Zacks INVESTMENT MANAGEMENT

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CAPE Ratio Says Market Is Overvalued…But Is It?

The Nobel laureate economist, Robert Shiller, recently penned an article in *The New York Times* warning, amongst other things, that market valuations (as measured by the CAPE ratio) were at levels not seen since 1929 and 1999.[1] Market historians would note that 1929 and 1999 preceded weak decades for market returns, with the Great Depression on the one hand and the Tech Bubble and Great Recession on the other.

With the start of a new decade in 2020 and the historically high CAPE ratio, it begs the question: *are we in year one of a weak decade for stocks?*

First, an Understanding of How the CAPE Ratio Works

A good starting point for understanding the CAPE ratio is to think about the basic P/E ratio first. The P/E (price to earnings) ratio measures a stock's price relative to its per-share earnings over the last year. It is a widely-accepted metric for valuation, but Shiller and fellow economist John Y. Campbell saw a problem with it.

They recognized that a company's earnings can be fairly volatile from year to year, and that earnings volatility is especially true during peak and trough years in a business cycle. So, to minimize the effect of short-term business cycle gyrations on the valuation measure, the two economists created a ratio where the stock price is divided by the company's average earnings *over the previous 10 years*, instead of just a single year. This helps "smooth" out the number and allows for comparing valuations over a longer time horizon.

A high CAPE ratio signals an overvalued market, and Shiller notes that the current CAPE ratio (31) has only been higher twice in history: 1929 and 1999. The S&P 500 fell some -85% through 1932 and -50% in the 2000 bear market.[2]

Ready to Run for the Exits? Not So Fast.

The CAPE ratio is a useful indicator and has plenty of merits. But in my view, making investment decisions based solely on CAPE ratio levels is flawed, if not outright wrong.

For one, the CAPE ratio uses decade-old earnings data, which is great for historical comparisons but tells us virtually nothing *about what lies ahead* (which is exactly what we want to inform our investment decisions). Factors like falling energy prices, cheaper commodities, productivity gains, currency fluctuations, and powerful new technologies and innovations (just to name a few)

are likely to contribute significantly – or conversely weigh down – a company's future earnings, in my view.

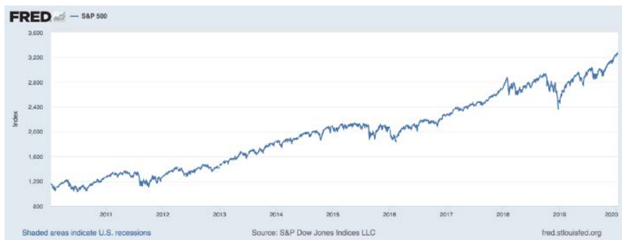
Remember, a stock's price today is greatly influenced by what investors are willing to pay for expected earnings, meaning that sentiment, growth forecasts, innovation, and management play key roles. The CAPE ratio doesn't account for any of these things.

Another reason I believe investors should not rely only on CAPE ratios to make investment decisions: *doing so would have likely meant missing out on big gains in this bull market.*

In 2013, *The Wall Street Journal* wrote of a "rising concern among some market watchers that stocks are being lifted by a potentially dangerous bubble, with Shiller's index seen as one of the early warning signs."[3] In 2016, *The Wall Street Journal* published an article titled, "Stock Valuations Flash a Warning Sign" when the CAPE ratio rose above 27. In that article, readers were reminded that when the CAPE ratio reaches it top decile, the S&P 500 averages about 4% annually for the following ten years.[4]

Either of these articles – or the dozens of others that cited warning signs for the CAPE ratio over the last decade – could make a theoretically compelling case for investors to pare down equity exposure. But the chart below illustrates quite clearly why I believe it would not have made good investment sense to do so.

In Spite of CAPE Ratio Warnings, the S&P 500 has Continued to Climb



Source: Federal Reserve Bank of St. Louis[5]

Bottom Line for Investors

Investors are constantly searching for ways to 'value' the market. Valuations help us determine when stocks are cheap and therefore attractive, or when they're expensive and should be avoided. But valuations alone should not direct an investment strategy. If they did, and you relied on the CAPE metric as a proxy for when to invest in the last twenty years, you may have never owned equities! For a long-term growth investor, that would have been a mistake, in my view.

If today we saw a confluence of negative economic data alongside a high and rising CAPE ratio, then we'd probably have something to fear. But we don't think that's the case at all.

