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Financial markets 2020: When will P/E ratios be great again?



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On November 4, the stock market hit a record level. The returns were 12.4 percent from November 4, 2018, to November 4, 2019. This is an above average return (the average is about 7 percent). Our forecast last year was that the market would increase “below average,” so we were wrong.

But from November 4, 2018, to October 9, 2019 (233 days), the returns were 6.6 percent, so we were really on track most of the year. But then the market proved us wrong by adding \$1.5 trillion to the wealth of Americans in 18 days. Given the whipsaw of economic news reports, if we just wait for the right moment to measure annual returns, we can make financial market forecasts great again.

We think what happened over those 18 days is indicative of what will happen in 2020. Let’s review:

- **The Federal Reserve cut the federal funds rate.** This shifted many interest rates down (not the mortgage rate though). Cutting the federal funds rate is often, but not always, a path to lower interest rates. It was this time. Lower interest rates are a common way that stock prices rise. It seems the market responded to the cut, at least to this point.
- **The interest rate story about our economic future reversed.** From the end of May until October 15, longer-term rates were lower than the short-term rates. This is called an “inverted yield curve.” It is a common sign that the market expects a recession since lower interest rates often indicate lower economic activity. But then, magically, the longer rates went higher than the shorter and remain there. It seems stocks

responded to the forecast by moving up (or maybe the reverse happened?).

- **The perpetual trade war seems to be petering out.** The trade deficit with China fell 3 percent in September, and for the moment the two sides appear to be closing in on a deal. The U.S. trade deficit fell in September.

Still, economic growth is anemic and the U.S. trade deficit is 13 percent higher than when Trump took office. The great economic question of the Trump administration is how much faster the economy would be growing without the damage of his trade protectionism. The recent report of lackluster 1.9 percent growth in the third quarter shows again that you can't escape Adam Smith's revenge for indulging in bad economic policy stemming from political goals.

The economy continued to grow as consumer spending provided nearly all of the growth in GDP. For the second quarter in a row, the mighty consumer had to offset falling business investment to produce positive growth.

The last two quarters of business investment have been negative after nearly two years of healthy gains that had revived with the Trump presidency and the recharging of business animal spirits. Early on in the administration, the Trump policy mix of tax reform and deregulation clearly made a difference to investment and growth. Investment accelerated in 2017 after falling in the Obama administration. Estimates are that U.S. companies repatriated nearly \$1 trillion from overseas since tax reform passed.

GDP growth accelerated to 3 percent for a time in 2017-2018 along with investment, but then came Trump's entirely discretionary trade intervention. More than the damage from tariffs, the uncertainty of what Mr. Trump might do next caused business confidence to fall. This has led to increases in hurdle rates for capital projects across the board, thus slowing capital investment, ultimately yielding slower output that is reflected in roughly 2 percent GDP growth in the last two quarters.

The economy is now down again to the slow Obama growth plane.

President Trump and some in the White House blame the Federal Reserve and Europe for this slump, but neither explanation holds up.

- Europe hasn't grown fast for decades, and its 2017 growth bump was helped by faster U.S. growth.
- Businesses were not starving for money even before the Fed began cutting rates again this summer.

The strong evidence is that trade policy is the main growth culprit. Basically driving downhill with the brakes applied, U.S. manufacturing has slumped, which is related to slowing exports. Slower growth in China from the trade war has reduced the exports of U.S. farm, industrial and construction equipment. The third-quarter decline in spending for information processing equipment, much of which is exported, was the largest in seven years.

A study by Federal Reserve economists this year looked at two waves of trade policy "shock," first in 2018 and then in the first half of 2019, and estimated that the impact reduced GDP growth by about 1 percentage point. In the National Association for Business Economics October survey, 53 percent cited trade policy as the key downside economic risk through 2020.

In October, the Fed continued trying to counter that risk by cutting the federal funds rate for the third time this year—for a total of 75 basis points—to between 1.5 percent and 1.75 percent. With inflation at about 1.7 percent, this means that the *real* interest rate for banks is negative, even with the economy growing 2 percent and the jobless rate at a historic low of 3.5 percent. This is not tight policy. The White House is just wrong about the Fed, which is doing what it can to countervail the ill effects of the risky trade policies led by Trump.

