

January 23, 2009

Downunder Daily

The Bigger the Bubble...

It's a simple, but important, question: Why aren't equities cheap, given how far they have fallen?

The answer is simple: because the starting point was the biggest Wall Street bubble of all time. Consequently, the market has to fall farther to reach the same highly attractive valuation levels that marked the lows at the end of prior super-bear cycles. In short, the bigger the bubble, the bigger the pop.

Wall Street is now in the midst of its fourth great super-bear market. (It's conventional to define a 20% market decline as a bear market. By 'super-bear' I mean multi-year peak-to-trough declines – super-cycles that may include significant rallies and more than one conventionally defined bear market. On this view, the 2003-07 bull market was a bear market rally.) The market more than halved (in real terms) in each super-bear period. The S&P 500 had fallen 56% at its low in this cycle (Exhibit 1).

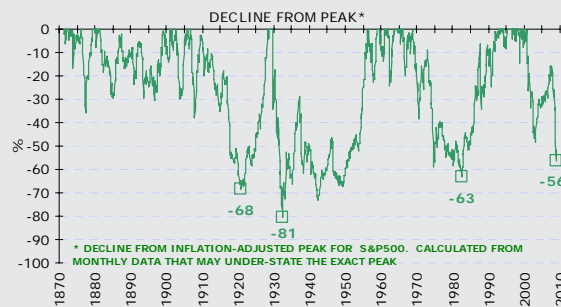
Equities were very cheap at the end of the prior three super-bear markets. My preferred measure is the so-called Graham-Dodd P/E (based on a trailing 10-year inflation-adjusted earnings series). The G-D P/E at the bottom of the prior three super-bear markets was 4.9 (1920), 5.5 (1932), and 6.8 (1982). The conventional trailing P/E was also in single digits in each case.

Now, however, the Graham-Dodd P/E is around 15.7. That is below the long-run average (16.4), but far from the super-cheap levels seen at the end of the prior three super-bear cycles. The S&P 500 would have to fall by one-half to two-thirds from current levels to be in the valuation range seen at the end of those prior bear markets. Yep, the S&P 500 would be very cheap at around 400.

Why is the market still so far from super-cheap levels, despite halving from the peak? The first – trivial – reason is that this bear market still isn't as severe as the three prior super-bear markets. The average inflation-adjusted decline in those bear markets was 70%.

Exhibit 1

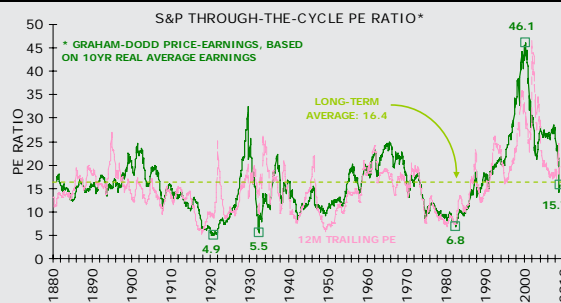
One of the Great Bear Markets...



Source: BLS, Standard & Poor's, Morgan Stanley Research

Exhibit 2

...Still Hasn't Made Equities Super-cheap



Source: BLS, Standard & Poor's, Robert Shiller, Morgan Stanley Research

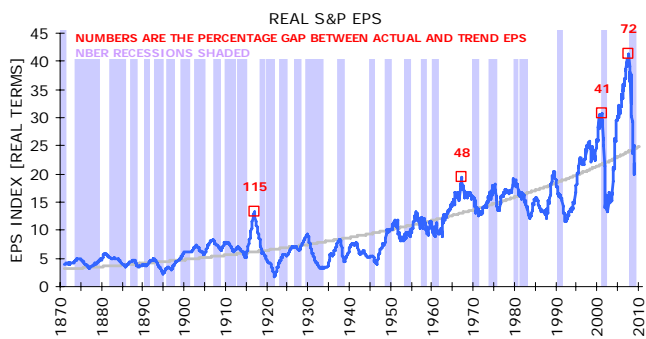
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The second, more important reason is that this bubble was bigger. What is now popping is arguably the largest-ever US equity bubble.

