The US is Cheap

Richard Bernstein

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US stocks are cheap

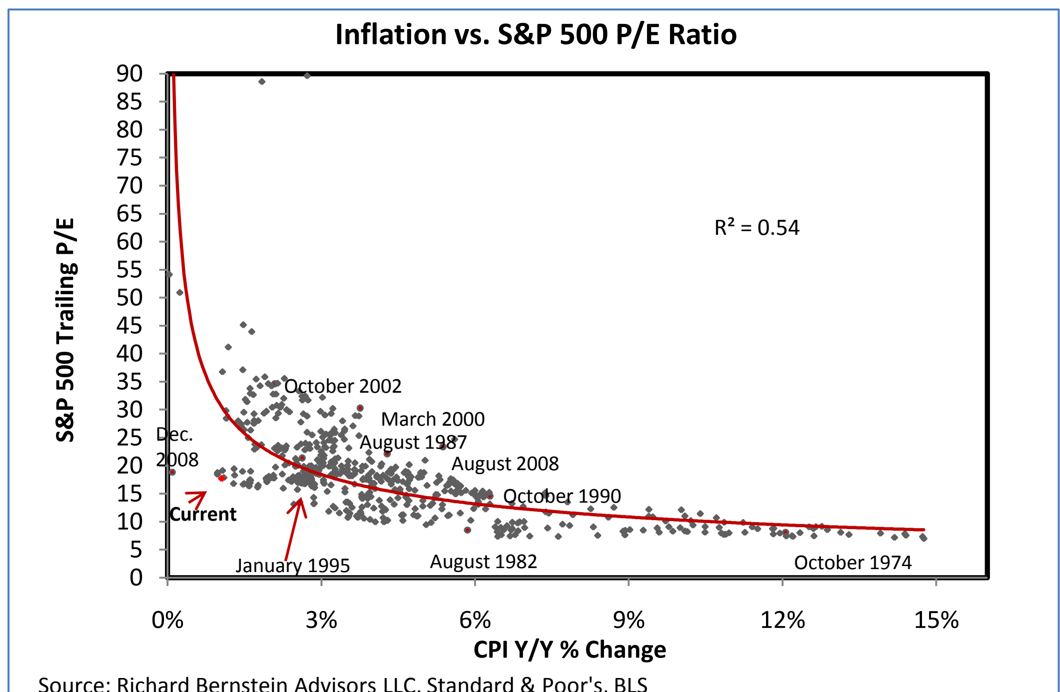
Some have suggested that the US equity market is expensive. We disagree. That's not to say that a sustainable bull market is at hand, but when accounting for the very low rate of inflation, US stocks appear quite undervalued when viewed in isolation, and fairly valued when compared to global equity markets.

Unfortunately, value is a notoriously poor market-timing tool. Most value investors err by buying too early – "We might buy early, but we'll be in at the bottom!" – and it is always hard to differentiate between recognized value and so-called "value traps". We continue to rely upon our favorite economic indicator, weekly initial jobless claims, to help us identify when the economy is likely to recover further.

Don't forget to account for interest rates and inflation

Chart 1 shows that there has historically been an inverse relationship between PEs and inflation, in which PEs tend to rise as inflation falls, and *vice versa*. This certainly argues against the current, extremely bearish view that deflation implies single-digit PEs. On the contrary, significant inflation, not deflation, has historically led to single-digit PEs. We find it difficult to envision in the near future single-digit valuations, because the current inflation rate is less than 2% and inflationary expectations have generally been falling.

Chart 1



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As unlikely as it might sound, current US equity-market valuation is exceptionally attractive when compared with data of the past 50 years. Using the current rate of inflation in the model, the implied S&P 500 PE is well over 20. Even assuming an inflation rate of 2.5% (*i.e.*, the current implied inflation expectation from the 5-year TIPS spread five years out), then the implied PE would still be a bit over 20.

A review of 1930s PE ratios

The historical relationship between PEs and inflation existed during the 1930s and is not a phenomenon of just the past 50 years. The table below shows various valuation inputs for each year in the 1930s. Several points are worth noting:

- The S&P 500 PE ratio was flat from 1930 to 1932, three years of extreme deflation. Deflation ranged from -6% to -10%, but the S&P 500 PE ranged from 13 to 17. Most significantly, at the end of that three-year period, when aggregate compounded deflation was -24%, the S&P 500 PE was 17, not single digits.
- The S&P 500 PE was 9 by year-end 1937 – a year during which inflation almost tripled.
- Deflation resumed in 1938 (-2.8% inflation), but the stock market nonetheless advanced and the multiple more than doubled.
- PE multiples compressed again from 1938 to 1940 – a period during which deflation subsided and low inflation returned. In addition, earnings growth was strong.

It appears, then, that the history of PE ratios during the 1930s supports our view regarding PEs and inflation, and that the probability is extremely low that the combination of low PEs and deflation should be a central investment theme.

