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Equities Round-Up for 2009

March 2009

After posting record losses for the first two months of 2009, global stock markets rebounded in March. Although the move was swift, the first quarter generated double digit losses for most stock indices. The S&P 500 was down over 11% while the MSCI Int'l index posted a nearly 12% loss for the quarter.

Just as the euphoria in the first quarter of 2000 caused the S&P 500 to trade up to a P/E of over 45x trailing ten-year earnings, the fear in the first quarter of 2009 saw the S&P 500 trade down to a P/E of below 11x trailing ten-year earnings. Although it is impossible to peg the exact low or high valuation for stocks during a particular economic up cycle or down cycle, there is one important lesson to learn from the last decade: Never use forward earnings estimates to value indices after large moves in either direction because using this methodology will cause you to rarely sell or buy at extremes. Let's examine 2000 and 2009 for clarity.

2000: With the S&P trading above 1500, the common bullish theme went something like this: "Stocks are trading at a P/E of almost 30, BUT this year's earnings are going to grow another 15% to $65 per share, plus 2001 should see another 15% growth to $75 per share. At $1500, the market is only trading at 23x, and it's growing like crazy… plus this is a new era for stocks!"

As we all know, earnings peaked and proceeded to plummet. By smoothing out earnings over a longer period of time the valuation excess would have been far more noticeable. By averaging the preceding forty quarters (ten years), the earnings were $34.77. At the early 2000 high, the ten-year P/E was over 45!

2009: Fast forward to 2009, with the S&P trading at lows of 666. The common bearish talk had a similar theme: "Stocks are trading at a P/E of almost 10, BUT this year's earnings are going to fall by a ton, and using earnings that could be as low as $30, the P/E is 23x. That is not cheap… plus, this is a new era for stocks!" So based on this method, the S&P 500 price fell over 57% from a high of 1555 to 666, but the P/E was 23 in both cases?! If we once again smooth out earnings today, the forty quarter average is $62.40. This places the P/E at 10.6x the recent low.

Two extremes that seemingly traded at P/Es of 23, now trade at P/Es of 45 and 10.6 with earnings smoothed. 2000 and 2009 suddenly look dramatically different.