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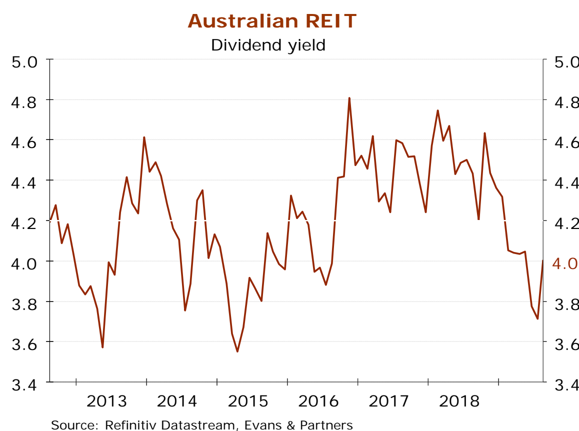
Is TINA real?

One of the difficult questions for investors is whether equity valuations deserve to be higher because of the large falls in interest rates in recent years. The subsequent rush into equities has been labelled TINA as in *There Is No Alternative*.

On face value, equities have a better *relative* valuation than bonds and appear to be the only major asset class where investors have the potential to make decent returns on capital over the next few years. However there are other factors to bear in mind:

1. Lower bond yields partly reflect weaker economies and lower trend earnings growth for equities.
2. Lower bond yields reflect a less stable macroeconomic and political background. Political risk is elevated and economic imbalances have grown.
3. Empirically, the relationship between bond yields and equity valuations has not been that strong.
4. Lower bond yields should have a more significant impact on some sectors than others. The largest re-rating so far has occurred in growth stocks, rather than bond proxies.



Source: Refinitiv Datastream, Evans & Partners

Recommendations

Our conclusion from this analysis is that it is likely equities will trade at a somewhat higher valuation than history for an extended period, given the greater demand for equities that will potentially come from yield investors switching into shares.

As a guide we estimate this may result in Australian equities trading at a price to earnings ratio (PE) of around 15x compared with the long term average PE of around 14x. At the moment this means that the ASX 200 will start to look more interesting at an index level of around 6,200 points and we will look to review our market recommendation at around this level.

At a sector level, sustained lower yields are a more compelling argument for holding bond proxies such as REITs and infrastructure. These are the sectors that should benefit most from the migration of yield investors, yet this does not appear to be reflected in valuations to date.

Is TINA real?

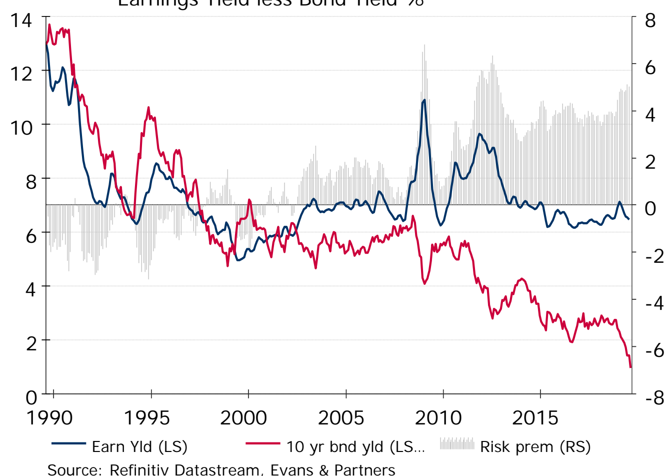
One of the difficult questions for investors is whether equity valuations deserve to be higher because of the recent large falls in interest rates. Equity valuations have been driven higher in recent years with low interest rates and the lack of other compelling investing options cited as key reasons. This rush into equities has been labelled TINA as in *There Is No Alternative*.

On one level it seems inevitable that flows into equities will occur as a result of the collapse in yields in interest rate securities. The reality is that equities appear to be the only major asset class where investors could have the potential to make decent returns on capital over the next few years. But on another level it seems dangerous to push the argument too far because you are effectively saying that one asset class (equities) should become more mispriced, because another asset class (debt) is already extremely mispriced.

The case for higher valuations

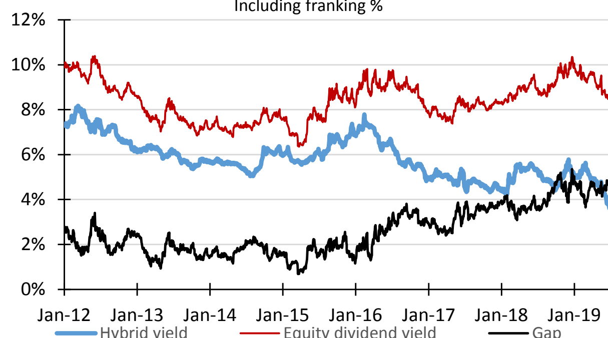
The TINA argument is a reasonably compelling one and there is little doubt that equities have a better *relative* valuation than bonds. Bonds and almost every form of listed debt instrument are the most expensive they have ever been.