Table 1

S&P 500 PEs During the 1930s

Year End	Tr. 4Q EPS	Prices	P/E	EPS Growth	Prices App	LT Govt Yield	CPI
1930	0.97	15.34	**16**	-40%	-28%	3.3%	-6.0%
1931	0.61	8.12	**13**	-37%	-47%	4.1%	-9.5%
1932	0.41	6.89	**17**	-33%	-15%	3.2%	-10.3%
1933	0.44	10.10	**23**	7%	47%	3.4%	0.5%
1934	0.49	9.50	**19**	11%	-6%	2.9%	2.0%
1935	0.78	13.43	**17**	59%	41%	2.8%	3.0%
1936	1.02	17.18	**17**	34%	28%	2.6%	1.2%
1937	1.13	10.55	**9**	11%	-39%	2.7%	3.1%
1938	0.64	13.21	**21**	-43%	25%	2.5%	-2.8%
1939	0.90	12.49	**14**	41%	-5%	2.3%	-0.5%
1940	1.05	10.58	**10**	17%	-15%	1.9%	1.0%

Source: Richard Bernstein Advisors LLC, Morningstar, S&P

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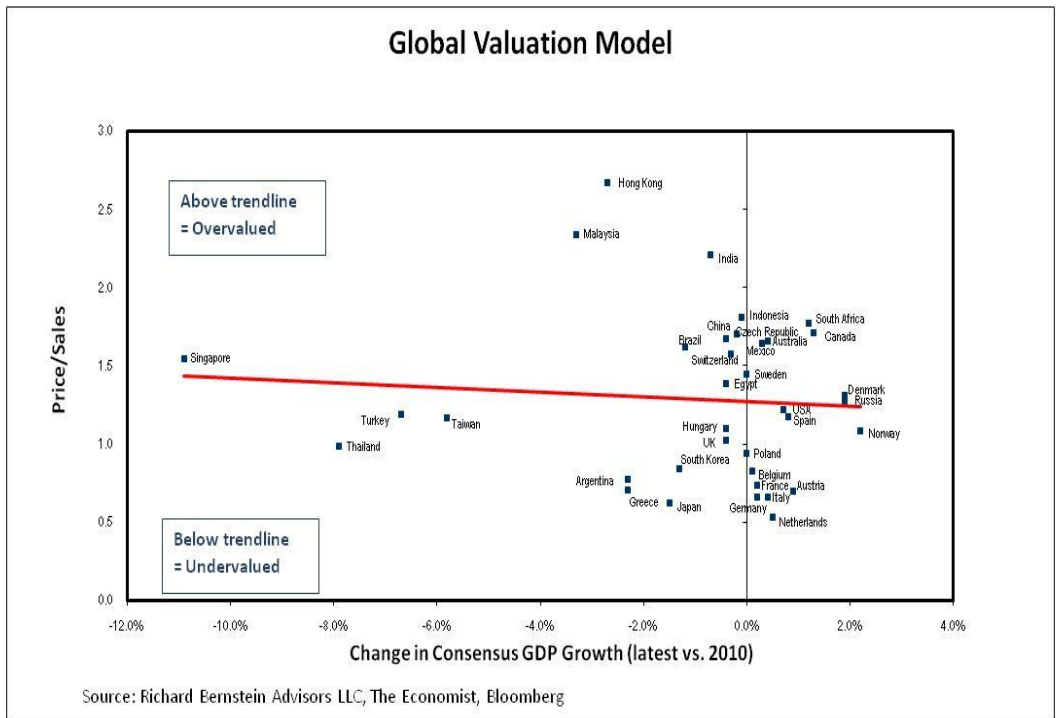
US vs. other markets

The US stock market looks fairly valued when viewed against other global stock markets. Emerging (and especially the BRIC) markets continue to look very overvalued to us. Europe remains quite undervalued in our model, and has been for some time. Europe has largely been a value trap, and we have yet to see a meaningful catalyst to convince us otherwise. Overall, we find developed markets to be considerably more attractive than emerging ones.

Our global valuation model compares countries' price/sales (P/S) ratios to consensus forecasts for changes in GDP growth. We use P/S ratios in an attempt to normalize countries' accounting vagaries and their inherent cyclicality (*i.e.*, sales are less cyclical than earnings). Attractive markets within the model are those with both conservative P/S ratios and forecasts for accelerating GDP growth.

It is puzzling that investors remain so enamored of the emerging markets. Forecasts for many emerging countries call for decelerating GDP growth, and most are quite expensive. It seems that investors are captivated by high GDP growth rates but oblivious to the fact that financial markets price assets based on changes in growth and in expectations. The probability of positive growth surprises over the next year or so seems greater in many developed markets than in the emerging markets.

Chart 2



Source: Richard Bernstein Advisors LLC, The Economist, Bloomberg

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Don't get caught in the maelstrom of doom

We would be among the first to admit that the path of the US economy is currently quite uncertain, and we have our indicators (like weekly initial jobless claims) to help us divine whether the economy is more likely to continue to recover and expand or fall back into recession. Regardless of the uncertain path ahead, investors have to keep their wits about them. Much of today's debate over of the relative probabilities of extreme deflation, extreme inflation, and other horrible outcomes often seems to be based largely, if not entirely, on supposition.

Even if the notion that deflation is looming might be plausible, the forecasted combination of low PE ratios and deflation is not. PE ratios tend to increase during periods of deflation. Corrolarily, PE compression is a by-product of inflation, not deflation.

Investors should probably discount the extremely bearish forecast of deflation coupled with low PE ratios. If one rules out that improbable outcome, then the US equity market will appear rather cheap.

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