MORNING BRIEFING
May 23, 2017

(A) Few Differences This Time?

See the collection of the individual charts linked below.

(1) Not all valuation measures are flashing red. (2) Misery Index near previous cyclical lows. (3) Misery-adjusted forward P/E around its mean. (4) Rule of 20 no longer bullish. (5) Buffett isn't giving much weight to his ratio. (6) Price-to-sales ratio awfully high. (7) Fed Model says stocks cheap compared to bonds. (8) China's demography remains bullish for growth. (9) China's population growth slows. (10) But China's rural-to-urban migration continues apace.

Valuation: A Less Miserable Measure. Almost all valuation multiples are flashing that stocks are dangerously overvalued. Are there any valuation models suggesting that the danger signals might be false alarms? There is one. It shows the inverse relationship since 1979 between the S&P 500 forward P/E and the Misery Index, which is the sum of the unemployment rate and the CPI inflation rate. Let's have a look at it and compare it to a few of the other valuation indicators:

(1) *Misery Index very bullish.* During April, the Misery Index was down to 6.6%, near previous cyclical lows (*Fig. 1*). That's down 6.3ppts from its most recent cyclical peak of 12.9% during September 2011. Over this same period, the forward P/E has risen from roughly 10 to 17, well above its average of 13.8 since September 1978 (*Fig. 2*).

The theory is that less misery should justify a higher P/E. A low unemployment rate should be bullish for stocks unless it is accompanied by rising inflation, which could cause the Fed to tighten to the point of triggering a recession and driving the jobless rate higher. Nirvana should be a low unemployment rate with low inflation, which seems to be the current situation. In this happy state, a recession is nowhere to be seen, which should justify a higher valuation multiple.

Joe and I construct a "misery-adjusted" P/E simply by summing the S&P 500 forward P/E and the misery index (*Fig. 3*). It has been trendless and highly cyclical since September 1978, with an average of 23.9. Its low was 18.5 during November 2008, and its high was 33.0 during March 2000. During April, it was 24.3, in line with its average. That's somewhat comforting.

(2) *Rule of 20 no longer a buy signal.* Less comforting is the Rule of 20, which tracks the sum of the S&P forward P/E plus the CPI inflation rate (*Fig. 4*). So it is the same as the misery-adjusted P/E less the unemployment rate. I moved to CJ Lawrence in 1991. My mentor there was Jim Moltz, who devised the Rule of 20, which states that the stock market is fairly valued when the sum of the P/E and the inflation rate equal 20. Above that level, stocks are overvalued; below it, they are undervalued.

The rule was bearish just prior to the bear market at the start of the 1980s. It was wildly bullish for stocks in the first half of the 1980s. It turned very bearish in the late 1990s and bullish again a couple of years later in mid-2002. Those were all good calls. However, like most other valuation models, it didn't signal the bear market that lasted from October 9, 2007 through March 9, 2009. At the end of 2008, the Rule of 20 was as bullish as it was in the early 1980s. That was another very good call. By early 2017, it was signaling that stocks were slightly overvalued for the first time since May 2002.

(3) *Buffett ratio sees no bargains.* Another valuation gauge we follow is the price-to-sales (P/S). The S&P 500 stock price index can be divided by forward revenues instead of forward earnings (*Fig. 5*). However, the forward P/S ratio is very highly correlated with the forward P/E ratio. So it doesn't add much to the assessment of valuation.

A variant of the P/S ratio is one that Warren Buffett said he favors. It is the ratio of the value of all stocks traded in the US to nominal GDP (*Fig. 6*). The data for the numerator is included in the Fed's quarterly Financial Accounts of the United States and lags behind the GDP report, which is available a couple of weeks after the end of a quarter on a preliminary basis. Needless to say, it isn't exactly timely data.

However, the forward P/S ratio, which is available weekly, has been tracking Buffett's ratio very closely (*Fig. 7*). In an interview he did with *Fortune* in December 2001, Buffett said, "For me, the message of that chart is this: If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%—as it did in 1999 and a part of 2000—you are playing with fire." That's sage advice from the Sage of Omaha. His ratio was at 1.69 during Q4, while the P/S was 1.90 in mid-May, suggesting that we are playing with fire.

On the other hand, a year ago in a 5/2 CNBC interview, Buffett said, "If you had zero interest rates and you knew you were going to have them forever, stocks should sell at, you know, 100 times earnings or 200 times earnings." He was speaking hypothetically, of course. More recently, this year in a 2/27 CNBC interview, Buffett said that US stock prices are "on the cheap side," and added, "We are not in a bubble territory." He also announced at the time that he had more than doubled his stake in Apple since the new year and before the tech giant reported earnings on January 31.

(4) *Fed model still bullish.* To round out the discussion, we should mention that the Fed's Stock Valuation Model showed that the S&P 500 was undervalued during April by 61.9% using the US Treasury 10-year bond yield and 24.9% using a corporate bond yield composite (*Fig. 8*). This confirms Buffett's assessment that stocks are relatively cheap compared to bonds. If more investors conclude that economic growth (with low unemployment) and inflation may remain subdued for a long while, then they should conclude that economic growth and inflation remain historically low. That's a Nirvana scenario for stocks, and would be consistent with valuation multiples remaining high.

