

Zacks Research System (ZRS)

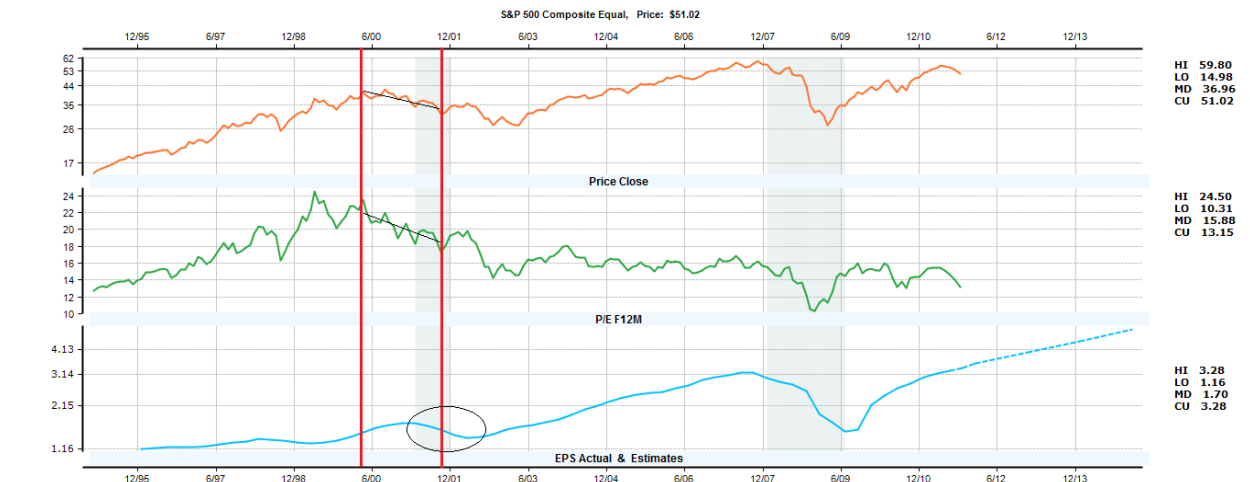
Trends in Equity Valuation since September 11th, 2001

Prior to the attack on 9/11, US equity valuations were already struggling with the fallout of the dot-com bubble, so to understand equity valuations post 9/11, one must look back to those valuation trends leading up to and including the dot-com bubble. For our analysis of equity valuation for the broad market pre and post 9/11, we will utilize a Zacks Composite of the equal weighted average S&P 500 (SP5E) as our market proxy.

In the late 1990's as investors rode the frenzy of the dot-com craze, equal weighted average equity pricing for the broad market was being bid up far in excess of respective 1-year forward earnings. On March 10, 2000 the dot-com bubble burst and thus began a steady valuation unraveling, a forward earnings multiple contraction that continues to this day, a period spanning more than 12 years.

Forward Earnings Multiple Contractions Since 2000

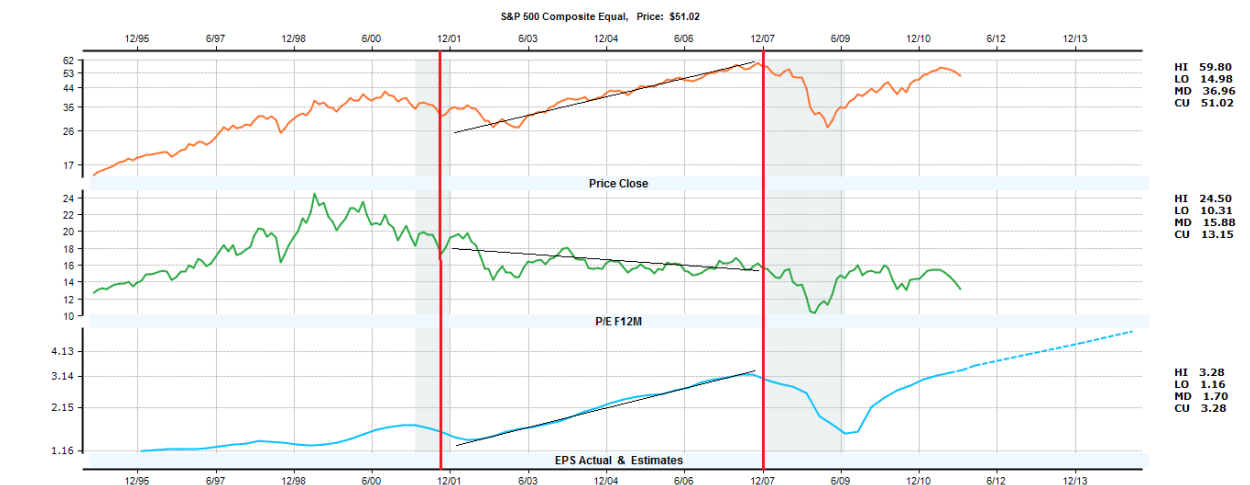
The chart below illustrates that from the height of the dot-com bubble through to the days prior to 9/11, post dot-com era forward earnings multiple contraction was driven by a period of price decline in excess of the decline in forward earnings.



