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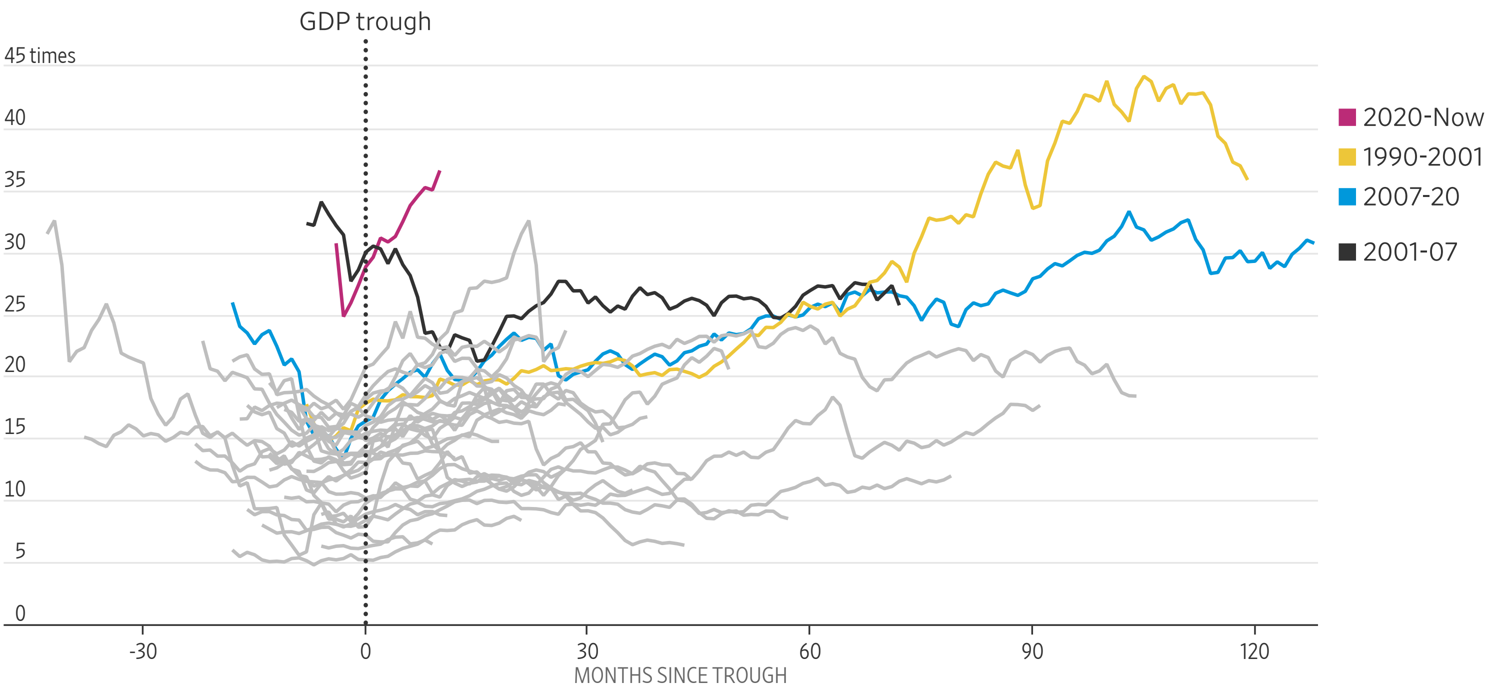
# The Economy Is Recovering: How to Invest When Everything Is Expensive

Stock valuations have never been so stretched at the beginning of an economic cycle. Savers need to plan for lower future returns.

**S&P Composite 1500, cyclically adjusted price/earnings ratio**




Note: Economic troughs are defined by the National Bureau of Economic Research:
Source: Prof. Robert Shiller

*By Jon Sindreu*
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The good news for your portfolio is that the economic rebound from Covid-19 is looking like a fact. The bad news is that financial assets have never been so expensive at the start of a recovery.

Stock markets have shaken off concerns about rising bond yields and are setting new highs. As of Friday, the S&P 500 index is up 10% this year.

Analysts usually compare share prices to the earnings companies generate, which is what investors ultimately have a claim on. Nobel laureate Robert Shiller uses data stretching back as far as 1871 to calculate price/earnings ratios, averaging profits over a decade, adjusted for inflation, to correct for economic booms and busts—a metric known as the Shiller P/E, or cyclically adjusted P/E ratio (CAPE).



