Why Are You Paying 25 Times Earnings for Stocks?

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SALTA, ARGENTINA – Today, we write about corporate earnings.

Unless you're playing the game of "greater fool" – buying in the hope that someone out there is willing to pay a higher p
only reason to buy a stock is for its earnings.

As a shareholder, you participate in the business's profits. All else being equal, as earnings rise, so do stock prices.

Weighing Machine

Investors have their moments of darkness and their periods of euphoria.

Over the short term, this changes the "multiple" investors are willing to pay for each dollar of earnings.

When investors expect higher future earnings, price-to-earnings (P/E) ratios rise. When they expect lower earnings a, P
fall.

But when all is said and done, hope and despair give way to the reality of earnings. You pay for a stock. You expect to
money back.

Over the long run, stock markets rise and fall, more or less… sort of… on earnings.

Billionaire investor Warren Buffett famously described the stock market as a "voting machine" over the short run… and
machine" over the long run.

Earnings are what investors are putting on the scales.

According to figures from Yale economist Robert Shiller, over the history of the S%26P 500, investors have paid an ave
$15.65 for each dollar of underlying earnings.

With the S%26P 500 trading at 25.4 times earnings, investors today are willing to pay 60% more than the historical ave
each buck of earnings.

Fed Model

Is that "too high"?

The so-called Fed model – which compares how much investors are willing to pay for stock market earnings to how mu
willing to pay for income on long-term government bonds – tells investors not to worry about it.

Because interest rates are so low, it makes sense that stocks should be high. If you have to pay $40 for every dollar of from a government bond, you shouldn't mind paying $25 for a dollar of corporate earnings.

That's the theory.

But government bond yields are low because the Fed pushed them down by diktat. This pushed up the amount investo
willing to pay for stocks without any need for increased earnings.

Ultimately, prices are the only reliable measure of what a stock is worth. But they are subject to change without notice.

And when investors get around to "weighing" earnings, they are likely to begin selling stocks.

Accounting Tricks

Years ago, when we were still young, naïve, and intelligent, we asked our company accountant a simple question: "How
money did we make last year?"

"How much do you want to make?" came the follow-up question.

Then, and even more so now, accountants could bend the numbers as much as a government statistician.

A "9" can be turned on its so it becomes a "6." A "5" can be straightened into a "1." A "3" can be welded to another "3"…
turned into an "8."

You get the idea. Numbers don't lie. But if you beat on them hard enough, they'll tell any tale you want to hear.

Over the last 17 years, corporate earnings have been hammered from both directions: Revenues have been pounded u
costs have been smashed down.

In the 1990s, the SEC (the stock market regulator) changed the rules, allowing corporations to express their earnings in
imaginative ways.

It permitted them to take out of their operating costs items that they regard as "special" or "non-recurring." This leaves t
substantial latitude to increase "earnings" using accounting tricks.

According to one estimate, if earnings since 1999 were expressed using the old-fashioned rules, half the increases of th
century would disappear.

That would leave P/E ratios even more out of whack. Based on honest earnings, the P/E ratio for the S%26P 500 might
40… putting the stock market in dizzy, dippy, disastrously overvalued territory.

Flat Earnings

Not only do corporate accountants distort the figures; so does the phony-money system.

Like everything else, company earnings have been flattered by the Fed's cheap credit.

Auto companies, for example, were able to use cheap credit to sell more cars and trucks. Universities and colleges used cheap loans from the feds to increase student debt. The oil industry used cheap loans to buy more rigs and pump more oil.

All of these things ended up as additional sales and profits on corporate reports.

Cheap credit also drove up stock prices in a more direct way. Corporations borrowed cheap money to buy back their shares.

When companies buy back their shares, they cancel them.

This reduces the overall share count and increases the earnings per share of the remaining shares. Stock prices go up without the need for higher earnings.

If the numerator won't budge, C-suite execs calculate, we'll roll the denominator!

But wait…

Despite spending some $2.5 trillion on share buybacks over the last three years…

…despite huge new inputs of buying, selling, investing, and speculating with cheap credit…

…and despite crackerjack accounting folderol, removing billions of dollars' worth of "ex-items" from the cost side of the ledger…

…earnings per share are lower today than they were in 2013!

So why pay 25 times earnings for stocks?

Beats us.

Regards,