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Looking at the Evidence

We have written on many occasions highlighting the risks of current Stock Market valuations, particularly in the US. It still seems to us though that many investors are ignoring the evidence.

The case for a continuation of a rising stock market seems to be founded on ultra-low interest rates and Central Bank willingness to undertake Quantitative Easing programmes that in recent years have supported equity prices.

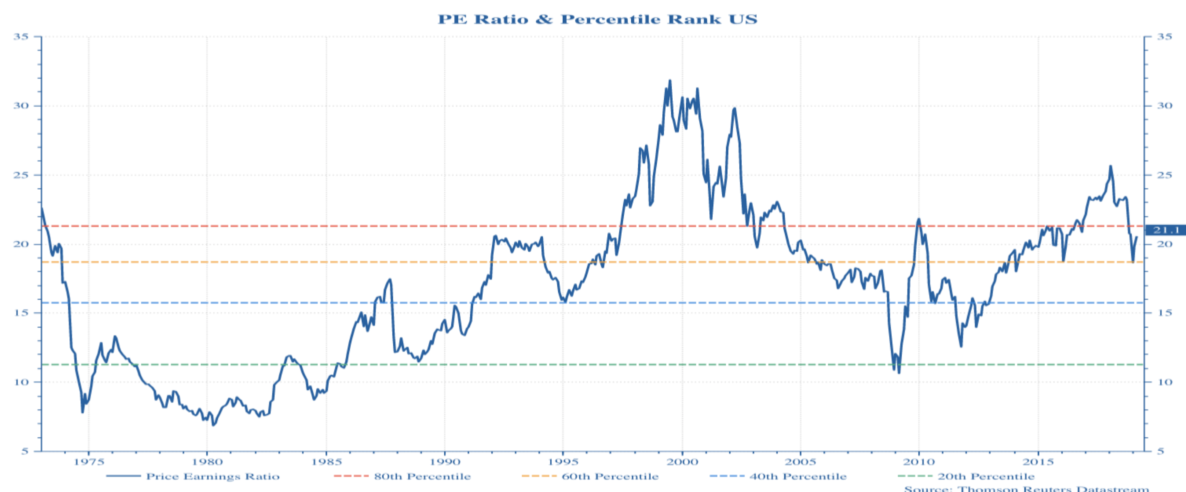
Whilst interest rates are low the yield on some stocks looks very attractive; after all, even at the current modest inflation levels the real value of cash at the bank is being eroded.

We use the US given its importance and links to other markets and the availability of data back over fifty years or more. The indicators here are not exhaustive but are some of the key ones that we look at in making investment decisions.

Valuation Levels

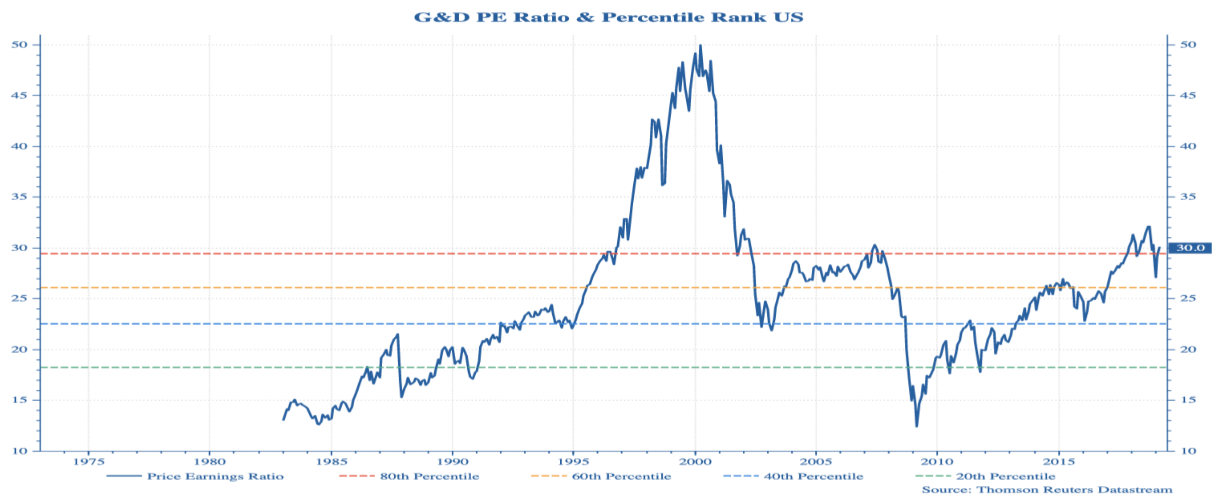
Stock markets valuation levels are typically assessed by price ratios; the most watched is the Price Earnings or PE ratio that divides the share price by the earnings per share (EPS). The EPS is effectively the profit for each individual share.

