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Global Strategy

Alternative view

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Popular Delusions

What to do when there's nothing to do?

Dylan Grice
(44) 20 7762 5872
dylan.grice@sgcib.com

Based on Shiller PE ratios, S&P500 valuations are back in their top historic quintile, historically this is a strong signal of poor long-term returns. Although Europe looks less egregiously expensive the investment case is far from compelling. So what do we do? The simple answer is nothing. The potential rewards being offered for the risks entailed in being aggressively overweight equities (or even just overweight) seem scant. But even when the macro case isn't interesting, there's usually *something* going on at a micro level. Some ideas for stocks and sectors which seem cheap in an absolute sense are given inside.

- It seems central banks botch exit strategies more often than not. In 1994 Greenspan's cack-handed removal of the emergency stimulus implemented during the S&L crisis triggered a bond market collapse which *severely* dented that year's equity returns. In 1998, the tardy withdrawal of the emergency stimulus implemented during the Asian crisis created the tech bubble. And in 2004, a similarly delayed withdrawal of the emergency stimulus implemented to combat the tech bust spawned the housing/credit bubble.

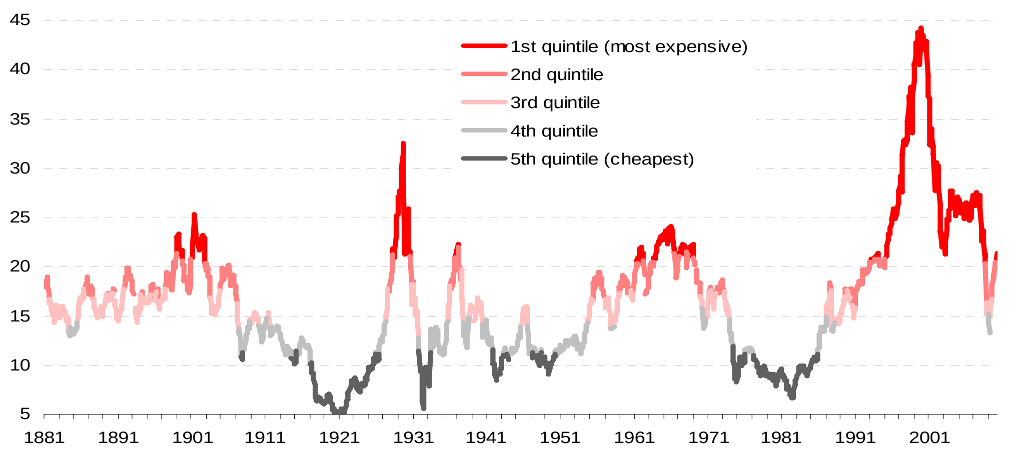
- Will the botched exit from this emergency stimulus resemble that of the 1994 vintage (bearish for risk) or those of 1998/2004 (bullish)? I suppose central banks might get lucky and smoothly engineer a 'normalisation' without any painful withdrawal symptoms … but in the real world credit growth remains subdued, as it did in Japan. If the economy double-dips – and Albert makes a convincing case it will - and fading stimulus leaves the economy in default-deleveraging mode, there won't be any exit strategy. There will be more QE ….

- If only my crystal ball was clearer ... fortunately though, no crystal ball is needed to see that equity markets are expensive. According to Robert Shiller's latest data, the S&P500 is back in its *highest valuation quintile.* The risk is there - as it always is - but the returns aren't. So what do you do? Go take a holiday if you can. Avoid the 'boredom trades'. But if you *have* to do something … some cheap stocks and sectors to think about are given inside.

