WELLS FARGO ASSET MANAGEMENT

Wells Capital Management

Economic and Market Perspective

March 16, 2017 Bringing you national and global economic trends for more than 30 years

Main Street misery shapes Wall Street values

James W. Paulsen, Ph.D
Chief Investment Strategist,
Wells Capital Management, Inc.

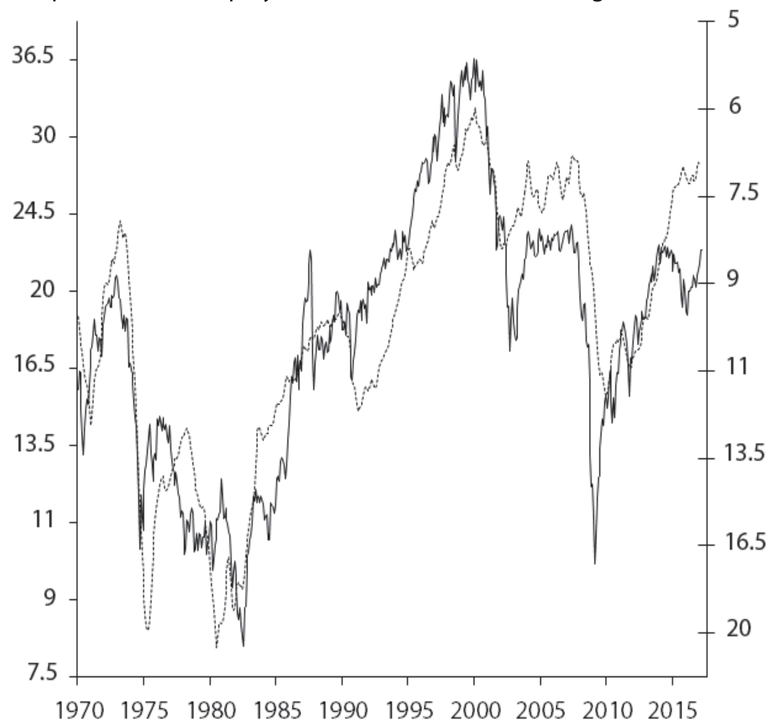
As the stock market climbs, investors are increasingly anxious about its valuation. Indeed, on trailing 12-month reported earnings per share, the price-earnings (P/E) multiple is currently about 25, significantly above the historical average. Undoubtedly, after an eight-year bull run where the S&P 500 Index has risen by about 3.5 times, valuation is extended and probably represents the greatest risk facing equity investors.

However, as the accompanying chart illustrates, the valuation of the stock market appears appropriate for conditions on Main Street than widely perceived. That is, the character of this economic recovery suggests stock market valuations should be high. This chart compares the S&P 500 P/E multiple (based on a trailing five-year average of earnings) to the Economic Misery Index since 1970. The misery index, made popular during the high-inflation 1970s, sums the annual core consumer price inflation rate and the labor unemployment rate. Main Street misery is most pronounced when jobs are scarce (i.e., the unemployment rate is high) while inflation ravages the real purchasing power of incomes.

Although the relationship is not perfect, during the last 50 years, the P/E multiple of the stock market has closely reflected misery on Main Street. During the 1970's stagflation years (when inflation and unemployment often rose together), the P/E multiple hovered near post-war lows. Conversely, the bull market during the 1980s and 1990s was supercharged by a more than tripling of the P/E multiple, reflecting a dramatic decline in Main Street misery. It is no coincidence the lowest P/E multiple during the last 50 years occurred when the misery index was near its record high, and the highest P/E multiple occurred at the top of the dot-com era when the misery index was at a 50 year low!

Chart 1

Stock market PE Ratio vs. Economic Misery Index*
***Sum of annual core consumer price inflation rate and U.S. unemployment rate**
Solid (left scale) — S&P 500 price to trailing five-year moving average of reported earnings per share, natural log scale.
Dotted (right scale) — Annual core consumer price inflation rate plus labor unemployment rate, inverted natural log scale.



