First Trust
Monday Morning OUTLOOK
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"Shiller P-E" No Reason to Sell

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In terms of market calls, few academics or economists can match Yale University economics professor Robert Shiller. In his 2000 book, "Irrational Exuberance," he argued that 10-year averages of corporate earnings smoothed out the ups and downs of the business cycle. Then, using this "cyclically-adjusted" level of earnings and comparing it to current stock prices he claimed to generate a better version of the P-E ratio.

Shiller's timing couldn't have been better. The "Shiller P-E ratio" was at an all-time high in 1999-2000, a clear signal of over-valuation and a reason to sell. Several years later, Shiller warned investors about a housing bubble, another prescient call. Although we don't see eye to eye with Shiller about how the economy works – he's a Keynesian, we're supply-siders – he's smart and he's had some excellent market calls.

Recently, Shiller has been saying stocks are over-valued again and his P-E ratio is back in the news. At the end of July, the ratio was 23.8, the highest since 2008.

While many investors are concerned about this, we think these concerns are misplaced. Back in 1999-2000, the Shiller P-E peaked at 44.2, *almost double the current ratio*. A P-E of 44.2 corresponds to an earnings yield on stocks of 2.26%. (100 divided by the P-E ratio.) This earnings yield can be compared directly to interest rates. In 1999, short-term Treasury bills were yielding almost 5.5% and 10-year Treasury Notes were yielding 6.5%. In other words, stocks were very pricey relative to bonds.

Today's Shiller P-E ratio of 23.8 generates an earnings yield of 4.2%, well above the current 10-year treasury yield of 2.6%. In other words, stocks are cheap compared to bonds.

Another interesting fact is that over the past thirty years, the average Shiller P-E has been 22.7 and the average 10-year Treasury yield 6.1%. During that time, the S&P 500 total return (including reinvested dividends) has been 10.8% per year.

Right now, at 23.8, the Shiller P-E is barely above the thirty-year average, but interest rates are substantially lower than 6.1%. As a result, history suggests an annual total return on stocks *above* the past thirty years.

All this is reason enough to calm down about the Shiller P-E, but it's not the only reason. A 10-year historical average of earnings, especially one that includes earnings during the Panic of 2008/2009 understates the profit potential of US corporations in an era of high productivity and new technology. Think energy production. Fracking has changed the world…a 10-year average underestimates the benefits.

Certainly, stocks aren't as cheap as they were in 2009, but they aren't as expensive as many seem to believe.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-13 / 7:30 am	Retail Sales – Jul	+0.3%	**+0.3%**		+0.4%
7:30 am	Retail Sales Ex-Auto – Jul	+0.4%	**+0.5%**		+0.0%
7:30 am	Import Prices – Jul	+0.8%	**+1.0%**		-0.2%
7:30 am	Export Prices – Jul	+0.1%	**+0.2%**		-0.1%
9:00 am	Business Inventories – Jun	+0.2%	**+0.1%**		+0.1%
8-14 / 7:30 am	PPI – Jul	+0.3%	**+0.3%**		+0.8%
7:30 am	"Core" PPI – Jul	+0.2%	**+0.3%**		+0.2%
8-15 / 7:30 am	Initial Claims – Aug 10	335K	**335K**		333K
7:30 am	CPI – Jul	+0.2%	**+0.2%**		+0.5%
7:30 am	"Core" CPI – Jul	+0.2%	**+0.2%**		+0.2%
7:30 am	Empire State Mfg Survey – Aug	10.0	**7.3**		9.5
8:15 am	Industrial Production – Jul	+0.3%	**+0.2%**		+0.3%
8:15 am	Capacity Utilization – Jul	77.9%	**77.9%**		77.8%
9:00 am	Philly Fed Survey – Aug	15.0	**22.7**		19.8
8-16 / 7:30 am	Housing Starts – Jul	0.905 Mil	**0.900 Mil**		0.836 Mil
7:30 am	Q2 Non-Farm Productivity	+0.6%	**+0.8%**		+0.5%
7:30 am	Q2 Unit Labor Costs	+1.3%	**+0.2%**		-4.3%
8:55 am	U. Mich Consumer Sentiment- Aug	85.3	**85.5**		85.1