American National Bank & Trust™
TRUST AND INVESTMENT SERVICES

Market Comment: Asset Prices and Inflation
December 8, 2017

We are seeing remarkable moves in asset prices. Not only are stocks sitting at all-time highs, but many different types of assets are setting new records. A few weeks ago a Leonardo da Vinci painting sold for $450 million; the price of real estate in many markets is making the housing bubble of 2008 look cheap; acreage in the Permian Basin sold for over $50,000 per net acre; Bitcoin continues to astonish the world as its price soars day after day; and traditional assets, like stocks and bonds, are all establishing record highs.

Most historic valuation metrics are indicating this is an expensive stock market. The average stock is priced in the 90th percentile of historic valuation levels. We mentioned the Shiller PE Ratio in our last market comment (*Market Comment: Don't Fight the Tape Nov. 1, 2017*) and it has continued to rise, now around 32 times earnings. Another measure, the market capitalization to Gross Domestic Product (GDP), which is a favorite of Warren Buffet, suggests elevated levels. The only other time this measure was higher was during the dot com bubble of the late 1990's. At that time, the market capitalization ratio peaked at 151%, whereas today it is 134%.

We acknowledge valuation metrics have flaws, and we recognize no single method works every time, but we also acknowledge that something is happening here. The decade of easy monetary policy seems to be fueling asset prices, and although the Federal Reserve (Fed) is working to trim its balance sheet, this is creating historic price moves. It has us scratching our heads a little because several data measures continue to suggest growth could remain very strong well into next year.

For instance, we think we should see a 10-15% adrenaline boost to EPS growth for most major US corporations from tax reform. The corporate tax rate is expected to fall from 35% to 20-22%. We expect this will result in the forward S&P 500 earnings estimate rising from $132 to $150.

Global growth continues to look strong as well. Recent data suggests worldwide GDP growth should eclipse 3% for 2018. This supports a robust global economy and, because of that, we could see multiples remaining high on stocks. If you apply 20 times multiple to the S&P 500 earnings of $150 we would see the index move to 3,000, or another 14% higher from today's levels. This could happen but there are likely to be some headwinds, one of which is inflation.

As the labor market remains tight and asset prices continue to rise, inflation should return. Our expectation is that the 10-year treasury will move toward 3.5% in the coming year. After all, this is just a return to more normalized levels, but the bond market could struggle, giving back some of its recent high valuations.

A possible warning sign to the bond market is the increased duration on US corporate credit. Duration measures the bond's sensitivity to the principal price when interest rates change. As yields rise, the bond's price will fall by its duration, measured in years. A record high of 7.3 years duration just occurred in the corporate bond market. As rates rise, this would challenge the complacency of the bond markets, and we could see a 30-year bond bull market in jeopardy.

Another area to watch for inflation is spending. As people start to realize the value of their assets have escalated during this expansion, it will continue to fuel a wealth effect. Wealth effect makes people feel wealthier and thus spend more money which could lead to some inflationary pressures.

To combat inflation the Fed will raise rates next year. If the 10-year treasury moves to around 3.5%, a reduced multiple of 17.5 times on the S&P 500 earnings is warranted. Therefore, placing 17.5 times multiple to the S&P 500 earnings of $150 we arrive at a price of 2,625 on the index, which is about the current value. This would make the current market fully valued and elevated stock prices would go nowhere.

So looking at the valuations right now, we have to take a step back and realize we are at historic levels. Inflation and the potential of correction is ever present and an unexpected event could drastically alter these valuations, but for now we continue to watch the data and plan accordingly.