China: More Urban, Less Rural. Demography has played a much bigger role in China's economy than in any other. That's because China has had the biggest population of all other countries. Economists usually ignore demographic factors because they tend to play out over long periods. In China's case, demographic factors are among the most important in assessing the country's economy. They remain very important in explaining why China is likely to continue growing faster than most any other countries for a while.

In December 1978, two years after Mao Zedong died, China's communist leadership decided that it was time to modernize the country's economy. Deng Xiaoping, China's new leader, announced an Open Door Policy that aimed to attract foreign businesses to set up manufacturing operations in Special Economic Zones (SEZ). This was the first step along the path that eventually led China to join the World Trade Organization (WTO) in 2001. Along the way, market reforms were implemented and foreign trade expanded.

I first started to study China's demographic developments in my November 7, 2003 *Topical Study* titled "China for Investors: The Growth Imperative." I observed that the Chinese regarded joining the WTO as their most important economic reform in 20 years. To join, they were required to accept numerous agreements to open their domestic markets to more competition from abroad. I posed a rhetorical question: "Why would the communist regime in Beijing agree to the capitalistic codes of conduct required to be a member of the WTO?" It would speed modernization, which was essential to creating enough jobs for the rapidly expanding population, which was rapidly urbanizing.

In a follow-up analysis dated January 21, 2004, I explained that rapidly increasing farm productivity in China was causing a huge migration from the agrarian sector to the cities. To avoid massive social upheaval, the Chinese needed to create lots of jobs in manufacturing, construction, and services. Joining the WTO was seen as an essential way to create more factory jobs among exporters. I saw that the Chinese government was becoming increasingly obsessed with what I called the "Growth Imperative." I wrote in that second China *Topical Study*: "I believe that China is driven by a 'Growth Imperative.' I believe the country must grow rapidly to absorb the huge number of new entrants into the labor force every year and to meet the needs of the large number of people who are leaving the rural areas and moving to the urban centers." The government fully realized that failure to expand employment could have serious consequences for the country's social and political stability.

I bolstered my argument by noting that to accommodate the roughly 20 million people per year migrating to the cities, the Chinese in effect had to build one Houston, Texas, every month! Allow me to update China's extraordinary demographic story:

(1) *Population*. China's population rose to a record-high 1.38 billion during 2016 (*Fig. 9*). It was up 8 million y/y. It was up 68 million over the past 10 years (*Fig. 10*). That increase is about equal to the population of France. However, it is significantly slower than the peak of 204 million in the 10-year population explosion during 1974.

(2) *Rural migration*. The percentage of the population living in rural areas dropped from 88.8% during 1950 to 82.1% during 1978, when China announced the Open Door Policy (*Fig. 11*). Then it fell to 62.3% in 2001, when China joined the WTO, and tumbled to 42.7% last year.

(3) *Urbanization*. The percentage of the population that was urbanized rose to 50% during 2010, and was 57.3% last year. Last year, the urban population increased by 21.8 million (*Fig. 12*). That is truly extraordinary, as this category has been increasing consistently around 20 million per year since 1996. Again, to urbanize that many people requires the equivalent of building a Houston per month!

CALENDARS

US. **Tues:** New Home Sales 604k, Composite, M-PMI, and NM-PMI Flash Estimates 53.2/53.1/53.1, Richmond Fed Manufacturing Index 15, Kashkari, Brainard. **Wed:** Existing Home Sales, 5.650mu, FHFA Price Index 0.5%, MBA Mortgage Applications, EIA Petroleum Status, FOMC Minutes, Kashkari, Kaplan. (Bloomberg estimates)

Global. **Tues:** Eurozone, Germany, and France Composite PMI Flash Estimates 56.7/56.6/56.6, Eurozone, Germany, and France M-PMI Flash Estimates 56.5/58.0/55.2, Eurozone, Germany, and France NM-PMI Flash Estimates 56.4/55.5/56.7, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 121.0/113.1/105.4. **Wed:** Germany Gfk Consumer Confidence 10.2, Japan M-PMI Flash Estimate, BOC Rate Decision 0.50%, Draghi, Kuroda. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—recovered 0.8% during the week of May 13 after dipping 1.2% the prior two weeks, which interrupted a four-week jump of 3.1%. It's within 0.5% of its record high recorded 11 weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB rebounded 1.1% after retreating 1.8% the prior thee weeks; it's only 1.2% below its record high recorded during the final week of February. Jobless claims fell to 240,750 (4-wa) after edging up the prior two weeks from 242,250 to 243,500; it's moving back down toward its recent low of 239,750 in late February—which was the lowest since 1973. The CRB raw industrial spot price index—another BBB component—moved sideways in recent sessions. Meanwhile, the WCCI is fluctuating around recent highs, climbing 1.0% after a 2.4% decline the prior week.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap, but SmallCap remained 0.3% below its early May record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings slowed to 9.8% y/y from a 64-month high of 10.2%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 32-month high of 12.6% from 11.4%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's was steady at a 15-week low of 11.0%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.4% and 11.8%, MidCap 11.3% and 13.4%, and SmallCap 8.6% and 19.9%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were slightly lower for all three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E edged down w/w to 17.3 from 17.4 and remains near the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E fell to 17.9 from 18.2, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's is up from a three-year low of 15.0 in January 2016. SmallCap's weakened to 19.1 from 19.4, which compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016 and remains close to SmallCap's record-high P/E of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.90 and MidCap's 1.25 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 0.99 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823