Global Strategy Team
Albert Edwards
(44) 20 7762 5890
albert.edwards@sgcib.com

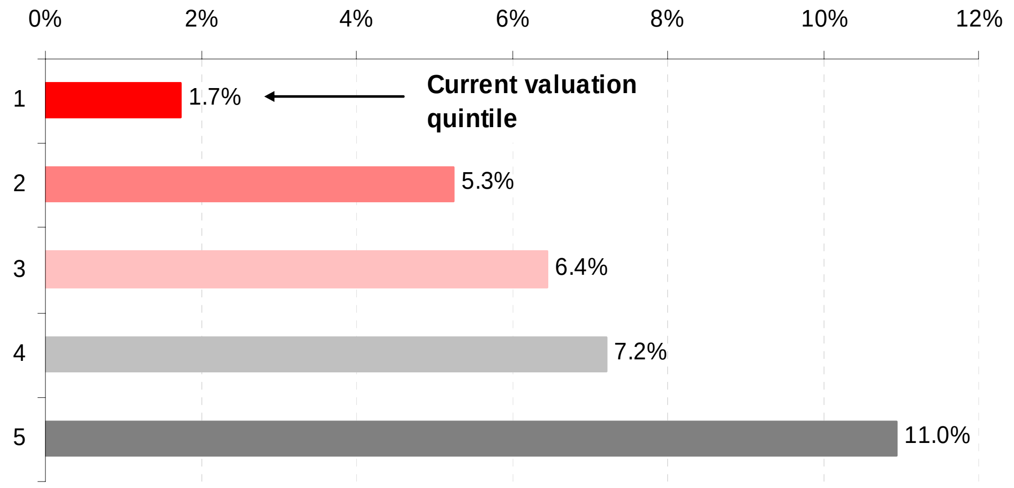
Dylan Grice
(44) 20 7762 5872
dylan.grice@sgcib.com

Return-free risk? Shiller PE now shows S&P to be in *top historical valuation quintile*



Source: Robert Shiller, SG Cross Asset Research

10yr returns following from using each valuation quintile as an entry point



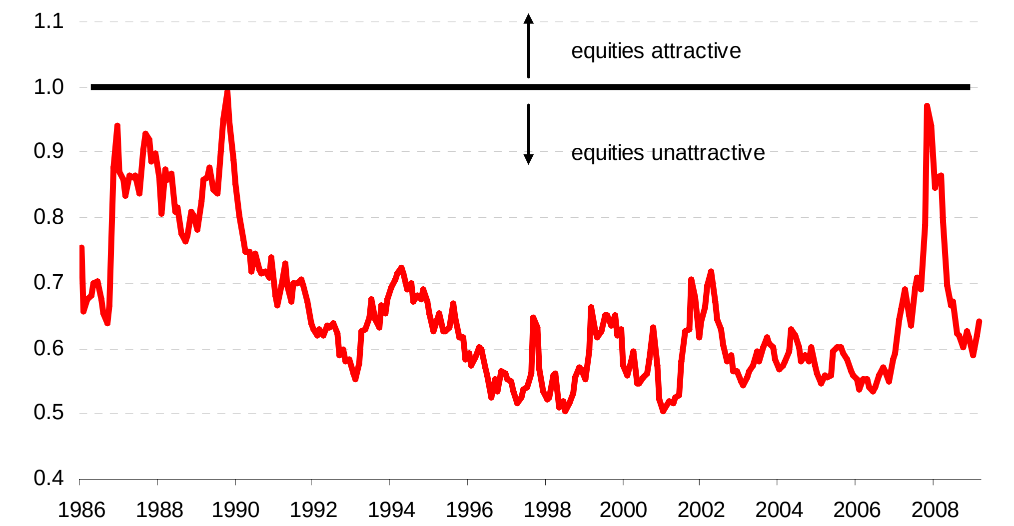
Source: SG Cross Asset Research

The chart above shows the 10y real returns which have accrued to investors using each valuation quintile as an entry point. If history is any guide, those investing today can expect a whopping 1.7% annualised return over the next ten years.

The bottom-up picture tells the same story. Regular readers know that I use a residual income model to estimate the intrinsic value of each stock in our universe (developed market, large and medium cap non-financials in the FTSE World Index). I aggregate those into an intrinsic value for the market. A more detailed discussion of the calculation is given here, but all I really do is assume that a company which earns only its required return is worth no more than its book value. By capitalising expected *excess* returns (defined as RoE less required return) onto book value I arrive at an intrinsic value which I can compare to the market price. This gives me an intrinsic value to price (IVP) ratio, the market aggregate for which is given below.

When the IVP ratio is 1.0, estimated intrinsic value equals market price. The market is 'fair value' which means it can be expected to deliver the required return (which I set at 10%). This was where we were a year ago. Today, the market is roughly as expensive as it's recently been.

