A BULLISH, NON-CONSENSUS VIEW OF THE U.S. MARKETS

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It is popular in financial circles today to have a subdued outlook for the U.S. markets. Last week, we saw a number of posts from the financial blogging community and Twittersphere discussing elevated valuations of U.S. markets, particularly when it comes to the cyclically adjusted price-to-earnings ratio (CAPE). These CAPE prognosticators all possess very poor conjectures for forward-looking returns.

Of course, I am biased by Professor Siegel's work on the CAPE ratio. Professor Siegel suggests that the traditional profit levels utilized in the standard CAPE are based on overly depressed and deflated reported earnings levels that yield overly bearish outlooks. For background reading on the topic and alternatives to the traditional CAPE, see Professor Siegel's FAJ paper.

It was a great contrast to have First Trust economist Brian Wesbury on my podcast last week to discuss his economic and market outlook.

In the first 10 minutes of the show, we discussed both the recent employment report with Professor Siegel and some of these arguments on the valuations of the market and biases in the CAPE ratio.

30%–40% Returns Coming?

Wesbury has a capitalized-profits approach for valuating equity markets—and the inputs into his model rely on the national income and products accounts (NIPA) and an after-tax profit series. The NIPA profit series is also utilized by Professor Siegel as a substitute for the traditional reported earnings figures of the CAPE analysis. By this model, he estimates the U.S. equity markets to be undervalued by around 20%.

Based on those undervaluation levels from today's earnings figures and an improving upcoming profits picture, Wesbury believes we have a potential for 30%–40% upside from today's market levels over the coming two to three years.

In addition to using a NIPA profit series, Wesbury assumes a 3.5% 10-Year treasury—a level that is more than 1.2 percentage points higher than current levels—or an increase in bond yields that is 50% higher than today's depressed levels.

Wesbury—like Siegel—believes the CAPE's dour outlook is reliant on earnings figures that are too downtrodden and biased—something NIPA cleans out. Using a tax series used by firms to figure out how much taxes they are paying—as opposed to just what the accounting treatment suggests is earnings—is one way to judge the health of U.S.

markets.

Where does Wesbury come up with 3.5% to discount equities? This is very close to the nominal gross domestic product (GDP) levels we have been experiencing recently. He sees monetary policy as compressing rates artificially—which is why he sees rates below that more neutral rate.

If Trump’s fiscal packages—whether reduction in regulation or cuts in corporate tax rates—can cause real GDP growth to move closer to 3%—and we get inflation pressures up to 2%—that would be a level the treasury market just is not prepared for today. Wesbury emphasizes that this is not his current base rate but that it is a possible scenario.

Our discussion on the podcast touched on a number of topics, including the great technological age that we live in today, how regulatory changes could improve the economy, various tax policies, international markets and the dollar.

Wesbury brings an interesting perspective to the markets that counters some of those who offer very pessimistic views of U.S. markets, and I am very grateful for his appearance on our show. To hear more, listen to the full podcast.

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Cyclically Adjusted Price to Earnings (CAPE) Ratio : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

National income and products accounts (NIPA) : are one of the main sources of data on general economic activity in the U.S..

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Inflation : Characterized by rising price levels.