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Are shares good value & what about bank deposits?

Key points

- Shares are cheap using forward price to earnings (PE) ratios and when comparing the level of the dividend yield to the bond yield. Thanks to low government bond yields and higher dividend yields, shares should provide a good risk premium over bonds for the decade ahead.
- While Australian bank deposit rates are attractive for risk-averse investors, the 5% plus dividend yield on Australian shares once franking credits are allowed for means that only modest capital growth is required for shares to outperform bank deposits.

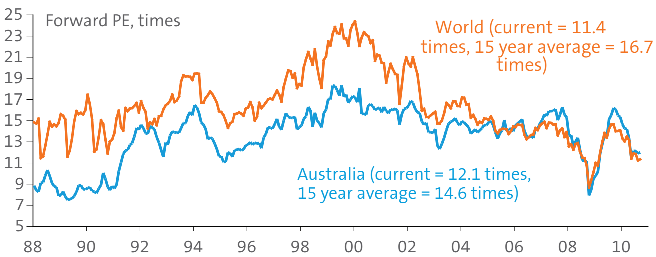
Introduction

Shares have had a good rally over the last few weeks as US and Chinese economic data has surprised on the upside. However, apart from Asian and emerging market shares, most share markets are still well below their April highs and uncertainties about the strength and sustainability of the global economic recovery remain. But the big question for long-term investors is whether shares offer decent long-term return prospects compared to alternatives like government bonds and bank deposits.

Price to earnings multiples and the Shiller PE

The simplest way to value shares is to compare share prices to the level of earnings (i.e. the PE). The chart below for US and Australian shares shows that when consensus 12-month-ahead earnings are used, shares aren't as cheap as they were early last year, but PEs are still below average levels seen over the last 15 years.

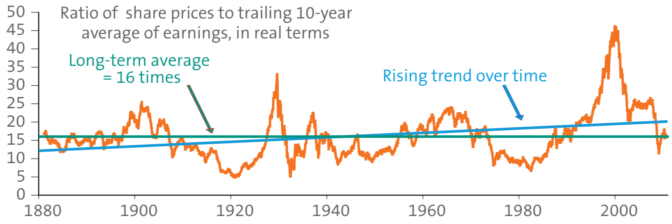
Shares are cheap



Source: Bloomberg, AMP Capital Investors

Another approach, which is designed to smooth out cyclical swings in the level of earnings, is to use a 10-year trailing average of the level of earnings. This approach, popularised by Robert Shiller in his book *Irrational Exuberance*, suggests that while US shares are not expensive like they were at the height of the tech boom, they aren't cheap either (see next chart). The Shiller PE has a long-term average of 16 times and it's currently right in line with this, suggesting just average returns going forward.

US shares are around their long-term average PE



Source: Global Financial Database, Thomson Financial, AMP Capital Investors

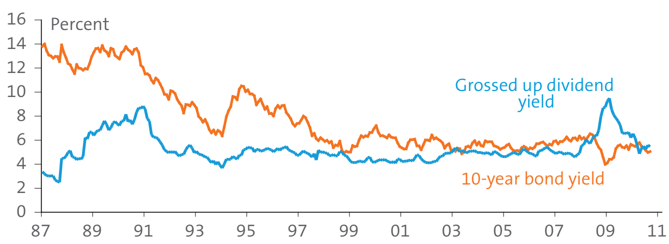
Many argue that since the Shiller PE moves around its long term average over time, this would mean it needs to move lower to offset the period where it was well above average (i.e. 1995 to 2007), ultimately taking the PE back to the sort of lows reached in 1920, 1932 and 1982. This would suggest more downside for shares ahead. The general tendency is for high PEs to precede low returns and vice versa.

However, it's not clear the Shiller PE has to fall to past extreme lows. Today, shares are highly liquid, transaction costs are very low and it's easy to set up a diversified portfolio to reduce overall risk. This was not the case 50 or 100 years ago. As a result, it's likely the fair value line for the Shiller PE may be trending higher over time and on this basis US shares are cheap. The conclusion seems to be that while US shares are not offering the spectacular returns which followed the malaise of the 1970s/early 1980s bear market, the level of the PE is consistent with low positive returns over the next decade.

Comparing dividend yields to bond yields

The more important issue is to compare the sort of prospective return from shares to that of other assets. An obvious alternative is government bonds. The next chart compares the dividend yield on Australian shares to the 10-year bond yield. While the gap between the dividend yield grossed up for franking credits and the bond yield is not as extreme as it was during the global financial crisis (GFC), it is positive again. This means shares now provide a slightly higher cash flow than government bonds, with only modest capital growth required from shares to produce a decent excess return over bonds.

