Front Harbor
Macro Research

March 25, 2018

Couple tweaks to valuation approach

With the market now well off its high again, it may be an appropriate time to introduce some tweaks to my main approach to valuation. These tweaks seem appropriate in their own right, but they are in the *bullish* direction, so it is probably best to incorporate them when the market has not been ripping higher.

There are three tweaks:

> Trend earnings are no longer calculated as a 10-year moving average of inflation-corrected operating earnings in a manner that is analogous with Shiller's approach. Instead, I attempt to smooth earnings to net out the effect of the business cycle by taking a weighted-average of a long-history of inflation corrected earnings, where the weights are forced to follow a geometric decay. The main purpose of this change is to avoid an abrupt rise of "trend" earnings as the effects of the Global Financial Crisis drop out of the 10-year window, which is now imminent.
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> Trend earnings are adjusted higher to incorporate the one-off but presumably permanent effect of the corporate tax cut. Assuming, as I do that there is little reason to believe that competitive pressures will necessarily arbitrage away the impetus to after-tax earnings, the trend earnings series must be ratcheted higher immediately to incorporate the tax cut. This has the effect of driving down the multiple and driving up the (trend) earnings yield, in both cases by about 7% and in opposite directions.
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> Most importantly, I no longer adjust the earnings by the full deviation of my proxy of potential growth from its full sample average. Instead, I agnostically split the difference with the conventional approach (which has no adjustment) and take on board <u>half</u> that gap.

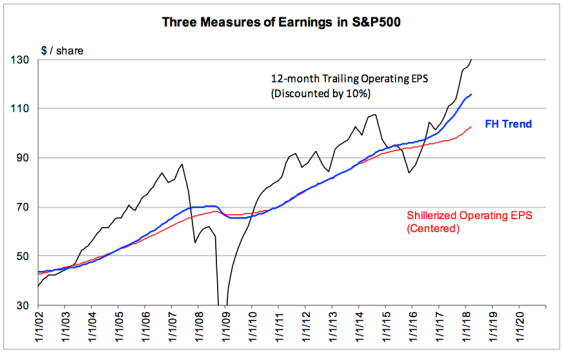
The effect of these tweaks is to raise the estimated equity premium by about a percentage point. About 80% of this is due to the decision no longer to adjust the earnings yield for the full effect of the apparent potential growth slowdown. But rather than go tweak by tweak, I will just present a brief summary of my current approach.

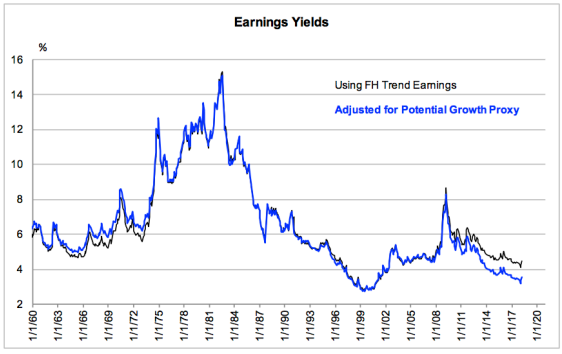
Before that, though, here are the two main practical conclusion. First, these tweaks reinforce the point that equities are not overvalued but are roughly fairly priced for the serene macro backdrop (including politics) that <u>appears to have been</u> in place for the past several years.

If that serene backdrop disappears, equities will go lower. Otherwise, they will probably go higher — once the market has delivered the financial conditions tightening required to allow the Fed to hit its objectives. Valuation is not a particularly powerful influence on prospective returns, except arguably when it is at an extreme. And this does not appear to be one of those times.

Second, there is probably no "correct" measure of valuation and the meaning of the term itself is somewhat dubious, because the "average" macro backdrop is largely a fiction. The appropriate valuation metric probably depends on the environment, so this will definitely not be my final word on this theme.

With those points in mind, consider the chart at the top of page 2, which presents a picture of trailing operating earnings as well as a couple ways to smooth them out to dial down the transitory influence of the business cycle.





Source: Robert Shiller, BEA, Bloomberg, S&P Global, FH calculations. Trailing earnings incorporate consensus to March.