The S&P Composite 1500 is trading at a CAPE of 37. That is more than twice the historical average, though still less than the dot-com bubble peak of 44. It reached 33 before the 1929 crash.

The problem with an "everything rally" is that, yes, everything is now expensive. Among stocks, even many pandemic-stricken cyclical industries such as airlines aren't cheap anymore. And with interest rates at record lows and economic growth accelerating, bonds are looking stretched too. Treasurys could offer some value, but 10-year yields are still under 1.7%. As for corporate bonds, the extra return they offer relative to government paper has fallen to near its recent historic low.

Nor is there a dip to buy in real estate. Home prices have risen during the pandemic and are close to 2007 levels relative to rents.

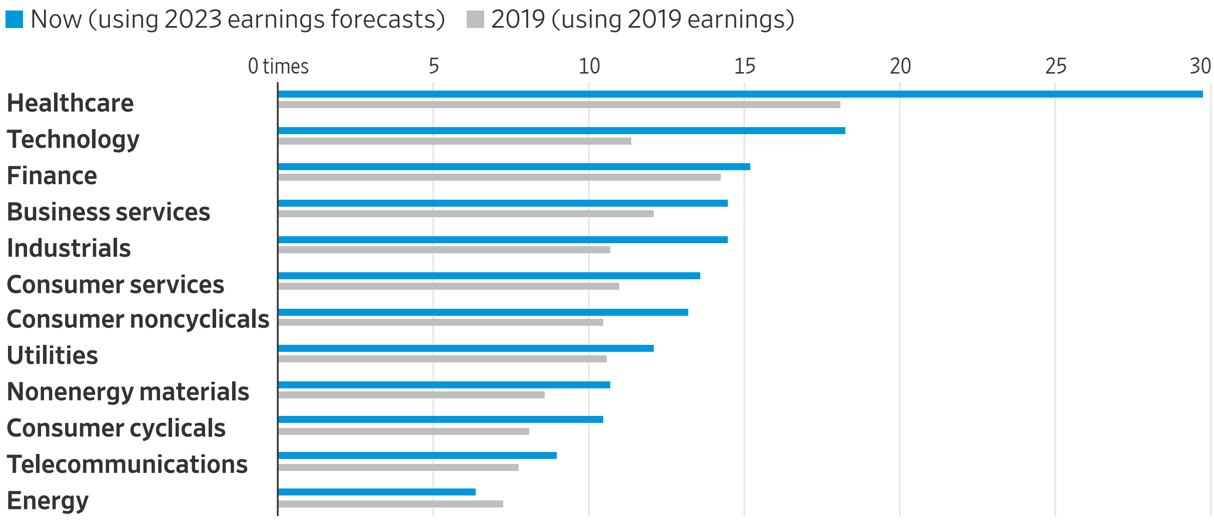
Savers shouldn't panic yet. Waiting for a bubble to burst based on high valuations has led to terrible investment decisions in recent decades. Prof. Shiller himself has underscored that low rates make equities more attractive. And while there are signs of irrationality—including the proliferation of special-purpose acquisition companies—they aren't comparable to the mom-and-pop craze for Pets.com in the early 2000s. Today's market leaders are technology giants that make tons of money. All of this justifies higher valuations.

Also, thanks to activist fiscal and monetary policies, Americans are awash in cash. A strong rebound from the 2020 trough is under way, judging by the latest economic data.

The relevance of high valuations isn't—as often thought—that they point to a crash. Rather, they are an indication that, over the long run, gains might be lower.

**Stocks are expensive across the board**

S&P 500, enterprise value to Ebitda* by sector




*Earnings before interest, taxes, depreciation and amortization

Source: FactSet

Historical data show that negative returns can happen at almost any level of valuation, but that overall there is still an inverse correlation between CAPE and future 10-year equity returns. Usually, stocks progressively cheapen after economic growth reaches a peak. Once they hit a bottom, they slowly become expensive again. In the 2009-2020 cycle, for example, CAPE started at 16 and ended at 31.

