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Reading The Markets | Long-Term Outlook

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Slower Growth Should Lead To PE Multiple Compression

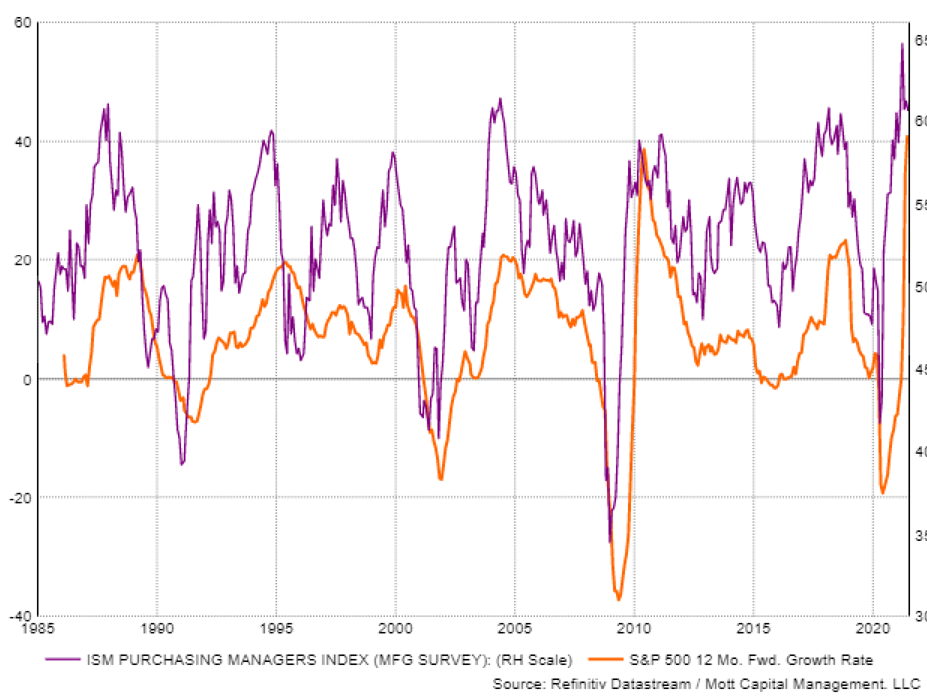
Data ending the week of July 2 supports the idea that the economic recovery appears to be losing steam. While the economy is still growing at a healthy pace, that is far from recession, the **slower GDP growth should translate to lower breakeven inflation rates and lower earnings growth rates which together should compress PE multiples across the equity market by at least 15%.**

The bond market appears to be picking up on signals of economic slowing as well. Rates on the 10-year bond fell to around 1.43% on July 2 from 1.53% on June 25, marking the lowest closing yield since the last FOMC meeting in mid-June.

Economic Growth Appears To Have Peaked

The ISM manufacturing report missed estimates falling to 60.6, down from last month's reading of 61.2. This report happens to be highly correlated to the S&P 500 earnings growth rates. History shows that since 1985, peaks and troughs in the ISM manufacturing index are positively linked to peaks and troughs in the S&P 500 earnings growth rate. **Given that the ISM Manufacturing index has likely peaked, it seems reasonable that growth rates in earnings are peaking.**

Exhibit 1: *The ISM manufacturing report is highly correlated to S&P 500 EPS growth rates*



