Are Stocks Richly Valued?

Key Takeaways

- Despite the strong market run, the S&P 500 P/E ratio does not appear particularly high relative to the average of the past 25 years. Earnings have seen a strong cyclical recovery from the depths of 2009, but it has been earnings growth, rather than multiple expansion, that has driven most of the market advance.

- Valuations are not constant; they vary over time with the inflation rate. For example, higher inflation is linked to higher earnings yields (i.e. lower P/E’s) and lower inflation is linked to lower earnings yields (i.e. higher P/E’s). P/E ratios are in line with current inflation rates.

- While a correction of 10 – 15% is always possible in equity markets, we do not currently see any fundamental reason for a crisis-like sell-off.

The U.S. stock market has had a tremendous bull run since hitting a low in March 2009. Given the size of the run-up, it seems reasonable to be concerned that the market has gone too far, too fast and that valuations may be at high levels. The recent extreme downturn during the financial crisis would also explain why many investors are quite sensitive to the risk of a potential new bear market.

The chart above illustrates two significant market drawdown periods: the “tech collapse” and the “financial crisis.” In the first period, we saw a market drawdown of ~40%, which was primarily valuation based, as forward P/E multiples came down from around 25x to around 16x (~36%), implying that earnings only went down approximately -4% over the period.

Conversely, the latter period saw a drawdown of almost the same magnitude (~44%), but the drop was mostly driven by a falloff in earnings rather than multiples. By the end of the second quarter of 2009, forward P/E’s were only marginally below their pre-crisis level. Earnings, on the other hand, were significantly lower. In the worst single month of the crisis, earnings had fallen almost 90% year-over-year, the largest decline in the past 146 years, and an annual rate of decline that was more than twice as steep as the falloff in the Great Depression.
Despite the strong market run, the S&P 500 P/E ratio does not appear particularly high relative to the average of the past 25 years. Earnings have seen a strong cyclical recovery from the depths of 2009, but it has been earnings growth, rather than multiple expansion, that has driven most of the market advance.

While this is somewhat comforting, it leaves a larger question unanswered. We know that corporate earnings are cyclical and that measuring P/E ratios based on a single year’s earnings is, at best, an uncertain enterprise. It would be far better to look at a longer term measure of corporate profitability that adjusts for economic cycles.

Fortunately, such a measure exists. The Shiller CAPE ratio – the cyclically adjusted price to earnings ratio – is calculated by taking the current level of the S&P 500 and dividing it by the 10-year average earnings adjusted for inflation. Unlike standard P/E’s, the CAPE is currently at a notably higher level (28x) than the long-term average (18-19x). Absent any other metric, these levels appear high. However, long-term valuations are not constant; they vary over time with the inflation rate. As the 70-year chart above shows, higher inflation is linked to higher earnings yields (i.e. lower P/E’s) and lower inflation is linked to lower earnings yields. In our opinion, this makes a great deal of sense, as other asset classes, particularly bonds, are priced off inflation. For example, if GIC’s were paying 10% per year, investors should pay a much lower multiple of earnings than if GIC rates were at 1%.

The Mackenzie Bluewater Team feels that ten-year P/E ratios are currently in line with inflation rates. Clearly, if inflation were to go up substantially and quickly, there would be concern about the valuation of the US market. The global economy appears to be strong and recovering and US policy is supportive of further growth. While a correction of 10-15% is always possible in equity markets, we do not currently see any fundamental reason for a crisis-like sell-off.

For more information on the Mackenzie Bluewater Team, please visit www.mackenzieinvestments.com or contact your financial advisor.