# Three Factors Skewing Valuation Models

Debate continues to rage over whether it is possible to beat the markets. Many investors believe it is, and they aim to build successful investment strategies using valuation models to determine the true value of companies. However, low interest rates, rising political uncertainty and rapid technological change are all significantly affecting valuation assessments, making today's task much more complicated.


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## Low interest rates are skewing traditional models

The traditional discounting models used in stock valuations have reached their limits in today's low-interest-rate environment. The underlying arithmetic at work in modelling makes the fair value of equities appear too high when the low level of the market interest rate for a risk-free investment is not accompanied by a correspondingly low expectation for future payment flows. These factors must align, since a low-interest-rate environment generally accompanies a period of weak growth. Yet investors all too frequently omit the second step of adjusting future payment flows when building their own models.

Even when these factors do align, however, valuation difficulties arise. Consider that when a central bank's monetary policy is too expansive,

## Key Takeaways

- Low rates are complicating traditional discounting models, though the gradual normalization of monetary policy means central banks should affect valuations less over time
- Populist-fuelled deglobalization could curb economic growth, weighing down valuations and making it difficult to assess a company's true value
- High-tech innovations complicate the work of valuing equities: disruption makes it hard to identify winners and losers, but productivity gains should have a positive impact
- Properly assessing valuations has always been difficult, but today it's even more challenging; fortunately, some tools – like cyclically adjusted P/E – are better than others

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it can cause investors' risk-tolerance levels to increase and equity prices to overshoot their long-term fair value.

Fortunately, interest rates should begin affecting valuation models less and less. As the global economic environment improves, we expect central banks on both sides of the Atlantic to reverse their expansionary monetary policies of recent years, albeit at a very slow pace. As a result, the interest rates on risk-free investments should rise slowly. We expect valuation distortions to fade gradually.

## Politics present a challenge to valuation models

Another factor that makes it harder to assess valuations today is rising political uncertainty – particularly the growing popularity of populist parties worldwide. The kind of deglobalization favoured by many populists would increase barriers to trade and migration, which could curb economic growth – and, consequently, earnings growth, primarily via a reduction of productivity growth – and weigh down valuations.

At the same time, deglobalization is also inflationary. First, the gap between aggregate demand and supply in an economy closes more quickly as the supply side is negatively impacted by lower productivity growth. Second, higher administrative prices in the form of protectionist customs duties would directly lift prices. The impact on valuations from higher inflation is ambiguous as it affects both the numerator and the denominator in discount models.

## High-tech changes add a high degree of uncertainty

The fact that technological innovations are appearing at an increasing pace is not in dispute; what is less clear is how they affect the work of valuing equities.

High-tech disruption results in winners and losers at the level of individual stocks. Since it is difficult to identify the victors and their victims in today's rapidly changing environment, one could easily make the case that higher risk premiums are justified.

At the same time, the technological revolution could lead to productivity gains for the overall economy. This should have a positive impact on the discounting models used to evaluate the overall market, since expected earnings or cash flow stream should rise as the economy improves.

So far, we have not seen any indications of a structural rise in productivity growth in the global economy as a whole – which is surprising in and of itself. The jury is still out on the future path of productivity growth. However, unless productivity ultimately picks up, the earnings growth expectations currently priced into some stocks and stockmarkets may turn out to be too high.

## Our choice for valuing equities

In view of the above-mentioned challenges, we believe that one of the best options available to investors is the use of historical valuation multiples to draw comparisons. This approach has served investors well over many decades.

For our part, we prefer to use the cyclically adjusted price-to-earnings ratio – commonly known as CAPE or Shiller P/E. A real-world application of CAPE ratios to the S&P 500 Index shows that US valuations are indeed stretched; their current level is 31 while their historical average is 16.6. At the same time, the CAPE ratios of Europe and emerging markets shows that these regions still offer value, from our perspective.

## Investment conclusions

As monetary policy is normalized and the Federal Reserve shrinks its balance sheet, we expect the S&P's CAPE to move lower – which could have negative implications for US equity investors who are caught off guard.

We also expect that geopolitical trends – particularly populism – will continue to create headwinds for both economic growth and markets, though the impact of populism is more likely to be felt in the long run rather than the short term.

Technological shifts paint a murky picture for valuation models: they could lead to productivity gains for the overall economy, but the trend towards disruption is a major complicating factor.

Above all, properly assessing valuations remains a critical task for most long-term investors and their managers. Fortunately, some tools – like CAPE – are better than others.



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