associated with equities, but many investors have been reluctant to cut exposure for several reasons.

One is TINA, i.e. 'There Is No Alternative': bonds and cash simply do not deliver the returns needed to meet the objectives of savers. Investors have no option but to accept higher risk if they wish to meet their future income requirements.

Another important factor supporting equity exposure is that policymakers are committed to economic recovery. Reviving and sustaining economic growth, as well as reducing unemployment, are the priorities. Consequently, in the debate about sustainable growth and corporate earnings, there is a sense that central banks will respond to economic weakness, just as the European Central Bank has recently done.

However, the use of central bank forward guidance has created a perception that central banks are underwriting equities, known in the markets as the "Draghi put", for example. When accompanied by massive liquidity provision, the effect has been to suppress volatility, creating an environment where investors are willing to accept lower returns whilst taking greater risks.

Of course, this is a dangerous process as it can, and has, led to the creation of bubbles in asset prices. The concern is that current central bank policy will lead to a massive misallocation of capital and the same problems which led to the Global Financial Crisis. The bubble would be in a different market but may prove as damaging. However, such concerns have been downplayed by Federal Reserve Chair Janet Yellen. In recent comments to Congress she indicated that she would only be worried if financial market bubbles threatened a systemic crisis and, as the banks are now better capitalised, that risk is low.

The question for investors is whether this environment has made equities too expensive. There are certainly pockets of the market which seem frothy, but in aggregate we do not see significant overvaluation. For example, price-to-earnings ratios have risen over the past year and are generally above average but are not extended, with most markets trading well within their historical range. The exception would perhaps be the European markets of Spain, Italy and France which seem to be discounting a significant recovery in earnings. At the other end of the spectrum, Japan and the emerging markets look attractive on this metric.

Amidst concerns about an end to the equity bull market and the seemingly conflicting behaviour of bonds we remain positive on shares. There may be an element of 'TINA' about this but we still believe that

equities can generate a premium for investors. Moreover, policymakers continue to target growth and in doing so offer support to equities."

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