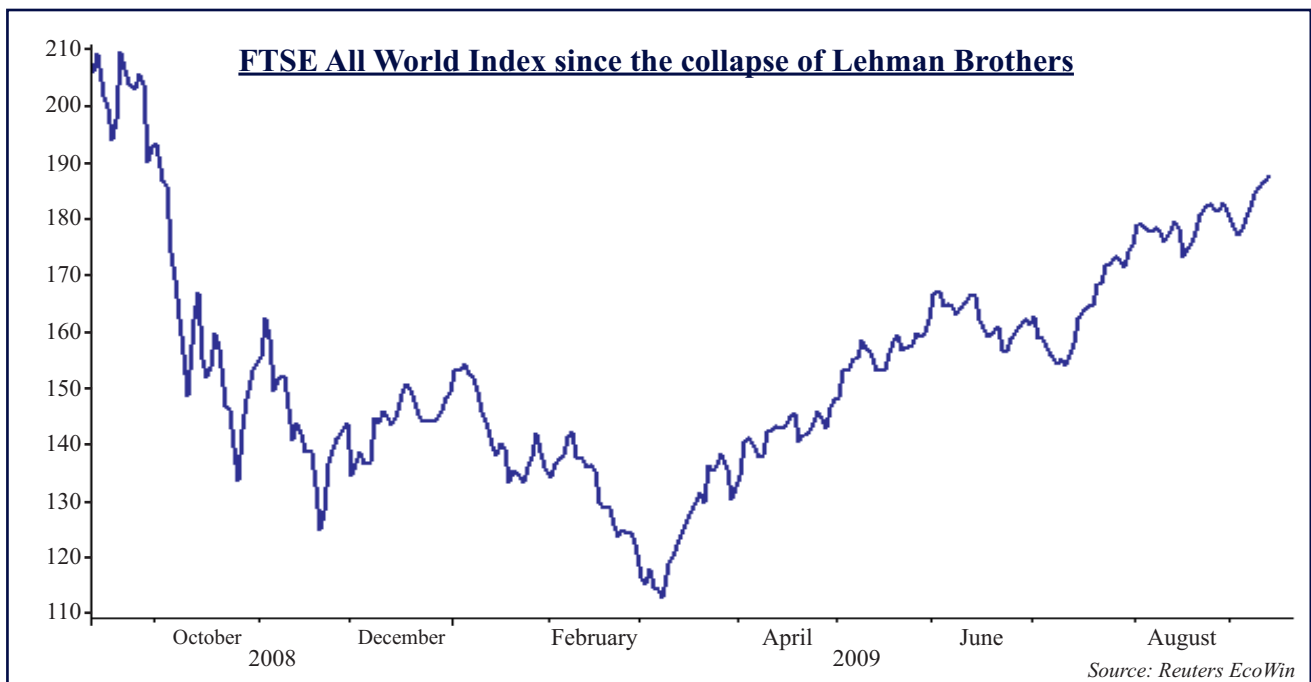


BACK TO NORMAL? ONE YEAR ON FROM LEHMAN

Yesterday was the first anniversary of the bankruptcy of Lehman Brothers, the event that triggered the bleakest phase of the credit crisis. The months that followed the failure of the 158-year old US investment bank saw unprecedented levels of risk aversion. Credit markets iced-over, investors feared for the security of their assets including cash holdings at commercial banks and, for several weeks, the collapse of the entire global financial system seemed a realistic possibility to many.

One year on, and helped by government intervention on a monumental scale, the mood in global financial markets is markedly different. Economic data releases are now surprisingly good, both here in the UK and abroad, and the outlook of investors has become one of optimism. Companies have played their part in this mood-change, with many profit statements matching or exceeding analysts' estimates. Even merger and acquisition activity is showing signs of revival, as is apparent from the talks between Kirin and Suntory in Japan and T-Mobile and Orange in the UK, as well as the £11bn bid from Kraft for Cadbury. These developments have allowed global equity markets to recover some poise; shares have risen by 16% since the end of June and are now 66% above their March lows (see chart).



Naturally, it is encouraging to see portfolio values continuing to recover. However, we are bound to ask if such a recovery in share prices is not 'a bit too good to be true'. After all, as recently as six months ago, for many commentators, financial and investment markets looked like they would not return to normal for a generation. By March, interest rates had been cut to record lows, several banks had been partially nationalised by their respective governments and public sector finances were being battered by the twin costs of recession and the financial sector bailouts. Have all of the problems simply melted away in the summer sun? The answer, of course, is 'no'. The effects of the financial crisis, such as reduced access to credit, and the costs of the measures taken to deal with it, including much higher public debt and taxes, are likely to be with us for many years. So why have equity markets rallied so strongly?

The key explanation for recovering share prices is to be found, in our view, in the power of exceptionally low interest rates. At 0.5% here in the UK, official interest rates are much lower than they have been at any time since reliable records began. The situation is similar in other major economies. The impact of interest rates at such low levels is manifesting itself in several areas: the pressure on heavily indebted consumers has eased, companies have been able to refinance debt and some investors, having regained their risk appetite, have been buying back into shares in preference to low yielding cash accounts. However, while low interest rates are helpful in many respects, they clearly do not solve the long-term structural issues that triggered the credit crunch.

Given the above, how should investors respond to equity markets that have risen phoenix-like from the ashes of the global economy?

Firstly, it should be accepted that super-low interest rates are likely to be here for some time. The recent meeting of the finance ministers of the G20 in London confirmed as much, as did the central bankers' meeting at Jackson Hole last month. Secondly, we need to factor into our valuation of equity markets other developments over the past year. These include reduced wage inflation and lower raw material prices, both of which should help support short-term profit expectations. Finally, we should acknowledge that, with the spectre of a repeat of the 1930s receding, value is once again the arbiter of stock market prices. On this basis, and despite the rally, equities in developed markets appear reasonable value both in absolute terms and relative to government bonds or cash deposits. For now at least, share prices look underpinned.