High levels suggest investors are bidding up stock prices in the belief that earnings will continue to grow at current or better rates in the future.

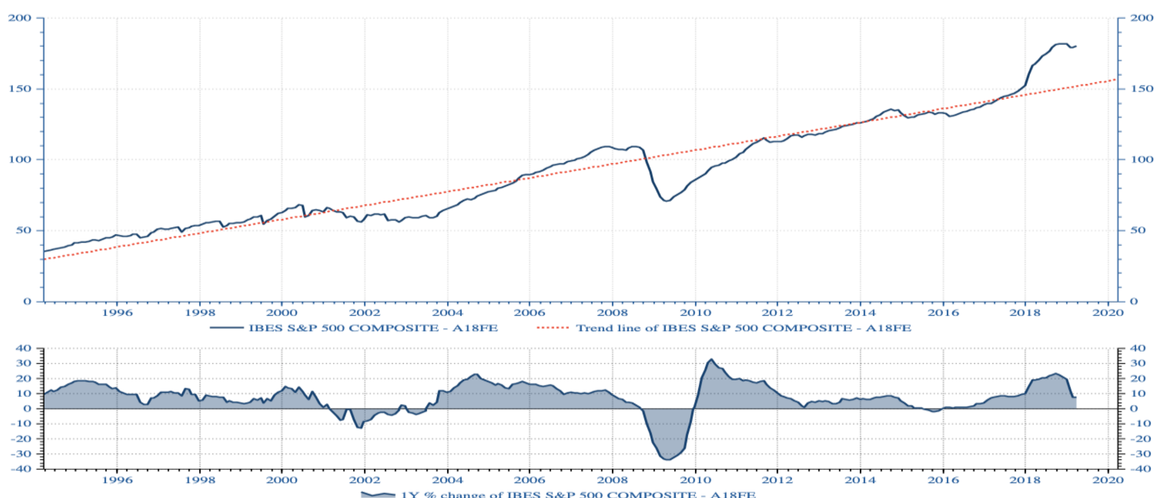


Here we see that the US PE ratio peaked in 1999/2000 (Tech Bubble) before hitting the lows of the Financial Crisis. Late 2018 we also saw a warning sign as the ratio was in the 80th Percentile (top 20%) of readings at almost 25x earnings.

EPS are quite volatile and to iron out the business cycle we use the Graham & Dodd PE (the EPS is effectively averaged over ten years); and using this we see that the G&D PE ratio is currently at levels last seen in the Financial Crisis.



You may wonder what the problem is? Well EPS need to continue to grow to justify high PE ratios and these growth rates may well be reaching a peak. The graph below shows how EPS are well above their long term trend and growing at well over 20% in 2018 which is not sustainable.



