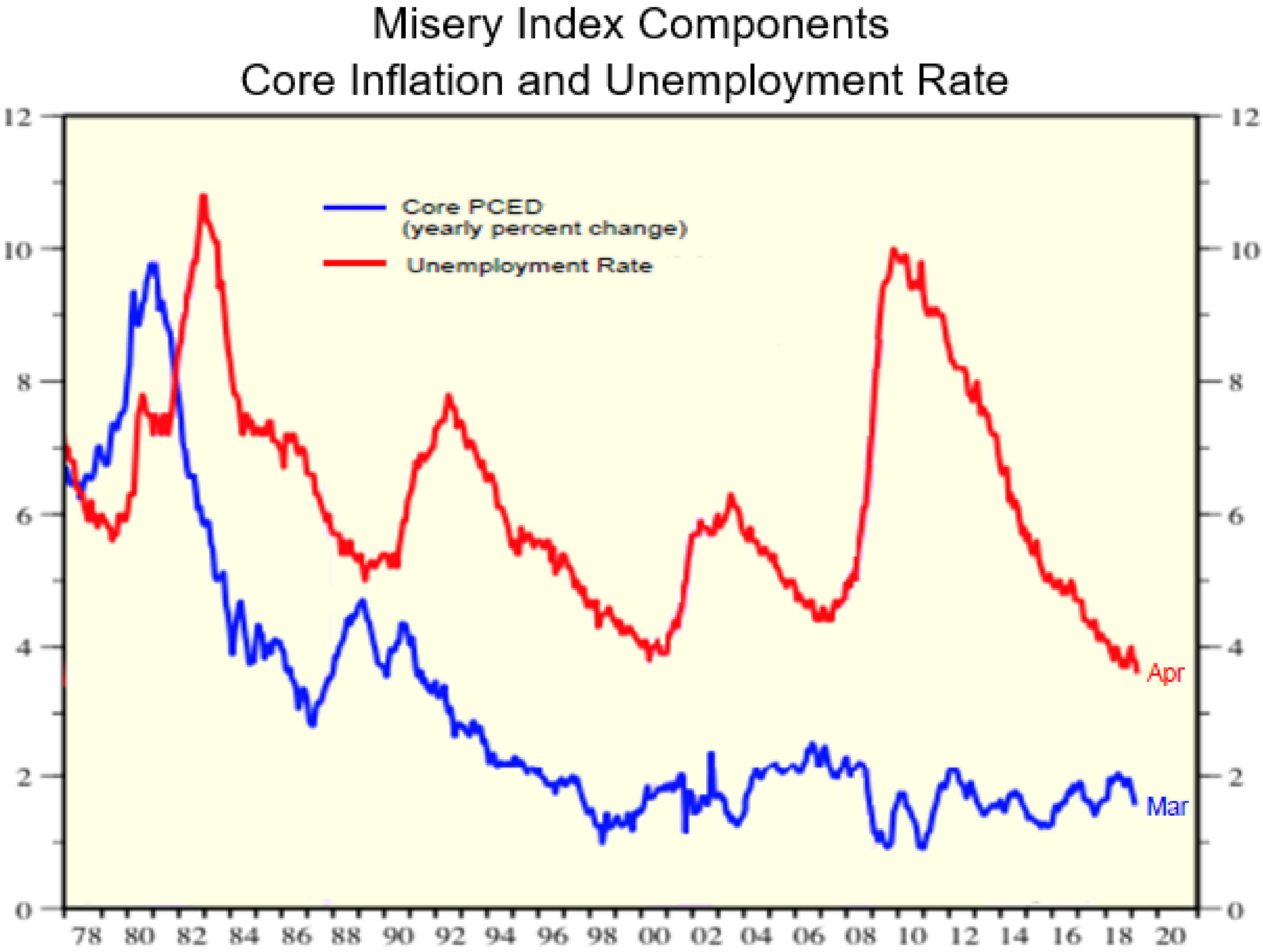
Chart of the Month

May 2019



Sources: US Department of Commerce, US Department of Labor, and yardeni.com.

While Wall Street is currently preoccupied with the U.S.-China trade negotiations, the fundamentals of the domestic economy are as strong as they have been in at least two decades and perhaps a half century or more.

