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"Don't Panic"

Since we last wrote to you economic news has worsened markedly and as a result equity markets have continued to fall sharply, and have recently been joined by the corporate bond market as well. This being the case, the question needs to be asked: why stay with equities, even now?

I have listed below ten reasons why I believe that investors would be very badly served by panicking out at this late stage.

1. Government and central bank intervention is unprecedented in the scale and the speed of its delivery. Authorities have made it clear they will expend every effort to ensure the recession does not grind into a depression. Their armoury is by no means exhausted.

2. Inflation is falling rapidly. This will allow central banks to cut rates sharply, even after recent very aggressive moves. For example, crude oil is down to below $50 per barrel compared with a peak of nearly $150 per barrel.

3. Investor pessimism is at extreme levels. This is a lagging, not a leading indicator.

4. Market top-down earnings forecasts now discount worse profitability than in previous lows. In the corporate bond market implicit (expected future) default rates are higher than in the depths of the Great Depression.

5. Director share purchases are at an all-time high and top quality long-term investors such as Warren Buffett and Anthony Bolton are now buying the market.

6. The UK equity market is now trading at around 9x (depressed) 2009 earnings estimates. This level of valuation is appropriate to a time of high, not falling inflation.

7. The yield on the UK equity market is very close to the yield on government bonds, which implies zero dividend growth over the next 10-15 years. With the collapse of inflation we can expect gilts to rally strongly at the short end, making the relative valuation of equity income still more attractive.

8. History shows that buying equities when they are lowly rated produces superior ten-year compound real returns. In the UK there is a 70% correlation between the valuation at which you buy shares and the extent of ten-year returns thereafter.

9. Equities hit their trough between six and fifteen months before the economy hits its trough. Earnings momentum has already collapsed. Markets begin to discount normality well before it is apparent.

10. Three times out of four, the market rallies sharply after a fall of more than 20%. In 1975 the UK market shot up by nearly 100%. In the 1930s the US equity market rose by over 200% from the end of 1932 to the end of 1936.

This is not to say a recovery will occur immediately. Amongst the catalysts that are required, we need to see a normalisation of the spread between LIBOR and short-term interest rates (which does appear to be happening, slowly), for corporate bond yield spreads with government stock to narrow, and for housing markets to stabilise in the UK and especially in the US.

Even without these factors in place, however, it is too late to sell. Given the magnitude of rallies after market falls of the extent we have seen these last 18 months, it is almost never possible for those who have cashed up to reinvest in time to capture them. Failure to participate in these strong periods has a very damaging effect on investors' long-term returns.

At Principal we are looking to exploit the pricing anomalies that are being thrown up by markets at the moment. In particular we are adding corporate bond exposure to our portfolios. After its worst six weeks on record, we believe this asset class now offers equity style capital upside and very significant yield attractions at a time when the returns on cash are trending towards zero. This is balanced by reductions in our exposure to highly defensive, but very expensive areas of the market and to cash.

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