## LATEST THOUGHTS ON U.S. MARKET VALUATIONS

Jeremy Schwartz — Global Chief Investment Officer 12/04/2017

Professor Jeremy Siegel recently appeared on CNBC and suggested that the U.S. equity markets were approaching fair value and that markets might "pause" some of their strong gains in 2018. Siegel still believes corporate tax cuts are one factor that supports the market strength and that earnings should receive a boost from pending changes. He saw about 5% more gains in 2017 and predicts stocks having more difficulty next year.

Absent the corporate tax plan, we'd have a cloudier picture for U.S. stocks. But one question continues to come up in conversations: what about extended market <u>valuations</u> and the <u>cyclically adjusted price-to-earnings (CAPE) ratio?</u>

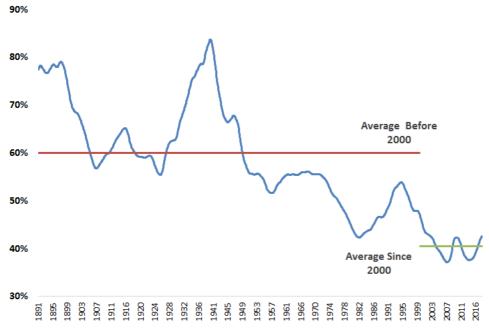
A piece on <u>U.S. market valuations</u> I posted earlier in the year has generated a lot of interest, and I updated it with more recent data below.

Robert Shiller and Jack Bogle are market prognosticators who tend to be more subdued in their outlook for U.S. equities. Earlier this year, Bogle presented his outlook for 10-year returns at the annual Chartered Financial Analyst conference in Philadelphia and suggested we've seen strong gains in the markets over the last 35 years that resulted from valuation expansion, and hence had a subdued outlook. Bogle's model was fairly simple: take the 2% <u>dividend yield</u> on the market today, add in his personal estimates of 4% earnings growth and subtract 2% from speculative market activity or his anticipation of a decline in valuation ratios over the coming decade, and you come up with an outlook for 4% returns over the coming decade. If we assume there is 2% <u>inflation</u>, this would lead to just a 2% real return after inflation. Note that this is largely similar to Shiller's outlook for returns from high CAPE ratios.

One chart that I think is not talked about enough in the context of valuation changes on the market is the dividend payout ratio of the market. I show a smoothed 10-year average <u>dividend payout ratio</u> in the spirit of Shiller's 10-year smoothed earnings for the CAPE ratio. Prior to 2000, the dividend payout ratio averaged 60%. Since 2000, the dividend payout ratio has averaged 40%. This change in the nature of how firms reinvest their earnings, conduct stock buybacks and pay dividends is absolutely critical to the future earnings growth we are likely to get.

10-Year Average Smoothed Dividend Payout Ratio

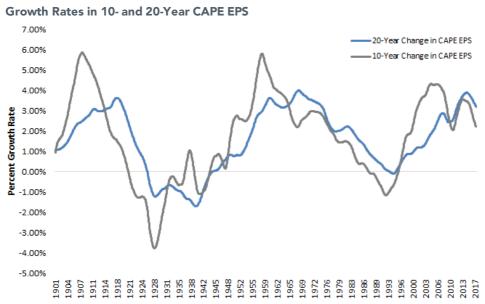




Source: Robert Shiller online data library. Data for the period 2/28/1881-9/30/2017.

Those who assume that earnings growth rates will revert to some historical average growth rate when firms paid out 60% of their earnings as dividends are assuming that all this money not being paid out—used for either <u>buybacks</u> or other reinvestment in business—is being completely wasted. That is an incorrect assumption, in my view.

This chart looks at the rolling 10-year and 20-year earnings growth rates of the CAPE <u>earnings per share (EPS)</u> that Shiller uses to make his dour forecasts on the market. If these numbers were to <u>mean revert</u>, that would be a cautionary tale for the markets. But in my view, the earlier declining dividend payout ratio means we are likely to see upside changes to these earnings figures. What is possible?