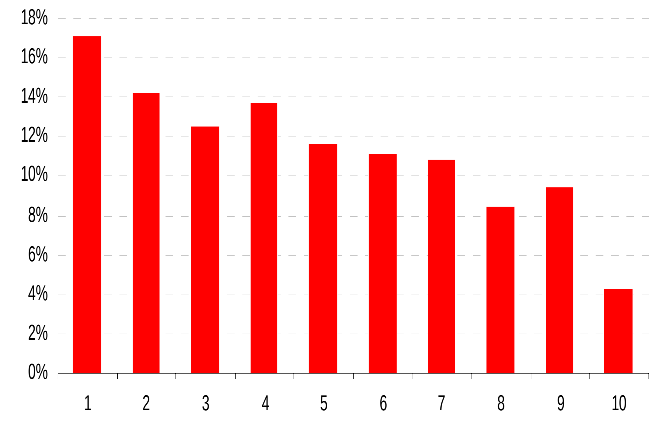
Bottom-up valuations giving the same message



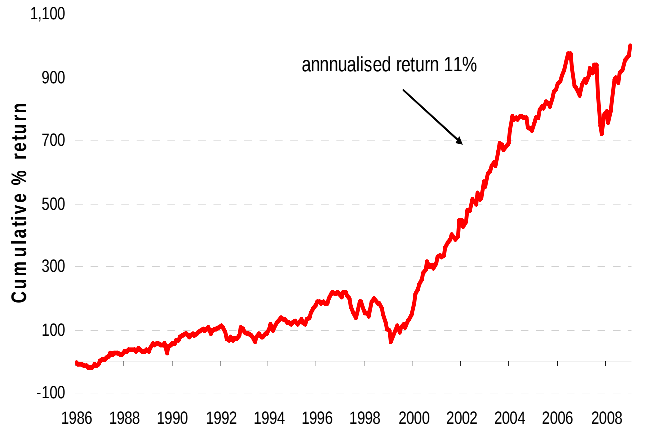
Source: Factset, SG Cross Asset Research

The IVP ratio isn't the perfect model by any means and there are a few things about it which make me uncomfortable (e.g. using forecasts to calculate future excess returns). But on balance I think it ticks more boxes than it misses. For one, I like the *absolute* (as opposed to *relative*) nature of valuations thrown out. For another, it seems to work. The following left chart shows the performance of stocks over time when sorted into deciles according to their IVP ratios: the higher the IVP ratio, the higher the returns. The right chart shows cumulative returns since 1986 of a hypothetical long-short strategy in which we buy the highest IVP decile stocks and sell the lowest. Both show that there is some sort of 'edge' to be had in purchasing stocks with higher IVP ratios.

Historic annualized returns by IVP decile



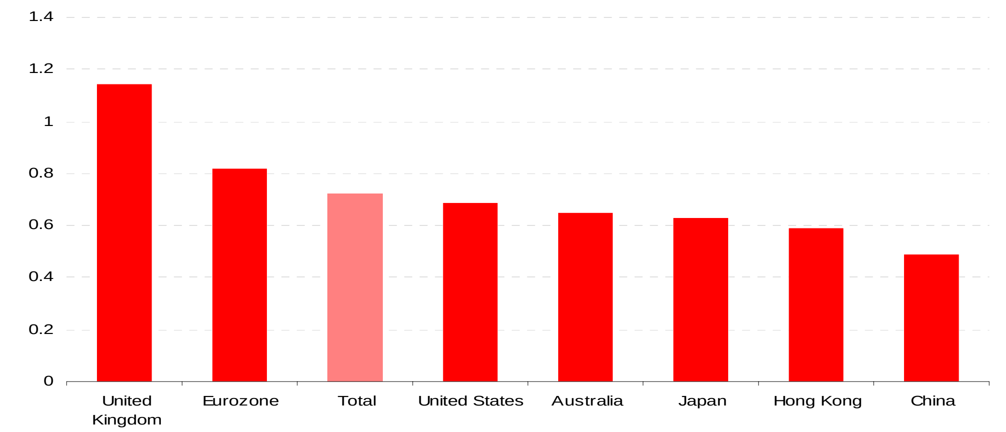
Cumulative returns to long top/short bottom IVP decile