Some of my favourite charts related to this are shown below. The first compares the Australian bond yield and the Australian earnings yield. The earnings yield is simply the inverse of the PE and moved closely in line with bond yields between 1990 and 2007. Since then, the divergence has continuously expanded and is now approximately 5%.



Source: Refinitiv Datastream, Evans & Partners

Another way to illustrate this is looking at the gap between the yield on bank hybrids and bank equity. Hybrid prices have surged since the federal election and this has taken the average yield to maturity on bank tier 1 hybrids down to around 3.5% (including franking), which is a record low. This makes bank equity attractive on a relative basis, considering the dividend yield including franking is around 8.5%. A 5% gap between these asset classes over the same underlying companies has never occurred before.



Source: Datastream, Evans and Partners

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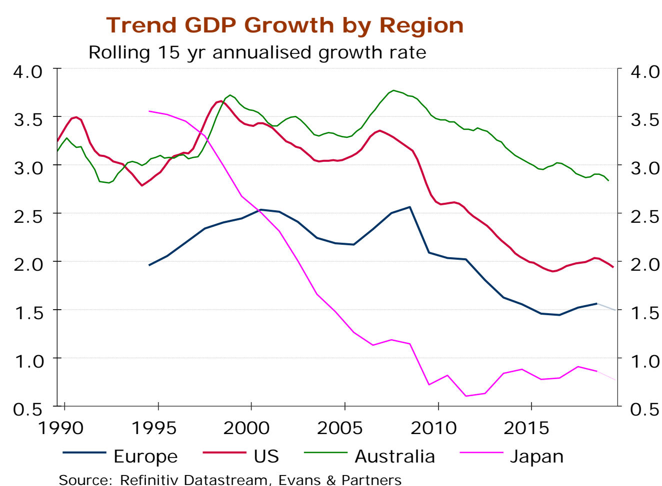
But how far should we push this?

However, investors need to bear in mind a few factors before they get carried away with declaring a new paradigm for equity valuations.

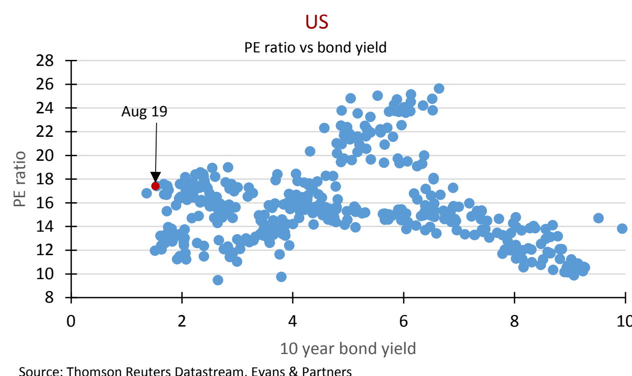
1. Lower bond yields partly reflect weaker economies. The fall in bond yields during the 1980s and 1990s was unambiguously positive for equities because it mostly reflected lower inflation. Investors were effectively discounting the same earnings profile at a lower discount rate. But in recent years at least part of the fall in yields reflects lower trend rates of economic and earnings growth. The chart below shows the decline in the trend rates of Gross Domestic Product (GDP) growth for various regions since the financial crisis.



Source: Refinitiv Datastream, Evans & Partners

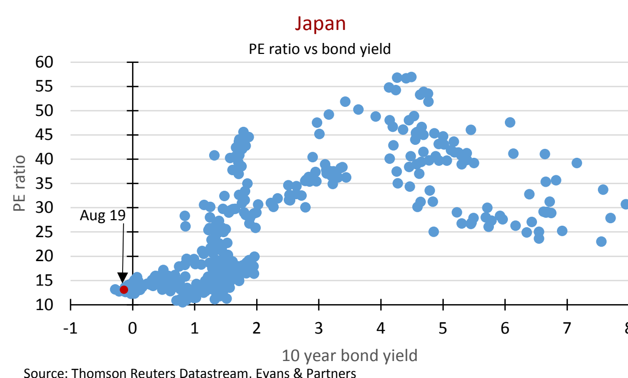
2. Lower bond yields also reflect a less stable macroeconomic and political background. Over the past decade political risk has been elevated, including instability in Europe and growing tension between China and the US. There are also significant economic imbalances such as high debt levels in the US and China. Such elevated risks justify some increase in the risk premium for equities relative to bonds.

3. Empirically, the relationship between bond yields and equity valuations has not been that strong. The chart below shows this over time for the US. The dots shows the PE ratio and bond yield at the end of every month since 1982. If there was a strong relationship between the two then the line of best fit would be from top left to bottom right. This scattering shown appears more random.



