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What Multiples Are Telling Us Now

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With price-earnings multiples currently about equal to the long-term historical average of 15.5 times, matters offer a wide-open field for both bulls and bears—the one seeing plenty of upside, the other seeing plenty of down. Though from a strict, mechanical interpretation of the averages, both sides seem evenly matched, mechanistic applications of history seldom help. The addition of context favors the bulls.

Certainly, the historical record argues against drawing easy buy and sell signals from a simple application of the averages—that is, seeing a "buy" when multiples simply fall below historical averages and a "sell" signal when they rise above them. What follows is a review of matters since the 1950s, which shows how such mechanistic comparisons can often mislead.

- It is true that multiples at 12–13 times historical earnings in the 1950s were lower than these averages and that the market experienced a great rally during that decade. But, of course, present day historical averages are hardly applicable to that earlier period. When investors at the time looked farther back to get their historical averages, they saw the Great Depression, the Second World War, and much lower multiples—low enough to have made their ratios of 12–13 times earnings look dangerously high. Mechanistic investors would then have stepped out of the rally.

- In 1962 (the beginning of the great rally of the 1960s), multiples hovered at about the current historical average, giving what in this context would be considered a neutral signal. But as the rally continued for the next three to seven years, multiples rose and stayed consistently above the average, suggesting that a simplistic, mechanical application would have prompted investors to sell much too early.

- By 1973, multiples again dipped below this historical average. If investors had used the mechanical comparison as a buy signal, they would have joined the market just in time to suffer the market's 1974 drop of more than 33%.

- To be sure, multiples in 1974, at 7–8 times earnings, did look attractively low, allowing even mechanistic investors to join the rally that carried into the 1980s. This application also would have kept them there until 1985. But by then, multiples exceeded the average, signaling a sale to the mechanistic investor and, consequently, depriving him or her of the 1986 rally. A mechanistic application would, however, have avoided the crash of 1987.

- Lower-than-average multiples would have put investors back into the market for the 1989 rally, but kept them there through the market stagnation of 1990. After that, multiples of well above 20 times earnings would have kept those who invested on this mechanistic basis out of stocks through the entire, great 1990s rally.

- Higher-than-average multiples would have argued against equities throughout the rally of 2002–2007, and then would have looked attractive in late 2008, five months and some 25% before the market actually bottomed. But to be fair, this mechanistic approach to multiples would have made stocks look attractive at the March 2009 bottom.

If the record on the mechanistic application of averages is spotty, adding the context of bond yields can help considerably. Because bonds are equities' chief competitor for the investment dollar, a comparison of valuations with

yields is essential and a far superior way to proceed than simply making comparisons of current multiples with history. When yields are high and this competition, consequently, is keen, equities need lower multiples to attract investment dollars, whatever else is happening, than when bond yields are low and the competition for the investment dollar is less keen. Such considerations could have helped avoid many of the missteps of simple comparisons to the averages.

- In the 1960s rally, for instance, equities could advance from lower-than-average multiples to higher-than-average multiples in part because bond yields actually fell between 1962 and 1965. It was not until yields began to rise again after 1966 that the rising multiples became suspect.

- The low multiples of 1973 looked falsely attractive when simply compared with the historical averages. But a recognition that bond yields were twice their levels of the early 1960s would have offered essential perspective and made investors insist on still lower multiples before buying. That would have kept them out of the market when prices fell in 1974.

- The failure of these simple comparisons in the late 1980s also would have benefited from the perspective offered by bond yields. Though multiples might have stood above their historical averages in 1985, the drop in yields by more than 100 basis points (bps) in 1986 easily sustained the market rally, despite the rise in multiples. Conversely, the sudden rise in bond yields in 1987 should have made investors look for higher-than-average multiples, redoubling their ability to avoid the 1987 crash.

- The great drop in yields throughout the 1990s, by more than 200 bps in fact, could easily have explained the market's ability to sustain a rally while multiples consistently remained above their longer-term averages. Similarly, a less dramatic downward shift in bond yields between 2002 and 2007 also should have alerted investors that stocks could sustain higher-than-average multiples.

The other critical context concerns prospects for earnings growth. Always vague, such forecasts nonetheless color the direction of prices and multiples at every turn. When, for instance, investors have reason to expect rapid growth in the economy and in earnings, whether for cyclical or for longer-term reasons, they will push up multiples in anticipation. Then, when those earnings are realized, multiples can actually adjust back down, even as stocks continue to rally. Such patterns developed in the mid-1960s, the 1980s, and earlier in this century. Multiples, having risen in anticipation of the earnings growth, then edged down when the earnings growth occurred, and did so even as stocks continued to rally in the periods 1967–1968, 1983–1984, and again through 2004–2006.

Now, looking forward into the next 18–24 months, the market begins with multiples neither high nor low. But bond yields—whether Treasuries or corporates—look low relative to the same history over which the historical multiples are calculated, seemingly leaving room for stocks to carry higher-than-average multiples. At the same time, prospects for further earnings gains seem good. Earnings have come in at levels 25–30% above the easy comparisons of the past year, and as long as the economy continues to grow, which is likely, these good earnings figures should continue, though the pace of advance will almost certainly slow going forward. If, as is entirely likely, the earnings among the stocks in the S&P 500® Index[1] rise around 20% for the next 12 months or so, there is ample room for stock price gains even as multiples decline, much as happened in the mid-1960s, the 1980s, and in the earlier years of this century.

Risks abound, of course. They always do. The economy could suffer a second recessionary dip. The European situation could create another financial crisis that could unhinge matters. But the probabilities argue against such eventualities, leaving equities open to rise on the bases of today's average valuations, neutral to favorable influences from bond yields, and room to follow at least a good part of the likely rise in corporate earnings.

[1]The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

An index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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