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In Pursuit of Value

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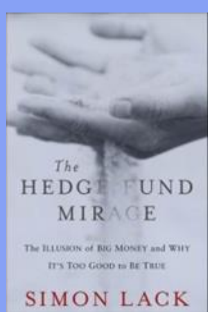


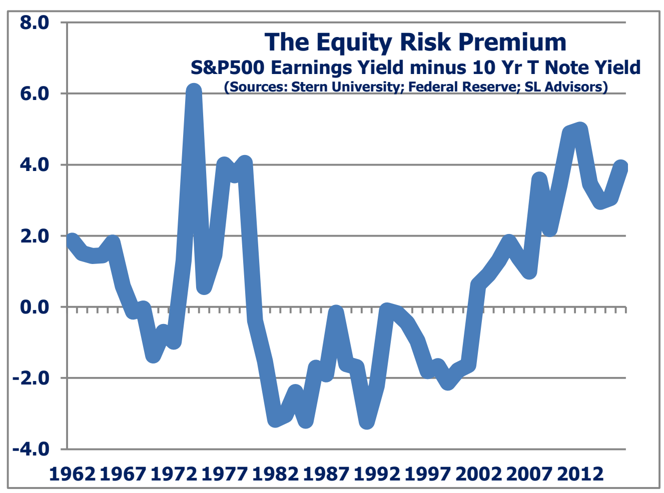
How Expensive Are Stocks?

What if stocks aren't expensive at current levels? What if bond yields aren't going to rise anytime soon? As we noted in a blog post a couple of weeks ago (see The Shrinking Pool of Cheap Assets), markets are inexorably drifting higher as investors seek the possibility of returns above inflation. Meanwhile, the view that equity markets are due for a slump draws more adherents as it increasingly looks as if we're priced for perfection.

We don't know where stocks will go. There will most assuredly be another 10-20% drop at some point and it'll probably come about because of something few expected. But you can't really evaluate stocks without considering interest rates, since equity investors always have a choice.

Investing is all about choices. At its most fundamental, it reflects the choice to defer consumption today in order to save for tomorrow. Successful investing allows greater consumption in the future. Investing also requires making choices across asset classes. It's meaningless to describe something as cheap without comparing it with something else.

Our October 2010 newsletter was when we first wrote about the Equity Risk Premium (ERP), comparing the S&P500 earnings yield with the yield on ten year treasuries. The earnings yield isn't a perfect metric because some portion of most companies' earnings is reinvested for growth. But assuming the portion of such reinvested earnings doesn't fluctuate much (admittedly a non-trivial assumption), this does allow for a long-term perspective of relative valuation. Back in 2010 we inferred from the historically wide spread that stocks were cheap relative to bonds (the S&P500 closed 2010 at 1,256 and ten year treasuries at 3.85%). Since then both asset classes have delivered positive total returns, with bonds[1] generating 5.6% p.a. and stocks 15.3%. Remember the "lost decade" of 2000-10 when equity returns were essentially flat? In 2000 the ERP was -1.8%, reflecting that equities were expensive compared with bonds.



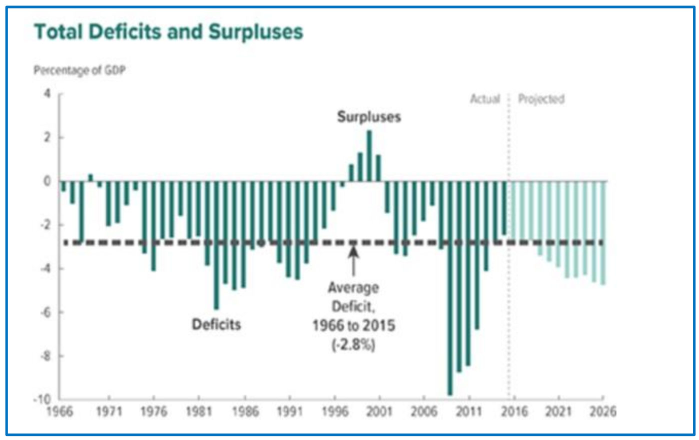
This year the ERP has moved in favor of stocks. Bond yields have dropped, further lessening their appeal, and S&P earnings growth of 12.5% has outpaced the market's return, driving down the P/E slightly (P/E is the inverse of earnings yield).

