Front Harbor
Macro Research

January 21, MLK, 2019

Equity valuation remains middling

From my perspective, the simplest resolution here would be for growth finally to slow meaningfully in response to: the financial conditions tightening we have seen, a loss of fiscal impetus, and some so-far minor shocks from the government shutdown, the lower oil price and international trade shocks.

Ideally, investors would view the slowdown as *required,* to respect supply-side constraints in the labor market. There would be less focus on a remedy from the Fed and a greater recognition that the US economy has simply entered a phase where the risks of recession are unavoidably higher, even if not particularly elevated quite yet. Once that more straitened environment is accepted and perhaps discounted into lower stock prices, we might have in place the conditions for moving back to a long in equities. It's been a year. And it is not as though there have been no wiggles.

But the set-up I have in mind is obviously not the only possibility and it is taking a very long time to develop, assuming even that it is coming. To some extent, this has not been surprising, as this low-vol economic backdrop is *also* slow-moving and not strongly inclined to generate cycle-ending inflation pressures. What has been a bit more surprising has been just how *extremely* quiescent inflation has been (particularly relative to the Fed's preference of above-2% inflation) and then, in turn, how willing the Fed has been to probe for a response on the inflation side.

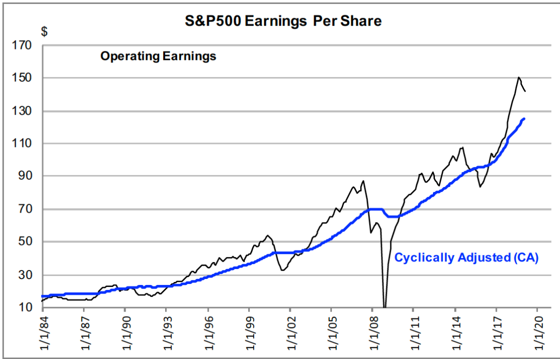
I had expected them to be a bit more adamant about the need to approach effective full employment along a shallow tangent, rather than being as willing as they have been to let employment growth continue to rip. But the fact that this story is playing out frustratingly slowly does not necessarily change the story. As I read it, the story justifies limiting/eliminating directional risk, rather than being outright short.

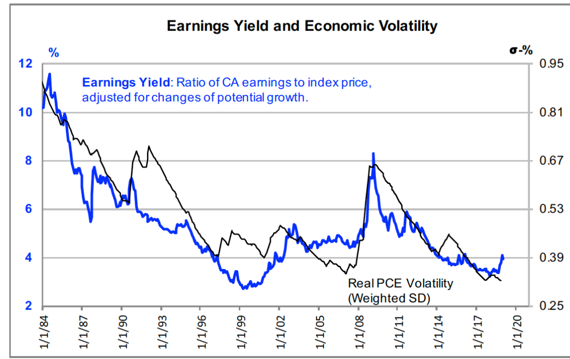
That last consideration is reinforced by valuation, which currently seems appropriate to a low-vol economic environment that is inclined to persist. The business cycle has not been repealed. But the odds favor the secular backdrop staying low-vol.In the remainder of this brief note, I will review and reiterate some of the logic behind my own valuation metrics. If you are pressed for time and prefer to avoid words, there is a fairly self-explanatory picture on page 2.

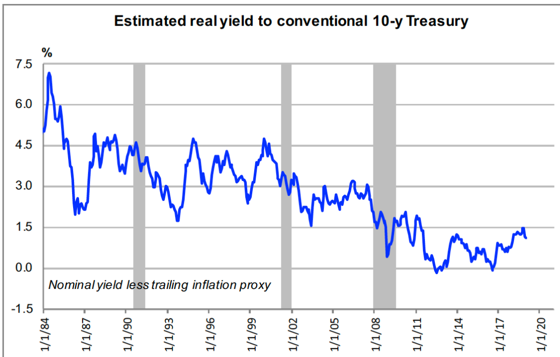
Cyclically-adjusted earnings

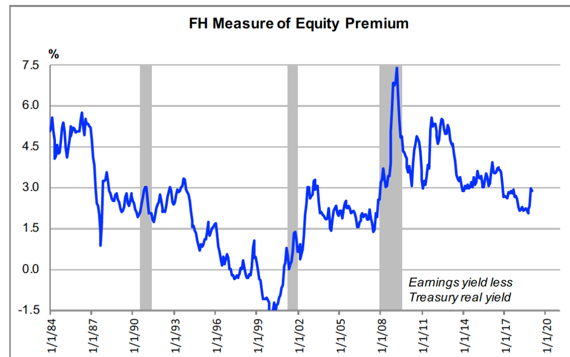
My measure of underlying earnings *starts* with quarterly earnings as aggregated by S&P Dow Jones. Before annualization, these reached a cycle high of $41.38 during the third quarter. They are meant to have slipped to $40.32 (false precision) during the fourth quarter and are projected to slip further to $38.98 during the first. I will leave a discussion of estimates manipulation to others. The effects of it on my measures of valuation are about zero.