Australian shares are paying a grossed up dividend higher than the bond yield



Source: Thomson Financial, AMP Capital Investors

The equity risk premium

A more formal way to compare the prospective return from shares versus bonds is to calculate what is known as the equity risk premium (ERP). Over very long periods, the excess return of shares over bonds has varied. Over the period since 1900 it has averaged 4.4% p.a. in the US and 5.9% p.a. in Australia. However, the realised ERP over the last 110 years was probably exaggerated by a low starting point for the PE ratio, making it easier for shares to produce decent returns. Our assessment is that the appropriate ERP going forward is around 3.5% for developed market shares and around 4% for Asian and emerging shares.

A simple way to think of the prospective (or likely) ERP for the next five to 10 years at any point in time is as follows:

Likely ERP = dividend yield + growth rate - bond yield

The growth rate is the growth rate in share prices. This is assumed to equal the long-run growth rate in profits, and this in turn is assumed to equal long-term nominal growth in the economy. This approach makes intuitive sense as the return on shares equals dividend income plus capital growth. The next table provides current figures for each of these, the prospective ERP and, for comparison purposes, our estimate of the required ERP.

The prospective ERP over the next five to 10 years (% p.a.)

	Dividend yield plus	Growth less	10-year bond yield	= Likely ERP	Required ERP
US	2.0	4.8	2.7	4.1	3.5
Europe	3.5	3.8	2.4	4.9	3.5
UK	3.3	4.0	3.1	4.2	3.5
Japan	2.0	2.8	1.1	3.7	3.5
World	2.5	4.6	2.4	4.7	3.5
Asia	2.3	8.0	2.7 ^	7.6	4.0
Emerging	2.7	7.0	2.7 ^	7.0	4.0
Aust	5.4 *	5.5	5.0	5.9	3.5

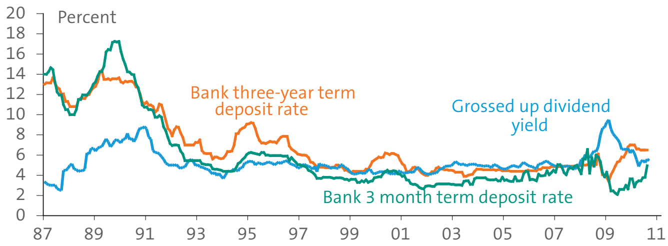
^ Asia and emerging share estimates assume US bond yield. * Includes franking credits. Source: Bloomberg, AMP Capital Investors

This suggests it's **likely that ERPs for shares are still well above what we think is required. This is particularly the case for Asian and emerging shares.** These estimates are far more attractive than was the case in 2007 when the last cyclical bull market peaked and when Australia offered a prospective ERP of 3.6% and the US 2.5%.

But what about high bank deposit rates?

Another comparison many are now making in Australia is to bank interest, with term deposit rates having risen. This, along with the volatility in share markets over the last few years, has increased the attractiveness of bank deposits. According to the Westpac/Melbourne Institute's September consumer sentiment survey, 31% of consumers nominate bank deposits as the wisest place for savings, which is up from 17% three years ago. This compares to just 11.5% nominating shares as the best place for savings. The next chart shows the dividend yield on Australian shares against average bank term deposit rates for three months and three years on deposits of $10,000 or more.

Australian grossed up dividend yield v bank term deposit rates



Source: Thomson Financial, Reserve Bank of Australia, AMP Capital Investors

Several points are worth noting. First, excluding the period of the GFC, the current relationship between the dividend yield and bank term deposit rates is not particularly unusual compared to that of the last decade, where periods of higher rates from term deposits occasionally occurred. In fact prior to 1997, bank term deposit rates tended to run well above the dividend yield. If bank depositors think they have it good today with three-month term deposit rates of 4.95%, this is nothing compared to 1989 when such rates were around 17% and more than double the dividend yield.

Second, while bank deposits offer security and are a good option for the risk averse, the term deposit rate is all an investor will receive over the term of the investment, whereas with shares there is the prospect of capital growth as well. For example, if share prices rise in line with nominal gross domestic product growth of, say, 6% p.a. over the next three years, then this will provide a total return of just over 11% p.a. once dividends and franking credits are added in. This is well above the average three-year term deposit rate of 6.5%.

Third, just as some banks may offer even higher deposit rates than shown in the chart, some shares pay even higher dividend yields, e.g. utility stocks and bank stocks are paying average dividend yields of more than 7% allowing for franking credits. So **bank shares are arguably better value than bank deposits!**

Finally, bank deposit rates in other major countries are nowhere near as high as in Australia. In fact in the US they are near 1%, which is well below the US dividend yield.

Conclusion

While near-term uncertainties remain, shares do seem to offer reasonable value compared to bonds and bank term deposits for patient long-term investors.

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