Do valuations and PE ratios matter when the cost of money is zero?

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With ultra-low interest rates and governments running significant budget deficits partially funded through central bank purchases of government bonds, it's become extremely difficult for many investors to understand whether valuation parameters for stocks matter anymore when the cost of money is effectively zero.

This article discusses why valuation parameters and fundamentals remain an essential element in selecting stocks for one's portfolio.

What is money?

We're used to thinking of money as notes and coins, which is currency we may use for transactions, but increasingly money is entries in bank accounts we can use to pay for tangible goods and services, and intangible things like Bitcoin or bonds. Over time, there have been many types of money with the coin perhaps the best known.

Coins traditionally were made of precious metals such as gold and silver, which was no doubt the basis for backing modern money with gold for a period. Money has also in the past taken the form of cowrie shells, beads, grain and other products, and in prisons apparently cigarettes are often used as a currency. A banknote has no value in and of itself, but represents a commonly accepted IOU. Historically these were issued by private banks, but in the early twentieth century this role was taken over by central banks.

The concept of an IOU that a note or an account at a bank represents is crucial, because it highlights that money is based on trust and confidence. If people doubt that a note or the amount in their bank account will not be exchangeable for anything of value, or of the same value that was previously attainable, there will be massive problems with the monetary system. This has been demonstrated in the past in hyper-inflationary periods in Weimar Germany and Zimbabwe, and can be currently experienced in parts of Latin America, where US dollars receive favourable black market treatment. Logically, there should be a very finite limit to the amount of money in circulation that people are prepared to trust as holding value and representing value.

The nineteenth century saw extraordinary economic growth as the industrial revolution took hold, with advances in manufacturing and transport thanks to steam and other engines, and advances in communications. However, this period was also characterised by a number of depressions and financial panics, usually caused by excessive credit creation and speculation. These financial panics were usually accompanied by higher interest rates, as private banks tried to attract deposits to strengthen their reserves, and savers demanded a premium for lending money.

The advent of Central banks

To our generation, it seems natural that there should be central banks to issue a nation's currency and to control the crucial price of money, the interest rate. However, this is a modern paradigm whereby society implicitly accepts that an institution will do a better job than market forces. Even in the face of enormous inequality, several episodes of rampant speculation and financial crises, and questionable moral choices where risk-taking bankers have been saved at the expense of more conservative institutions and mainstream society, there is remarkably little debate as to whether we should allow such institutions to have such influence or to exist at all. The US Federal Reserve was created by Congress in 1913 after much debate.

Since their inception, central banks have always played a pivotal role in the economic management of the country where they have been established. While the mandates of each central bank may vary slightly from country to country, their main role is seen to be in essence that of determining the appropriate monetary policy, to regulate their country's banking system, to stabilise the nation's currency when required, to keep unemployment low, and to prevent high inflation. Currently most central banks are trying to increase inflation as they have chosen to measure it, a policy that rather surprisingly is not widely challenged. Central bank measures of inflation almost always exclude asset prices, including people's most expensive and important purchase: housing.

The main tool traditionally used by central banks for managing their country's economy was through the use of interest rates, which the central bank raised when inflation looked like it was increasing beyond manageable levels or to support the country's currency. Conversely, interest rates were reduced when a central bank wanted to stimulate its economy, when inflation was under control and when the economy needed further stimulus to help economic growth and reduce unemployment.

Unconventional policies

In recent years we have seen central banks use more unconventional tools such as quantitative easing (QE - alias money printing) and the use of zero or negative interest rates as a means of making monetary conditions as lax as possible to stabilise and try to restimulate an economy that was hard hit.

These less traditional policies were used extensively by the Bank of Japan after the Japanese share and property markets both crashed in 1990. As a result, Japan faced a massive depression when asset prices crashed following a huge bubble which had seen prices reach delirious levels. At the time, the Bank of Japan's policies were met with much criticism by many other central banks – led by the US Federal Reserve – which deemed the policies irresponsible and a means of seeking to avert what was seen as necessary pain for the Japanese economy to adjust to the economic realities of its property and sharemarket crashes.