Where available, I like to use operating — rather than reported — earnings, in order to limit the effects of write-downs during recessions. Those write-downs were particularly an issue, even after cyclical smoothing, in the wake of 2000 and 2008. However, operating earnings have a systematic upward bias of about 10%, even outside crisis periods, so I discount the operating earnings data by that amount. This has no effect on the basic shape of my valuation metrics or on the interpretation of them, so long as they are viewed in terms of deviations from their own means. But it makes the absolute measure of yield more realistic and allows me to splice the recent earnings data with the more distant historical periods, (before the mid 1980s) when only reported earnings figures are available.









Source: S&P Dow Jones Indices, Robert Shiller, Bloomberg, BEA, CBO, FH calculations

All data are to Friday close.

To cyclically adjust that underlying earnings series, I use an approach that rhymes with the approach used in Shiller's CAPE, but with three important differences.

- The cyclically adjusted (CA) earnings figure is not a 10-year moving average of inflation-corrected earnings. Rather, current period earnings are incorporated into the cyclical measure at a rate of 20% a year. In other words, the weights follow a geometric decay, rather than being truncated abruptly at 40 quarters. This makes the effect of recessions fade gradually over time, rather than disappear on an arbitrary date.

- In the current period, for which earnings are never actually available, I use a figure based on the consensus estimate for the current quarter, rather than assuming (implicitly) that it must be equal to the "average" value excluding that observation. This eliminates a *minor* bear bias in the estimated yield that would arise if following Shiller to the letter.

- Finally, I center the smoothed earnings series on *today* by inflating each quarterly earnings series not only for inflation but also for long-term historical trend real EPS growth for the relevant period of each quarterly earnings observation. Without going into a long song and dance, this gives me a sense of where cyclically adjusted earnings might be for today, as opposed to five years ago. This eliminates a *major* bear bias (at least in the *absolute*[1] values of the PE and multiple) that would arise if following Shiller to the letter.

[1] This is not a major issue within Shiller so long as the Shiller values are interpreted as deviations from their own means, rather than compared with what the conventional values, such as price to forward earnings, imply in an effort to scare the children. But why not do it properly, so the scale of the figures produced is immediately intuitively sensible?

Accordingly, CA earnings are currently **$125**, which implies a multiple of 21 ½. This multiple probably seems high relative to what most readers are used to hearing of. That is intentional, because the conventional metrics are probably too generous. But it should be compared with its own history, like all valuation metrics.

Earnings Yield

To calculate the earnings yield, I *start* by simply inverting the multiple, to generate 4.7%. I end up — in some cases — comparing the equity market's estimated earnings yields with the real yield available in the bond market. But the yield in the bond market has been depressed *at least in part* by a presumed slowdown of potential growth, related in part to total factor productivity. So is it really fair to compare an unadjusted earnings yield with a Treasury yield that itself presumes slow economic growth and thus low real returns in the private sector.

I don't know[2], so I follow the safer course of splitting the difference. In the current period, potential growth appears to be about 140 bps below its full-sample average over the period for which estimates are available. So for the current period, the earnings yield is reduced by 70 basis points. There is actually an adjustment for all historical periods, but by construction that adjustment has an average of zero. I think, but cannot prove, that this adjustment makes my approach marginally more conservative than the consensus approach. I remain far to the bull side of the followers of Shiller, but for now, there are not many of them. Anyhow, I measure the S&P500 as delivering a cyclically adjusted earnings yield of 3.95% (false precision).

As you can see from the top right panel in the chart on page 2, my measure of the CA "earnings yield" has been somewhat correlated with my measure of underlying economic volatility (the same one I use when discussing the term premium) since the mid-1980s, which is what is shown in the chart. The correlation before then is much weaker (and not shown), presumably because inflation was high and volatile back then. The recent correlation is **not** strong enough for us to draw an inference about valuation from whether the earnings yield (or equity premium) is above or below what might seem implied by underlying economic volatility. Rather, the main point is a simpler one. Lower-than-historical economic volatility would seem to justify higher-than-typical valuations. Prospective returns should be lower as a function of this, but that seems to be what the world offers us. In my view, it would be wrong to expect this condition simply to go away.

