

# the market view: UK

June 2007



**Ian McVeigh** of Jupiter Unit Trust Managers believes there is still plenty of value left in UK equities.

After four years of rising equity markets, investors seem to be turning increasingly cautious. Slowing US growth and rising UK interest rates are further fuelling their fears, as do newspaper stories about how equities are at seven-year highs.

I would view it the other way round. Equities have only gone back to where they were seven years ago and I can see plenty of scope for them to make further progress from here. In my opinion, investors have yet to take into account two major factors: the sheer scale of earnings growth over the past six years and the large valuation gap between equities and bonds.

## value in equities

Between 2000 and 2006, cumulative earnings growth in the UK was 68%. This growth remains strong, supported by firm domestic and global economies and robust consumer demand. Rising inflation and the strong housing market are pushing up interest rates but I believe the equity market still looks undervalued against the current level of interest rates, as the prospect of robust earnings growth continues to call for further equity re-rating. The UK market's average prospective price/earnings ratio is currently around 13x, well below the

23x recorded at the end of 1999 when interest rates were at about the same level as now. So we see no danger of an equity bubble forming any time soon.

The second reason why equities should have further scope to appreciate is that their valuations are at low levels compared with bonds. Over the past 30 years there has been a strong correlation between equity and bond valuations, but this has recently broken down. When the TMT bubble burst in early 2000, weak equity markets led to large pension deficits and employers were forced to inject large amounts of money into their employee pension schemes. Pension funds are increasingly reluctant to take that risk, as their main imperative is now to match liabilities rather than to make profits. They have been selling equities and buying bonds on a massive scale as a result.

## growth fuelled by cheap debt

Even so, over the last four years equities have continued to appreciate steadily, helped by the high level of M&A activity and companies' share buyback programmes. Debt has been very cheap in a low interest rate environment.

Private equity companies have taken advantage of opportunities created by this mismatch between equity and bond valuations, borrowing at around 4% to take over companies which provide an 8% earnings yield. I expect these conditions to persist for some time, continuing to boost corporate activity. Companies are also likely to continue to buy back their own shares, improving shareholder returns in order to fend off potential hostile takeover approaches.

A further point to note is that equity volatility has now become much lower, and I expect this to prompt institutional investors to reconsider their strategies and start buying equities whose valuations are undemanding. This could lead to a considerable re-rating of equities.

## immediately optimistic

I remain optimistic about the outlook for UK equities, although I would not be surprised if volatility edges up in the short term from the current very low levels. I believe that investors will be very well rewarded on a three-year view, which is typical of the time horizon one has to take when holding equities. ■

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