The operating earnings series, shown in black on the left panel, is discounted by 10% to reflect that operating earnings tend to be about 10% above reported earnings outside periods of crisis, when reported earnings are particularly heavily affected by write-downs. What I am trying to achieve here is a series the nets out the effect of those write-downs *and* can be spliced to reported earnings for all periods during which operating earnings are not available, which is the period prior to 1988.

A popular way to net out the effect of the cycle is *Shillerize* the underlying earnings series in a manner analogous to the approach used when calculating the CAPE. The only tweak I would (and did) introduce to the algorithm was to "center" the resulting earning series by multiplying each observation by a 2% trend real growth factor compounded over five years. The result is shown in the red line.

The thick blue line is my new proxy of underlying trend earnings. As mentioned, it is calculated as a long weighted average of trailing earnings, where the weights decay at 20% a year. It is also centered and adjusted by a tax-cut scalar that assumes a value of 1 for all periods prior to January 2017, rises linearly to 1.07 by January 2018, and subsequently converges back to 1 at a rate of 20% a year. The re-convergence is not relevant yet, but it will be in the future.

The right panel of the chart shows my estimates of the earnings yield with and without my (now partial) adjustment for the deviation of contemporaneously estimated trend growth from its full-sample average.

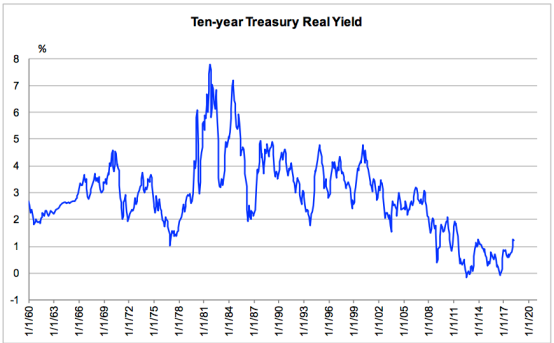
Conventionally, there is no adjustment for potential growth when calculating the earnings yield. And this conventional approach is based on the premise that if trend earnings are calculated correctly then they will *by definition* set the expected return.

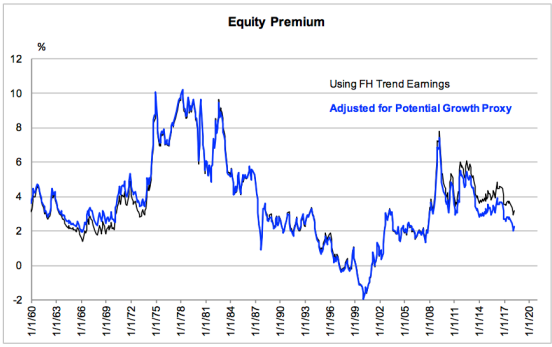
My approach differs from the convention, because I recognize the logic behind the convention as largely <u>semantics</u>, referencing a conception of earnings that is defined to deliver the theoretical result but could not possibly ever be observed. But I am not confident I know precisely how properly to incorporate slower trend growth. And my kludge involves comparing the non-commensurable concepts: the earnings yield and a growth adjustment. For now, then, I split the difference. This is not rocket science and my objective is to get close.

Now let's turn to the equity premium, which I define as my preferred measure of the earnings yield less my proxy of the real yield offered in the conventional 10-year Treasury. The equity premium, shown in the chart on the top of page 3, looks to be pretty close to prior periods of low volatility, low inflation, and serene politics, occurring in: the mid-1960, the pre-bubble mid-1990s, and the mid-2000s.

The premium is well above where it was during the late 1990s, which is widely considered to have been an equity bubble.

Separately, and as I have mentioned before, it may seem odds to take any comfort from the fact that valuation is close to where it was in the mid-2000s, before the global financial crisis. But that crisis was not really related to valuation developments in equities. The world almost ended and equities went down in response. That is not evidence that they had been expensive, although other securities clearly were.





Source: Robert Shiller, BEA, Bloomberg, S&P Global, FH calculations. Trailing earnings incorporate consensus to March.

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