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What's driving the UK equity market?

Published on: 2 June, 2017 | Author: Investment Team

Why are UK stocks trading at all time highs whilst the political picture is so uncertain?

We have written many times before about how valuation is the primary driver of equity returns over the medium term. The price you pay for an investment today has a disproportionate influence on the return you can hope to achieve from that investment in the future. There are many measures of an equity's value: the price you pay for a year's income, the price you pay for every Pound of value on its balance sheet, the current dividend yield it pays to you. All valuation measures are subjective in some way. The value of a balance sheet can be written down by a bad investment decision taken by a company whilst the earnings a company generates will fluctuate from year to year.

To help manage against these risks, economists have derived CAPE, the cyclically adjusted price to earnings ratio of a company. It is a valuation measure which aims to smooth out the earnings volatility exhibited by companies by using an average of ten years of earnings (adjusted for inflation). This reduces its volatility due to individual events such as 2008, however, most importantly, it provides an indicator of the price being paid today for the average longer term earnings generated by a company. As with a standard price/earnings ratio, a high number implies expensive and a low number cheap.

A company called Star Capital calculates the CAPE for most equity markets from the United States to the Philippines at each calendar quarter end to assess prevailing value. Interestingly, the US equity markets is trading on a CAPE of 27.5 times earnings, with Ireland and Denmark the only more expensive markets at present. This in itself is not an issue as the US market has traded at high CAPE ratios before and this is not a precursor to an imminent fall in the S&P 500. What is interesting however is that the UK equity market is trading on a CAPE of 15.3 times earnings, a near 50% discount to the US. It is also one of the cheapest developed markets on this measure, behind only Spain and Italy.

Now, history does not repeat itself, but it can rhyme. The UK equity market hitting new all time highs does not mean that it is expensive, nor does it mean that it will fall or rise over the coming year. For one, the 'real' value of UK equities it not at all time highs as inflation has eroded this by over 30% during the past decade alone. Secondly, the companies listed in London are 10% cheaper for overseas buyers today than they were prior to the Brexit vote (due to the devaluation of Sterling). These two factors might just help explain why UK equities are continuing to rise.

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