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By Greg Gann

Is Today's Price to Earnings Relationship

Indicating a Correction?

There are essentially only two factors that affect the price of everything. They are aggregate demand and the cash flow anticipated from an asset. Evaluating these two metrics with respect to stock and bond funds helps to determine fair market value, and whether the current price is reasonable or frothy.

The basis of aggregate demand is the number of people with the need for particular goods or services. If I am trying to sell one hundred watermelons from the back of my pickup truck on the side of a country road where only fifty cars traverse per day, it is highly unlikely that I will sell them all. However, if 1000 people travel that road per day, there is likely to be much greater demand to support my sales efforts. The population and nature of the population are objective determinants of aggregate demand. A forty-two year old with two children, on average, spends considerably more than a seventy-five year old. It is more likely that the forty-two year old is spending on home improvements, food and clothing for his growing family, automobiles, education, etc. than his seventy-five year old counterpart. Thus the aggregate demand for goods and services directly tracks age waves.

Because of the sheer size of baby boomers, following their age migration is a leading economic indicator. In the 1980s and 1990s, these baby boomers, who are the largest percentage of the population, were arriving at their peak spending years, thereby rocketing aggregate demand. Fast forwarding twenty to thirty years later to the present, these same baby boomers are either in or entering retirement. They have transitioned from maximum spenders to maximum savers. They have shifted from being the largest demographic paying into governmental programs such as Social Security and Medicare to being beneficiaries of such assistance. They have and will continue this transformation from being givers to receivers. It will be several years before the millennial generation reaches its peak spending years. And, because millennials have larger educational debt than baby boomers incurred and have fewer opportunities for lucrative income, they are delaying their own household formations, and hence are likely pushing out further the time period during which their spending will peak. All of this is easy to track. It is objective. And what we know is that demographics affect aggregate demand, and corporate earnings and GDP will be constrained by demographic headwinds and the associated limitations with respect to aggregate demand.

Now let's examine the market from the perspective of the cash flow and earnings generated by companies that comprise the major stock indices. The fact that companies' earnings have benefitted from low interest rates is undeniable. This fact in and of itself has inflated the price investors have been willing to bid for revenue and earnings. This is fairly obvious and often cited. What is less understood and appreciated is the impact of low and steady inflation with respect to rising prices investors have been willing to pay for earnings.

The Federal Reserve has not raised interest rates in over nine years. Since 2008, it has bought assets from the banks, and in the process has more than doubled its own balance sheet in the process. It has done this through working in a symbiotic relationship with the Treasury, whereby the Treasury has printed massive amounts of dollars, doubling the federal debt load within the last seven years. The objective of purchasing bank assets was to create demand for these assets beyond that set by the market, thereby suppressing interest rates in hopes of creating inflation. Interest rates have been reduced to levels never seen before. Today the federal funds rate stands at 0%. The most basic and fundamental economic theory says that lowering interest rates and flooding the economy with cash should be inflationary. There are very few relationships with such a strong cause and effect. Nonetheless, even after seven years of such "stimulus" and on a scale of absolute historical magnitude, we still are not seeing any real signs of inflation.

The Fed has orchestrated almost the perfect goldilocks scenario for price inflation based on maneuvering interest rates to the extent that they have made inflation appear as low and steady rather than high or deflationary. And while everyone cites low interest rates with market price escalation due to the paltry interest that can be earned elsewhere, the real impetus has been the ways in which they have camouflaged deflation through their massive cash injections. It is so important to appreciate that stock prices fall during periods of inflation as well as deflation. By creating this goldilocks scenario where the economy appears neither too hot to cause inflation but not too cold for deflation, everything appears "just right", and this produces the perfect backdrop for stock price inflation with respect to cash flow and earnings generated.

To better understand the price to earnings relationship and how this relationship is impacted by inflation expectations, I will use commercial real estate to provide context. A commercial property (if leased) generates cash flow. If the cash flow exceeds fixed expenses such as maintenance, taxes, and finance expenses, that excess is deemed "free cash flow". In a period of low and stable inflation, typically a buyer is willing to pay a higher multiple for that free cash flow. The price of the property is determined through assessing the free cash flow (yield) that the property should generate in comparison to what another investment would yield. In a low and steady inflationary period where interest rates are low and not moving significantly, the buyer of the property would compare the yield from the property in comparison with say what a U.S. government bond would yield or what a stock would yield. In a period where the yield from the government bond or the stock is low especially in comparison with the yield from the rental income, the property buyer would jack up his price bid to purchase the property and the cash flow that the property would likely generate. In periods where inflation is anticipated to rise, a similar buyer of the property would conclude that cash flow from the rental income wouldn't go as far, and accordingly would lower his price bid. Similarly, in periods of deflation, a prospective purchaser would conclude that he might have to lower rental income to remain competitive and fully leased. Consequently, in a deflationary period, the purchaser would lower his price bid.

I absolutely credit the monumentally experimental policies of the Federal Reserve with averting what could have spiraled in 2008 into a second great depression. And, it is also my contention that the prolonged and unorthodox policies of the Fed have been designed to prop asset prices, thereby resulting in people feeling "richer" and as a result spending more. I also believe that the fundamental weakness of the economy would be much more evident in the absence of their actions. After all, even with so much capital having been pumped into the system, we currently have one of the lowest percentages on record in terms of the working age population being gainfully employed. And, if everything is so wonderful, ask yourself, why can't they raise interest rates? And, why is such a small percentage of the working age population employed? And, why are we seeing record numbers of people on food stamps? And, why aren't wages increasing? And, why are commodities tumbling? And why is China slowing? And, why are we so worried about other countries slowing? And, why have we not seen top-line corporate earnings growth?

If deflation were obvious, prices would not have escalated as they have. If deflation is exposed once interest rates begin to rise, then prices will come down, and to the extent to which they were propped up, they might very well come tumbling down. The Fed has used extraordinary measures to cure an ailing economy. They want us to believe that they are in control and that everything is strong so that we don't lose confidence, suppress spending, and unravel all their efforts. Quite frankly, they are scared. Otherwise, they would not have resorted to such drastic measures. Try as they might to lower interest rates to stimulate growth, they are impotent to overcome demographic shifts and normal business cycles. To think otherwise is a fool's errand.

Most retail investors are allocated in ways that are conducive strictly for upwardly trending markets. Knowing that markets trend upwards, sideways, and downwards with fairly even occurrences, institutions, endowments, and pensions invest very differently than where retail investors are exposed, and in ways that are conducive for any direction. Our approach is much more aligned with the institutions and endowments. We are about complementing relationships rather than replacing them. No one person controls all the good ideas. Plus, it never hurts just to get a second opinion. If you would like specifics from our research or specific investment opportunities appropriate for sideways or downward trending markets, please email back. Also, you have my permission to forward this to anyone else whom you think would also would benefit.

Because retirement savings are too precious to waste,
Greg Gann

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