Fed Chairman Jay Powell said at his news conference that the rate cuts are already showing up in a stronger housing market. And housing in the third quarter contributed to GDP growth for the first time in seven quarters. But housing is a form of consumption and doesn't drive the productivity gains and higher wages that other business investment does. The Fed will have to watch not to repeat the excesses in housing and other non-production assets of the 2000s that eventually came to grief.

The larger point is that monetary policy can't make up for bad macroeconomic decisions. Zero rates couldn't lift the economy above 2 percent in the Obama years when regulation and high tax rates undermined business confidence and investment. Negative rates are no panacea for trade shocks either.

With this as a background, we turn to fundamentals, which we hope may be great again soon. Stock prices are determined by the future streams of cash flows—driven by earnings—and the valuation of these cash flows, which is the present value using a set of discount rates that reflect risk. Typically, this is summarized by earning forecasts and a valuation ratio—the P/E ratio. We call these “fundamentals.”

Fundamentals

The positive fundamental factors for stock returns in 2020 are:

- ***Earnings growth:*** Analysts are forecasting earnings will increase 9.8 percent in 2020 for the S&P 500. Energy is predicted to grow 25.2 percent. Financials is expected to be the worst sector with a 4.8 percent growth. Sectors with above-average expected earnings are energy, industrials, materials and consumer discretion.
- ***Revenue growth:*** Revenues for the S&P 500 are expected to rise 5.3 percent in 2020. The best sector, communication services, is expected to rise 9.1 percent, while the worst sector, financials, is predicted to rise 1.9 percent.
- ***Year-over-year revenue growth:*** This is a positive 3.1 percent for the S&P 500 from third quarter 2018 to third quarter 2019, led by health care.
- ***Quarter 3 earnings and revenue “beats”:*** Of the 355 companies in the S&P 500 that have reported for the third quarter of 2019, 76 percent have reported earnings above the mean estimate of analysts (higher than the historical average of 69 percent) and 61 percent have reported revenues above the mean estimate (below the historical average of 66 percent).
- ***IPOs:*** There have been 140 IPOs (as of October 15) that raised \$43 billion. This is down 4 percent over this time last year, but much larger than 2016-2017. The biggest sector was technology, where Uber raised \$8.1 billion and Slack raised \$7.3 billion (but we also had the disaster of WeWork).

The negative fundamental factors for stock returns in 2020 are:

- ***Year-over-year earnings decline:*** From third quarter 2018 to third quarter 2019, earnings declined 2.7 percent for the S&P 500. S&P 500 companies with more international exposure have the largest declines. For those with over 50 percent of their revenue outside the U.S., the earnings decline is -7.6 percent.
- ***International exposure leading to greater risk:*** 38 percent of revenue for S&P 500 firms are international: Information technology is 57 percent, materials is 54 percent, consumer staples is 45 percent, and energy is 41 percent.
- ***Six sectors are showing a year-over-year decline,*** led by energy, materials and information technology. Five sectors are showing a year-over-year increase, led by health care and utilities.
- ***Companies are guiding earnings downward for the fourth quarter, and analysts are expecting year-over-year to be negative.*** 2019 earnings will quite likely be lower than 2018.
- ***The market is rewarding positive surprises more than average, but also punishing negative earnings surprises more than average*** (2 percent more for positive, -2 percent more than average for negative). This results in an increase in volatility, presenting another drag on valuations.
- ***Forward P/E ratios are high.*** As of November 4, 2019, the 12-month forward P/E ratio for the S&P 500 was 17.2. (This is current price divided by forecasted earnings. Multpl.com shows the current S&P 500 P/E ratio at 22.1.) The P/E ratio is above both the five-year average (16.6) and also the 10-year average (14.9).
- ***The Schiller cyclically adjusted P/E ratio (CAPE) is currently at 29.0,*** which is near one of its highest measurements, the other two occurring in (a) 1929 just prior to “Black Tuesday” when the Schiller measure was

also about 30, and (b) in the latter part of 1999, just prior to the dot.com crash. In 2020, we expect most companies to continue to produce positive earnings over the coming year, which should help bring the Schiller P/E ratio measure for the market back into line. But there is little room for valuation to grow without improved earnings in 2020.