Global growth is expected to hit close to 3% in 2020, interest rates remain low globally, inflation is low and controlled in the U.S., the labor market is strong as ever, and corporate profits are expected to post strong growth following weak comparisons in 2019. The CAPE ratio may signal trouble in the decade ahead, but at the end of the day (and decade), I believe it is fundamentals, earnings, growth, and innovation that will determine the market outcome.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The New York Times, January 2, 2020. https://www.nytimes.com/2020/01/02/business/gut-feelings-are-driving-the-markets.html

[2] The New York Times, January 2, 2020. https://www.nytimes.com/2020/01/02/business/gut-feelings-are-driving-the-markets.html

[3] The Wall Street Journal, November 21, 2019. https://www.wsj.com/articles/shiller8217s-warnings-spark-debate-1385053512

[4] The Wall Street Journal, August 14, 2016. https://www.wsj.com/articles/stock-valuations-flash-a-warning-sign-1471189314

[5] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, January 14, 2020.

IN FOCUS THIS WEEK

- The latest inflation reading and what it could mean for 2020
- The U.S. and China sign a limited trade deal. Now what?
- Deficit spending supports economic growth

Inflation in Check

The latest inflation reading from December 2019 confirmed what has been the case for the better part of the entire decade: inflation remains in check. The consumer price index showed a year-over-year increase of +2.3% in December for all goods, largely in-line with the Federal Reserve's 2% target. For the decade, prices climbed at their slowest pace since the Great Depression, which we would argue was driven partly by technological advances (which put downward pressure on input costs, production, and cost of goods sold) and largely by the massive amount of spare capacity created as a result of the 2008 financial crisis and recession.[1] While the costs of many consumer goods continue to decline or remain steady, other areas have experienced rapid inflation, such as medical care and the cost of education. As you can see in the chart below, inflation growth has not been this slow since the 1960s, but that period was also followed by significant spike that few expected. In our view, one of 2020's surprises could be that inflation rises at a faster clip than many expect (though nowhere near what we saw in the late 1960s).

Source: Federal Reserve Bank of St. Louis[2]

U.S. and China Sign Limited Trade Deal

Over the past year, businesses and markets have grappled with uncertainty stemming from the U.S. – China trade dispute. Business investment fell significantly between the two countries in 2019, and total trade between the two nations also dropped. 2019 figures show that China exported 12.5% fewer goods to the U.S. while importing 21% fewer goods. Though economic activity between the two nations suffered in 2019, it was not enough to derail the economic expansion at home or abroad. Enter 2020, and the U.S. and China are at the table signing "Phase 1" of a trade deal, one that aims to increase Chinese purchases of U.S. goods and services, further open Chinese markets to foreign companies (particularly in the realm of finance), and provides stronger protections for intellectual property and against forced technology transfer. Many provisions in the trade deal benefit U.S. companies, but it remains to be seen how China follows through – or whether they do at all. For instance, the language in the deal states that neither party (U.S. or China) will require or pressure persons to transfer technology, but China stopped short of agreeing to any law changes. In fact, the U.S. request for China to change laws was one of the reasons previous talks collapsed. There is also the fact that tariffs on some $370 billion in Chinese goods remain in place, which keeps price pressure on many U.S. multi-nationals.[3]

Deficit Spending Supports Economic Growth

Overall economic growth is driven by consumer spending, investment, government spending, and trade. While investment and trade have experienced some headwinds associated with the U.S. – China trade dispute, the other two categories – consumer spending and government spending – have not blinked. The U.S. consumer remains healthy amidst strong job growth and modest, but positive, wage growth. The U.S. government has also demonstrated a healthy penchant for spending, even as revenues have not grown as anticipated with the tax cut. In the twelve months ending December 2019, the federal deficit totaled $1.02 trillion, which marked the first time the deficit has creeped over the trillion mark since the aftermath of the 2008 financial crisis. Tax receipts grew 5% in 2019 but outlays grew by 7.5%, providing support to U.S. GDP growth in the calendar year.[4]

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[1] The Wall Street Journal, January 15, 2020/ https://blogs.wsj.com/economics/2020/01/15/newsletter-everyday-low-prices/?guid=BL-REB-39697&mod=searchresults&page=1&pos=12&dsk=y

[2] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, January 16, 2020.

[3] The Wall Street Journal, January 15, 2020. https://www.wsj.com/articles/u-s-china-to-sign-deal-easing-trade-tensions-11579087018?mod=djem10point

[4] CNBC, September 12, 2019. https://www.cnbc.com/2019/09/12/budget-deficit-smashes-1-trillion-mark-the-highest-in-seven-years.html

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