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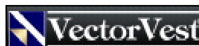
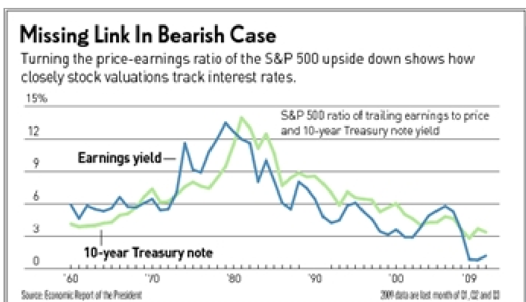


VIEWPOINT

Shilling For Shiller In Permabear Press

By ALAN REYNOLDS

Posted 03/12/2010 06:17 PM ET



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On the March 9 anniversary of the stock market implosion a year ago, a front-page story in the Wall Street Journal featured one of the same bears making the same bad argument he made a year ago.

The article, "Worries Rebound on Bull's Birthday," was almost entirely devoted to trying to explain a graph by Robert Shiller of Yale, titled "Stocks Still Expensive." The New York Times ran the same graph on March 15, 2009, to warn us that the ratio of stock prices to earnings "hasn't fallen as far as the market bottoms of 1932 and 1982."

By then, reports from Barron's, Bloomberg and the Wall Street Journal had already suggested that the Dow could fall to 5000 and the S&P 500 to 500. The Journal's headline on March 9, 2009, was "Dow 5000? There's a Case for It."

All such ill-timed warnings relied on falling valuations, not falling earnings.

Writing in Forbes.com last March 12, Nouriel Roubini found it "realistic to expect that the multiple may fall in the 10 to 12 range," so he concluded that "the S&P could fall to 600 ... or even to 500 (10 times 50)."

Now, fast-forward a year to Shiller's newest graph in the Journal. It displays his "cyclically adjusted" ratio of current S&P 500 stock prices to company earnings over the past 10 years.

By splicing together antique stock indexes as though they were comparable to today's S&P 500 companies, the data reach back to 1881. The 130-year average is 16.36. Because of that, the Journal explains, Shiller "has found that when this ratio has gotten above 20, as it is today (20.64), it has signaled that the stock market was expensive and sooner or later would hit a stretch of subpar returns."

Suppose you could accept Shiller's idea that it makes sense to link today's stock prices with profits over the past 10 years rather than profits in the future. Would shunning stocks when

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03/15/2010 01:00:23 PM ET

Investing Tip

Remember, it's very important to purchase at the proper buy point.

Shiller's index topped 20 actually be a hot tip about market timing?

Here's the bottom line: Following Bob Shiller's "over 20" rule would have kept you out of the stock market every single month from December 1992 to September 2008. All that time Shiller was presumably scolding investors, warning that "sooner or later" there would be a market downturn.

Since downturns are bound to happen, sooner or later, there were a couple of times Shiller's rule might have seemed prescient. Yet anyone acting on that do-nothing advice continually from 1993 to 2007 would have forgone many lucrative investment opportunities.

The most fundamental problem is that Shiller imagines that the price-earnings multiple is mean-reverting, so the current P-E ratio can easily be judged high or low relative to its average over 130 years. This is where my own graph comes in.

It shows that P-E ratios are not greatly affected by psychology, as Shiller believes, but rather by interest rates. This is easily shown by turning the P-E ratio upside down, which produces an earnings-price ratio, sometimes called the earnings yield. Clearly, the trailing E-P ratio tracks the yield on 10-year Treasury notes quite closely.

When interest rates are low, P-E ratios are high (so E-P ratios are low). For one thing, the discounted present value of future earnings goes up when the discount rate goes down. For another, dividends look more attractive relative to low bond yields.

These E-P ratios are based on trailing earnings over the past four quarters, rather than 10 years of past history (as Shiller does) or analysts' estimates of the future (as the "Fed model" does).

