A Better P/E Ratio

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis shows why he prefers an alternate method for calculating company P/E ratios. The conclusion is that the market is not that much over-valued.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **A Better PE Ratio**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

Wednesday, September 6, 2017

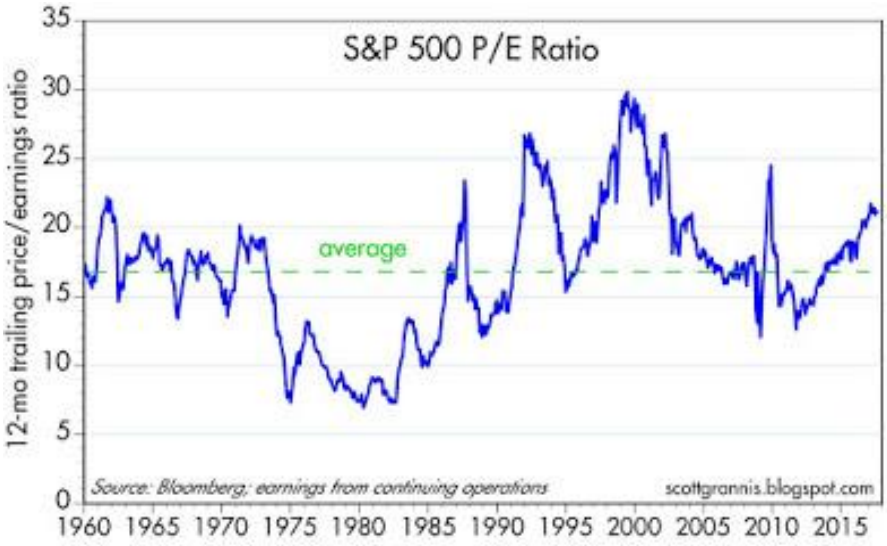
A Better P/E Ratio

This post is an update to a 4-yr old post titled "Equity valuation exercises."

Back then, I observed that stocks were fairly valued according to a standard measure of PE ratios (prices divided by 12-mo trailing earnings per share from continuing operations). But they looked to be quite under-valued if measured against the most recent quarterly annualized measure of after-tax, adjusted corporate profits that is produced in the National Income and Product Accounts (NIPA).

Art Laffer long ago taught me the value of using NIPA profits. This measure of profits is based on information supplied to the IRS, and it is then adjusted for capital consumption allowances and inventory valuation. It has been calculated the same way since 1947, and we can be reasonably sure it does not artificially inflate profits (who would overstate their profits to the IRS?); Laffer calls it simply "true economic profits." Using this measure, which is calculated quarterly, also gives us a more timely measure of profits, compared to using a 12-month average of profits.

Here is a chart of PE ratios for the S&P 500 using trailing earnings per share, which suggests that stocks today are moderately overvalued:



