The current question on many investors’ minds is why is the stock market falling when the economy appears to be, at least mildly, rebounding? Many argue that investors are “depressed” and acting “irrationally” by ignoring the improving fundamentals and that the stock market is “disconnected” from the real economy. I disagree with the psychobabble, finding it very strange that many struggle for a reason to explain why the market isn’t going up. Is it “fears” of terrorism, “fears” of accounting irregularity, "fears" that the recovery will continue to be tepid? For many, the search goes on, all the while either blind to, or feigning blindness to, the most obvious explanation in the world, that stocks are still quite expensive. Paraphrasing the Clinton campaign, I’d say “it’s not about the economy stupid,” and unlike many others who point to Enron/Tyco/WorldCom/etc., I would add the rejoinder that “it’s not about the stupid accounting.” Of course, these are both important catalysts for the market’s difficulties, and both undoubtedly make the situation worse, perhaps greatly so, but both are catalysts not causes. The last two years has been about valuation, specifically a return towards, and not yet to, normalcy. Bullish pundits would like our problems today to be merely a “crisis of confidence” because psychological problems, like the touted reasons for other stock market declines of recent memory (Anthrax warnings, mid-east tensions and terrorism, tangled presidential elections, etc.), can go away in short order. In contrast, overvaluation goes away slowly and painfully (or quickly and very painfully).

In fact, some go further. Rather than ignoring valuation, many pundits, strategists, and portfolio managers are daringly willing to declare U.S. stocks “cheap” based on two years of suffering. They are, in all probability, very wrong. Based on the last 10-years earnings the market’s (S&P 500) P/E is now (6/30/02) about 26 versus a historical average of 14-15. If you don’t like these 10-year P/Es, you can use 1-year trailing P/Es, but that’s not going to help your cause (you get about 40, the highest ever recorded). Alternatively, if you are willing to use “forecasted 2003 operating” earnings as the “E” in P/E you can get the number down to about 20, but note that each word in succession (“forecasted” “2003” “operating”) brings with it very suspicious baggage, and shouldn’t be compared to the historical average 1-yr trailing P/E of 14-15, but with some smaller number reflecting the likely historical impact of these perpetually Panglossian assumptions. Any way you slice it, despite two years of falling prices, any instinct or fervent wish that shares must now be cheap runs headlong into the mathematical tyranny that they are not. Stocks are not priced near to the gigantic bubble levels of early 2000, but are still priced at the upper range of historical experience, and thus now offer significantly less attractive returns to long-term investors than the historical experience that is often used as their sales pitch.

