



Commentary

A Bull in the Land of Bears

Everyone I know is cautious. Few investors are interested in owning equities and almost everyone wants to own bonds. Investors are clamoring for the security of bond funds while equities have rarely been more attractive relative to bonds.

What if I told you that stocks have never been cheaper relative to bonds except in March 2009? What if I then told you that when stocks have been this cheap relative to bonds they have generally produced returns > 50% over the following 12 months?

Stock valuations are inversely correlated to interest rates. The Fed Model has clearly shown this strong relationship for the last 50 years. Historically, when interest rates have been high, P/E multiples have been low and when interest rates have been low, P/E multiples have been high. When investors speak of the long-run median P/E of 15x earnings for the S&P 500, they are also referencing the long-run median 10-year treasury yield of approximately 6.6% ($100 / 15 = 6.6\%$ yield).

The S&P 500 currently has a 12x multiple on the \$95 12-month forward expected earnings. If we apply the long-run median 15 P/E to forward earnings the market should reach 1,425 or 26% higher within the next 12 months. If we adjust the P/E for the current, below average, 3% 10-year yield, the P/E would be 33x ($100\% / 3\% = 33$ P/E). Applying the 33x to the \$95 EPS gives an index value of 3,135 or 120% higher.

Given that the Fed Model has been very predictive over that last 50 years, some of the following **MUST BE** true:

- 1) The market is undervalued and will appreciate substantially.
- 2) The 10-year bond yield is too low and yields must appreciate substantially.
- 3) Forward earnings are too high and must come down.

I will rule out #3 given the incredible cost controls exhibited by companies. My guess is that earnings are too low and will surprise on the upside as companies have significant operating leverage to a recovery.

My guess is that a combination of #1 and #2 are correct. It is hard to believe interest rates can go much lower and rates will most likely increase. There is much talk of deflation, but I have a hard time thinking of any prices that have not been rising with the exception of real estate.

If interest rates stay at current levels, the Fed Model would predict that we would have a 33 P/E multiple on the market. I would not make this prediction; however, in 1999 the P/E multiple peaked at 24x and interest rates were much higher. Anything can happen!

When stocks have been this cheap relative to bonds, stocks have generally returned >50% absolute over the next 12 months while bonds have generally posted anemic or negative returns. In conclusion, stocks should massively outperform bonds in the near future.

– Derek Webb

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