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Stock Markets and the Rule of Law

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What I don't do on this site is give financial advice or tell anyone what to invest in. The Reformed Broker is a forecast-free blog. What I will do on this site is provide you with a running commentary of my market-related insights and thoughts as events unfold. I'll point you toward other interesting content around the web. I'll challenge your perceptions, call it like I see it and, occasionally, I'll make you laugh.

A link to the blog's website is provided here: http://www.thereformedbroker.com/.

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Stock Markets and the Rule of Law

By Josh Brown
January 11, 2019

How many multiple points on the S&P 500 are at risk if the populace gets to a place where they no longer believe we are a country of laws – laws that apply to everyone, including the politicians who happen to be in control at a given a moment?

I don't know the answer, but I guarantee you it is not zero. It is a number for sure.

Matt Levine on this weekend's chaos with respect to the latest executive order from the Trump administration:

> If the president can, without consulting the courts or Congress, banish U.S. lawful permanent residents, then he can do anything. If there is no rule of law for some people, there is no rule of law for anyone. The reason the U.S.A. is a good place to do business is that, for the last 228 years, it has built a firm foundation on the rule of law. It almost undid that in a weekend. That is bad for business.

When you hear an investor compare U.S., U.K., German, and Japanese stock market valuations with the countries that make up the Emerging Markets index, try to keep in mind the fact that the discounts of the latter are nearly always warranted. We can debate about the degree of cheapness in emerging Latin American or Asian stock markets – this is subjective. What is not up for debate is whether or not there ought to be a discount. Of course there needs to be.

The reason why, very simply, is the presence of a rule of law that applies to everyone – or, at least, the perception of a rule of law. Shares of stocks are contracts: agreements between the owners of a business and those who manage it on behalf of those owners. These contracted agreements – regarding the payment and allocation of cash flows, safeguarding of intellectual property, continuance of competitive business practices, respect for minority shareholders, etc. – are sacrosanct.

The same could be said of the governance environment in which the companies operate. Investors need to feel that there is fairness and a set of rules that everyone must adhere to. No one would build a house on quicksand and no one would exchange currency for pieces of paper in an environment where legal protections no longer mattered.

In 2002, an early research conference that was looking at the challenges of valuing emerging market stocks, was convened at the University of Virginia. The panelists concluded the following:

> The valuation of firms in any market also depends on the degree to which investors' rights are protected. Because a firm's share price reflects the cash flow per share that non-controlling shareholders expect to receive, this share price should fall if non-controlling shareholders expect expropriation by either corrupt officials or controlling shareholders. To the extent that official corruption and poor corporate governance distort the decision-making of the firm's management, they also destroy shareholder value.

> Because emerging markets in general have a more corrupt environment and weaker corporate governance institutions, financial markets tend to price assets in emerging markets at a discount with respect to comparable assets in developed markets.

Fifteen years later, this conclusion remains correct. The stock market valuations in emerging markets continue to earn this “corruption” discount, despite the fact that, for the most part, the economies to which these stock markets belong are growing at a significantly rapid rate compared to the developed world.

Investors do not pay up for faster growth if it is accompanied by concerns about governance and the potential for political interference.

Let us take a quick look at some current earnings multiples to give you a sense of how important investors’ perception of lawfulness can be.

The United States stock market currently sells at a price-to-earnings (P/E) multiple of 21.8 times (trailing 12 months) and a cyclically adjusted price-to-earnings (CAPE) multiple of 26.4 times.

In comparison, the Russian stock market sells at a P/E of 9.1 times and a CAPE of 5.9. It is the “cheapest” large stock market in the world. The reason for this discount is that these are stocks that trade in a dictatorship, wholly controlled by the whims of the Kremlin. CEOs can be jailed for operating or even speaking against those in power. Assets can be confiscated or reassigned at will. State control of corporate entities does not encourage investors to pay up for minority stakes in these businesses.

Similarly, China’s P/E is 7.2 times – one third the valuation of U.S. companies – and its CAPE is 12.8 – less than half that of the United States’ stock market. China has been taking steps to liberalize its financial system and corporate environment, but these things happen very slowly. Bear in mind that official statistics put the growth rate of China’s economy at more than double that of the USA. Again, governance issues and fear of political interference help the world’s second largest economy earn quite a discount for its stock valuations.

A composite index of emerging markets countries, based on Thompson Reuters data, now carries a P/E multiple of 16 and a CAPE of 14. Comparatively, an index of developed markets countries has a P/E of 21.8 and a CAPE of 21.9. This is a large gap, and a lot of the difference can be explained by investor confidence that their money will be treated fairly.