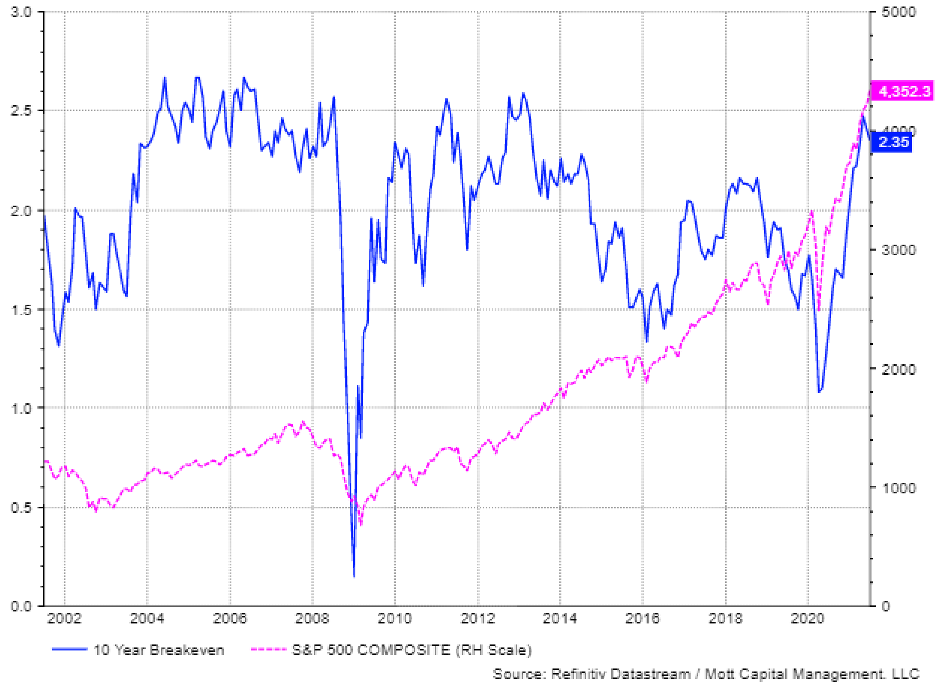
Additionally, the second quarter is expected to be peak GDP growth, and growth rates are expected to decelerate in the third and fourth quarters. Consensus estimates have second-quarter growth peaking at 9.5% and then slowing to 7.1% in the third quarter and 5.1% in the fourth quarter. **Currently, the [Atlanta Fed GDPNow] model forecasts a second-quarter growth rate of 7.8%. This would suggest that the second quarter may be running at a slower pace than initial estimates.**

Exhibit 2: *Peak GDP growth is expected in the second quarter. The Atlanta Fed GDPNow forecast slower growth than the consensus forecast.*

Slow Earnings Growth And Falling Inflation Expectations Will Compress PEs

The bond market appears to be picking up on these slower signals. Falling yields are translating to lower breakeven inflation rates. **Rising inflation expectations have been a green light for the equity market to push higher. Still, the two have diverged meaningfully in recent weeks.** The two are not always best of friends, and it could be the on-again, off-again relationship that is merely shifting. In fact, from 2013 through 2015, inflation expectations fell continually, but it didn't stop the stock market from rising. At least on the surface, it appears this way.

Exhibit 3: *Breakeven inflation expectations do not appear to correlate to the S&P 500 at first blush.*



However, the falling inflation expectations are one reason why we have seen more economically sensitive parts of the equity market decouple from the broader S&P 500. For example, the housing sector and the Dow Jones Transports appear to be following the path of the reflation signals.

Exhibit 4: *The economically sensitive parts of the equity market appear to be tracking inflation expectations closely*

But there is more here; in fact, when looking at changes in the S&P 500 earnings growth rates and PE multiples, we find that the two actually move in lockstep with breakeven inflation expectations. Inflation expectations anticipate growth in the economy, and S&P 500 earnings estimates are another way to measure that growth. Meanwhile, the PE ratio is simply an expression of how much investors are willing to pay for those earnings, with higher growth rates demanding higher PE multiples and lower growth rates requiring lower PE multiples. Therefore, when inflation expectations are rising, PE multiples are expanding, and when inflation expectations are falling, PE multiples are contracting. At the same time, the trend in the earnings growth rate determines the PE ratio's longer-term direction.

The market pushed higher from 2013 to 2015 because earnings growth rates were trending higher, expanding multiples longer term. However, the fluctuation in the PE multiple during the uptrend appears to correspond to changes in breakeven inflation expectations. So while the broader trend in the PE multiple was higher due to improving earnings growth rates, the up and downs during that uptrend were primarily determined by inflation expectations.

Exhibit 5: *Long-term PE multiples trends appear to be determined by the direction in EPS growth rates, while breakeven inflation rates determine the ups and downs within those long-term trends.*

It seems that both earnings growth rates and breakeven inflation expectations are poised to move lower, which is likely because the growth in the economy is poised to normalize. In the end, it should lead to lower PE multiples on the S&P 500.

How the market responds to lower PE multiples will largely determine how far the multiples and earnings estimates rise or fall. **Assuming the multiple falls to the October 2018 and February 2020 peak of around 18.5, it would reflect an S&P 500 value that is 15% lower than its current value of 21.8, which would equate to a level of approximately 3,685.**