While the Bank of Japan's unorthodox policies – as well as several large Japanese government stimulus programmes – did help the Japanese economy avert a depression, they also resulted in a decade of very slow growth which became known as the 'lost decade'. Despite being among the loudest critics of these policies, when faced with an economic depression as US housing prices slid in the Global Financial Crisis in 2007/08, the Federal Reserve also used QE extensively as the US economy and banking system faced complete collapse as house prices in the US dropped heavily after an unprecedented boom and a plethora of derivatives caused massive problems for financial institutions.

These unconventional policies were also used extensively by the European Central Bank in more recent years, as many bonds of countries such as Greece, Italy, Portugal and Spain jumped in yield as those countries

experienced economic weakness and pressure in staying in the Economic and Monetary Union (EMU) of the European Union.

In fact, unconventional policies and central bank intervention have now seemingly become the norm and have been continuous since the GFC in 2008. To soften the blow of the 'Great Recession', interest rates were lowered close to zero across the world, and unconventional quantitative easing strategies of buying longer-dated bonds (government and mortgage-backed) pumped liquidity into markets, making the cost of borrowing for consumers, corporates and governments exceedingly cheap.

While real economies took some time to recover, asset prices (shares, bonds, property, and so forth) recovered quickly, and the economies of the world stabilised. It appears that we are seeing a similar occurrence this time with the COVID-19 crisis, although the falls and recoveries of sharemarkets have been much faster.

Do fundamentals matter any more?

With interest rates now firmly set at zero around the developed world, and governments running significant budget deficits partially funded through central bank purchases of government bonds, it has become extremely difficult for many investors to understand whether valuation parameters for stocks or understanding where we are in the economic cycle matters any more.

Rather than getting swept up in the excitement of 'liquidity' and the hype of many 'high growth' tech stocks, IML's approach to the current environment is to remain focused on the underlying fundamentals of each company that we look at. It's important to remember that some things never change – for instance, ***the value of a company remains the sum of its discounted future cashflows***.

i.e. Present value = year 1 cashflow/(discount rate) + year 2 cashflow/(discount rate)^2 .....

The key questions for us are the inputs:

A. What will the annual cashflows in future be given the economic uncertainty?

B. What is the right discount rate to use when valuing a company?

Forecasting future cashflows

Forecasting what a company's annual cashflows will be into the future is always a difficult task at the best of times, but today, given the enormous disruption caused by COVID-19 to real economies all around the world, assessing the outlook for sustainable demand has become an extremely complex task.

Cast your mind back to 2009, when the then US Federal Reserve Chair Ben Bernanke famously said that the economy was seeing "green shoots". Many investors turned immediately and chased cyclical stocks to position themselves for the expected strong economic recovery. What occurred was actually quite different – cyclicals struggled for many years as they dealt with the hangover of debt and industry overcapacity from the GFC.

Today we are faced with a similar situation and question: what will the shape of the recovery look like once the major impact of the COVID-19 circumstances subside? Will it be a V-, U-, or even W- shaped recovery?

Of course no-one knows the answer to these questions with any certainty, although realistically any prudent investor – such as IML – must recognise the potential risks on the horizon, which could take many forms.

The economic recovery could be interrupted by one or several of the following:

- a second wave of infections
- weaker than expected demand when the currently huge stimulus measures wear off
- weaker than expected corporate margins due to industry overcapacity
- trade wars between China and the US
- higher corporate taxes (particularly for tech companies)

