Irish equities not such a bargain

Irish stocks look like great value for money these days, but investors are cautioned to look before they leap

Joe Mottley

The Iseq index has fallen more than 30 per cent year-to-date, putting it at the bottom of the international performance table. Headline price/earnings ratios on some leading stocks have dropped far into single-digit territory, and many show dividend yields of over 5 per cent. Domestic stockbrokers and fund managers are as one in extolling the compelling value now on offer.

Are they right? Perhaps. But here are a few cautionary observations to keep in mind before committing new money to the Irish market.

Valuations are not exceptionally low relative to the past. The most popular valuation measures, the price-to-earnings (P/E) ratio and dividend yield, look attractive at first glance: 12.2 times and 2.5 per cent respectively. However, the P/E ratio is an unreliable guide when the "E" (earnings) are at a cyclical high and may have some distance to fall. I believe Ireland is now in this position.

Meanwhile, using the price-to-book-value (P/BV) ratio may give a more stable indication of long-term value. And it is interesting to observe that most of the major stocks are now close to, or only a little lower than, their 20-year average P/BV ratios. Not expensive, but not outstandingly cheap either.

Similarly, dividend yields at best are only back up to their long-term averages. AIB and Bank of Ireland, for example, now yield 5 per cent and 6.1 per cent respectively, but in the pre-Celtic Tiger years, bank yields often traded well above these levels.

Don't underestimate the risk of a sharp profits downturn. We have only just started to see analysts' earnings per share (EPS) forecasts being cut. This could have a long way to run. International investors, in selling the market down this year, have implicitly declared their belief that Irish domestic earnings were buoyed by a prolonged and extraordinary boom, and are now set to reverse. The Iseq index is overwhelmingly a financials and construction play, with a 60 per cent weighting across these two sectors.

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Many countries have seen an explosion in property values and credit creation over the past decade, but few more dramatically than Ireland. Irish commercial bank assets relative to GDP are now, at 569 per cent, second-highest in the developed world; the average house price has risen 270 per cent since 1996; and last year, our house-building output per capita was four times the European average.

As our economy adjusts back from these extremities, there could be much pain ahead for the most directly exposed sectors.

Ireland's woes are part of a global phenomenon. Financial stocks everywhere have been hit by the turbulence in credit markets, the catalyst for which was the sub-prime crisis in the US.

While Irish banks may have minimal exposure to US sub-prime mortgages, they have every reason to fear the wider souring of the credit cycle. Higher wholesale funding costs, sharply decelerating loan growth and a pick-up in bad debt charges are all on the cards for the next year or more, and could do far more damage to earnings than currently reflected in analysts' forecasts. On a broader front, while no major overseas markets have fared as badly as Ireland this year, they almost all sit on P/E ratios which seem historically low. The catch, once again, is that profits are historically high, and valuations on the basis of normalised, or "trend" earnings are far less attractive.

Sooner or later, the usual cyclical forces will bring about a retreat back towards normalised profitability – and right now investors are starting to bet on "sooner" rather than "later". Although Ireland has fallen ahead of other markets, it is unlikely to take the lead on the way back up. Cheap relative to other markets? It's always difficult to make reliable cross-border comparisons. Yes, the Iseq might look like value against other markets on some measures, but the exercise is only meaningful on a sector-by-sector basis.

In some sectors, such as food and beverages, Ireland compares well. However, financial stocks dominate the Iseq index – with a 41 per cent share – and Irish financials are not any cheaper than their global peers.

The P/BV ratio for Irish banks, for example, might look reasonable at 1.7, but the corresponding figures for US, German and British banks respectively are 1.6, 1.5 and 1.4. The dividend yields of British banks currently fall in the 5.5 per cent-to-9 per cent range, eclipsing those of the Irish sector. If you think the Irish market is cheap, make sure you're not overlooking even better value elsewhere.

In conclusion, the wise investor might do well to question the siren song of those who have a vested interest in talking up Irish shares. There are undoubtedly some individual stocks which are now attractive (and should be evaluated relative to their international peers), but an across-the-board commitment to the market at this juncture would demonstrate bravery rather than wisdom.

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