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Steady – For Now.

Last quarter I stated that I believed the market was “fairly valued”, and that one should not “chase” it higher. We would have to wait for earnings to come in higher. Evidently, the markets believe that too. Although the markets did work slightly higher over the past quarter, it’s not by much. August was VERY quiet. But now we get into the 4th quarter. Although it doesn’t have a great reputation (Black Monday, elections, etc.), but over the last 25 years, the S&P 500 has gained more during the 4th quarter than the other 3 quarters combined! 246.9% vs. 199.6%. Yep Yogi, who would have thunk it!

Now the boring, but important, stuff – P/E ratios. I have stated in the past that the best form of market valuation is the P/E ratio. Many advisors and economists point out that the “average” S&P 500 P/E Ratio (over the past 25 years) has been 15.9, and is now around 17. So, obviously, the market is “over-valued”. I used the same argument, in reverse, a year ago when the P/E Ratio fell to 15. It also is important which way corporate earnings are expected to go (the “E” in the equation). But it is very important not to look at P/E’s in a vacuum. Here’s the punchline, when interest rates are low, you should expect P/E’s to be higher, and vice versa. To make a point, when Jimmy Carter was President, we had a 7 – 10% inflation rate, money markets were paying 13%, and the P/E Ratios were only 8 – 10%. But when inflation fell to 2 – 3% in the late 1990’s we now had P/E’s at the mid 20’s (actually hitting 30!). See the chart below.

EXHIBIT 5 : Valuations S&P 500 P/E Ratios vs. Inflation
Source: Bloomberg

Inflation	Average P/E	Peak P/E	Trough P/E
<2%	19.3	30.1	11.3
2-3%	19.7	29.8	12.2
3-4%	15.8	23.4	9.9
4-5%	15.2	20.2	10.2
5-6%	11.1	15.5	7.3
6-7%	10.2	15.1	7.5
>7%	9	13.5	7

At our current inflation rate of 2%, the “average P/E” should be 19.3%. So, a 17 P/E ratio, actually looks cheap! So, this is why we have been keeping our asset-allocations constant and consistent. The downside (maybe a 5% correction) is limited. As Sir John Templeton once said, “Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria.”

If you would like to discuss the market and/or your account(s), please call me at 713.428.2050, x2 or via email to josborn@houcap.com.

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