

Yes, equities are cheap

Even taking into consideration risks, some interest rate increase and the different treatments of goodwill depreciation, prices are not stretched in the euro-zone.

By Juergen Trojan*

The stock market is gradually recovering from the unnerving break it suffered in May-June and is regaining a new lease on life. In fact, the setback fits in well with the seasonal pattern that typically shows some weakness in the May-October period, to be followed by an advance in the subsequent months. In my opinion, the DJ Euro Stoxx 50 - currently changing hands around 3,800 - has the potential to move toward 4,000 or even 4,500 after the traditional weakness of September and October.

I would like to emphasize that, yes, stocks are cheap in the standard comparison with bonds and also if we take into consideration some adjustments to account for risks, expectations and changes in the rules. Tracking it through history, usually earnings yields are in line with bond yields. When earnings are below government bonds rates you may have a good buy opportunity in the stock market. This method has been amply discussed as the Fed model.

Once before, in the 1990s, it

worked pretty well, and you could foresee the year end target for the German Dax with a range of 2-3%. What about now? The DJ Euro Stoxx 50 is going for 12 times earnings. Turn it around, and you have an earnings yield of 8.3%. That's far higher than 10-year bond rates, currently at 3.8-4%, suggesting stocks are

attractively priced. However, some adjustments are necessary.

First of all, the change in the treatment of goodwill depreciation has boosted earnings by approximately 20% as far as the DJ Euro Stoxx 50 is concerned. This cuts the earnings yield to 6.6%. Then, let's assume interest rates are on their

way up and add some risk. With this in mind, we have 6.6% for stocks and say 5% for bonds: the spread has tapered off, but keeps on favouring stocks.

Bottom line? European bourses are not expensive. If the DJ Euro Stoxx 50 rises to 4,000, or even 4,500, it does not cease to be in line with the fundamentals. I would not anticipate a move into the expensive area because conditions are not appropriate for this to happen.

Equally significant is the fact that the



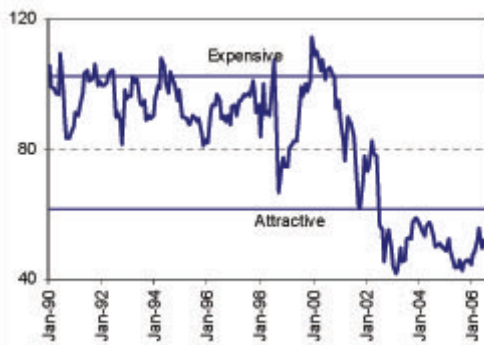
Juergen Trojan

market action itself is somewhat encouraging, if not convincing. When shocks occur, the market seems strong enough to survive. Remember when oil prices were consistently rising? Stocks refused to go down and only for a few days during the Israel-Lebanon war did buyers retreat. Or do you remember when British police announced they had arrested several people in connection with a terrorist plot to blow up aircraft flying from the United Kingdom to the United States? Well, market participants did not lose their nerve and the intra-day fall was as modest as 2%. Both may be signs that our bourses are perhaps in good shape.

Some weakness may be associated with September and October - months traditionally vulnerable to setbacks but thereafter I would not be surprised if there was a successful attempt to reach new highs. Liquidity and valuations are there.

***Juergen Trojan, advisory, member of DVFA**

Fed model and the Pan-European market



Continental stocks are very attractive based on the classical Fed model which compares earnings yield with bond yield. Some say the model is not working any longer. Some say it is a good time to buy.

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