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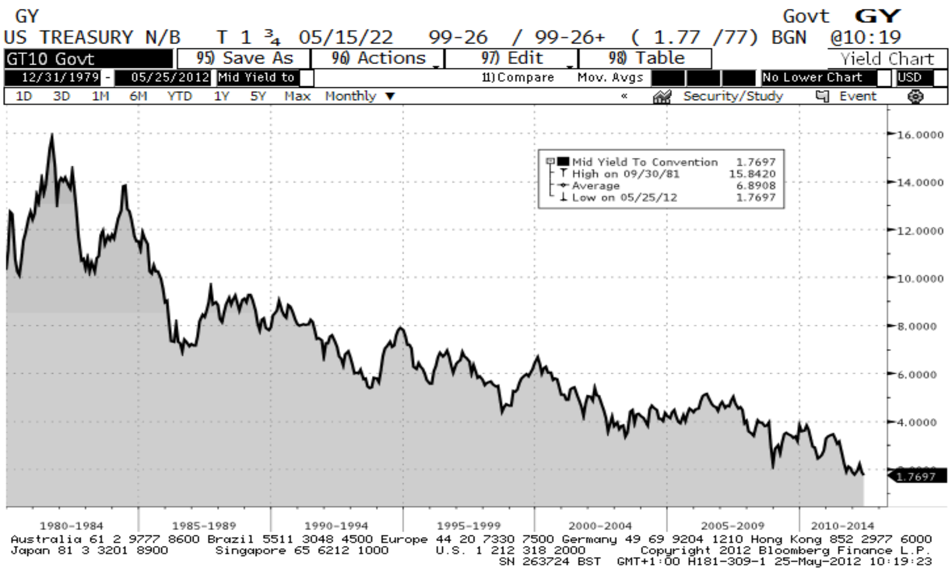
"There's enough bang in there to send us all to Jesus."

- Anonymous commentator on the nature of JP Morgan's Chief Investment Office credit exposure.

The most important attribute of any investment is the price you first pay for it. An attractive valuation can ultimately transform even the lousiest of investments into a good deal. But overpaying can turn an ostensibly high quality investment into a dud. Courtesy of trillions of dollars' worth of stimulus (SocGen's Dylan Grice points out that since 2008, the US Federal Reserve and the Bank of England have printed enough money to buy up 60% of the issuance of their public debt) US Treasuries, UK Gilts, Japanese government bonds and German Bunds now represent return-free risk. 5 year paper in each of those markets now yields substantially less than 1%. If they ever amounted to high quality investments, they certainly look like junk now – albeit with a valuation more commonly associated with the bluest of blue chip assets.

One of the arguments cited in favour of equities as a generic asset class today is that they look favourably valued versus government bonds. But there are a few problems with this argument. On any rational analysis, the bull market in interest rates looks like it may be drawing to a close.