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Since 9/11 we have witnessed further forward earnings multiple contraction but the underlying valuation drivers are extremely different. Where post dot-com era forward earnings multiple contractions were driven by a decline in price and decline in forward earnings, the equivalent post 9/11 era forward multiple contractions were driven by a period of price increase coupled with a 225% growth in broad market earnings.

The chart below illustrates that from 9/11 through to the onset of the great recession, forward P/E multiple contraction was driven by a period of price increase less than the overall increase in forward earnings.

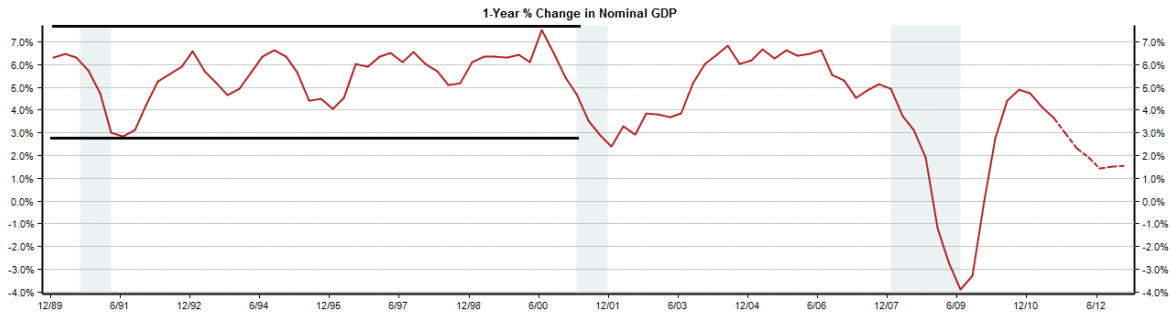


Other than the fact that broad market price levels did not keep up with their respective growth in earnings, how else would one explain post 9/11 forward earnings multiple contractions? Why do post 9/11 valuation drivers differ from that of the post dot-com era leading up to 9/11?

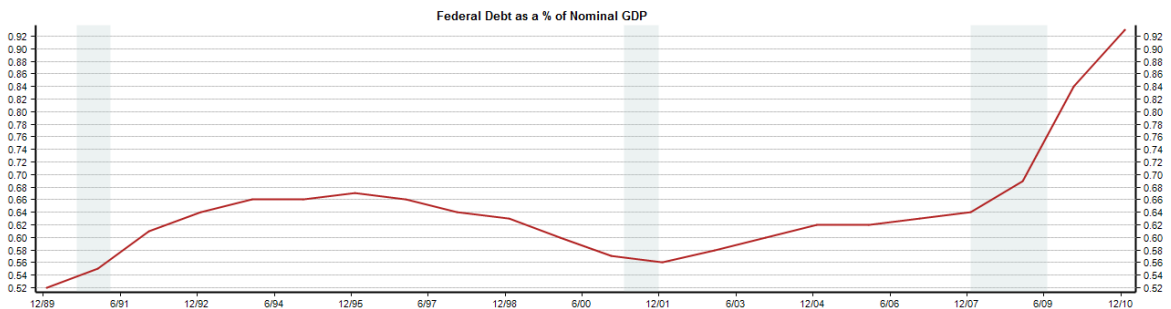
September 11th, 2001 – The Macroeconomic Turning Point

The events of 9/11 triggered a macro-economically induced turning point for forward earnings multiples and related valuation benchmarks. 9/11 marked a change in monetary and fiscal policy that subsequently sparked the decade long unwinding of forward earnings multiple valuations despite an overall broad market earnings increase of 225% over the same time period.

