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## Finance

BY MARK VAN MOURICK

# ON INFLATION AND STOCKS

What brokerage firms won't tell you.

**T**he bull market for public stocks, which started in 1983 and progressed with only minor interruptions until 2000, was a once-in-a-career occurrence. This is not a bearish forecast or doomsday speak. It's about revealing the truth through one simple chart that most investment professionals have not seen, let alone would be willing to share with you.

While the value of public stocks (or anything else, for that matter) is based on what people are willing to pay at a given point, stocks trade on multiples of corporate earnings expectations. Ultimately, valuation or "price" depends on how high or low those multiples (price-earnings, or P/E ratios) go. It's as simple as this: Stock returns are based on the fluctuations of the price plus any dividends received over time. If P/E ratios stayed the same, at the current average of 29, then stocks would be worth 29 times their earnings and stock returns would be based entirely on earnings growth and dividends.

Predicting overall corporate earnings growth for U.S. stocks is just as easy. Overall corporate earnings growth has grown with amazing steadiness at about 4 percent per year (less in recessions and more in boom times). But, what people are willing to pay for those earnings is another matter as purchases have varied widely.

When the bull market started in 1983, the average P/E ratio was only seven. Today, it has grown to a multiple of 29. As P/E ratios rose, stocks not only benefited from earnings growth, they also benefited from higher and higher multiples, which were paid for by those earnings. For example: if a stock earned \$1 per share and traded at seven P/E in 1983, it would have been priced at \$7 per share. If, over 10 years, its earnings grew to \$2 per share, and its P/E ratio stayed at seven, the price would have doubled to \$14. If, however, the P/E ratio grew to 21, 10 years later, the stock would be \$42 (and not \$14) on the same \$2 earnings. We experienced this phenomenon in the last bull market as earnings rose normally, while P/E ratios rose dramatically.

Back in the '70s, corporations had earnings growth but falling P/E ratios diminished their returns as they went from 20 down to seven. In sum, rising P/E ratios accelerate stock market profits, while falling P/E ratios diminish profits. So, if you can predict if P/E ratios are going to rise or fall, then you can predict stock market returns.

Here's the part of the story no one is willing to share: It's easy to predict changes in P/E ratios because they are lock step with inflation. As inflation went up in the '70s, P/E ratios dropped, zig for zag, until inflation peaked at 9 percent and P/E ratios bottomed at seven. When inflation dropped, again in zigzag fashion, P/E ratios followed suit by rising to 29 when inflation finally dropped to today's 1.5 percent.

It's very important to recognize that P/E ratios move in very close correlation to inflation. If inflation remains at 1 to 2 percent, P/E ratios will remain at a high 25 to 30 level. Stock prices would then advance slowly, based on earnings growth and stable P/E ratio. This would produce 4 to 5 percent returns (based on earnings growth) plus dividends, currently averaging 1 percent; totaling a 5 to 6 percent total return from the stock market. This is the best-case scenario, because inflation (and P/E ratios in lock step) rarely stays still very long.

If we have any lower inflation, it would go below 0

percent, which is deflation – the kind of ugly economic environment that has plagued Japan for the past 12 years. Since 1990, the Japanese index (Nikkei) went from 40,000 down to its current 10,700. When deflation happens, earnings shrink and stocks collapse. If inflation rises, even modestly to 4 percent (our long-term average), P/E ratios will drop from 29 back to 15 (also, our long-term average). This would result in stocks

that would be worth half as much as they are today given the same earnings.

We really have only three scenarios: a) Inflation and P/E ratios are the same – in which case stocks will advance slowly; b) Inflation will drop – creating deflation and lower earnings, resulting in lower stock prices; and c) Inflation will rise and P/E ratios drop, resulting in lower stock prices.

The only way that we could see different results would be if the tight relationship between inflation and P/E ratios cease to exist. Even if this happened in our lifetime, P/E ratios are unlikely to go up from their highest level to even higher levels.

It's easy to see why the 17-year-old bull market was a once-in-a-career occurrence. We went from a high inflation rate to a low one, justifying a P/E ratio expansion from seven to 29. This kind of inflation decline cannot possibly happen from our current 1 to 2 percent level, so you can forget about a repeat any time soon of 20 percent returns from the general stock market.

You may have known this rationally, but now you know this statistically. Nevertheless, don't expect the brokerage firms to tell you – they won't. Why? Because their whole investment product mix is based on a bull market for U.S. stocks. Instead, look to diversify into bonds, real estate, natural resources, trust deeds, private business and cash. It's going to be a new ball game in this millennium, and the sooner you realign your portfolio, the better. **OCM**

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