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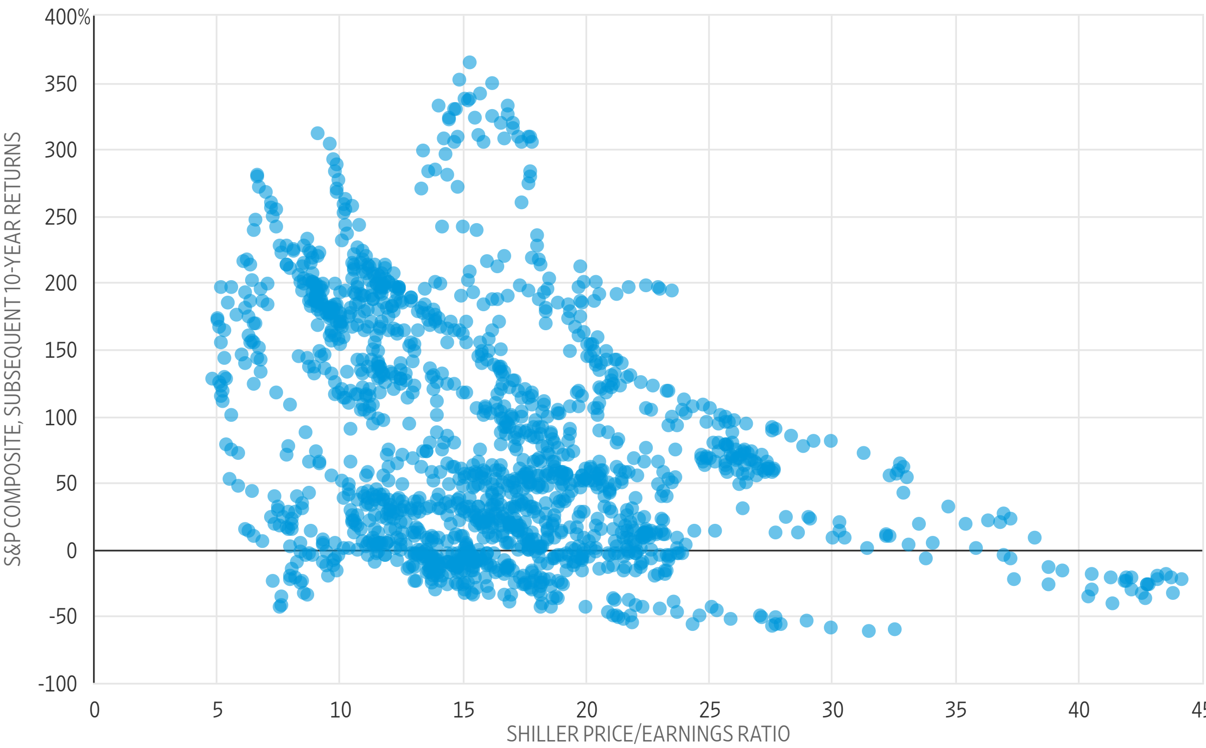
*Do you expect lower returns from your stock investments in the near future? Why or why not? Join the conversation below.*

Not this time: Markets rallied last spring in anticipation of a 2009-like rebound as the economy reached a trough, so valuations are at their highest starting point for a recovery ever. Replicating the last cycle's stellar performance would take them to an unprecedented CAPE of 52, which is hard to imagine.

Earnings will likely rebound much faster from a pandemic than after previous crises: FactSet predicts a 23% year-over-year jump this quarter. But even using optimistic post-Covid-19 profit expectations, markets are pricey.

Paradoxically, it is easier to protect against an immediate crash than to find a solution to investment returns eventually being lower. The irony of a world in which stocks have less of an upside but are protected from calamities by central banks and governments is that it might actually be better to buy more of them. Portfolios with 70% in stocks and 30% in bonds—versus the traditional 60/40 tilt—can squeeze out more of the extra returns equities tend to provide.

**There is an inverse relationship between stock returns and valuations**




Source: Prof. Robert Shiller

Many money managers are recommending discounted cyclical and foreign stocks, but low valuations aren't an indication that their underperformance over the past decade is at an end. Commodities might offer better upside exposure to global growth: Despite recent gains, they are historically cheap.

So much optimism about the postpandemic recovery bodes well for the economy itself. For savers, however, it means planning for a future with lower returns.

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