The case against stocks is their still relatively elevated P/E ratio, currently at around 18.2 for 2016 estimated earnings. But alternatives to stocks are not cheap, which is why the ERP makes stocks look attractive. Interest rates are artificially low, and a return to normalcy

[1] Bonds are defined here as the Dow Jones Corporate Bond Index

would render stocks less appealing. Rising rates have been widely expected for many years. Since 2010, when the Fed began making public their expected path for short term rates, we've learned to live more or less permanently with an expectation of a near term tightening. It has been often promised and rarely delivered. The economy is better for it.

Ask yourself, what's the difference between (1) a policy of stealth default by setting interest rates on our debt too low to cover inflation after taxes, and (2) current monetary policy? The answer is, very little beyond the absence of rhetoric describing current policy in this way. It's true Janet Yellen didn't speak in Jackson Hole about the economic benefits of maintaining low rates to ease the burden of an overly indebted society, but her actions are indistinguishable from such a philosophy. We needn't concern ourselves about the rightness of this approach, merely its likely path going forward. Fitch calculated annual savings of over $500BN for sovereign issuers compared with the interest rates that prevailed five years ago. Budget deficits everywhere are substantially diminished as a result.



The current U,S. Federal budget deficit will probably be the best news on this topic for a long time to come. The Congressional Budget Office (see chart) forecasts that on current tax and spend policies the burden of under-financed entitlements for retiring baby boomers will cause the budget deficit to start widening again.

The complete absence of the deficit as an election issue portends little likelihood of any action. Both Federal and household debt as a percentage of GDP have been falling since the 2008 financial crisis, testament to the success of monetary and fiscal policy. Low rates have helped bring this about. You could argue that negative real rates are in our national interest, as long as lenders can be persuaded to accept such indefinitely. Some worry about a spike in bond yields caused by foreign sellers tiring of the self-interested debtor denying them better terms. China and Japan each own more than $1TN worth. But this seems unlikely, because they couldn't sell meaningful amounts without driving prices sharply lower, and they own such large quantities because of a dearth of choices. These investors are clearly not that demanding of a fair return on their capital.

While the Fed will eventually deliver a second hike, the path towards neutral (which they define as a Fed Funds rate of 3%) is likely to be lengthy. Suppose ten year treasury yields double in a year's time to this neutral 3%, as investors build in some risk premium against the possibility of faster rate hikes? According to FactSet, 2017 S&P Earnings are forecast to grow by 10%. So an unchanged S&P would mean a P/E of 16.6 by then and, coincidentally, an ERP also of 3.0%, only modestly lower than today's. Stocks would still look attractive compared with bonds. The average ERP over 50 years is 0.6%. That includes twenty years during which it was negative, something that doesn't seem plausible with today's low interest rates. But under such circumstances even an ERP of 2.0%, a level it's exceeded for less than a quarter of the past 55 years, would cause the S&P500 to be at 2,625, 20% higher than it is today. 3% treasury yields and an ERP of 1.5% (still almost 1% above the long term average) would imply an S&P earnings yield of 4.5%, therefore a P/E of 22.2, and an S&P500 of 2,918. And what if interest rates don't double as the preceding example assumes?

The point here is not to make a forecast, but to highlight the vulnerability of the bearish case to continued low interest rates. Economic shocks will occur and by definition they're hard to

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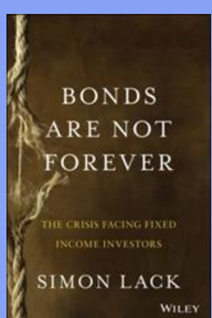

forecast. But if the Fed maintains its benignly lethargic monetary policy, 3% ten year yields with consensus earnings growth could result in meaningfully higher stock prices. It’s rarely comfortable to be bullish at the highs, but the Math shows the discomfort that may face those in the future who are under-invested in stocks today.