Looking at the figures through September of last year (the latest available), the trailing E-P ratio was down to about 1% while the bond yield was closer to 3%. That disconnect is simply because trailing earnings toward the end of a recession are deeply depressed, so that stock prices based on expected recovery look high relative to the previous year's earnings.

Earnings over the past year are a poor predictor of future earnings, and earnings over the past 10 years are even worse.

When the E-P ratio was unusually high, as in the inflationary 1978-81 period, it means the P-E ratio is very low and bond yields very high. To suggest that the E-P or P-E ratio will invariably return to some long-term norm, as Shiller does, is to suggest that bond yields will likewise return to some long-term norm. But interest rates are determined by variables — such as inflation and real returns on invested capital — that are not simply determined by predictable past trends.

The permabears might make a plausible argument against buying stocks if they argued that a big spike in bond yields was imminent. But that would be inconsistent with their usual forecast of stagnation and deflation. So they're still peddling the fallacy of "above average" multiples, as they were a year ago.

For the press to still be recycling Robert Shiller's stale arguments against buying stocks in March 2009, despite what happened since, is a remarkable example of the media's inclination to favor downbeat theories over any actual good news.

• Reynolds is a senior fellow with the Cato Institute and the author of "Income and Wealth" (Greenwood Press, 2006).

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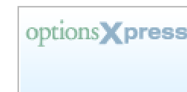

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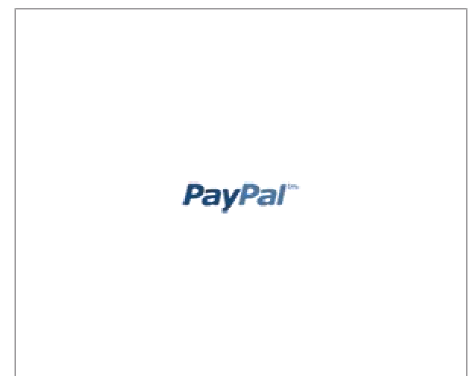

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Posted By: deaconblue(15) on 3/15/2010 | 9:40 AM ET

"It doesn't take too many of these to lift the average P/E to values above 20x." Shiller's PE doesn't average the PE's, it aggregate S&P 500 earnings, adjusts them for inflation, and averages them over the past decade. This method only works at an index level, it would not work for an individual stock.

Posted By: deaconblue(15) on 3/15/2010 | 9:39 AM ET

Furthermore, Shiller's 10 year PE (adjusted for inflation) works at an index level because the economy has a very consistent growth pattern over time and periods of unusually high earnings growth are followed by periods of low growth. The 10 year PE smooths this trend for cyclical variations. Finally, Shiller's PE dropped to 13 in March of last year, below long term averages, so many people would have chosen to buy given that metric.

Posted By: deaconblue(15) on 3/15/2010 | 9:37 AM ET

The author is correct that interest rates need to be taken into account, but I wonder if he's ever taken a finance course before. If you buy stocks when the earnings yield is low, then you are accepting a lower expected return going forward. That's all Shiller is really saying- the price you pay matters.

Posted By: Conventional Wisdumb(40) on 3/13/2010 | 11:01 AM ET

I am not sure what point the writer is trying to make about the market. With two massive selloffs over the past 10 years a buy and hold investor has lost so much money on an inflation adjusted basis that you have to wonder if the stock market is anything other than a volatility casino. If you can time it you will win, if you can't well the Nasdaq is still 60% below its all time high nearly 10 years ago! The S&P 500 needs to rise 35% more to get to its peak of Oct 07!

Posted By: MaxiLeery(20) on 3/13/2010 | 9:09 AM ET

The real problem with "Average" P/E ratios: From time to time stocks have prices many times greater than earnings. Between the 1st Quarter 2000 and 4th Quarter 2009, several stocks had P/E ratios in excess of 500. EBAY's P/E was 5000 in 1Q2000, Honeywell - 1440x. It doesn't take too many of these to lift the average P/E to values above 20x. The median P/E for the last quarters ending Dec 2009 was 17.6 vs. the average 21.4, with the latter including negative P/Es. Yearly medians = 15.5x.

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