Source: Robert Shiller online data library. Data for the period 2/28/1881–9/30/17.

Changing dividend payout ratios have already translated to better earnings growth. Prior to 1982, the average dividend yield on the U.S. equity market was approximately 5% per Shiller's data, and we had an average dividend payout rate of



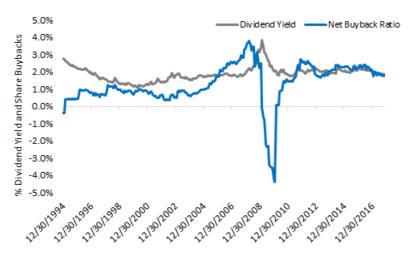
nearly two-thirds of earnings paid out as dividends. With only a third of earnings reinvested, firms were still able to achieve earnings growth of 3.3% per year.

	EPS Growth	Avg. Div. Yield	Avg Payout
1871-1982	3.3%	5.0%	64.7%
1982-2017	5.6%	2.5%	51.0%
Latest Year	20.4%	2.0%	46.7%

Source: Robert Shiller online data library. Data for the period 2/1/1871–9/30/2017. Past performance is not indicative of future results.

Since 1982, payout ratios declined to an average of 51%, while at the same time firms started conducting stock buybacks. The average EPS growth during this period of reducing dividend payout ratios was an increase of 230 basis points (bps) per year, from the previous long-term average of 3.3% per year to 5.6% per year. In just the latest year, there has been a large increase in earnings, with a 20% year-over-year earnings growth as of the latest September quarter, with an average dividend yield of 2% and average dividend payout ratio of 46.7%.

When we look at the last 20 years, and particularly the last seven, we see consistent signs of 2% dividend yields with 2% net buyback ratios. The latest trailing 12-month net buyback for the S&P 500 was 1.84%. These net buybacks are going to continue to support earnings growth for the 10-year look-ahead period. These firms have locked in future EPS growth because they reduced their shares outstanding.



Sources: WisdomTree, FactSet. Data for the period 12/30/1994-11/22/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

Returning to the table above, where I showed the earnings growth since 1982 as being higher than the previous 110 years, the current dividend payout ratios are consistent with an even further drop in the payout ratios from their average since 1982. I can see a case that earnings growth picks up even from that 5.6%-per-year mark that we had for the period 1982–2017. It would not surprise me to see earnings growth of 6% to 7% per year over the next decade.

The standard pushback is that firms are just leveraging up to conduct buybacks—that interest rates are at historical lows, leading to higher margins than are sustainable. The reverse case is that the changing composition of companies—into higher-margin businesses that have more revenue abroad with lower tax rates than in the U.S.—also means margins may not be mean reverting anytime soon either. Of course, no one knows how the future will unfold, including me.

The charts above caution anyone relying on historical patterns of earnings growth trends from over-extrapolating them into the future. Professor Siegel looks at the current <u>earnings yield</u> of the market associated with a 20 <u>price-to-earnings ratio</u> and thinks 5% is a pretty good indicator of long-term, after-inflation real returns. Add in inflation of 2% and you get



7% nominal returns. This is a touch below their historical 6.5% to 7% that he showed in Stocks for the Long Run as being the historical return to U.S. equities, but it is not dramatically different. I think his model for looking at the markets makes more sense than some of these more dour predictions—for what that's worth.

Important Risks Related to this Article

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

For standardized performance and the most recent month-end performance click <u>here</u> NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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

View the online version of this article <u>here</u>.



## **IMPORTANT INFORMATION**

U.S. investors only: Click <u>here</u> to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ( www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.



## **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.

**Dividend yield**: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Inflation**: Characterized by rising price levels.

**Dividend Payout Ratio**: The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

**Buyback**: When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

**Earnings per share**: Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**Mean reversion**: The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

Basis point: 1/100th of 1 percent.

**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.

**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.