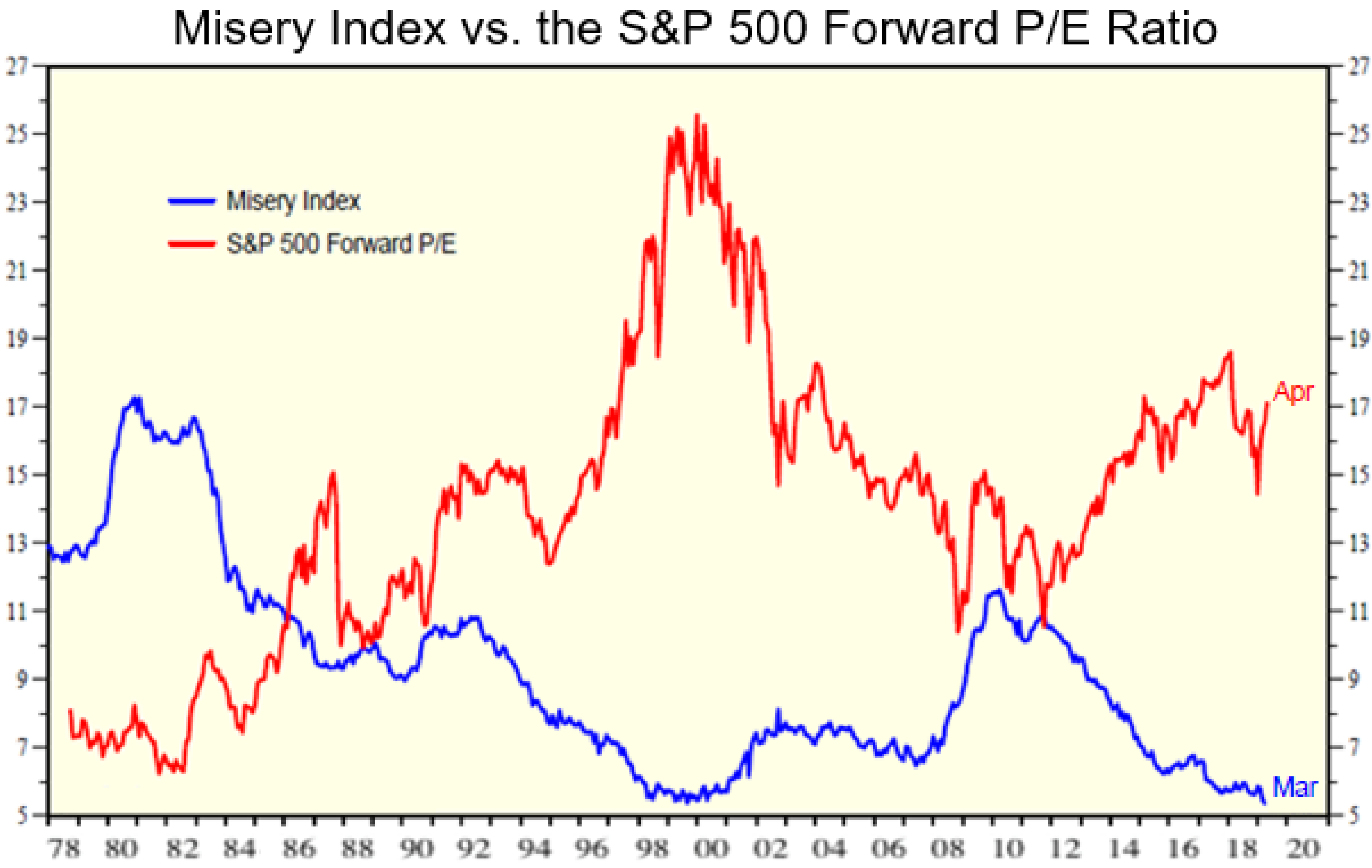
The "core" personal consumption expenditures index, which is the Federal Reserve's preferred measure of inflation, decelerated to a rate of 1.6% year-over-year in March or 0.4% below the Fed's target of 2.0%. As shown in the chart above, the PCE (blue line), which excludes the volatile categories of food and energy, has been ebbing and flowing in a range between 1.0% and 2.5% since the late-1990s. The inflation rate has remained stubbornly low for more than 20 years, confounding the Fed as well as economists at large.

Meanwhile, the unemployment rate (red line) fell to 3.6% in April, the lowest level since December 1969. Unemployment and inflation were once thought to be inversely correlated, with a low unemployment rate generally corresponding with higher inflation. However, this phenomenon, known as the Phillips curve, has not been present during the current cycle, most likely owing to the increase in productivity from new technologies.

The misery index, designed to measure the economic health of the country by adding the inflation rate and the unemployment rate (see the blue line in the chart below), is virtually tied at 5.2% for its lowest level since the 1950s. As described in our August 2013 Chart of the Month, "both the magnitude and direction of the index are important in gauging the economy. A high or rising sum suggests a weak or worsening economy. Conversely, a low or falling sum suggests a strong or strengthening economy."

Generally speaking, low inflation means low interest rates and low capitalization rates. The latter results in higher price/earnings multiples, equity valuations, and stock prices. By extension, as demonstrated below, a low misery index produces higher P/E ratios and a high misery index is consistent with lower P/E ratios. Importantly, the S&P 500 forward P/E, while above its historical average, is currently about one-third *lower* than its peak in 2000, which was the last time the misery index was at a similar level. In other words, stocks are not even remotely approaching the bubble-like valuations of that era.

As a rule of thumb, the misery index and the forward P/E tend to add up to roughly 20-25. The sum, which is presently about 22, sits comfortably in the middle of its range, suggesting that valuations are appropriate based on this methodology.



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, I/B/E/S data, and yardeni.com.

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