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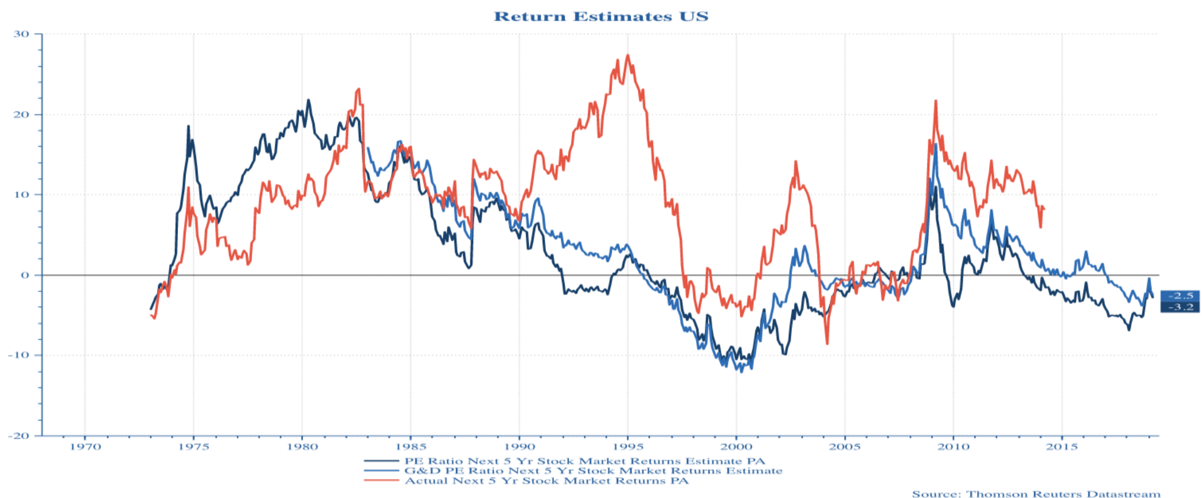
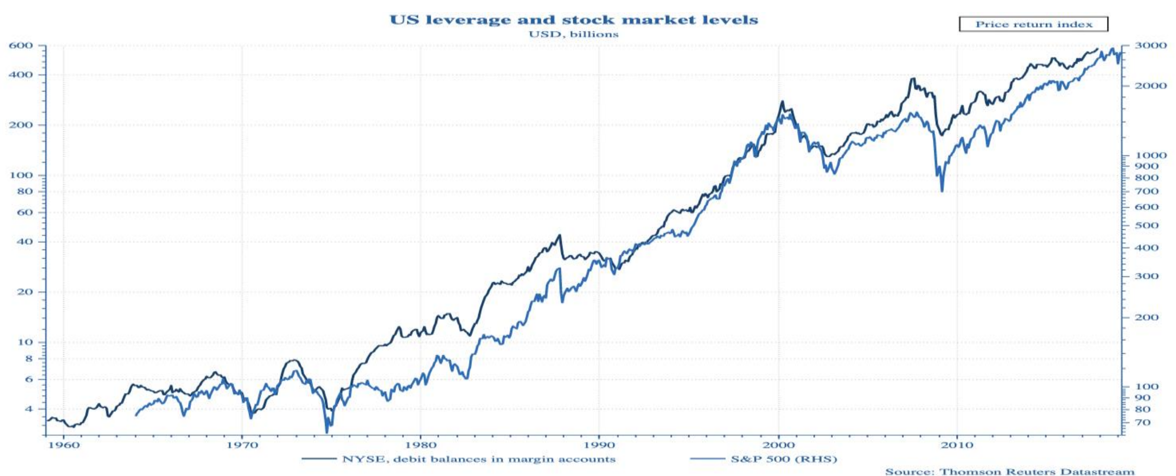
If EPS falls, then the PE ratio will rise further; investors will start to consider this too high and sell equities bringing down not only the PE ratio but also prices.

This links to the components of stock market returns; PE expansion or contraction, earnings growth and dividends. Below is our simple model that shows the prospective returns from the PE reverting back to its long-term average coupled with the dividend yield investors receive.

