

# **C** *Economic & Market* Commentary

## **Valuation**

Valuation has been a frequent topic of our *Economic & Market Commentaries* over the last few years, but, during this time, this issue has repeatedly been at the heart of investor satisfaction (or dissatisfaction) with the markets' movements. Simply put, valuation is a measure of how much the market will pay for the current assets of a company and its expected future profits (earnings). There are many complicated methods used to calculate valuation, but one of the more common measures is the ever-popular Price to Earnings multiple (P/E).

As an example, if a company is expected to earn \$2.00 per share, and its P/E multiple is 10, the stock will be priced at \$20 per share ( $\$2.00 \times 10 = \$20$ ). P/E's differ from company to company, and factors such as the economy, market environment, industry, and company-specific issues come into play when determining the P/E for a company. In addition, the P/E and earnings are not mutually exclusive, and the two can change simultaneously, magnifying the resulting price change. Major moves in the stock markets typically occur when there is either a P/E expansion coupled with increasing corporate earnings or a P/E contraction coupled with declining corporate earnings.

Over the last seven years, we have seen three such combinations of changes in earnings and P/E. In the late nineties, earnings rose along with P/E's, and stock prices rose faster than earnings. As earnings plummeted from the last half of 2000 through the first half of 2002, P/E's, after spiking to 50-year highs as a result of a sharp drop in earnings, began what became a five-year decline, and stock prices fell faster than earnings. As earnings began recovering in the latter half of 2002, the markets battled falling P/E's, and stock prices rose more slowly and more sporadically than earnings. From about August of this year to the present, earnings growth was coupled with rising P/E's, and stock prices rose faster than earnings.

In a market environment which sported non-threatening valuation levels (low P/E's) in the first half of 2006, inflation forecasts were lowered, first by the Federal Reserve Board (Fed), as evidenced by a stable Fed Funds rate and minutes of its meetings, then later, in droves, by the Wall Street analysts. This was the scenario that we had been anticipating, and it was the springboard that got the market going in the second half of the year. During the last quarter of 2006, the P/E for the S&P 500 stock index expanded, and, by itself, contributed to about a 5.5 percent increase in the S&P 500 stock index.

At this point, the P/E for the S&P 500 has risen to what we consider to be a reasonable level, where stocks look neither cheap nor expensive. While earnings growth is expected to be lower than it was in 2006, without fighting the headwind of rising inflation and falling valuation levels experienced in the last four years, stock markets can produce competitive investment returns in a lackluster economic environment that may surprise most investors.

Interest rates on the 10-year Treasury note have ranged between 4.4 and 5.2 percent during the year, and the debate on the future of interest rates sounds much like the old “tastes great/less filling” Miller Lite beer commercials. If the economy avoids dipping into a recession in 2007, then the 10-year Treasury rate is too low. If the economy does dip lower and the Fed feels compelled to lower interest rates once or twice in 2007, the yield curve will still remain inverted unless the 10-year Treasury rate increases. With either scenario, the yield on the 10-year Treasury should stay in a relatively narrow band, not offering substantial capital gain opportunities for bond investors. In terms of a bond market valuation, the 10-year Treasury sports a P/E a little north of 21, which is a bit higher than the P/E of 15 for the S&P 500.

Expectations for slower growth in 2007 and an uncertain outlook for future Fed actions are complicating the picture for investment markets in 2007. While the popular opinion is that the Fed will lower the Fed Funds rate in the first quarter to spur economic growth, it may be forced into a position to raise, rather than lower, the Fed Funds rate, if the specter of inflation looms larger than problems associated with slowing growth. The minutes of the last two meetings reiterated the Fed’s lingering inflation concern, which may be the real risk to the financial markets in 2007. These issues will likely hold the markets’ attention during the first quarter, as economic data continues to be digested.

We continue to favor the international aspect of the investment markets, as international economic growth rates may surpass domestic growth rates, and the U.S. dollar exchange rate may continue to fall. For the U.S. investor, international markets should serve as both an opportunity to participate in higher growth rates, and a cushion against a weaker U.S. dollar. While still an important component to global economic growth, the overall economic dominance once possessed by the United States is being gradually usurped by the combination of other mature and growing economies around the world.

Stephen J. Taddie  
December 31, 2006