In the Spotlight

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Value is in the Eye of the Beholder

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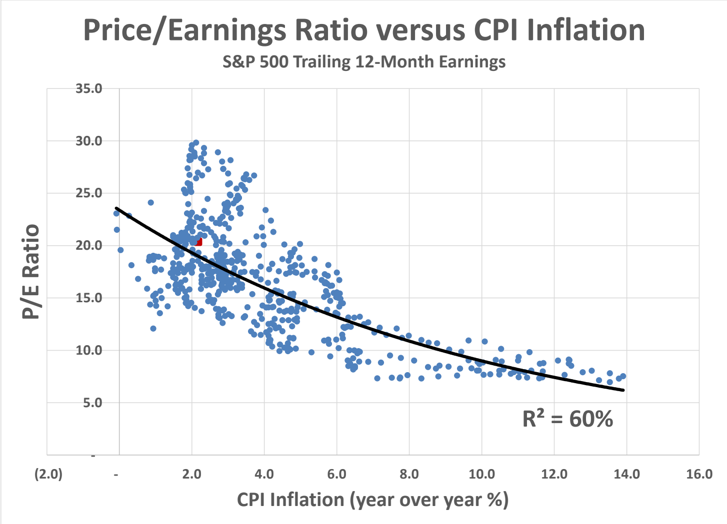
May 14, 2018

S&P 500 Price/Earnings Ratio versus Inflation
Last 50 Years

Inflation(%)	Average PE	PE as of April 30	Implied Change	Max PE	Min PE	Range	# Observations	% Observations
<= 1.5	17.7			24.1	12.1	12.0	39	7%
1.5 to 2.5	**20.4**	**20.4**	**0%**	**29.8**	**13.7**	**16.1**	**144**	**24%**
2.5 to 3.5	19.3	20.4	(5%)	28.9	12.6	16.3	163	27%
3.5 to 4.5	15.2			26.7	9.9	16.8	67	11%
4.5 to 5.5	15.0			20.2	9.8	10.3	51	9%
5.5 to 9.5	11.8			18.1	7.3	10.8	91	15%
> 9.5	8.4			10.9	7.0	4.0	45	8%
Entire Range	**16.7**	**20.4**	**(18%)**	**29.8**	**7.0**	**22.9**	**600**	**100%**

Behold the S&P500's historical price earnings ratio as compared to its long-term average over the last 50 years. **By this measure, across all inflation levels, stocks are expensive.** If the PE ratio reverted from its current level of 20.4 to the average of 16.7, stocks would have to fall by 18%.

Behold the relationship between PE level and inflation. The table shows the average PE by inflation level interval. We are in the 1.5 to 2.5% interval. The average PE when inflation is in that interval is 20.4 – the same PE as the current level. **By this measure, stocks are priced near fair value.**



The chart shows the relationship between PE ratio and inflation. The fitted black trend line shows that the **inflation level has explained 60% of the variation in the PE level over the past 50 years**. This strong relationship makes intuitive sense since higher inflation levels come with higher interest rates, higher interest rates drive higher earnings yields (earnings over price), and therefore lower PE's (price over earnings).

That said, the variation in PE is much greater at lower inflation levels. You can see the variation in the chart or in the range column on the table. This may be a result of fewer observations at higher inflation levels, or that when inflation is high, it becomes the dominant factor driving PE's to low levels. When inflation is low, other factors become more dominant – changes in growth, inflation expectations, politics, a crisis like 2008-2009 , to name a few.

So where does this leave us? **Given current inflation levels, stocks are fairly valued as measured by PE ratio.** However, the geopolitical backdrop could drive the PE ratio much higher or lower. If inflation "permanently" moves to a higher level, then the normal PE level, and therefore stock prices, can be expected to move lower. Our view is that the current rise in inflation is modest and cyclical, the core inflation rate is unlikely to breach 3% during this cycle, and it will likely revert back toward the Fed target of 2% over time.

Email research@wealthcarecapital.com with questions, comments or requests. Sources: Bloomberg, Bureau of Economic Analysis.

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