Chart of the Month

June 2017

S&P 500
Forward P/E Ratio

Fed Chairwoman Janet Yellen told an audience in London yesterday that asset valuations are "somewhat rich" using traditional metrics like price-earnings ratios. On the same day, Fed Vice Chairman Stanley Fischer said "price-earnings ratios now stand in the top quintiles of their historical valuations" and San Francisco Fed President John Williams proclaimed that "the stock market seems to be running on fumes."

Question: Should investors be concerned if Fed officials are now calling into question the level of stock prices?

Answer: Based on history, not really.

In a speech in December 1996, then Fed Chairman Alan Greenspan questioned whether "irrational exuberance" had unduly escalated asset values. Inclusive of dividends, the S&P 500 subsequently gained 33% in 1997, 28% in 1998, and 21% in 1999, a more than doubling in total in the three years after Greenspan's comments before finally peaking in 2000.

More recently, in July 2014, Yellen warned that valuations in the biotechnology and social media sectors had become "substantially overstretched." The largest biotech ETF climbed more than 50% over the course of the following year before peaking. Facebook, the largest holding in our growth strategy, has risen about 125% since then.

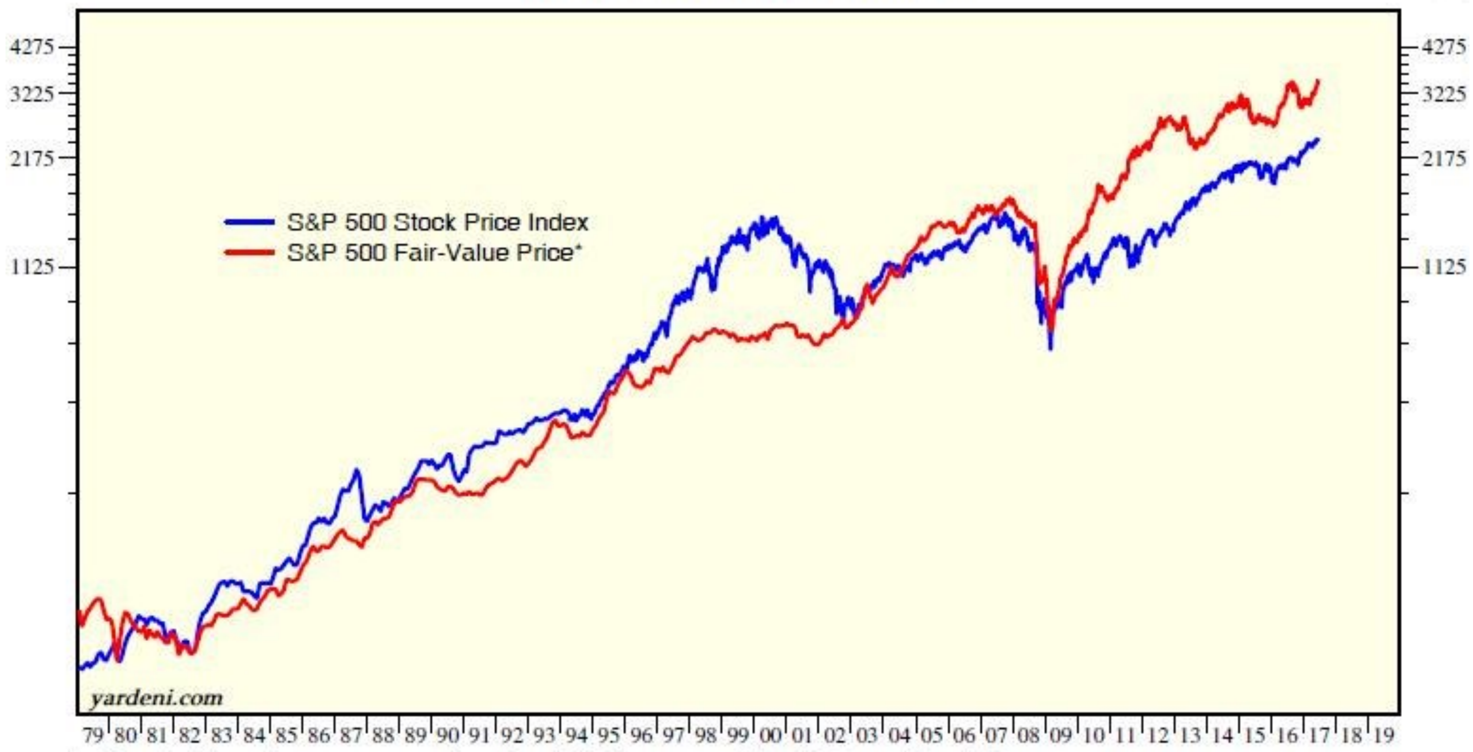
While we're not suggesting that the market is going to advance more than 20% for each of the next three years (as it did after Greenspan's now infamous comments), we're mindful that the Fed does not have a good track record in calling major market tops. As such, we are not overly alarmed by yesterday's comments from Yellen, Fischer, and Williams.

Although Fischer is correct in stating that P/E ratios are historically high, they are about halfway between their lows in late 2008 and their highs in 1999 (as shown in the chart above). Importantly, despite being higher than average in an absolute sense, stock valuations are actually low when compared to corporate bond yields (as detailed in the chart below).

In fact, in a CNBC interview in May, Warren Buffett said, "The most important item, over time, in valuation is interest rates." He added, "Measured against interest rates, stocks are actually on the cheap side." Furthermore, at Berkshire Hathaway's annual shareholders meeting, Buffett stated that "stocks are dirt cheap" if rates stay around current levels or increase only modestly over the next 10 years. Of note, as it relates to interest rates, Yellen said they will "remain low for quite some time" yesterday when speaking to the British Academy.

Ironically, the risk to the stock market is less about the level of P/E ratios than it is about the Fed tightening too aggressively and causing the yield curve to invert, which almost always foretells a recession and a bear market. As a result, here's hoping that the Fed will stick to managing monetary policy in a prudent manner rather than weighing in on stock valuations.

S&P 500
Stock Valuation Model



* Year-ahead forward consensus expected earnings divided by average of Moody's Aaa and Baa yields.

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