

Q&A

## Who Says This Market Is Overpriced?

By Leslie P. Norton

Last summer the stock market's price/earnings ratio suggested that stocks were highly valued. Seeking confirmation, John Apruzzese, chief investment officer of Evercore Wealth Management, looked to the market's real earnings yield—trailing 12-month inflation-adjusted earnings divided by price. Turns out this less widely followed metric was right around the average level of the past 60 years, leading Apruzzese, who crafts Evercore's market outlook and asset-allocation policy, to conclude that the market was reasonably valued.

"John has always focused on the core issues in investing," says Ed Yardeni, chief of Yardeni Associates, another market bull.

Yardeni says that Apruzzese's study of the real earnings yield "neatly incorporates inflation into a stock-valuation model. It's a simple model that is easy to construct and comprehend, and it has a good track record."

We checked in with Apruzzese, 60, to see what his indicator says about the market today and longer term. After all, Evercore's clientele of high-net-worth investors, foundations, and endowments has a long time horizon. Here are his thoughts.

### **Barron's: Why do you prefer the real earnings yield to the P/E ratio?**

**Apruzzese:** Inflation is absolutely crucial for long-term investors. It's the most important macro factor. Oddly, the market is stuck on the P/E ratio. When people talk about Treasuries, they don't say that if a bond yields 2%, it is selling for 50 times the coupon. It's upside-down. The conventional way of saying inflation is important is the Rule of 20, which is that the P/E plus inflation should equal 20. Why is that?



It makes much more sense to think about the earnings yield than to use a reciprocal. Once you do that, it falls into place. You can take the earnings yield and subtract inflation and that's the real earnings yield.

Last summer we went back and looked at 60 years of history of the real earnings yield. It averages 3%. It's important because for much of that period inflation was a lot higher. The average inflation rate over the past 60 years is 3.7%. When inflation is at that level, the market has to sell for a lower P/E ratio.

### **So how is the market valued today?**

The inflation rate has been at 2% for 15 years now. We are in a long-term regime of 2% inflation. Last summer, everybody was saying that we have good economic and earnings growth, but the risk is that the market is too expensive. We tested that. We concluded that the market is at an average valuation. It is not expensive.

That's significant because people are looking at the CAPE [cyclically adjusted

P/E] ratio, which looks really expensive using the average of the past 10 years. Of course it does, because it includes 2008 and 2009. As soon as that rolls forward, the P/E falls. On the other hand, people might say the P/E isn't that expensive relative to low bond yields. Inflation is related to bond yields, but bond yields are artificially low. For example, the 10-year Treasury should nominally yield GDP [gross domestic product] and be at 4%. But it doesn't because it has been manipulated by the central bank. When bond yields return to normal, people will have lost the justification for the current P/E.

Today, on the real earnings yield, the market is almost exactly at its long-term average. Valuation isn't a good market-timing tool. Markets can stay overvalued or undervalued for quite a while. But it's a check for the long term. We're investing for the long term. We are interested in the 10-year expected return because it factors into what one's allocation should be, versus other asset classes. Right now, our 10-year expected return is 7% [a year]. A lot of our competitors have an average expectation of 5% to 6%, because they say the market is at a high valuation.

### **What is your inflation forecast?**

We think inflation stays down in the 2% range, which is also the market's expectation. It has moved up a bit. It will continue to stay low because of demographics—the lower growth in population and the labor force—and because of technological innovation. The one thing that people aren't thinking is that the tax cut could be disinflationary. What will corporations do with their tax savings? The choice that is conventional is more dividends, more share buybacks, more investment, and higher wages. But if a company and all its compet-

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itors suddenly get a drop in costs, what's a common thing that businesses do? Drop prices. It's debatable whether this is a result of taxes, but prices are coming down for the consumer-staples area—for Procter & Gamble (ticker: PG), and the food companies.

#### **What is your market outlook?**

The market is reasonably valued. We have some concerns. In some respects, things can't get better than they are. When do you get 20% earnings growth eight years into an economic expansion? Half of that is because of the tax cut, so earnings would have been up 10% anyway. Even in the best case, the growth rate will drop back down to 10%, at least. The CEO surveys are at all-time highs, and consumer sentiment is really strong. So we're concerned that things are maxed out. We don't think there's a major drop in the market until we get a recession. But it's been shown that even if there has been a long expansion, cumulative growth isn't all that high. In the

past, average GDP growth was more like 3 1/2%, 4%—and we've been at 2%.

What kills an expansion is excesses. There are a few signs: synchronized global growth, and the tax cuts and deregulation and fiscal stimulus, and nobody believes the central bank will increase interest rates as fast as they say. But we're not there yet. We have never experienced the central banks now trying to reduce their balance sheets and increasing rates. It's all new. The yield curve is flattening and it is important to watch that.

#### **Which sectors do you like and dislike?**

We have been overweight for quite a while in consumer discretionary, including Domino's Pizza (DPZ) and Home Depot (HD), and technology, including Mastercard (MA) and Applied Materials (AMAT). We're avoiding consumer staples, utilities, and telecom.

#### **What is your view on bitcoin?**

The speculative mania from last year has died down. The conventional wisdom on

Wall Street is that blockchain technology is significant but cryptocurrencies are the closest thing to tulip bulbs that we've seen in a long time. I think that's wrong. Cryptocurrencies are real and here to stay and have a true economic purpose. Bitcoin is a topic unto itself. What is interesting are the others—ethereum, ripple, litecoin. They're a completely new species—not equities, not bonds. Why do we need them? Because there's a need for open-source global standards.

Just think about http, the software that allowed for websites, or the underlying software for email. You wouldn't want any entity to own it because it's a global standard. In the future, we will need a few more open-source global standards. But the coders would like to get compensated. That's the purpose: It's a way to compensate the people designing and the early adopters. You eventually want the network effect, but you have to initiate it.

**Thanks, John.**