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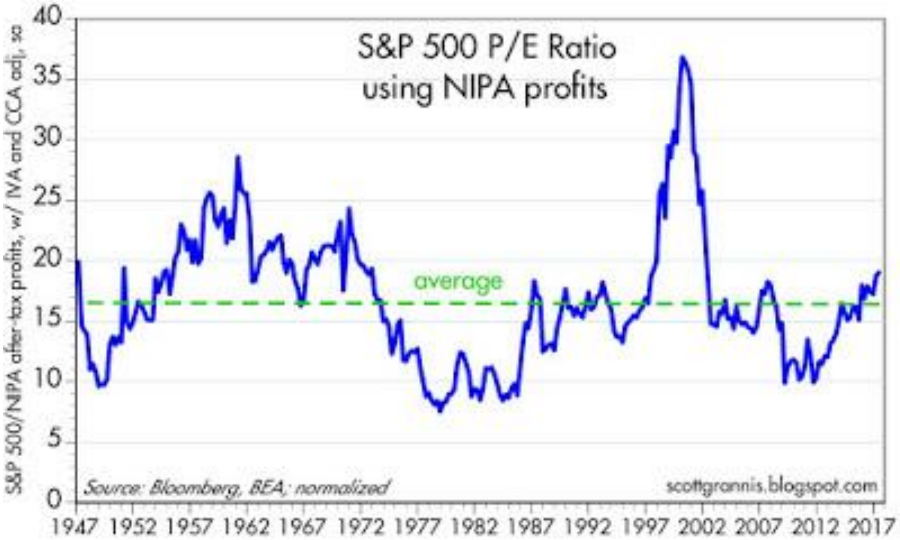
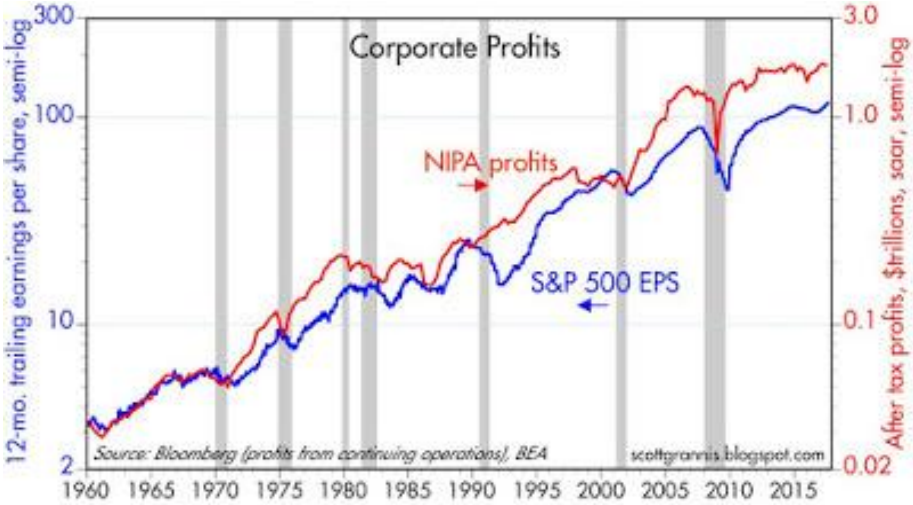
Here is a chart of PE ratios for the S&P 500 using NIPA profits (I have normalized the result so that the long-term average is the same as the average for the standard measure of PE ratios), which suggests stocks are only modestly overvalued:



Both methods produce similar results, but the NIPA method suggests that PE ratios are only about 13% above average, whereas the standard method suggests PE ratios are about 28% above average.

For the curious, here is a chart that compares NIPA profits to 12-month trailing earnings per share (the latest NIPA profits, released last week, are as of Q2/17, while EPS are as of August 2017):



In my 4-year-old post linked above, I discuss some of the reasons for the divergence in these two measures of profits that began around 1990 (e.g., changing accounting standards and changing taxation regimes). Those problems do not affect the NIPA measure of profits, which is why I tend to prefer them.

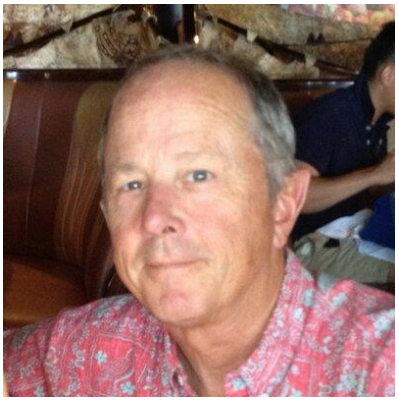
The two charts above compare NIPA profits to nominal GDP. Note how strong profits have been since the recession of 2001. Since the end of 2001, NIPA profits have almost doubled (+185%), while nominal GDP has increased by only 80%.

Over the years, I have argued that this is, at least, in part due to globalization. Large and successful U.S. corporations have been able to generate a much higher level of profits by selling into the rapidly-expanding global market. Global GDP has increased 125% since 2001.

All things here considered, it is not surprising that stocks have done so well of late, and that PE ratios are moderately above their long-term average.

BW: See ABOUT THE AUTHOR below.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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