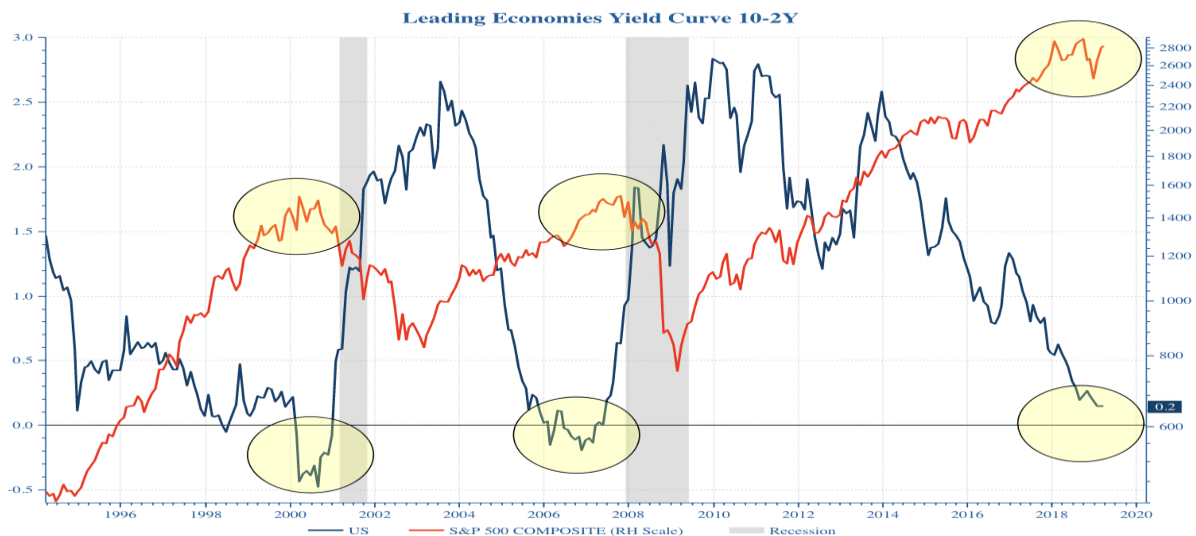
With the exception of the Tech Bubble this model has been relatively accurate in providing a guideline for future market returns – currently we are more negative than the Financial Crisis.



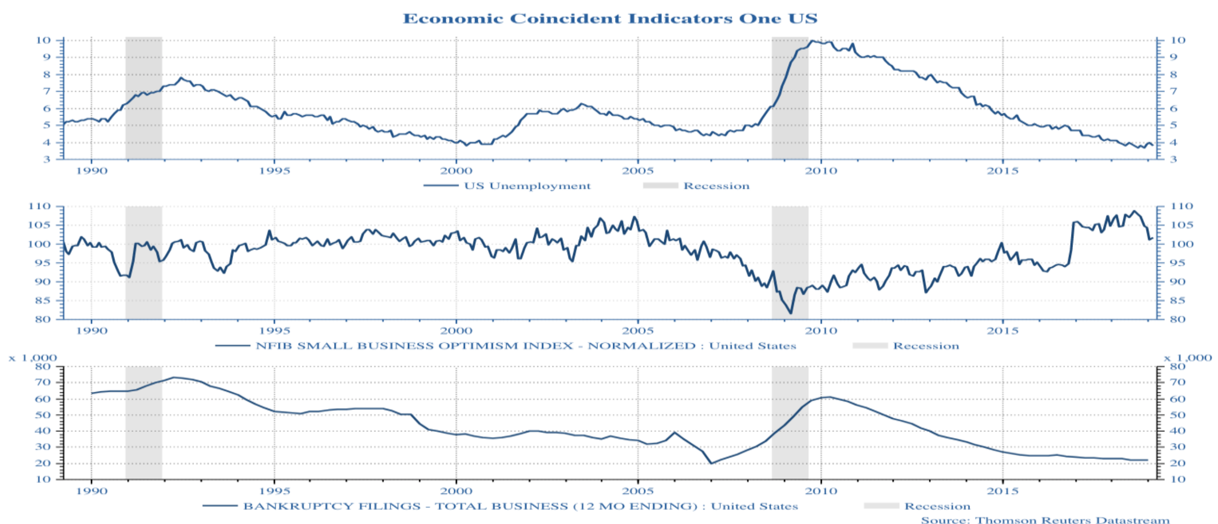
Stock Market growth has also been driven by high levels of borrowing on low interest rates.



The prospect of a US recession is also pretty high due to the shape of the Yield Curve; this is the interest rate on Government Debt over different time frames – normally you would expect a higher rate in the future. The graph below shows the difference between the Yield on 10 Year US Treasuries and 2 Year US Treasuries; in the last 25 years when this gap is small recessions have followed and Stock Markets declined. We are now at a level that should clearly put us on alert.



There are also lots of parallels and coincident economic indicators that we have seen before at market tops. The highs of 1999/2000 and 2007 where characterised by low unemployment, high business optimism and low bankruptcy filings by businesses.



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There are also remains the possibility for investor preferences to change the Yield on Cash and lower risk Government Debt in the US is now higher than the Dividend Yield from equities – the result is that we may start to see investors move into these lower risk assets.

Looking at the above there is little that would make us adopts a more positive outlook for the US equity market; although we would not be surprised to see it continue upwards!