Source: SG Cross Asset Research

The next chart shows where the geographical value is. The UK has an aggregate intrinsic value above its market capitalization, while the Eurozone looks less egregiously expensive than the rest. I also find it interesting that Japan looks so expensive using an IVP framework. Funnily enough, I think there may be good *speculative* reasons for owning Japan (which I'll try to write up shortly) but the *investment* case is weak. Even though PB and PE ratios are historically low, the earnings power of Japanese assets is even lower and by anchoring valuation on the earnings power of assets the IVP framework picks this up.

Intrinsic Value to Price ratios by country

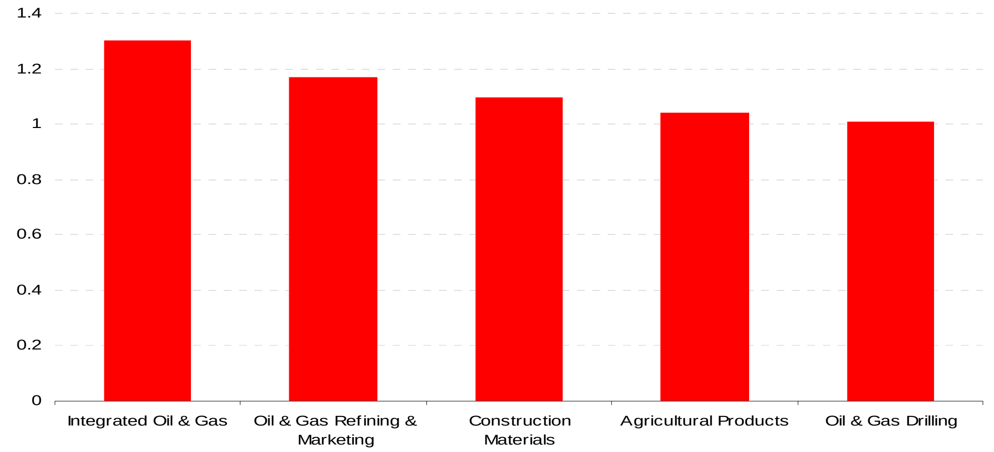


Source: Factset, SG Cross Asset Research

The following chart shows the sectors trading below intrinsic value. Although a cursory look reveals a heavy resource bias, some interesting sub-sectors emerge. For example, integrated oils are cheap. True, they always seem to be. They're 'too big' and have gone 'ex-growth.' But the long-term growth numbers I've used for them (e.g. Royal Dutch Shell) are actually *negative* so they allow for this. And if we overpay for strong growth, mightn't we underpay for weak growth? According to Factset, Integrated Oils have been one of the best-performing sectors over the last 15 years returning 12.3% annualized, against 8.5% for the World.

Refiners and construction materials are interesting too, with names like Valero and Lafarge operating in depressed sectors in sluggish developed markets. Surely these are interesting places to look? Among the drillers, Transocean – the market leading deep-sea driller in an oil market increasingly reliant on deep-sea fields for future growth – is trading below estimated intrinsic value on our IVP analysis and as such, statistically, it has a higher 'expected return' than other stocks in the market.

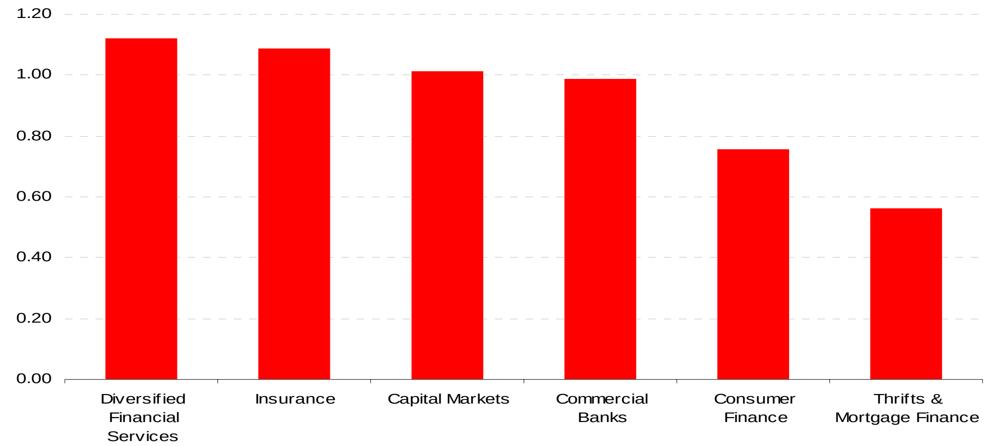
Intrinsic Value to Price ratios by MSCI sub-sector