10 year US Treasury yields, 1980 to 2012



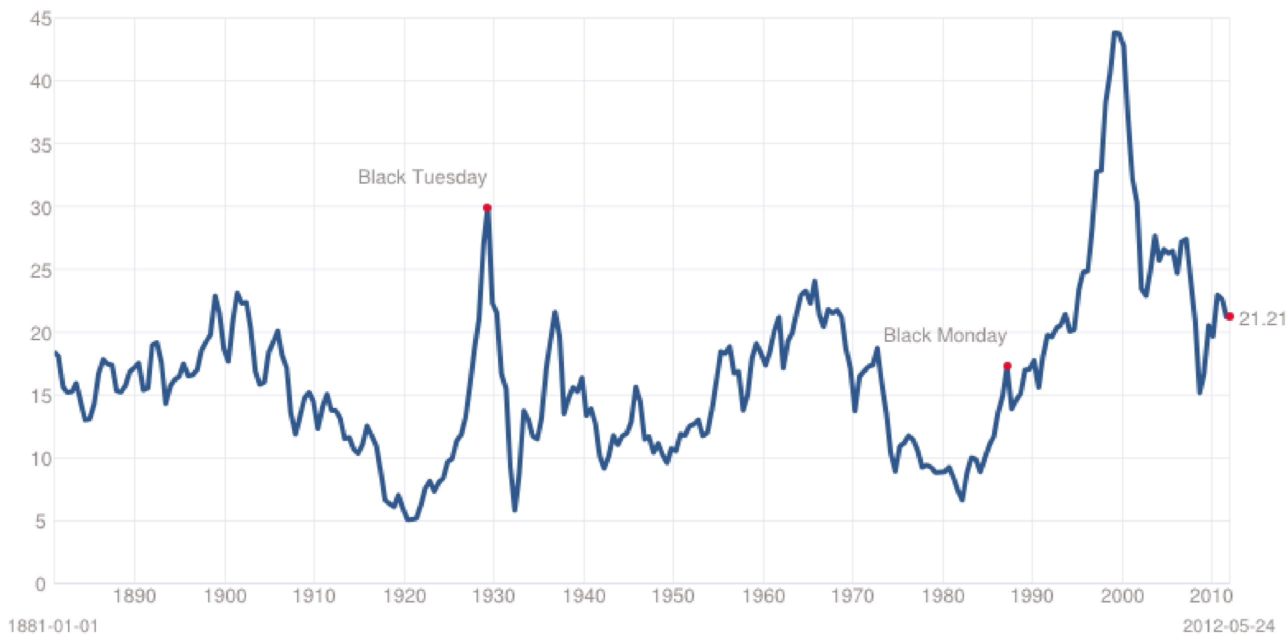
Source: Bloomberg LLP

Of course, yields in the US government bond market could go lower, but they are already beyond the pale for any unconstrained investor (30 year paper @ 2.8%, anybody ?). And that issue of constraint represents another problem. The 'stocks are cheap versus bonds' argument presumes that markets are rational and that investors can switch effortlessly between the two. But that is simply not the case. Institutional bond managers (given that government debt is hardly a market in which retail investors participate to any significance) tend to pursue rigid mandates. US government bond fund managers are unlikely to drift into European government debt or corporate debt, and vice versa. This polarisation of agency risk may well account for much of the overvaluation in government bond markets – there is nowhere else realistically for the managers to go. Government bond fund managers are, therefore, even less likely to switch into the equity markets in search of sensible risk-adjusted returns. (Admittedly, macro hedge fund managers are likely to have more discretion.) So 'stocks are cheap versus bonds' is a somewhat flimsy platform to build a compelling investment case upon:

- Western government bond markets are outrageously expensive;
- Many players in western government bond markets are effectively forced buyers;
- Most players in western government bond markets do not have the flexibility of mandate to consider any other form of investible assets (i.e. stocks), so the relative valuation argument is almost entirely of academic interest only.

So much for one side of the argument – how about the other ? Once again, in large part it comes down to valuation.

Cyclically adjusted price / earnings ratio for the S&P 500

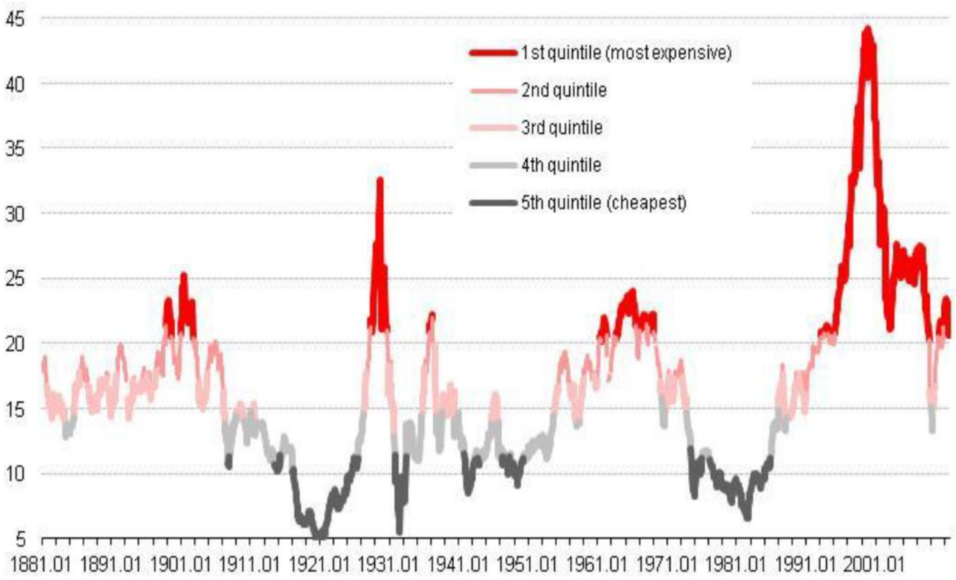


Source: Multpl

The broad US stock market trades on a cyclically adjusted ('Shiller') p/e of around 21 times. (Note that at this level it is valued more highly than it was during Black Monday in 1987.) While admittedly cheaper than at the height of the dotcom boom, this is not "cheap". Both the mean and median cyclically adjusted p/e are around 16 times.