Put simply, U.S. stocks, bonds, and real estate are the most trusted and relied upon financial “risk assets” on planet earth. We have strong contract law and, as a result, people all over the world allocate to these instruments with confidence. We should not take this for granted or fool ourselves into believing it is permanent.

The appearance or perception of a President who can do whatever he likes is not going to be a long-term additive to the valuations of U.S. businesses, or land, or buildings, or infrastructure. It was not long ago that the United States itself was an emerging market on the world’s stage. If we are not going to be a nation of laws, then attitudes toward pieces of paper that *carry no weight in the absence of law* will have to be rethought.

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Considering this week's threats from the President to unilaterally divert funding from the victims of natural disasters, or to order the military to begin construction on a symbolic wall, I thought this post, which I originally published on January 30th, 2017, a week and a half into the chaos of this administration, was fairly apropos.

We have seen multiple contraction over the last year for the S&P 500, but you can hardly blame it on people losing faith in our government institutions and discounting our equity market down as a result. It is more likely that the multiple contraction we have thus far experienced can be explained by the rising interest rate cycle and the slowing economic growth abroad, which is meaningful for the growth expectations of our publicly-traded corporations.

However, potential threats to the investor class's confidence in the rule of law do exist, and are arguably more present than ever. All of these threats are emanating from the White House. The President working around Congress to appoint his own Attorney General (by any measure, Whitaker is illegitimate), the use of the military for political purposes (pre-midterms border stunt, the current fake emergency, etc.), the crumbling of key alliances among democracies across the globe (too many examples to list), the wanton recklessness of shutting down the federal government and the use of its employees and agencies as political pawns – all of these things have the ability to erode confidence in the rule of law. They threaten the perception of America, and our standing as the most dynamic, well-funded, highly regarded economic superpower in the world with the deepest, broadest, and fairest markets.

I don't know how you quantify what that could cost us. I do know that the multiple investors will be willing to pay for our stock market will not go up if these feelings become prevalent enough domestically and around the world. The proof of that is to look at markets in which the rule of law is in doubt, corruption is rampant, and the government is seen as either hapless or kleptocratic.

I think we take a lot for granted in America. The story that we have all bought into, that "legal fictions" like Apple and Google and Wells Fargo and Berkshire Hathaway ought to be worth twelve to fifteen times their annual earnings while Russia's largest companies should only sell for five or six times, is one of those things. As Yuval Noah Harari explains in his book Sapiens, corporations are not naturally occurring phenomena. They are not written into the laws of the universe. Rather, they are just stories that we all agree upon.

The existence of Microsoft, the corporation, is a story we have told ourselves and everyone has bought into it. This means we all agree that it should be afforded certain rights and protections and that its shareholders should too – this includes the protection of its property and the legal recourse for it to defend itself from thieves, bad actors, corrupt executives, etc. If this story we have all agreed upon begins to fall apart in the eyes of the people with money invested, then so will the company's valuation. The implications for a massive loss of confidence in our rule of law are too terrifying to consider. I won't pull the thread any further for now.

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See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR

Josh Brown is a New York City-based financial advisor and the CEO of Ritholtz Wealth Management.

We help people align their investments with their financial goals and manage portfolios for them. Our clients range from high net worth households to corporations to retirement plans to charitable foundations. For younger investors and those just getting started, we've created the Liftoff automated advisor – a simple, low-cost way to access a professionally managed portfolio selected just for you.

He is also the author of the books *Backstage Wall Street* and *Clash of the Financial Pundits* from publisher McGraw-Hill. In addition, he serves on the advisory board of financial technology firms Riskalyze , Vestwell, Digital Assets Data Corp as well as CNBC's Financial Advisor Council.

In 2015, he was named to the Investment News "40 Under 40" list of top financial advisors.

ABOUT THE REFORMED BROKER

The Reformed Broker began in November of 2008 and has become one of the most widely-read sites on the financial web.

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In the Media

I have been featured in or have written for Fortune, Forbes, the Wall Street Journal, MarketWatch, Dow Jones Newswires, Bloomberg, Reuters, CNNMoney, Bloomberg, CNBC, the New York Post, Crain's New York Business, Investment News, Registered Rep, Financial Planning, Fortune, RIA Biz, Business Insider, American Public Media, NPR, TheStreet.com, the Washington Post, Buzzfeed, Barron's and the New York Times.

I am an on-air contributor to CNBC. My show, *The Halftime Report*, airs weekdays at 12 PM ET.
Our YouTube Channel, The Compound, is blowing up. Check us out!

Follow our latest updates with the Market Moment skill on Amazon's Alexa!

I am available to comment on most topics for print, web, television and radio. Get in touch.
Do you want me to speak or moderate at your next event? More info here.

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