Source: Factset, SG Cross Asset Research

Although I exclude financials from my screen (as I'm not sure screening is the right way to look at financial stocks) it's an interesting sector so I've run the numbers. "Diversified Financials" includes guys like ING, JP Morgan and BoA, the rest are self explanatory … the results suggest potentially lucrative pickings here *if* you can get comfortable with the balance sheets. A big if, I know, but I guess fortune favours those who do their homework.

Intrinsic Value to Price ratios in the financials sector



Source: Factset, SG Cross Asset Research

And finally, here are the names of the individual companies thrown up as having estimated intrinsic values higher than their market values. The names help show who's driving the sector numbers above, but some notable names from sectors which *don't* stand out as cheap include Kingfisher, Finmeccanica, AstraZeneca and Western Digital.

Stocks with a estimated intrinsic value higher than market price (IVP ratio >1)

Company Name	Country	Sub-Industry	Market Cap ($bn)	Intrinsic Value	Price	V/P
Royal Dutch Shell PLC (CL B)	United Kingdom	Integrated Oils	177,926	32.85	17.17	1.91
BP PLC	United Kingdom	Integrated Oil	177,341	10.10	5.79	1.74
Chaoda Modern Agriculture (Holdings) Ltd.	Hong Kong	Agricultural Products	3,517	13.79	8.40	1.64
Marathon Oil Corp.	United States	Integrated Oil	22,197	41.69	28.95	1.44
ConocoPhillips	United States	Integrated Oil	76,255	68.47	48.00	1.43
Lafarge S.A.	France	Construction Materials	15,079	63.52	47.63	1.33
Kingfisher PLC	United Kingdom	Home Improvement Retail	7,791	2.77	2.15	1.29
HeidelbergCement AG	Germany	Construction Materials	10,408	48.38	37.67	1.28
Pride International Inc.	United States	Oil & Gas Drilling	5,123	35.13	27.98	1.26
Vedanta Resources PLC	United Kingdom	Diversified Metals & Mining	5,592	31.98	25.48	1.25
Chevron Corp.	United States	Integrated Oil	150,812	89.56	72.30	1.24
Mitsui & Co. Ltd.	Japan	Trading Companies & Distributors	22,525	1698.08	1379.00	1.23
Valero Energy Corp.	United States	Oil & Gas Refining & Marketing	11,193	21.50	17.52	1.23
Sigma Pharmaceuticals Ltd.*	Australia	Medical, Surgical & Dental Suppliers	971	1.08	0.90	1.20
Western Digital Corp.	United States	Computer Storage & Peripherals	9,139	46.17	38.63	1.20
AstraZeneca PLC	United Kingdom	Pharmaceuticals	65,156	34.19	28.84	1.19
Finmeccanica S.p.A.	Italy	Aerospace & Defense	5,828	11.19	9.50	1.18
Carnival PLC	United Kingdom	Hotels Resorts & Cruise Lines	8,687	28.24	24.81	1.14
Autoliv Inc.	Sweden	Auto Parts & Equipment	4,427	50.38	44.61	1.13
Itochu Corp.	Japan	Trading Companies & Distributors	10,380	807.19	716.00	1.13
Rengo Co. Ltd.	Japan	Paper Packaging	1,171	630.67	564.00	1.12
Transocean Ltd.	United States	Oil & Gas Drilling	26,473	88.34	79.82	1.11
Telecom Italia S.p.A.	Italy	Integrated Telecomm	19,216	1.15	1.05	1.10
Omnicare Inc.	United States	Health Care Services	3,465	29.64	27.07	1.10
TABCorp Holdings Ltd.	Australia	Casinos & Gaming	3,841	7.29	6.77	1.08
Ameren Corp.	United States	Multi-Utilities	6,129	26.53	24.71	1.07
Gas Natural SDG S.A.	Spain	Gas Utilities	8,679	14.35	13.47	1.07
Marubeni Corp.	Japan	Trading Companies & Distributors	8,017	562.47	531.00	1.06
Sumitomo Corp.	Japan	Trading Companies & Distributors	10,667	1024.60	968.00	1.06
Pfizer Inc.	United States	Pharmaceuticals	139,312	18.49	17.55	1.05
Newell Rubbermaid Inc.	United States	Houseware & Specialties	4,239	14.46	13.75	1.05
Arrow Electronics Inc.	United States	Technology Distributors	3,523	29.56	28.21	1.05
Fidelity National Information Services Inc.	United States	Data Processing & Outsourced Services	8,784	23.22	22.54	1.03
Deutsche Post AG	Germany	Air Freight & Logistics	15,891	12.27	11.92	1.03
Bunge Ltd.	United States	Agricultural Products	9,136	61.21	59.59	1.03
Mirant Corp.	United States	Independent Power Producers & Energy Traders	1,618	12.87	12.58	1.02
Techtronic Industries Co. Ltd.	Hong Kong	Household Appliances	1,334	6.04	5.94	1.02
Royal Caribbean Cruises Ltd.	United States	Hotels Resorts & Cruise Lines	5,353	28.59	28.27	1.01
PPL Corp.	United States	Electric Utilities	10,488	28.67	28.48	1.01

