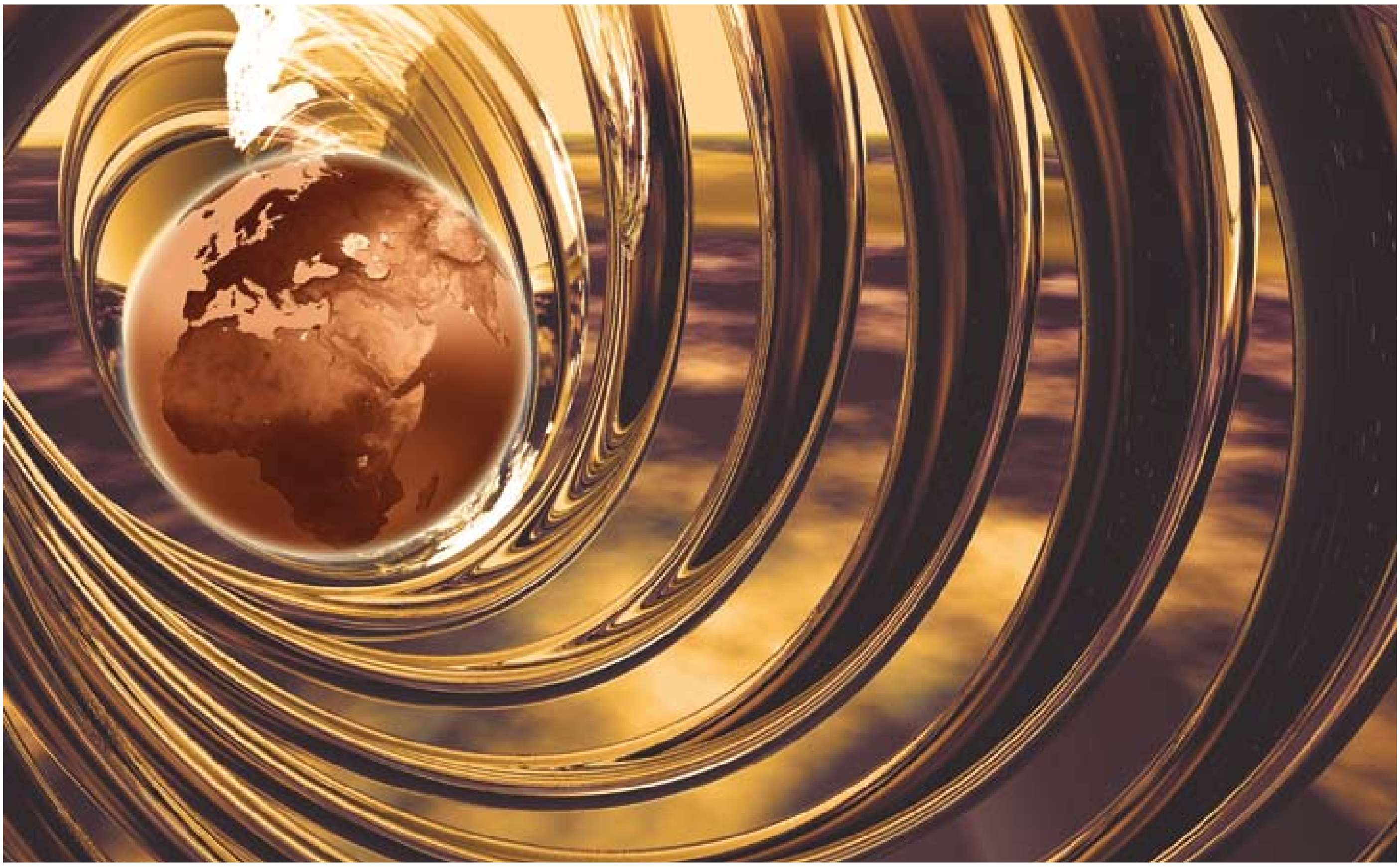
World stock prices look reasonable



David Morris, CEO of Global Wealth Allocation Limited compares wealth creation in the non-financial and financial sectors

GWA

Dividing the market into financial and non-financial sectors provides an insight into whether or not the market is undervalued.

In the financial sector, by the end of March this year, both prices and earnings collapsed together, having reached their respective peaks in May 2007 and October 2008. The fall in market value for the sector as a whole of more than 70% was matched by an equivalent fall in the aggregate earnings for this group, as shown in Chart 1.

So while the market value of financial stocks is at the same level of more than a decade ago, the level of earnings is also at levels not seen for at least eight years.

This behaviour is entirely consistent with the economic principle that over time the market value of a company must mirror the wealth that company creates. Convergence of markets to wealth trends is the long run nature of their behaviour.

In the short term however divergence of markets from the underlying wealth creation trend is the norm, as 'accidents of the moment' in Marshall's words, and 'whim and fancy' in Keynes' terminology, exert a disproportionate influence on prices. And this is what we observe in the non-financial sector of the market.

It would appear that the fearful collapse of prices in financials, which has been justified by severe losses, is having an understandable adverse effect on prices in the rest of the market, namely the non-financial sector. Chart 2 shows that divergence of market prices from the wealth creation trend is pronouced.

Whereas non-financial sector market prices had fallen by around 50% at the end of March, the earnings trend, as of February, remains flat. So the collapse in prices has not been matched by any deterioration of that sector's wealth creation.