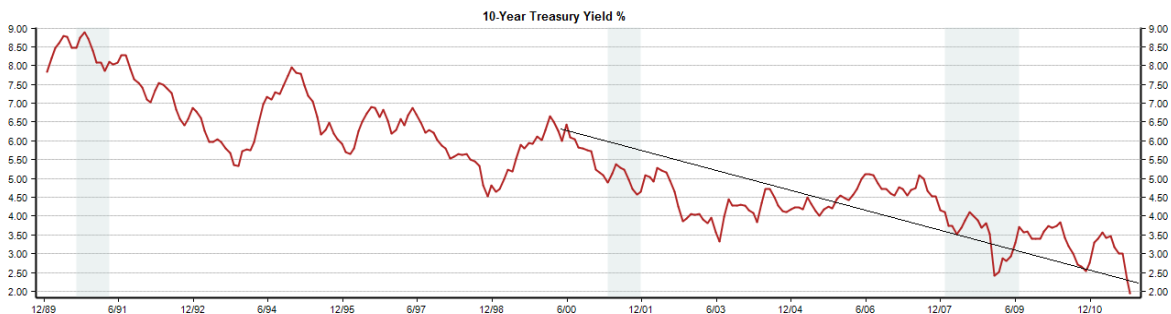
The dot-com bubble was complimented by a period of economic expansion in the United States. From 1990 through to 9/11 the 1-Year % Change in Nominal GDP ranged anywhere from 3% to in excess of 7%.



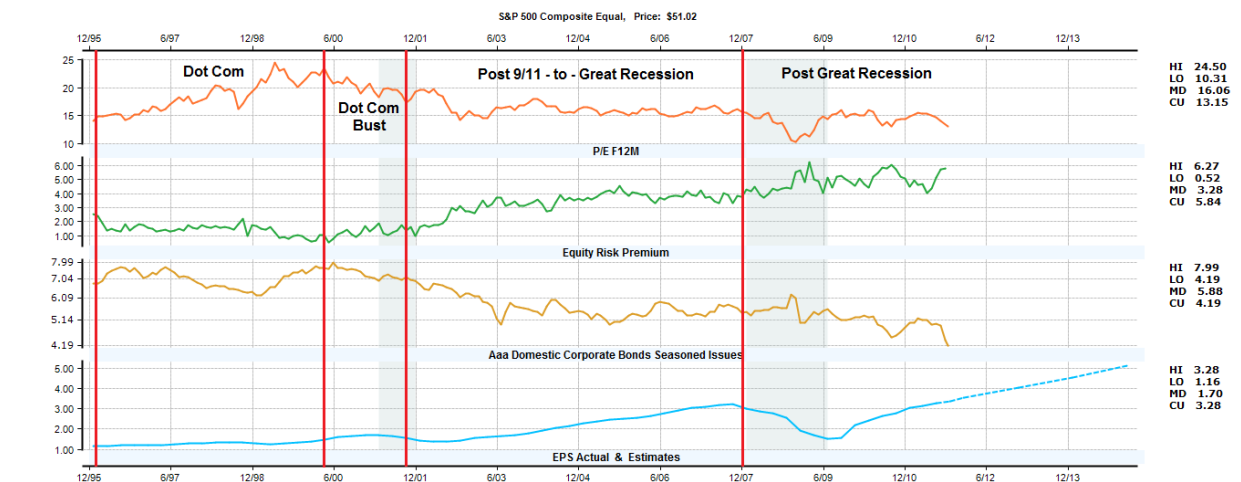
By 1995 “Federal Debt as a % Nominal GDP” had peaked at 67% and by 9/11 was down to 56%. Post 9/11 US military spending and bailouts related to the great recession coupled with an overall decay in economic growth have since pushed the federal debt to 93% of Nominal GDP.



From the height of the dot-com bubble through today, 10-year treasury yields have steadily declined in response to the related monetary and fiscal policy changes required to fund the 9/11 military response and bailout efforts still underway from the Great Recession.