The statistical likelihood of incurring attractive long term returns is dependent on starting valuation. Current valuations are simply not compelling. Dylan Grice, again, points to the likely range of long term returns:

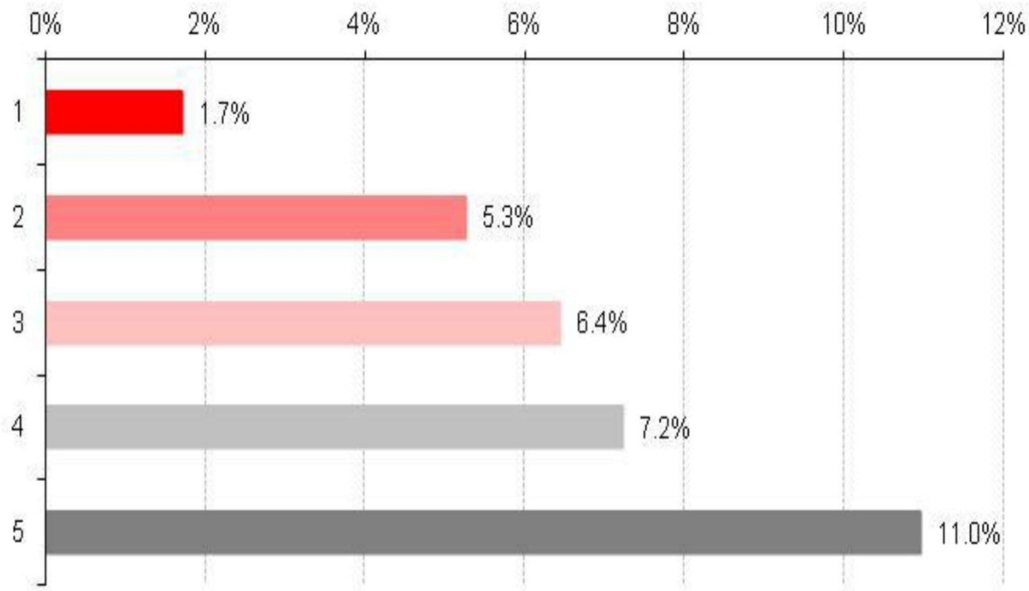
US stock market valuation broken down by quintile



Source: Robert Shiller, SG Cross Asset Research

We are currently still in the first (most expensive) quintile of historic market valuations. The implication of buying at current levels is shown below – and this assumes that investors have the patience to cling on for 10 years. We doubt that many will. Manage your expectations accordingly.

Subsequent 10 year annualised returns



Source: SG Cross Asset Research

So much for an objective statistical view of prospects for US stocks (for example). But there is a 10 ton (subjective) elephant in the room called the euro zone, with political leadership that could best be described as a cretinocracy.

One of the euro zone's brilliant new leaders swings into action

So while the relative (stocks vs bonds) valuation argument is founded on sand, and the absolute valuation argument (inasmuch as it addresses the US market at least) is on a somewhat weak foundation, there is a wholly separate problem in terms of how or indeed whether the euro zone survives in anything close to its current incarnation. The less favourable outcome includes debt contagion throughout the periphery and a second European banking crisis. Such an outcome is unlikely to be supportive for common stocks.

Recent political developments across Europe and the UK have shown the infantilized nature of the debate. As Tullett Prebon CEO Terry Smith puts it,

"1. The debate between those who propose policies designed to promote growth and those who see the need for austerity is a sterile one for a number of reasons.

"The simplest reason is that we are going to get austerity whatever people want. There is simply no source of additional money to spend to stimulate growth. The bond markets have had enough of governments who continually run unsustainable deficits. You cannot borrow your way out of a debt crisis.

"Additional deficit spending funded by increased borrowing would not produce the desired result even if it were possible. So far the UK economy has been the recipient of £500bn of deficit spending, £325bn of Quantitative Easing and interest rates have been at a 300 year low for over three years. These so-called Keynesian measures (I say "so-called" because most of their proponents seem to me to have about as much grasp of Keynesian economics as they do the topography of the far side of the Moon) have not managed to get the economy growing so far, and they will not. The velocity of circulation of money has slowed - people want to pay down debt where they can. The government is also an incredibly inefficient spender (unsurprisingly as it's not their money) - in the years prior to the recession it borrowed £2.18 for every £1 of growth. As Einstein said, to keep repeating the same actions whilst expecting a different outcome is a definition of insanity.

"2. The only way to generate growth is to cut the size of public spending sufficiently to allow for tax cuts. Individuals and companies are much more efficient at spending the money they earn than the government is on their behalf, so better to leave more of it in their hands."

Western governments (and the commercial banking groups with whom they are joined at the hip) are caught between a rock and a hard place. There is and will be no easy resolution to the debt crisis. It would be helpful if politicians, and the neo-Keynesian bumtards clogging up Twitter, could wake up to this harsh reality and not peddle dangerous untruths to a gullible but frightened electorate.

And finally.. On Friday 18th May we presented at the second MoneyWeek conference at the Queen Elizabeth II Conference Centre. If you are interested in acquiring the full audio recording which includes each of the 14 speakers, you can do so here. The files will only be available until Wednesday 30th May.

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