While the market price declines indicate that expectations are for non-financial company's earnings to fall by at least a further 50% from current levels, it has not yet happened.

And if it does happen, non-financial sector earnings will be at levels last recorded for the group not much less than a decade ago.

Given that the market has discounted a 50% future earnings decline in the non-financial sector from current levels, it would appear that any bad news now may not have the same negative impact that it would have had a year or even six months ago.

So limited downside price movement is not unreasonable at the current level of wealth creation and the negative expectations tied to it.

What can we expect from the financial sector? The risk to the banks is the dominant consideration here as they make up just over half the wealth creation in that sector.

Quite apart from the assistance provided by way of cash injections and guarantees to the banks, the biggest help to the restoration of their balance sheets and to improving their profitability is the positive yield curve.

Led by the Federal Reserve, short term interest rates are now on average more than 300 basis points below long term rates for government securities. As government bonds represent the risk free rate of return generally, all lending is priced against these securities.

To see the impact on the banking sector generally we need only apply the spread between short rates and long term rates for government bonds to the total assets held by the banks worldwide.

Given that banks take in short term deposits (borrow short) and lend them for typically longer periods or for much higher rates on demand credit, it is possible to outline in very rough terms just how much of a benefit to the banks a positive yield curve is currently.

Chart 3 shows the the shape of the current yield curve globally. It is broken down by major Country/Region to provide a conservative estimate of the spread between bank borrowing costs and bank lending rates for each. Simply multiplying this spread by the total bank assets provides an estimate of the gross revenues currently underpinning the global banking system.

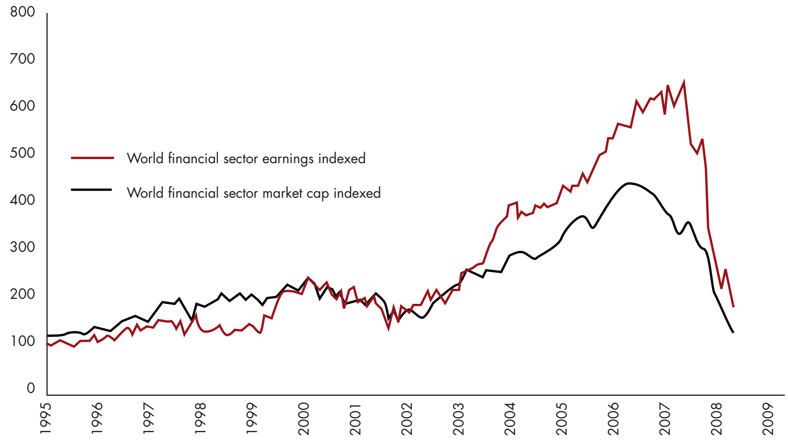
Now these estimates are obviously too high but nevertheless make the point that the banks today are facing a hugely positive economic environment due to the positively sloped yield curve which just 18 months ago was flat to inverted.

So with a positive yield curve underpinning the banks while recession impedes their growth, the March rally in financials has some justification. And as we all try work out how difficult the recession is going to be, the downside scenario priced into the market for non-financials is a 50% further reduction in earnings.

So the market is expecting no bad surprises in the financials that the positive yield curve won't take care of, and it is expecting non-financial sector earnings to return to levels of 10 years ago. Not unreasonable.

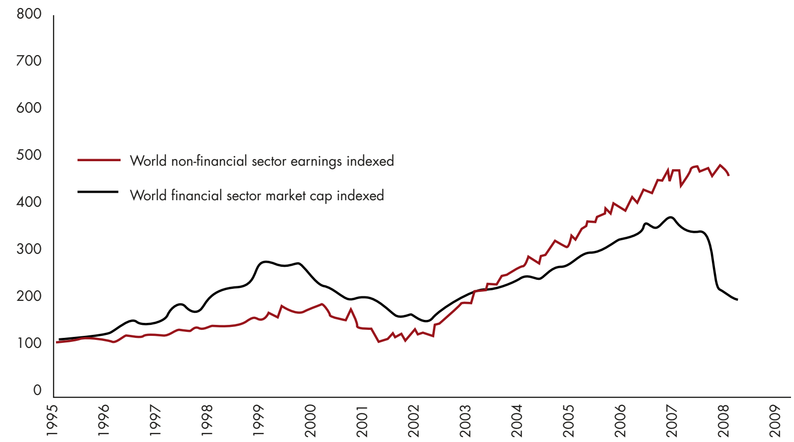
David Morris is CEO, Global Wealth Allocation Limited

Chart 1: Developed world financial sector earnings and market capitalisation indexed Q1 1995 to Q1 2009



Source: MSCI

Chart 2: Developed world non-financial sector earnings and market capitalisation indexed Q1 1995 to Q1 2009



Source: MSCI

Chart 3: World total bank assets and implied gross revenue (QI 2009)

	World Bank Assets ($ trn)	Yield Curve Slope (bps)	Est. Gross Revenue ($ trn)
Eurozone	27.0	319	0.9
UK	10.0	362	0.4
US	8.5	359	0.3
Japan	7.5	177	0.1
Rest of World	5.0	313	0.1
Total	**58.0**	**313**	**1.8**

Source: GWA