Ready For A Further P/E Derating

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I see but through a glass darkly. Sometimes, however there are glimmers of light. Four months ago, in early December, I examined the signals being broadcast by the various investment rules I have long followed and concluded that: "While global markets have been stable for the past 18 months, we may soon be entering a period of greater instability."

To guard against this possibility, I suggested a number of hedges to help protect portfolios should the investment environment indeed become more challenging. These included holding cash in yen and "to let go of over-owned, over-valued, over-bought and, lately, increasingly volatile tech names" (see **From A Ferrari To A Jeep**).

Arguably, my investment rules suggested this switch a few weeks too early. However, since late January financial markets have indeed seen a surge in volatility, accompanied by an appreciation of the yen and a steep sell-off in big tech names. As a result, it may be useful for readers if I now update my thinking about markets, and US stock valuations in particular.

The US economy shows no signs of heading into recession, and US equities are still heavily overvalued

First, let us imagine that we live in a world much like the real one, but in which there are few if any signs of emerging inflation, and no threat at all of trade protectionism. In this world, two things are immediately apparent.

1) US growth is in rude health, with no prospect of a recession in sight. My US recession indicator is currently reading +15, whereas the threshold at which I begin to worry about a possible recession is at -5 (see the upper pane in the chart overleaf).

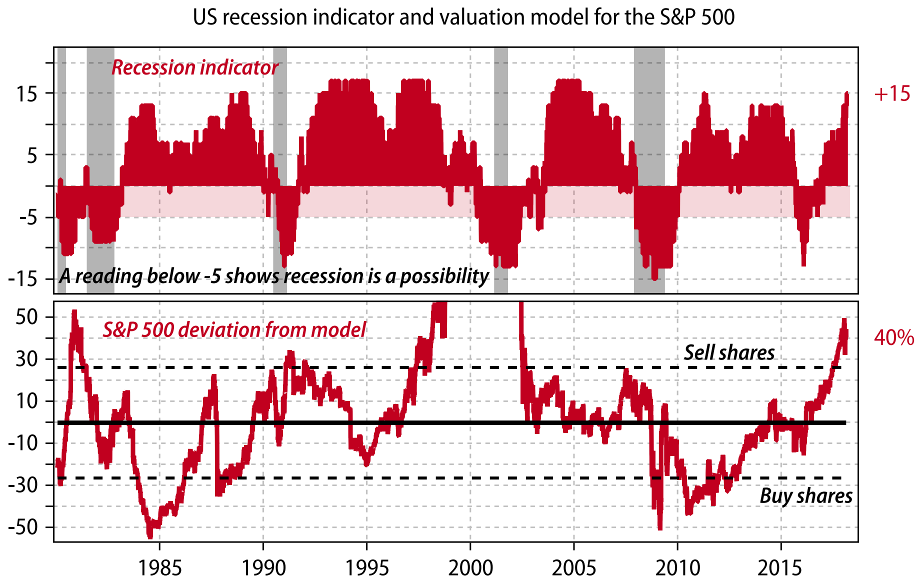
2) Despite the contraction in multiples since late January, the US stock market is still way overvalued according to my model, which is based on corporate earnings and normalized long rates (see the lower pane in the chart overleaf).

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
Germany retail sales slowed to 1.3% YoY in Feb from 2.5% in Jan	Below expected 2.4%	Continued strength in consumer sentiment suggests slowdown may be temporary
Eurozone manufacturing PMI fell to 56.6 in Mar from 58.6 in Feb	In line with 56.6 exp.; Ger 58.2 (from 60.6), Fra 53.7 (from 55.9), Ita 55.1 (from 56.8)	Manufacturing still growing but moderating on strong euro and bad weather
Australia RBA left benchmark rate unchanged at 1.5%	In line with expectations	Uncertainty over growth-inflation dynamics suggest RBA likely to remain on hold
Hong Kong retail sales volume rose 28% YoY in Feb, vs 2% in Jan	Above expected 5.9%; retail sales value rose 30% YoY in Feb vs 4% in Jan	Despite seasonality, strong retail sales shows HK economy benefiting from weaker US dollar

Recession Indicator & Valuation Model for the S&P 500



Gavekal Data/Macrobond

A downward rerating of US P/E ratios is needed...

With the probability of a recession low, there is little chance of an imminent slump in corporate earnings. As a result, the first explanation that springs to mind for the current equity market correction is that investors have been discounting company earnings too far into the future. Therefore a downward adjustment of P/E ratios is required. A -25% decline in the stock market, as occurred in October 1987, would take care of the problem in no time at all.

Remember, this applies in a world with neither accelerating inflation nor mounting trade protectionism.

What if inflation accelerates? Another strand of my research tells me that we may indeed be in the process of moving from the non-inflationary bottom half of my Four Quadrants grid to the inflationary top half (see **A "Once In A Generation" Shift**).

...and even more so if the world is moving from disinflation to inflation

If so, then we should expect a structural contraction in P/E ratios. Gavekal's research suggests the Shiller P/E ratio tends to rise by 5% a year when the economy is in the bottom half of the Four Quadrants, and that it contracts by -5% a year when we are in the inflationary top half of the grid. Therefore, if we do indeed move from the bottom half to the top, investors should expect a P/E contraction in the US of roughly 1 to 1.5 points per year.

The result is that the best investors can expect is for the US stock market to stagnate over the next few years, with P/E ratios contracting slowly as earnings rise. However, an abrupt downward rerating of P/E ratios cannot be ruled out.

To put it bluntly, the best that investors can expect is a market that goes nowhere for quite some time. The worst is an abrupt adjustment, which would lead to a buying opportunity, a little bit like the one after the 1987 crash. For investors who cannot seek safety in Asian bond markets, cash in yen, short-dated bonds and perhaps a little gold might help to reduce the volatility of their portfolios.

But what if we are moving towards a world that is both more inflationary *and* more protectionist? Or rather, what if the financial protectionism which has been in place for years leads both to inflation and to commercial protectionism?

The derating will be even more severe in an environment of protectionism

Then P/E ratios will really come down. For those who can, I would advise buying long-dated local-currency-denominated Chinese, Russian, Indonesian, Brazilian and Indian bonds as a hedge against this calamitous scenario.

Unfortunately, since the world's financial regulators decided their role is to prevent the managers of people's savings from investing in anything but their own local government bond markets, most of our readers cannot put such a hedge in place (this, of course, is just another form of protectionism, along with capital controls, exchange rate manipulation and fixed exchange rates. See **On Protectionism**).

Investors should be wary of platform companies and seek out volatility-reducing assets

It is hardly surprising that the movement of recent years in favor of financial protectionism should evolve into a move towards commercial protectionism. But the inevitable consequence is that P/E ratios will fall. Investors should be careful about holding the shares of what a few years ago we dubbed "platform companies"—asset-light corporations set up to benefit from globalized supply chains. They will be the main losers in a protectionist world. And at the very least investors should look to buy some volatility-reducing assets. They may not afford a true hedge, but they will at least offer some measure of portfolio protection.