

Weekly Note

To us there are no foreign markets.™

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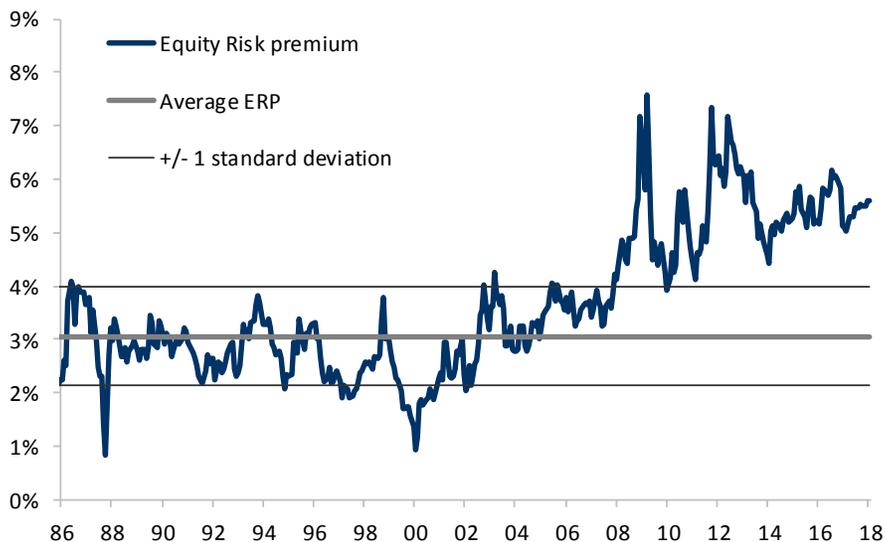
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There is a light that never goes out

We've written a lot about equity market valuations lately, which are no longer cheap but not quite expensive. This week we consider the modest rise in the equity risk premium (ERP) last year (figure 1), and consider if the market should have a higher valuation than it does now. We conclude that in theory it should, but in practice it's not a bad thing that it is not, priced for where we are today with earnings growth and low but rising interest rates. There is a light, and it may never go out, but the market may be pricing for it to flicker.

Figure 1: US Equity Risk Premium



Source: Datastream, Canaccord Genuity Wealth Management

We use an ERP to calculate the implied valuation of the US equity market, taking in to account interest rates, bond yields, and consensus earnings forecasts out to five years from now. We assume that from fifteen years hence earnings growth reduces to the growth potential of the US economy, which is just under 2.5%, and that earnings growth follows a straight line from five years to then. All this, we assume, is correctly discounted by bond yields at the appropriate maturity. The result is an ERP which has been rising for the past year or so (Figure 1).

Since 2008 there has been a light under the market and to many it has seemed as though it would never go out. Last year we saw the ERP rise from 5.0% to 5.6% suggesting that equity markets may be beginning to price a slight dimming in that light – may be no bad thing if, down the line, it starts to flicker. Equity valuations may no longer be cheap, but they are also getting comfortable with higher bond yields. We can't help but notice how higher bond yields this week really didn't trouble equity markets – maybe 2018 will mark the orderly adjustment between the two?

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