FINANCIAL TIMES

August 30, 2011 8:27 pm

'W' is for worry or for win?

By James Mackintosh

Glance at any chart of US equities over the past month and it spells "W". The plunge, dead cat bounce, fall back to the original bottom and recovery back to where it started combine to form a pattern often referred to as a "double bottom".

Technical analysts, the chartists who try to predict future pricing from graphs, regard a double bottom as a solid indicator of a switch from a downward trend to a period of rising prices.

A buying signal is exactly what the bulls have been asking for. Perennial optimists on Wall Street already highlight measures such as the gap between equity and bond yields to suggest shares are cheap, with economic gloom mostly priced in.

The facts suggest the W stands for "worry". Chartists themselves dismiss the pattern as not a proper double bottom, as it occurred over too short a period and came with too little volume on the final upward stroke. Volume needs to rise as investors come to believe in the upwards trend, but fell.

With or without the charts, equities are expensive on long-term valuation measures. One of the best is the cyclically adjusted price/earnings ratio (Cape), popularised by Yale's Robert Shiller. This tries to smooth out the ups and downs of the cycle by dividing price by 10 years of profit.

On this basis, US shares are 23 per cent overpriced against the average since 1881. Values are 11 per cent above their average since the second world war. Shares only look cheap – and then not especially so – against the average since 1985.

Since 1985 equities have been through the dotcom and credit bubbles, so it is no surprise valuations should be lower. Yet investors and analysts insist on comparisons with the period – in part because much data only goes back to the 1980s, when many were born.

Cape is no use for trading, often being out by years. But buying when it is low has been a good way to make money. It is not low now.

Printed from: http://www.ft.com/cms/s/0/08054af4-d321-11e0-9ba8-00144feab49a.html

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