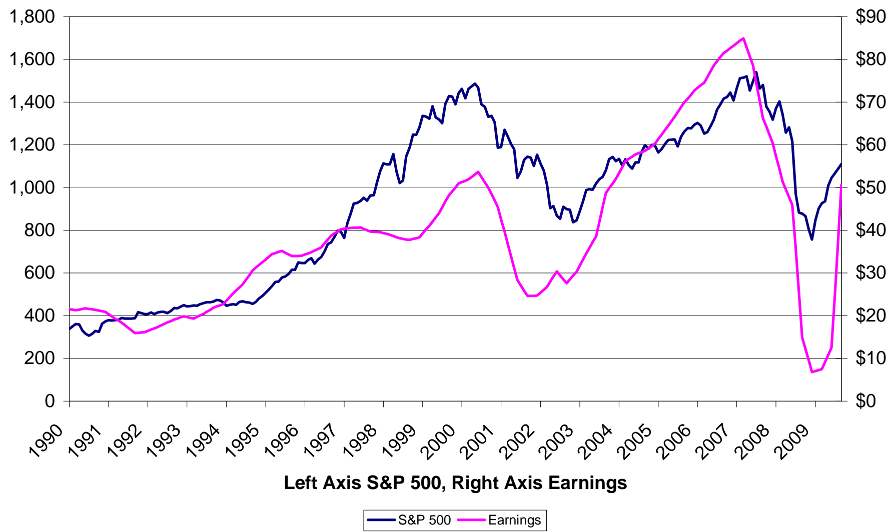
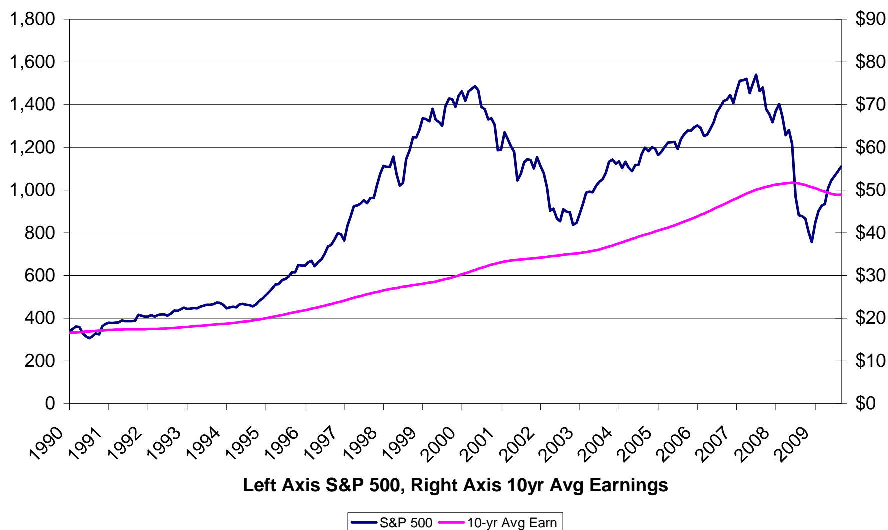
March 4, 2010

Note

RE: Setting Expectations III

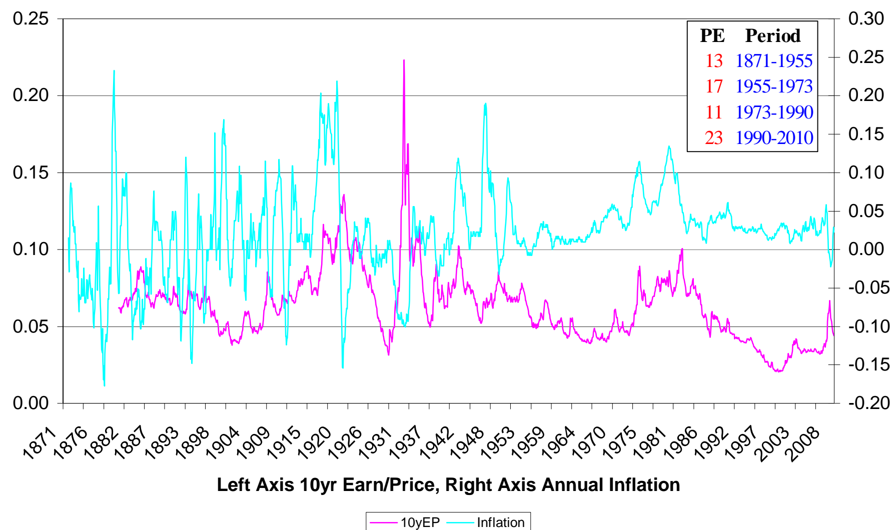
The first chart below makes plain the strong relationship between stock Price (S&P 500) and Earnings, but also the extreme volatility of both through this time period. Per the article we recently shared[i], smoothing Earnings by taking a 10-year average and relating that to current Price creates a more predictive ratio of future stock return. We have verified this predictive relationship and the second chart depicts the relationship. As Earnings continue their recovery, expected to grow from $50 to $69 over the next two years (38%), we can expect investors to respond per the first chart. As this occurs, remember the second chart and what ultimately takes place if/when investors run too far ahead of sustainable, long-term Earnings.





The final chart below relates Inflation to 10yr Earnings to Price, the inverse of course being the more familiar PE. When inflation was tamed during the late 1950s, 1960s and early 1970s, the market's PE hovered near the max of its normal range (PE averaged 17 from 1955 to 1973). When inflation flared during the 1970s and 1980s, the market PE dropped to the low of its normal range (PE averaged 11 from 1973 to 1990). As can be seen, what took place over the next/last 20 years was unprecedented, with PE averaging 23 from 1990 to 2010. A Dot-Com bubble-burst and Great Recession selloff later, the market is finally again pricing inline with historic norms.

10yEarn/Price v. Inflation



This contradicts Siegel's 200+ year chart that makes the case the market is still cheap relative to his inflation plus 6.5% trend line. If we split the difference, we conclude that the market is now about fairly priced, which means the market's "V" recovery is complete. Stock returns ahead should be inline with corporate performance and the degree to which inflation is controlled.

One implication of the above is that investors' expectations of 11-12% average equity returns is not realistic in a low inflationary environment, assuming we're starting from a "fairly" priced market, as market PE multiples don't have room to expand as they did from the early-70s to the present. To create double-digit returns in this environment will require effective active management, which fortunately for us is our forte.

Lowell D. Pratt, CFA
Eugene Y. Yashin, CFA

---

[i] Financial Analysts Journal Volume 66 Number 1 ©2010 CFA Institute "Economic Growth and Equity Investing" by Bradford Cornell