- ***Stock repurchases over dividends.*** Analysts estimate stock buybacks within firms of the S&P 500 to total about \$710 billion. Goldman Sachs forecasts that buybacks will fall 5 percent. Share repurchases have been a key short-term driver but in the medium term, this may be positive. Opting to repurchase shares rather than electing to invest in new projects is negative.
- ***Volatility levels:*** The VIX index measures volatility in the market by looking at S&P 500 options prices. It was flat and low in 2017, but has been high and volatile in 2018 and 2019—especially in October.
- ***Budget deficits:*** The projected budget deficit for 2019 by the Congressional Budget Office (CBO) is \$960 billion. This means that federal expenditures were \$960 billion more than federal revenue. The deficit is about 4.5 percent of GDP, up from 3.9 percent of GDP in 2018.
- ***U.S. debt:*** The deficit has caused the largest expansion of federal debt since World War II. The total debt (held by the public) is \$16.7 trillion, which is 79 percent of GDP. This ratio was 76 percent in 2018 and is expected to grow to 88 percent in five years with trillion dollar deficits starting next year. In five years, the CBO forecasts that the interest paid on federal debt will be larger than the defense budget. If interest rates rise to their historical average levels, the budgetary impact will be dramatic. Increasing the average rate by 1 percent will trigger an additional \$140 billion in federal spending. Given lackluster output

growth to compensate for more interest payments, higher rates will require reduced spending in other areas, increased taxes or both.

- ***Public debt is NOT increasing interest rates:*** The growth in federal debt should put upward pressure on interest rates, but there are plenty of lenders even at these low rates. (Germany has been issuing government debt with negative interest rates—not negative real rates, but negative stated rates.)
- ***The U.S. still faces a huge funding deficit*** in Social Security and Medicare payments. The present value shortfall is about \$62 trillion. This is equivalent to \$206,000 per person or \$825,000 per U.S. household. These problems are not insurmountable, but they do require common sense and bipartisan leadership—something that appears to be in short supply in Washington, D.C.
- ***International risks:*** The International Monetary Fund (IMF) says that “the pace of the global economy remains weak.” Momentum in manufacturing has weakened substantially to levels near the 2008 financial crisis. Rising trade and geopolitical tensions channel increased uncertainty about the future of global cooperation (surprise, surprise). China’s economy has slowed to below 7 percent, and the U.S. is actively engaged in international trade negotiations, including changes to tariff policies. It is not clear how these negotiations will end up, or what effect they will have on continued international trade, on U.S. companies and on the consumer marketplace. While it is conceivable the U.S. could ultimately gain trading advantages with certain countries and yield improved positioning overall in the longer term, downside risk is evident in both the short term and longer term.

Forecast

Looking forward to 2020, the positives may just outweigh the negatives for the market. The economy is anemic, and we think GDP growth will be about 2 percent in 2020 with inflation around 1.7 percent. Earnings are weak and likely to stay weak until business confidence is restored. Valuation is on the high side and is unlikely to move significantly higher. While the forecast is for small positive returns in the equities market, we also expect VIX to climb higher given considerable downside risk to this forecast.

But the White House has a strong political incentive to resolve—or appear to resolve—the trade problems they created. In this environment, we expect the return to equities to be positive, but again below the 7 percent average return over the past 50 years—and there is a significant chance of a negative return. If the administration policies stabilize, P/E ratios may become great again and the market could rise. Given the risks seen in Wall Street reports available for investors to consider, we think that value stocks would outperform growth stocks. We think that Treasury bonds will show small increases beyond their current level, and we think there are material long-term inflation risks that could make long-term bonds unattractive. Investors should stick to short-term bonds to reduce their exposure to higher interest rates.



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