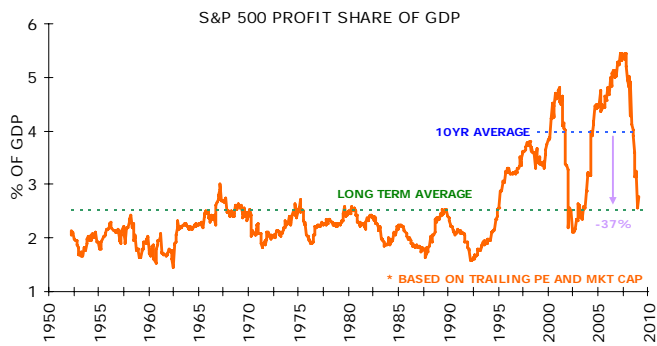
Exhibit 3 The E-Bubble Has Popped



Source: BLS, Standard & Poor's, NBER; Morgan Stanley Research

This was the largest-ever bubble because it was a double-bubble: a valuation bubble and an earnings bubble. To oversimplify, the first stage of this super-bear market (2000-02) was predominantly the valuation bubble popping; the current stage is predominantly the earnings bubble popping.

Exhibit 4 Further to Go on Valuation?

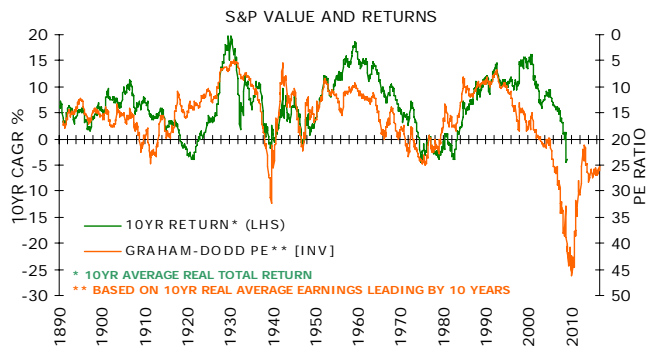


Source: Standard & Poor's, BEA; Morgan Stanley Research

Both bubbles – valuation and earnings – were big. The valuation peak in 2000 was the highest ever, in terms of both the conventional trailing P/E and the Graham-Dodd P/E (Exhibit 2).

The earnings bubble was likewise very large. This was the second-largest-ever earnings bubble, based on a simple measure of how far earnings were above trend (Exhibit 3). The largest-ever earnings bubble, on this measure, was in 1916. The subsequent four-year collapse of that bubble produced the first of the super-bear cycles.

Exhibit 5 The Biggest Bubble => the Worst Returns



Source: BLS, Standard & Poor's, Robert Shiller; Morgan Stanley Research

It now seems that valuations are below the long-term average (Exhibit 2) and earnings are below trend (Exhibit 3). It is, however, worth noting that the Graham-Dodd P/E may have been affected by the duration of this earnings bubble. The 10-year average earnings series is now well above its long-term average (Exhibit 4). A Graham-Dodd P/E calculated on the long-term average profit share of GDP (rather than the 10-year average) is still around 25.

Unsurprisingly, US equities are on track to report their worst-ever long-term returns as the largest-ever equity bubble pops. To restate the obvious: Returns depend on the price you pay. The cheaper the asset, the more likely that returns will be high – and vice versa. Exhibit 5 shows rolling 10-year returns on US equities (total return, adjusted for inflation), along with the price paid for the equities. (The price paid has been pushed forward by 10 years, so the price and actual return line up. The price series has been inverted, so the line is low when valuation is high.) Investors who bought equities in early 2000 – at the most expensive levels ever seen – look set to reap the worst-ever 10-year return on US equities.

Historically, buying equities on a Graham-Dodd P/E of 16 (current level) has led to a real 10-year return of around 5%. Not bad. But, as I've argued, perhaps not a handsome enough prospect to compensate investors for the clear cycle and structural risks they now face. Buying at a G-D P/E of 10 has historically led to 10% real returns. That, in my view, is a sufficient compensation for risk. All else equal, a G-D P/E of 10 is consistent with the S&P now being around 575. Buying equities on a G-D P/E of 5 has led to long-term returns of around 15%. In today's terms, that's buying the S&P under 300.

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The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

25 Cabot Square, Canary Wharf
London E14 4QA

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
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Hong Kong

Tel: +852 2848 5200