



**CAUTION – VOLATILITY INDEX STARTING TO RISE**

Independent Insight in an Uncertain World Plexus Global stock markets experienced a precipitous, nerve-racking fall during the first few days of August. This decline was fuelled by a number of poor economic reports, especially the non-farm payrolls data out of the US and global GDP data that are starting to soften. Added to this, speculation levels surrounding the outcome of the European debt crisis shot up amidst the seemingly unending ripples that this evolving story has been sending through the world's equity bourses.

After a decline of 8,9% during the first week of the month, the FTSE/JSE All Share Index made an attempt at a bottom. However, the damage overseas was far more severe, with the MSCI World Index and the MSCI Emerging Markets Index both declining by nearly 14%. European markets suffered the worst declines, however, with the French CAC losing 18,2% and the German DAX 21,6%. All of this happened in the space of only eight trading days!

Investors are currently extremely jittery. At the slightest hint of negative news we see equity markets taking the punch as risk-off trades dominate the market. The latest sell-off left investors a bit shell-shocked to say the least, as some blue chips were among the hardest hit, especially banking stocks. Investors would be hoping that this was indeed the bottom of the fall, but if history is anything to go by, even lower values might still be in the pipeline in a very volatile trading range in the medium term.

Historically these severe sell-offs do not normally correct overnight. Rather, some time is required for market players to digest the avalanche of bad news and of course the possible outcomes. In fact, quite a bit of time might be needed as the Greek default issue is being drawn out by some big European players, especially the ECB. Whilst a Greek default would not be desirable (if not probable), a default in Spain or Italy would have a much more severe effect on the markets.

Plexus is of the opinion that a "calmer" trading environment after the big falls recently may still be some way off though. Unfortunately, for those wanting to get back into the market, the message of the South African Volatility Index (see accompanying graph) is that the market has yet to calm down from August's extraordinary volatility, and may not yet be safe for investors to jump back in. While the South African Volatility Index is a relatively new technical consideration, it is already evident that once it starts hitting the higher levels the equity market is in danger of falling.

The barrage of negative economic data emerging globally and domestically has also put the South African Reserve Bank in two minds about rates going forward. Despite the fact that inflation is edging higher, the market is now starting to price in a possible rate cut at more than a 50% chance. As we all know, lower interest rates should act as a boost for equities as cash is more freely available for transactions and purchases, effectively boosting the economy, company earnings and share prices. Hopefully this will act as a buffer against possible further downside for the domestic equity market.

So what are investors to do? Conservative investors should stay on the sidelines for now in favour of the safety of cash or fixed-interest

assets until the high levels of volatility begin to diminish. However, as history has shown, this could take a number of weeks. Investors who can tolerate risk could follow a more aggressive strategy by averaging their available cash in on any big price declines over this period.

**FTSE/JSE ALL SHARE INDEX WITH SOUTH AFRICAN VOLATILITY INDEX**



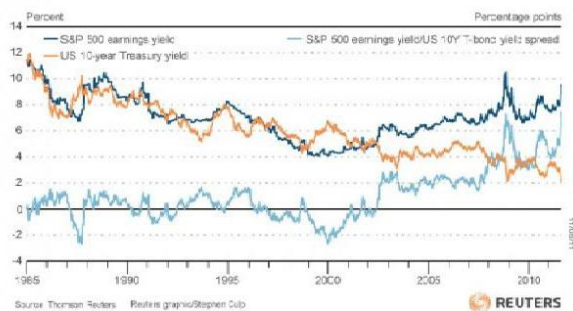
**DOES THE FED MODEL JUSTIFY BUYING EQUITIES?**

Firstly before we even start this debate, it is only fair to take a step back and explain what the Fed model is and what it attempts to do. In simple terms it is a model that compares the valuations of 10 year bonds to equities by comparing their respective yields. It argues that when earnings yields are above bond yields, shares are cheap relative to bonds and vice versa. Interestingly enough this model has not actually been endorsed by the Fed, but was penned by Ed Yardeni who came up with the concept when working at Prudential Securities (*Some of our readers might remember Ed Yardeni as the analyst who rose to fame over concerns about Y2K, but I digress.*)



In the graphs below, one can see that earnings yields are currently way above bond yields and, in fact, if the earnings yields are subtracted from bond yields, the difference sits at over 7%, the highest it has been in over 25 years. Based on this information, surely one should throw caution to the wind and buy equities and sell bonds?

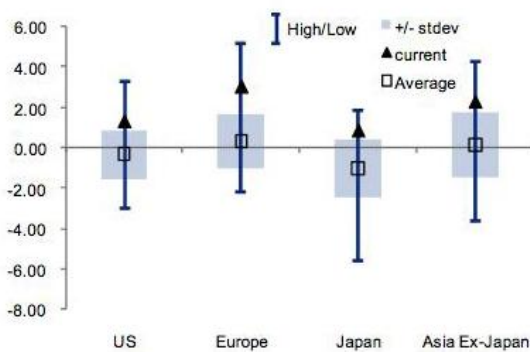
### The great earnings-yield divergence



Source: Thomson Reuters, Reuters graphics/Stephen Cole



**Exhibit 3: Dividend yields are high vs. real bond yields**  
Dividend yields minus 10-year real government bond yields. We use five-year avg. inflation as a proxy for inflation expectations. The distribution uses data from 1990 except for Asia ex-Japan where it is from 1995.



Source: Datastream, Haver Analytics, Goldman Sachs Global ECS Research.

Image: Goldman

However, as the FT has recently argued, the problem with the Fed model is that it does not always work (proving once again that there really are no holy grails in markets). If history is any guide, the Fed model would have indicated that shares were a lot more attractive at the start of the 1970s equities bear market than at the start of the bull market that began in 1982. In addition, earnings yields are a notional concept and tell one nothing about real cash flow, whereas bond yields are a true account of cash flow yield, for bond investors have no choice but to pay.

The same can't be said for the dividend yield, which for the most part is a good indicator of actual cash paid by companies and in this respect, equities are indeed offering a better alternative to bonds. The graph above indicates the difference between the dividend yield and the 10 year real bond yields (adjusting for inflation) and in every region, shares are offering value on this measure. Naturally one is assuming that dividends will grow, unlike coupons which are fixed, hence the reason for comparing dividends to real bond yields. As an example, the Euro Stoxx 50 yields 5.32 per cent - more than double German Bunds. But, before you mortgage the house, take note of the fact that this has been the case in Japan since 08 and it has not helped the hapless Japanese investors.

Bottom line: Dividend yields on stocks are attractive and help justify buying stocks in absolute terms, if one believes earnings forecasts (a topic for another weekly view). But to just compare bond yields to equity yields is not reason enough to buy shares. All it might be telling us is that bonds are expensive, not necessarily that shares are a screaming buy.

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2nd September 2011