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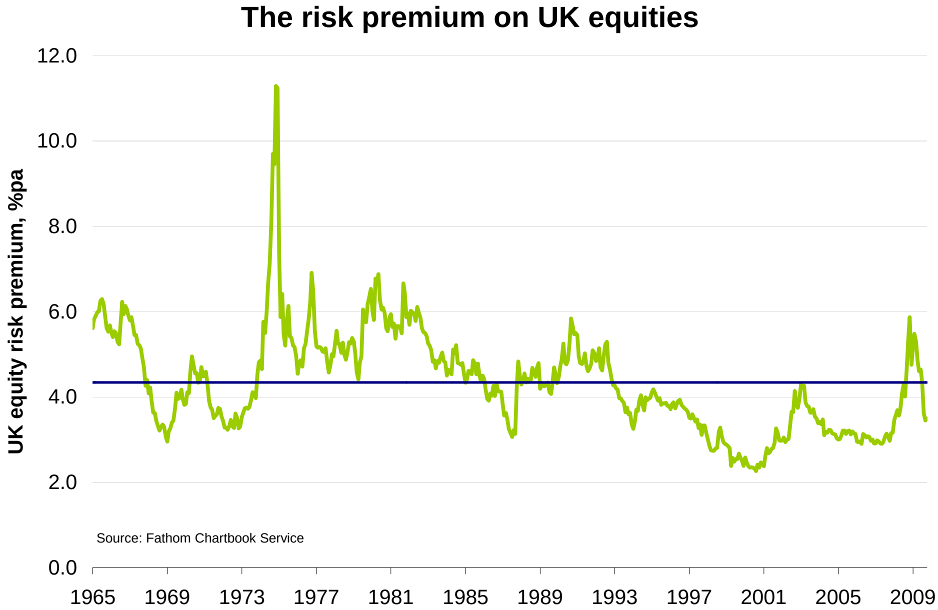
Over the last few months I have expressed a relatively bearish view of global equity markets and the UK stock market in particularly. And following each bearish article the market has simply shown me the proverbial 'V' sign and sailed on upwards in its merry, policy-inflated way. But undeterred by this ongoing humiliation, I am still unconvinced about the value case for many stock markets at the moment.

The headwinds facing much of the developed economies of the world should not be underestimated: savings ratios have to rise, debts will have to be repaid, public spending will have to be cut and taxes will have to increase. But it seems that equity investors are banking on a 'normal' recovery, a recovery where saving rates gradually fall as households become more confident about the world and where companies gradually increase investment because business leaders see an increase in profitable business opportunities. This is the sort of economic cocktail that generates a positive backdrop for equities and one where equity prices naturally rise. But this recovery will be different; in fact it's still a bit premature to even talk about recovery in the case of the UK, since output is still shrinking.



This week's chart illustrates the fairly weak valuation case for UK equities. The green line in the chart represents our estimate of the forward-looking risk premium on UK equities. So at each point in time it represents the premium required on UK equities over the expected, or required long term return on long-dated gilts. The blue line in the chart represents the average of this premium over the last forty five years; an average that comes to just over 4.3%. In March of this year the premium touched 5.5% and it was higher still at the end of October 2008. Today that premium has fallen to around 3.5%. Is this enough?

The last time the premium was that low, and falling, was September 2003 and before that April 1997. In both cases, economic growth and profits growth in particular, picked up strongly to justify (at least in the short term) buying equities with a relatively low embedded premium at that time. Today, a short-term boost to profits is about the best that can be expected.

The equity markets still seem to have the liquidity fuelled and momentum driven wind in its sails. At some point that wind will weaken as the myriad of economic headwinds get stronger. This change in the wind will probably come about when the monetary authorities of the world begin to turn off the liquidity tap. Led by Australia, the process of monetary policy normalisation has already begun. And as inflation gradually creeps back into the developed economies of the world, more central banks are likely to follow suit. At this point I suspect that equity investors will begin to question two things. First, their assumption that interest rates will remain at their current very low levels indefinitely and second the related issue of equity market valuations that today look at best a bit expensive, as the chart shows.

Last October I confidently predicted that the lows reached by global equity markets back then would mark the bottom of the equity market downturn. Six months later however, in March of this year, they reached this bottom again and went slightly lower still, which just goes to show that only monkeys should pick bottoms! However, if you can forgive the March “blip” to my pronouncement, then equity prices back in October were pricing in almost the worst of all possible future worlds; one where capitalism would be virtually dead. Back then too, the implied equity risk premium on UK equities was over 6.0%. That was the time to buy equities.

The problem with today’s valuations is that equity markets now seem to be pricing in the best of all possible outcomes for the global economy. I cannot bring myself to share this view. While the future is definitely brighter today than it was in the months that followed the collapse of Lehman Brothers, it’s not that bright.

So to return to my admittedly badly stretched sailing analogy; if you are blithely sailing along on the global equity yacht at the moment you might, at best, become becalmed very soon, or worse be blown backwards towards the harbour again in the New Year.