Demand for US equities peaked during the height of the dot-com era. In the chart below, note the broad market forward earnings multiple peak in March of 2000 and the subsequent decline in forward earnings multiple from that point forward. The steady decline in 30-year corporate Aaa bond yields since March 2000 mirrors that of the decline in 10-year treasury yields noted on the previous page, further confirmation that demand for risk free assets has been on the rise over the same time period; this increase in demand comes at the expense of the equity class.

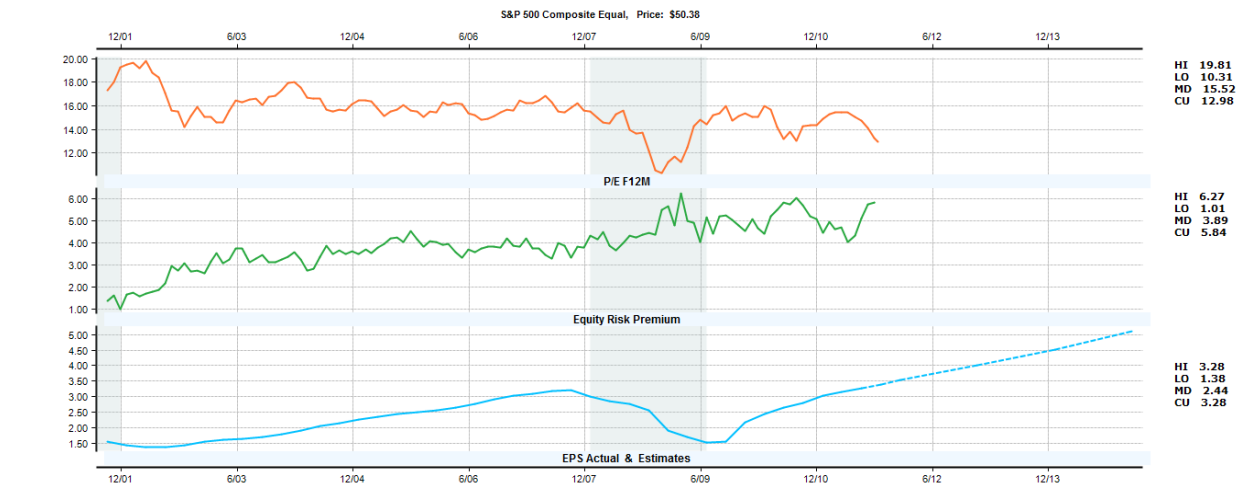


Equity Risk Premium Quantifies Macroeconomic Valuation Impact

As supply and demand would dictate, the act of investors shifting assets away from the equity class of securities into risk free assets is the primary driver behind that portion of the forward earnings multiple that is macro-economically driven. In the chart above, note that while forward earnings multiples were at their peak during the dot-com bubble the Equity Risk Premium was reaching lows of roughly .50%. In other words, in March 2000, investors were only requiring a .50% risk premium to invest in the equity class versus the risk free class of assets.

“Low” periods of Equity Risk Premium relative to its own history is a byproduct of investors bidding up the equity class of securities; the end result can be seen as forward earnings multiples at record highs. In the chart above, note the high degree of negative correlation in Equity Risk Premium since March 2000 relative to forward earnings multiples over the same time period.

Equity Risk Premium Reaches its 3rd Peak since the Great Recession



In the chart above, note that as of September 2011, Equity Risk Premium is again reaching all-time highs; the third such peak since the Great Recession. Note the associated negative correlation in forward earnings multiple.

The proof is in the ZRS charts, one can reasonably conclude that any alleviation in economic and/or political headwinds will likely send the Equity Risk Premium lower as investors bid up the equity class of securities. Alternatively speaking, continued economic and/or political uncertainty will likely send the Equity Risk Premium to new heights as forward earnings multiples continue their 12-year contraction to lows never witnessed before on such rising “forecast” earnings.

Zacks Investment Research is one of the only providers that can effectively quantify macroeconomic asset class demand shifts and subsequent impact on equity valuations in the form of an “Equity Risk Premium”. Contact your Zacks Research System (ZRS) sales or support representative for a demonstration of the Zacks Equity Risk Premium and the Zacks Valuation Model.

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9/22/2011

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More Information

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