Going forward, given stable low inflation of 2-3%, historically average earnings growth, assuming the accounting abuses and overstatement of earnings is not too bad (note that the largest potential effect of our accounting problems is not the “few bad apples” of outright fraud but the chance that the “E” we are plugging in P/E is systematically larger than reality), and most importantly given a stable market P/E that plateaus at today’s still high level, one can expect gross (of taxes and fees) nominal returns on the S&P 500 of 6-7%. This is not the bearish case; it’s the base case (based on stocks yielding an optimistic 2% plus 4 to 5% annual long-term earnings growth). Of course, if we get a positive surprise on long-term earnings growth we’ll do better (and the converse of course also applies), but despite desperately looking for a reason to forecast such a happy occurrence there is little theoretical or empirical support for forecasting higher than normal long-term expected earnings growth, other than wishful thinking. Dropping the assumption of a permanently high plateau for P/Es, and assuming some regression to the mean, things get worse. If earnings growth is average and 10-year trailing P/Es fall from 26 to just 20 over the next decade (still well over historical average), investors will achieve gross nominal returns of 4-5% per year on the S&P 500 and a zero risk premium versus government bonds. A fall to average P/Es (falling to average is perhaps pessimistic but certainly not a radical assumption) and we are looking at 2-3% annual nominal returns for a decade, and a negative risk premium. Any way you slice it, whether or not stocks fall further or just stagnate for a long time, the low expected long-term real return on large capitalization U.S. stocks is the central fact of today’s capital markets. Those building more aggressive forecasts into their long-term assumptions and actions are probably in for a rude (but perhaps slow and drawn out) awakening.
Now, as part of declaring stocks undervalued, many contend that today’s high P/E ratios are supported by the low interest rate / inflation environment. This is sometimes referred to as the “Fed model” as it was allegedly “discovered” buried deep in the obscure annals of a Fed report (some allege it was actually created by Francis Bacon). This argument is very common among strategists, the media, and pundits of all stripes. It is voiced thrice hourly on CNBC. “Well Maria, P/E might be high, but you have to remember that interest rates are low.” The argument that low interest rates should beget high P/E ratios comes in two flavors. First, many argue that when interest rates are low, investors should accept low stock yields (equivalent to high P/E) as stocks must now be compared to low-yielding bonds. In other words, stocks and bonds are “competing assets.” Second, and equivalently, many argue that a low inflation / interest rate environment raises the present value of future cash flows and thus the market’s fair P/E. These arguments form a dangerous mirage of common sense. While seeming plausible, they ignore the fact that earnings for the stock market acts much like the coupon on a real bond not a nominal bond. Meaning, when inflation is low, as it is now, so tends to be nominal earnings growth. As exhibit “A” I submit the current environment where pricing power is nil, as is nominal profit growth. Remember, a strong positive selling point of stocks is that they act like a long-term hedge against inflation. However, you can’t have it both ways. Stocks are indeed a good long-term hedge against inflation precisely because earnings tend to rise with inflation. But, sadly, the opposite also tends to be true, with nominal earnings growth tending to fall with a steady drop in inflation. In fact, when one does the math, the positive effect of lower interest rates / inflation on the present value of future earnings, and the negative effect of those future earnings themselves being lower when inflation drops, are offsetting in both theory and historical fact, meaning P/E ratios should not move very much with nominal rates. Those willing to pay a high P/E in low inflation environments (and thus get a low earnings yield on stocks) are accepting a “double whammy” as their stocks are less attractive on both scales (low yield and low expected nominal earnings growth).

Now, despite my protestations above, the historical evidence is that low inflation / interest rate environments do indeed tend to coincide with high market multiples. Doesn’t that prove that the Fed model is correct? Ah, here’s the rub, there is a crucial difference in causing something versus justifying it. Low interest rates / inflation has indeed often been the hook that gets investors to pay high multiples for stocks, probably because the error of comparing a “real” number like P/E (or it’s inverse E/P) to a nominal number like interest rates is so common. The proof of the pudding is, of course, in the eating. Purchasing stocks at high prices has historically turned out to be a bad idea over the next decade, despite possibly low starting interest rates, and a very good idea at low prices, despite possibly high starting interest rates. When the strategists show you their charts showing that low interest rates / inflation usually coincide with times of high P/E, and therefore conclude that today’s high P/E are o.k. because they are “normal”, ask them what usually happens next to long term investors, as it is not pretty. The bubble bursting has seen a lot of silly myths go up in smoke. The idea that earnings could grow at 15% per year ad infinitum, that technology stocks weren’t cyclical, that there were stocks you had to own at any price, etc. Perhaps the idea that low inflation / interest rates supports a massive P/E for the stock market is the next to go?

All is not grim, or more accurately, it is getting less grim. Although stock prices are still high (and expected future returns low), further declines are not necessarily in store. Unlike after 1999, if P/E ratios on these stocks are now priced to offer a small, but likely positive expected return over bonds, and it is possible that this is all the premium investors now require to bear equity risk. However, it’s important to note that even after 2+ years of bear market, the prospective long-term real return on stocks, both in the absolute sense, and when compared with bonds, is still very low versus history. To the extent investors know this, and are comfortable with it, the world going forward will see low returns, but perhaps no further substantial fall in prices. But, perhaps investors don’t realize all this? Perhaps investors believe that since P/E ratios are “normally” high when interest rates are low, things are normal now, and in such a normal environment stocks earn 5% over bonds and never lose over long horizons. Perhaps investors instinctively believe that if you are a contrarian and buy after big declines like we’ve seen, then the prospective long-term returns are even better. Perhaps investors have learned that stocks are wonderful investments over the long-term, but skipped the part about this being at historical average P/E’s of 14-15 and dividend yields of 5%. If investors are counting on any of this then we have a problem. To expect a 5% return premium over bonds, like stocks have turned in over history, and to expect it with the certainty that equities have historically delivered, prices do indeed have to fall much further, regardless of the Fed and their model.