A longer-term view

Sars masks an essentially healthy outlook for investors. JOSEPH CHONG puts things in perspective

Business Times - 14 May 2003

THE outbreak of severe acute respiratory syndrome (Sars) is currently a big worry, and rightly so as the consequences could be catastrophic if mishandled. However, looking three years forward, I believe it will not rank among the more serious illnesses in the history of mankind. It will be nowhere near as destructive as the flu of 1918-1919 which reportedly killed 20 million people worldwide.

I am optimistic in the medium-term because the authorities worldwide understand that until a vaccine or cure is found, quarantine is the most effective strategy. Mathematically, if every new infected person infects two others in a week, there will be about 67 million infected in the 26th week. Reduce it from two to 1.2, and only 114 will be infected in the 26th week.

Unfortunately, Sars will be a drag on the global economy, especially Asia, until it is effectively contained. While the macro outcome of Sars is clear, its threat to the individual is somewhat of a lottery in reverse. As with all other major risks, this could be mitigated by being properly insured.

The economic effects of Sars are debilitating in the short-term as some affected industries will go under. But things look different further out on the horizon. And, by definition, investing is an exercise for the far-sighted. For equities, investors typically perform a discounted cash flow or dividend discount analysis into perpetuity to calculate the present value.

One derivative of such analyses is the US Federal Reserve equity valuation model first published in 1998. Essentially, this model assumes that at fair value, the earnings yield on stocks should be equal to the US government 10-year bond yield. Stocks currently trade at about 6-7 per cent earnings yield in the major markets, while 10-year government bonds offer about 4 per cent.

Based on the model, stocks are currently 40 per cent undervalued relative to bonds. At the height of the equity bubble at end-1999, it was just the reverse: stocks yielded about 4 per cent while bonds offered about 6 per cent. The model signaled that the equity market was 40 per cent overvalued relative to bonds then. We currently appear to have a situation that is a mirror image of 1999.

Other signals we should not ignore:

- The large amounts of investor liquidity. The value in money market funds relative to the Wilshire 5000 (virtually the entire market capitalisation of the US) is 28 per cent. During the previous decade, the figure was never above 15 per cent. Should this ratio fall back to 15 per cent, a potential US$900 billion could move into stocks. Behind the dam is a mountain of water.
- The stock of communications and computing equipment relative to GDP has fallen far below long-term averages. A reversion to the mean would translate into a significant acceleration in business spending, boosting equities and real economies.
- First-quarter 2003 operating earnings were ahead of expectations. Although profit grew faster than revenue, this is still a big positive as companies need to be profitable before they can invest, thus expanding the overall economy.

Bonds are dear. Both short-term and long-term OECD real bond yields are at historical and statistical lows. For example, 10-year bond yields are at about 2.2 per cent versus the historical average of 3.5 per cent. Bond investors could suffer a potential double whammy of re-inflation and a reversion of real bond yields to historical averages as the demand for capital accelerates with an economic recovery.

In the final analysis, we would recommend that one needs to be adequately insured, have emergency cash set aside, get that will written, and continue investing. Indeed, this is what we would recommend even without the sword of Sars hanging over us.

The writer is managing director of New Independent, a financial adviser