UNDERSTANDING VALUATIONS ACROSS THE GLOBAL MARKETS

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Last week's *Behind the Markets* podcast featured a blockbuster discussion with Nobel Prize-winning economist and Yale professor Robert Shiller, Wharton Finance Professor Jeremy Siegel and Meb Faber, founder of Cambria Investments, talking about valuations across global markets and what they mean for forward-looking returns.

Shiller has written extensively on a metric referred to as the CAPE ratio, the cyclically adjusted price-to-earnings ratio that smooths earnings for business cycles by taking a 10-year inflation-adjusted average measure of earnings to value the market.

Shiller is famous for his book *Irrational Exuberance*, and he discussed how the late 1990s was described as being a "speculative orgy." While that makes it sound "crazy," in his view, it really wasn't. Judgments on valuations, when faced with an ambiguous situation for predicting the future earnings of companies, are quite hard.

Shiller created a new study on the "excess CAPE yield" that compares the CAPE's earnings yield to inflation-adjusted bond yields, and due to historically low bond yields (that are priced for negative after-inflation returns), his new equity premium CAPE model does not show the same level of "over-valued" estimates as the standard CAPE model (which looks at stock valuations alone).

Shiller's current excess CAPE model for the U.S. market suggests a 4% estimate for the equity premium over the coming decade, with 3% real returns for stocks and -1% real returns for bonds. Siegel's contrasting view is for 5% real returns over the long run.

Shiller interprets his CAPE model implications with a degree of humility and uncertainty, as past readings for high CAPE ratios meant poor forward-looking returns, though it is not a guarantee. He sees a new world emerging, enabled by shifting technologies.

Time for Value?

Shiller is unsure, based on innovation trends. He is currently researching the highly delicate equilibrium for companies to be creative, and Shiller sees this driven by leaders who may seem crazy but have genius in their approach. Perhaps surprisingly, some of Shiller's sector CAPE models currently favor technology stocks as "value sectors" when his indexes compare valuations of tech stocks to their historical averages looking back 20 years.

Meb Faber has done a lot of research on the CAPE ratio and sees the current 34 reading on the CAPE as the second-highest level (with only the internet bubble surpassing it) going back over a century. The average CAPE over the full period was 17, and Faber sees the current low yield and inflation zone justifying a CAPE of approximately 22.

Faber is much more favorable on valuations outside the U.S. While most Americans put 80% of their stock allocations in the U.S., a 50% allocation to foreign would be more "neutral" split without the home-country bias.

International developed markets have a CAPE ratio in the low 20s, which is particularly fine in Faber's view, and the emerging markets have a CAPE in the low teens, while producing 60% of the world's GDP. The market cap weight of emerging markets is now around 13%, while most Americans only allocate around 3% to emerging markets.

Faber is a “romping, stomping” bull on emerging markets given these under-allocations and two-third discount to the U.S. markets from a valuation standpoint.

Faber closed with how everyone wants to be Nostradamus and predict the next big crash, while they should be more like Rip Van Winkle—develop a plan, fall asleep and stick to the plan, ignoring market fluctuations in the short term.

This was a great final *Behind the Markets* episode of 2020! We’re looking forward to a post-pandemic 2021, and we wish you the best for the new year. You can listen to our full conversation below.

For more investing insights, check out our Economic & Market Outlook

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Cyclically Adjusted Price to Earnings (CAPE) Ratio : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

Inflation : Characterized by rising price levels.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.