
Six Beacon Street
Suite 925
Boston, MA 02108
Ph: 617.722.8322
Fx: 617.249.2020

Global stocks surged in the first quarter, with the S&P 500 Index of U.S. stocks rising a gaudy 23% from Christmas Eve to April 8th. At that point the index stood at 2,896 with a trailing price-to-earnings (P/E) ratio just shy of 21¹. That P/E ratio has only been matched or exceeded 17% of the time over the last 100 years, with much of the 17% coming during the ill-fated tech bubble of the late 1990s. The current P/E ratio is based on record high profit margins. If margins fall, as well they may, the P/E ratio would likely climb, perhaps considerably. All the more reason to worry that U.S. share prices are too rich. We share that concern, but it's worth understanding why an elevated P/E ratio may be warranted in light of recent events².

Our increased comfort (relatively speaking at least) with a higher P/E ratio is driven by changes in the interest rate outlook. Last June the Fed signaled three rate hikes in 2019 with the prospect of additional increases in 2020. Over the next nine months the Fed completed an about face and is now forecasting zero rate hikes in 2019 and a reasonable likelihood that the next move in the fed funds rate will be down. Turning points in Fed policy are always significant. What makes this one particularly important is that it heralds a transition from a world with lower bond yields to a world with lower bond yields **and a strong possibility that they will remain low for a very extended period of time**. To tweak an expression that has been used in financial press discussions of interest rates: "lower for longer" just became "lower for a **lot longer**."

After peaking last fall at 3.23%, the yield on the benchmark 10-year U.S. Treasury bond has declined sharply and sits at around 2.60% at this writing. Until we get significantly past the next recession, the fed funds rate will likely stay at or below current levels. If a recession is one to three years away and lasts for a year, and if it takes a couple of years of expansion before the Fed starts to hike rates again, it could be a very long time before yields on the 10-year Treasury get much over 3.00%. Even looking past the next recession and the initial phases of the next

¹ All P/E ratios are based on trailing twelve month GAAP earnings.

² We have some trepidation in defending high P/E ratios. Legendary investor and mutual fund pioneer Sir John Templeton wrote many decades ago that "the four most expensive words in investing are: 'This time it's different.'" Those words echoed a bit uncomfortably in our minds as we composed this commentary.

expansion, it's not clear that interest rates will rise dramatically. Most economists believe that due to very slow growth in the labor force and only modest productivity gains, trend GDP growth for the foreseeable future will be a tepid 2% or maybe even a bit lower. In that environment the Fed doesn't have to work as hard to keep inflation under control, and won't have to push rates as high to accomplish its objectives. To repeat: **lower for a lot longer!**

What does all of this have to do with whether U.S. stocks are too expensive? The answer becomes clearer when we flip the P/E ratio around. Earnings divided by price is known as the "earnings yield." It generally provides a rough estimate of future real (net of inflation) returns³. As of this writing the earnings yield on the S&P 500 is 4.8%, substantially below its historical average of 6.7%. While that suggests future returns will be somewhat lower than in the past (not the best news to be sure), the obvious question is, what's the alternative? The 2.5% yield on the 10-year US Treasury comes to less than 1% after accounting for inflation. BBB corporate bonds (riskier but still investment grade) yield around 4%, but that's only 2% net of inflation. By historical standards the earnings yield is low, but relative to bond yields it looks great.

The earnings yield advantage relative to bonds is alluring, but there's one small problem. What happens if P/E ratios revert to historical averages, dropping from 21 to 16 ("P/E compression")⁴? That would result in a 24% drop in share prices, which, at least in the short run, would overwhelm the earnings yield. The key question is how long the gap between the earnings yield and net of inflation bond yields will last. Several years of a three percentage point differential (relative to BBB bonds) looks paltry compared to the risk of a 24% share price drop. But, if bond yields are lower for a lot longer, preserving the earnings yield advantage for, let's say, ten years, the risk of P/E compression may be acceptable⁵. The bottom line is that the case for a 4.8% earnings yield (P/E ratio of 21) is a lot stronger now that the Fed rate hike cycle appears to be over than it was a year ago when the future course of interest rates and bond yields was a lot fuzzier.