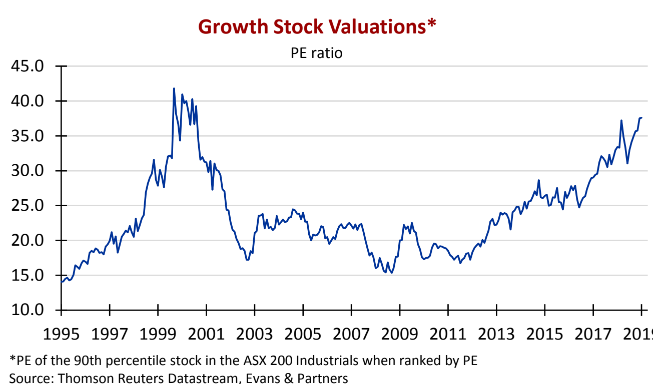
Source: Thomson Reuters Datastream, Evans & Partners

The chart below shows a similar exercise for Japan which has experienced a more significant economic change over this period and a long period of very low rates.



Source: Thomson Reuters Datastream, Evans & Partners

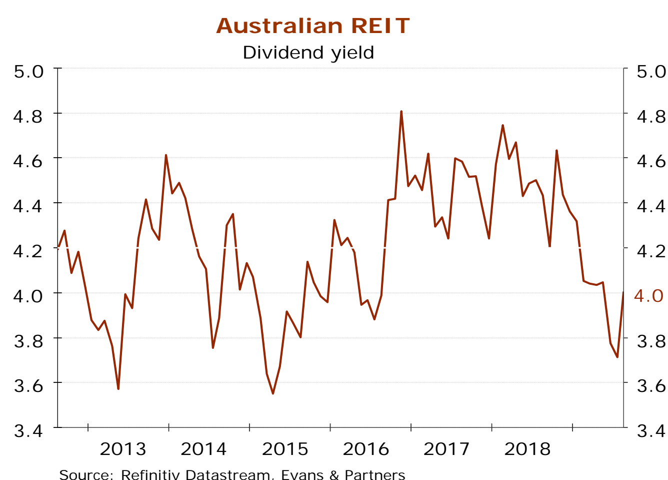
4. Lower bond yields should have a more significant impact on some sectors than others. The largest increase in valuations should have occurred amongst bond proxies (those stocks with the highest yields and most stable dividend streams). However this is not where the largest valuation uplift has been to date. Instead it has occurred amongst the industrial stocks, particular the growth stocks that already had high PEs. As a result the valuations of the 'best' stocks have surged.



*PE of the 90th percentile stock in the ASX 200 Industrials when ranked by PE
Source: Thomson Reuters Datastream, Evans & Partners

The rationale for higher-growth stock valuations is the scarcity factor – at a time when fewer companies are achieving growth, investors are willing to pay more for companies that can demonstrate it.

By contrast, valuations of sectors like the REITs are only slightly elevated relative to history. The chart below shows that the dividend yield for Australian REITs is not significantly lower than historical averages.

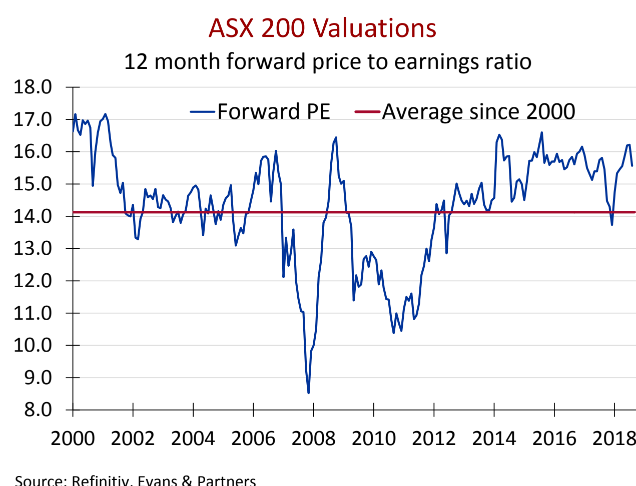


Source: Refinitiv Datastream, Evans & Partners

Putting this together

Our conclusion from this analysis is that it is likely that equities will trade at a somewhat higher valuation than history for an extended period given the greater demand for equities that will potentially come from yield investors switching into shares.

Forward PEs may trade above long term average PEs (around 14x), but exactly how much higher is difficult to estimate. Our guess is that number is around 15x. We will be reluctant to chase equities at higher valuations than that given our arguments on why yields should be lower and risk premiums higher. At the moment this means that the ASX 200 will start to look more interesting at an index level of around 6,200 points and we will look to review our market recommendation at around this level.



Source: Refinitiv, Evans & Partners

At a sector level, sustained lower yields are a more compelling argument for holding bond proxies such as REITs and infrastructure. These are the sectors that should benefit most from the migration of yield investors, yet this does not appear to be reflected in valuations to date.

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