DISCUSSING MARKET VALUATIONS AND MACRO OUTLOOK

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Last week's "Behind the Markets" podcast featured a discussion with John Apruzzese, CIO of Evercore Wealth Management, and Julian Brigden of MI2 Partners.

Apruzzese wrote an interesting paper on a global valuation model he uses that takes the earnings yield on equities and subtracts inflation to get a real earnings yield. He sees this real earnings yield over the last 60 years as being around 3%—and believes this is an important gauge for market averages. The paper was called "A Reality Check for Stock Valuations," and it added to the discussion for many market valuation models.[1]

Many look at price-to-earnings (P/E) ratios as being supported by low interest rates. But Apruzzese thinks relative inflation rates are the more important factor. A few other statistics Apruzzese cited: the P/E ratio over the last 60 years had an over .8 correlation with the Consumer Price Index and a .64 correlation with 10-Year Treasury yields.

Apruzzese looks at current real earnings yields and foresees a 5% earnings yield and 2.4% inflation—so, a 2.6% real earnings yield on trailing earnings. But with a pickup in earnings in 2018 resulting from the tax cuts, that leaves the market at a relatively fair multiple on his measure.

Apruzzese also told us the story about how Evercore Wealth Management was founded; it was a start-up with 12 partners from U.S. Trust that started investing in February 2009, right ahead of the bottom of the bear market. Evercore Wealth Management is now a $7.8 billion registered investment advisor, with 300 to 400 high-net-worth clients.

Robust Economy with a Higher Risk of Inflation Jumping

After hearing Apruzzese describe his model, which uses inflation as one of the large countervailing forces to earnings yields, it was then interesting to hear Brigden share the world view that our robust economy is showing risks of an inflation spike in his models. Brigden's models for inflation look six months out, and he sees core personal consumption expenditure heating up in September or October data.

Brigden sees growth plateauing in Europe around 2%—but this growth rate is still above the trend and represents a closing of Europe's output gap. Similarly, in China, he sees growth momentum slowing down but does not predict it completely rolling over.

Brigden said that in his 30 years of trading markets, he has never seen risk assets with prices nailed to the ceiling like they are today and bond yields as low as they are and nailed to the floor.

There were times Brigden has suggested to clients that they have short positions in bonds. Currently, he is neutral in bonds but expresses views with a strong dollar bias, particularly versus emerging market currencies that have funding pressures.

Brigden believes that one of the reasons we get a stronger dollar environment is a structural shortage in the dollar that started with the pickup in U.S. shale production and fewer imports of oil. The gap in dollar supply has been made up for with the capital outflows, which Brigden sees as "hot money." Brigden believes anything that starts a run on these capital flows for investors to repatriate money back to the U.S. is a catalyst for creating a very sharp move in the dollar higher for countries that funded themselves in dollars. Europe and Japan fund in their own currency so they have fewer funding pressures, but if there was a move higher in the dollar, Brigden believes this would likely spill over to the euro as well.

This was a very interesting conversation on global valuations, inflation pressures, and the dollar. Listen to the full podcast below.

Unless otherwise stated, all data is as of July 20, 2018.

[1] A Reality Check for Stock Valuations

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DEFINITIONS

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

Inflation : Characterized by rising price levels.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position.