Source: Factset, MSCI industry classifications, SG Cross Asset Research. *using Factset industry classifications.

IMPORTANT DISCLOSURES

BUNGE LTD	*SG acted as co-manager on Bunge's ltd secondary offering.*
Finmeccanica	*SG makes a market in Finmeccanica warrants*
Finmeccanica	*SG acted as joint bookrunner in the Finmeccanica's senior bond issue.*
Finmeccanica	*SG acted as co-manager in the Finmeccanica's senior unsecured HG bond issue.*
Gas Natural SDG	*SG acted as Joint-Bookrunner of Gas Natural right issue*
Gas Natural SDG	*SG acted as passive bookrunner in Gas Natural's bond issue*
Gas Natural SDG	*SG acted as Bookrunner and Mandated Lead Arranger in the acquisition financing of Union Fenosa by Gas Natural*
Gas Natural SDG	*SG acted as financial advisor to Mitsui in the purchase from Gas Natural of natural-gas-fired power stations in Mexico*
Gas Natural SDG	*SG acted as joint bookrunner in the issue of GAS NATURAL's senior bond (5.25% 09/07/14 EUR & 6.375% 09/07/19 EUR).*
Gas Natural SDG	*SG acted as joint bookrunner in Gas Natural's senior bond issue (3.375% 27/01/15 EUR ; 4.125% 26/01/18 EUR ; 4.5% 27/01/20 EUR).*
HeidelbergCement	*SG acted as co-bookrunner for HeidelbergCement share placement and right issue*
ING Group	*SG acted as co-lead manager in the ING's rights issue.*
Lafarge	*SG acted as joint bookrunner of the rights issue of Lafarge*
Lafarge	*SG acted as joint bookrunner in Lafarge's bond issue (5.5% 16/12/19 EUR).*
Lafarge	*SG acted as joint bookrunner in the Lafarge senior bond issue (7.625% 24/11/16 EUR).*
Lafarge	*SG acted as joint bookrunner in the Lafarge's senior bond issue (7.625% 27/05/14 EUR).*
Lafarge	*SG acted as mandated lead arranger and bookrunner for the partial refinancing by Lafarge of the acquisition of Orascom*
Telecom Italia	*SG makes a market in Telecom Italia warrants*
Telecom Italia	*SG is acting as advisor to Telecom Italia to evaluate various strategic options*
Telecom Italia	*SG acted as joint-lead manager in the Telecom Italia's bond issue (5.25% 10/02/22 EUR).*
Telecom Italia	*SG acted as Joint Mandated Lead-Arranger and Bookrunner in the acquisition financing of Alice from Telecom Italia by Iliad*

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