Equity premium

Roughly the same issue applies to my conception of the equity premium, which — as mentioned — is probably to the conservative side of consensus, although for reasons I would defend. Low underlying economic volatility means that the spread between the earnings yield and the very-low-risk return available in Treasurys should be narrower.

This creates a current set-up that strikes me at least as somewhat interesting. Note that the current value of the equity premium is currently at about 3%, having recently *risen* from a lower value in response to higher earnings, lower equity prices and lower Treasury yields. For a while in this cycle, 3% looked to have been a bit of a floor, now it looks — arguably — to be an attractor.

In the past cycle, the attractor for the equity premium looked to be about 2%, even though underlying economic volatility was a bit higher during the expansion phase of the 2000s cycle. In my view, there are two points to make about this.

[2] One of the reasons I don't know is that the standard approach to this issue presumes rational expectations and competitive, not just efficient, markets. The latter presumption in particular is being challenged these days, as profits are increasingly viewed as much more a function of intellectual property and market power generating rents than of classical competitive equilibrium. A separate issue arising from this is that profit margin mean reversion is a loser. But it is far too late to fight that fight. That approach has been discredited, although possibly with perfectly awkward timing. We shall see!

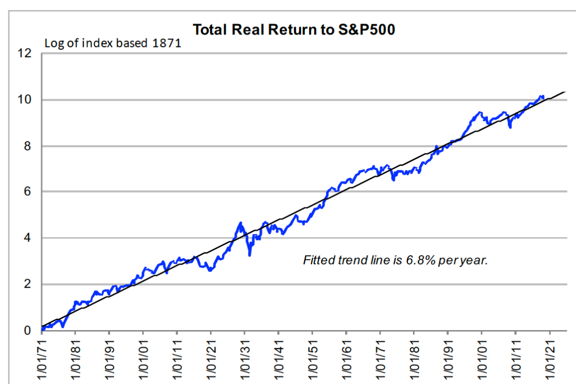
First, in accounting (as opposed to causal) sense, we might say that this *reflects* the low Treasury yield. After all, on the basis of the *absolute* yield to equities (as proxied by my earnings yield), valuation looks a bit *fuller* now than then. It is just that the Treasury yield is lower. So is this a cheat? I have tried to prevent it being so, with my kludge of subtracting half the apparent growth slowdown from the earnings yield calculation. But there is room for debate there.

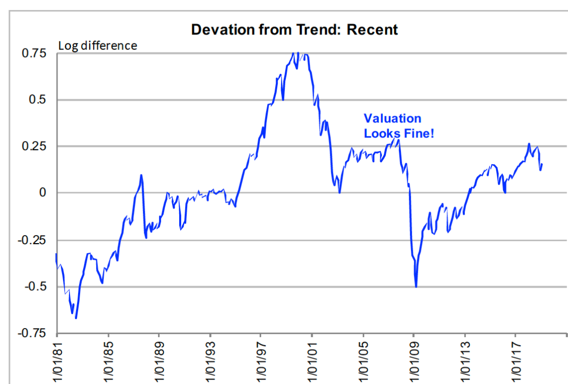
Second, and much more strikingly, it may seem to some readers as very complacent to take any comfort from the fact that valuation might now be less full than it was in the mid-2000s, during the expansion phase of the last cycle. Between the close of 2007 and the end of March 2009, an index measuring the cumulative real return to the S&P got cut almost in half.

But I venture that the comparison remains relevant, because the Global Financial Crisis was a surprise, to put it gently. It was not triggered by a valuation dysfunction in equities, although there were other dangerous forms of suspension of disbelief. If the next recession is bread and butter, rather than global calamity, then this comparison with the mid-2000s is perhaps a bit less crazy.

Not relying on an impending global financial crisis, I cannot rely on the idea that equities are dangerously stretched and an accident waiting to happen here. It would be easier if they could tick lower to discount the need for lower growth. But we seldom get what we want.

Some might take cold comfort from comps with the mid-2000s





Source: S&P Dow Jones Indices, Robert Shiller, Bloomberg, BEA, FH calculations

All data are to Friday close.

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