If misery on Main is shaping value on Wall, what are the implications for the rest of this bull market? First, it is noteworthy that relative to Main Street misery, the stock market today does not appear overly extended. The misery index currently is close to where it was in the early-1970s and during the mid-2000s and the P/E multiple today is comparable with the P/E in the early-1970s and where it traded in the last recovery. That is, relative to the misery index, the stock market does not currently appear overvalued as it perhaps looked in 1976, 1987, or even in 2000. If anything, relative to Main Street misery, it may be a bit undervalued.

Second, this relationship highlights the primary risks to the valuation level of the stock market—higher unemployment and faster inflation. The unemployment rate is not likely to spike significantly until the next recession, and our best guess is that the next recession is still a ways off. Inflation, therefore, is probably the primary risk facing equity investors during the balance of this recovery. A modest inflation increase would not be too troublesome for the stock market. For example, if core consumer inflation accelerated to 3.5% in the next few years, the misery index would rise to only about eight (i.e., 3.5 inflation and about 4.5 unemployment) which would not create tremendous pressure on current valuations. However, a more significant inflation problem would indeed contract P/E multiples.

Third, investors should consider the possibility that the misery index simply trends sideways during the balance of this recovery, similar to the last recovery. Although the inflation rate will likely rise some in the next few years, the unemployment rate could also decline further toward or even below 4%. If the misery index doesn't change much in the next few years, perhaps the S&P 500 P/E multiple will also remain roughly unchanged allowing investors to enjoy market gains in line with earnings growth. With dividends, this could result in 5% to 7% buy and hold returns during the balance of the recovery.

Finally, could valuations actually rise further yet in this recovery? It is worth highlighting that P/E valuations above 20 times earnings have been commonplace since the early-1990s, while this type of valuation rarely occured during the preceding 100 years. Why have stock market valuations been so elevated in the last quarter-century compared to the rather constant valuation range of the previous century? Could it be because Main Street misery has been uncommonly low during the last 25 years compared to historic levels? Examining the range of P/E multiples since January 1990, the current PE multiple is only slightly above average, in the 55th percentile over the entire period. Consequently, based on the valuation range evident in the stock market for more than 25 years, the current P/E multiple could rise and still not be considered excessive. Indeed, could this new valuation range evident since 1990 reflect a new and much lower misery index range compared to earlier decades? That is, if Main Street misery remains uncommonly low, could P/E valuations remain uncommonly high?

Eventually, this bull market will end and valuations in the stock market will contract, creating significant losses for investors. This may be due to the onset of the next recession, or it could occur despite an ongoing economic recovery, if inflation gets out of control.

For now, however, don't panic over Wall Street values until conditions on Main Street turn more miserable.

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D.
An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.

Wells Fargo Asset Management (WFAM) is a trade name used by the asset management businesses of Wells Fargo & Company. WFAM includes but is not limited to Analytic Investors, LLC; ECM Asset Management Ltd.; First International Advisors, LLC; Galliard Capital Management, Inc.; Golden Capital Management, LLC; The Rock Creek Group, LP; Wells Capital Management Inc.; Wells Fargo Asset Management Luxembourg S.A.; Wells Fargo Funds Distributor, LLC; and Wells Fargo Funds Management, LLC.

Wells Fargo Securities International Limited, First International Advisors, and ECM Asset Management Limited are authorized and regulated by the U.K. Financial Conduct Authority. First International Advisors and ECM Asset Management are also registered with the Securities and Exchange Commission in the U.S.

Wells Capital Management (WellsCap) is a registered investment adviser and a wholly owned subsidiary of Wells Fargo Bank, N.A. WellsCap provides investment management services for a variety of institutions. The views expressed are those of the author at the time of writing and are subject to change. This material has been distributed for educational/informational purposes only, and should not be considered as investment advice or a recommendation for any particular security, strategy or investment product. The material is based upon information we consider reliable, but its accuracy and completeness cannot be guaranteed. Past performance is not a guarantee of future returns. As with any investment vehicle, there is a potential for profit as well as the possibility of loss. For additional information on Wells Capital Management and its advisory services, please view our web site at www.wellscap.com, or refer to our Form ADV Part II, which is available upon request by calling 415.396.8000.

Wells Capital Management, Inc. | 525 Market Street | San Francisco, California 94105