We hasten to add that there are substantial downside risks at current U.S. share prices. The biggest one is the record-high profit margins we alluded to earlier. There are a number of valid reasons profit margins are historically high, chief among them the significant reduction in U.S. corporate tax rates that went into effect last year. Also, stock indexes are increasingly dominated by very high-margin intellectual-property based companies such as Apple, Facebook and Microsoft,

³ The idea is that earnings either (a) get returned to shareholders in the form of dividends or, what ends up amounting to the same thing, share repurchases, or (b) get reinvested in the business (or acquisitions) to drive future revenue growth. It should be noted that the earnings yield is only a very rough guide to future returns and even then only if earnings are not unusually low (such as might be the case during a recession) or unusually high, (as is arguably the case now).

⁴ 16 is the median P/E ratio on the S&P 500 over the last 100 years.

⁵ And, in a feedback loop that makes this sort of analysis rather tricky, the more acceptable the tradeoff looks, the less likely P/E compression becomes!

and that trend won't stop any time soon. Still, margins are overdue for a retreat as companies face tariff-driven higher raw material costs, upward wage pressures, and the impact of a stronger dollar. First quarter earnings reports are expected to show the first year-over-year decline in S&P 500 profits in several years. The big question is what happens beyond the first quarter. The stock market may be anticipating a brief dip in profits or maybe even a longer period of flat profits. It doesn't seem to be anticipating an extended decline.

Lower for a lot longer has significant implications for the U.S. and global economy. U.S. GDP growth has likely cooled a bit after a very strong 2018. Six months ago we highlighted the possibility that continued interest rate increases could lead to a recession, something that has happened more often than not following a rate hike cycle. But six months ago the increase in interest rates over the full cycle was expected to be 3.25 percentage points, as opposed to what now appears to be 2.25 percentage points. That's a significant difference in economic impact. The benchmark 10-year U.S. Treasury, which drives rates on fixed-rate mortgages, is hovering right around the average of the past two years. That suggests that the bulk of any negative impact from higher interest rates has already been absorbed. The most likely scenario is probably a gradual cooling of the economy over the next year or two to trend growth of 1.5 to 2%.

Arguably the biggest beneficiaries of the change in the U.S. interest rate outlook are emerging market countries. Rising rates in the U.S. makes the U.S. dollar more attractive relative to other currencies. The effect tends to be especially pronounced for emerging market countries, many of where central banks were forced to defend their currencies in 2018 by raising interest rates. And they were forced to do so in spite of the ill effects on their domestic economies. As major suppliers to Chinese companies, many emerging market countries have also suffered indirectly from last year's increased tariffs on Chinese exports to the U.S. If the U.S. and China complete a trade accord, a second cloud over emerging market economies will be lifted.

Efforts by Chinese authorities to combat the effects of those tariffs seem to be bearing fruit, with manufacturing rebounding in the first two months of the year and measures of services sector activity reaching 14-month highs. Signs of stabilization are more mixed in Europe but the overall picture for the global economy suggests gradual cooling in the U.S. but coming off of very strong numbers, and stabilization outside of the U.S.

Having argued that the interest rate outlook in the U.S. justifies, to at least some degree, elevated P/E ratios in the U.S. stock market, we feel compelled to comment briefly on the relationship between interest rates and P/E ratios in Europe. In short, they're way out of whack. Investment grade bond yields are, for the most part, significantly lower than in the U.S.—in some cases close to zero! Earnings yields on European stocks, meantime, are around seven percent. There is much not to like about the European economy and European stocks. The European population is rapidly aging. Banks didn't undergo the kind of restructuring that U.S. banks did after the 2008 financial crisis. European stock markets are relatively devoid of technology behemoths like Apple, Alphabet,

Amazon and Facebook. Despite all of that, high earnings yields and rock bottom bond yields strongly suggest that there's a lot more upside than downside in European stocks over the next five to ten years.

*April 12, 2019
Boston, MA*