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THE RULE OF 21

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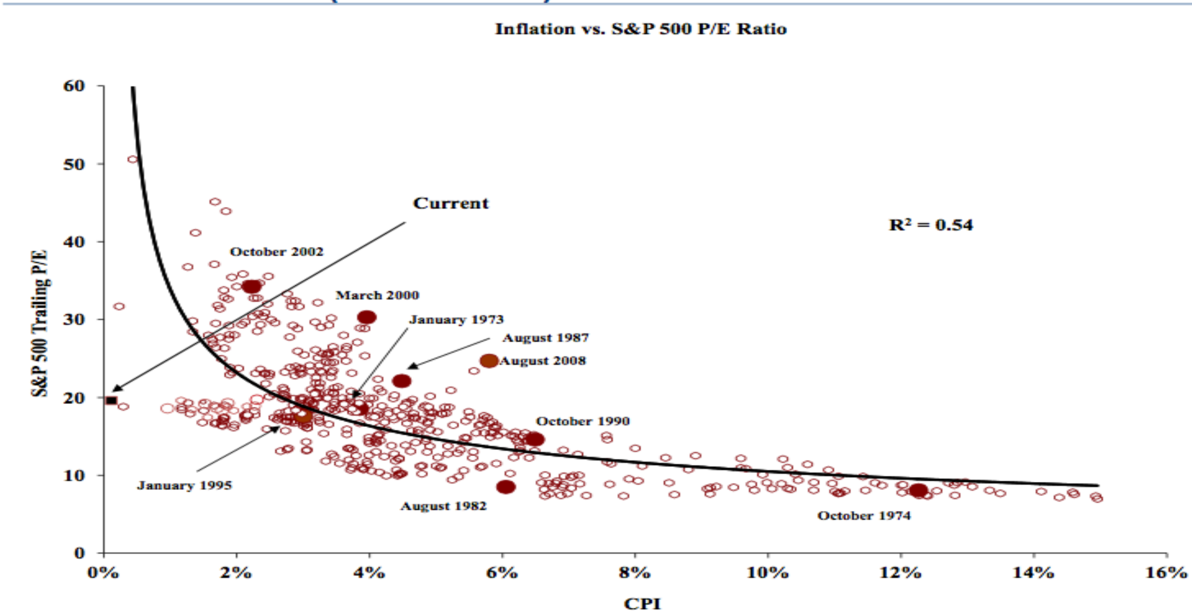
We all hear it. “The market is overvalued.” “The market is cheap.” “The market is in a bubble.” These are opinions echoed almost daily in the financial news and especially on TV. The reality is we live in a low inflation, low interest rate environment. What was true in yesteryear may not hold true today. Take for instance the often quoted P/E ratio so many look to as their barometer for fair value on the S&P 500. Most frequently very little context is given to this ratio other than its historical range and average. This is unfortunate because so much significant information gets missed.

As previously mentioned, inflation is low; the Core CPI increased 1.8% year over year excluding food and energy. Including food and energy, the headline CPI has actually declined year over year by 0.1% and the median consensus calls for 2015 Core CPI increase of 1.7% and 2% in 2016. With the boring information out of the way, now we can provide some *context* for investors.

Inflation vs. P/E Model (1965 to Present)



Source: BofA Merrill Lynch US Quantitative Strategy

This eye glazing chart demonstrates there is a fairly good relationship between the P/E ratio and inflation rates. Before this chart causes you a severe migraine, let me explain what you're looking at in simple terms. The relationship can be referred to as the "Rule of 21," which says that the sum of the P/E ratio and CPI inflation should equal 21. It's not a perfect relationship, but holds true generally.

What can we infer from this information for today's market? Given that the S&P is trading at a P/E ratio of 17.7x and the median headline CPI in 2015 is for 0.3%, this implies that the S&P 500 could actually experience P/E expansion of 3 points! Even using the Core CPI forecast would suggest further room for P/E expansion or at least a market multiple that is justifiable in the current, low inflationary environment.

The lesson is valuation is not black and white. Context is always important, as are economic expectations and it's especially important to consider a variety of valuation metrics which includes the P/E. The "Rule of 21" doesn't necessarily say the market is cheap, but it does provide important information to include in a holistic approach to valuation.

Sources:

CPI Data from Factset, BLS

Chart from Episode I: High valuations Savita Subramanian, Equity & Quant Strategist

MLPF&S Equity and Quant Strategy | United States 26 May 2015

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