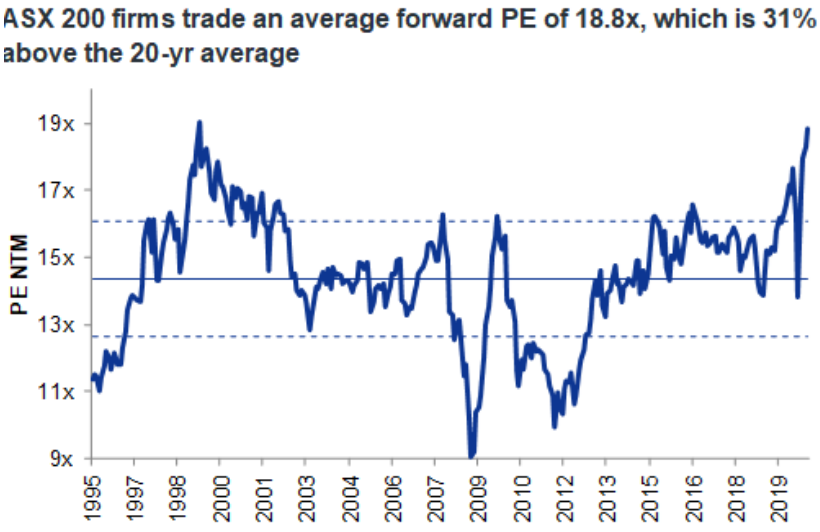
This list is far from exhaustive, but gives reason for concern that the economic recovery ahead may not be as smooth as is being priced into many companies' share prices. IML has always focused on providing downside protection for our clients, so given the extensive uncertainty and risks present, we are at this stage extremely reticent about investing in cyclical companies such as Qantas, BlueScope Steel, and James Hardie Industries, as their share prices appear to be implicitly assuming a strong economic recovery.

Our preferred option is to take a more conservative approach and invest in companies that have a strong competitive advantage, more recurring and predictable earnings, and experienced and capable management teams. These companies will perform well in strong economic environments but will also continue to prove resilient in tougher economic times. Companies such as Telstra, Coles, AusNet, Amcor, Brambles and Orica fit this bill for us.

Discount rates

The other key piece of the jigsaw in valuing any stock is the discount rate. What discount rate should an investor use today when seeking to value any company, given that long bond yields are close to zero in many countries, including Australia?

Clearly, using a discount rate of close to zero means that one can come up with some exceedingly high and generous valuations for companies that may become profitable in much later years – the current valuations of companies such as Tesla or Afterpay spring to mind.



Source: Investors Mutual

Again, at IML, we prefer not to get too carried away like many other commentators who are suggesting that historical valuation multiples should be "double" or "treble" what they have historically been due to low interest rates and QE. We think it is important to remember when determining a discount rate for valuing equities that there are two inputs.

The first to consider is the risk-free rate where investors have typically used the 10-year government bond as a measure for this. The second important and often forgotten input is a risk premium, normally referred to as the 'equity risk premium', which is the extra return required for taking on the risk over and above the assured returns from government bonds.

Therefore, the discount rate used in equity valuations is as follows:

Discount rate = long term government bond rate + risk premium

So, the important question investors need to determine is, what is the appropriate risk premium that should be used when valuing any company? Given the huge amount of liquidity that has been pumped into financial markets, many are arguing that risk premiums have been permanently lowered, which justifies far higher valuations for companies. For us, this is too simplistic and doesn't consider the high level of uncertainty/risk in the world today, or the fact that some companies are far riskier than others.

For example, the cashflows of companies like Coles or AusNet are far more predictable and in effect far less risky than the likes of Qantas, WiseTech, or BlueScope. Therefore, it would make sense to us to apply a lower risk premium to Coles and AusNet than that used to value higher-risk cyclical companies.

One would then conclude that the lower-risk stocks with resilient cashflows and some growth – such as Coles, Amcor, Aurizon and Telstra – should be enjoying the biggest PE expansion in these uncertain times, while more risky and less predictable companies like WiseTech, Afterpay and Qantas should actually be getting de-rated by investors, as the equity risk premium of these stocks should be escalating rapidly given the current economic uncertainties ahead.

The opposite has perversely occurred to date in the early part of this recovery cycle – much as it did in 2009 when many investors favoured cyclical companies over more defensive resilient businesses. Investors sold down many of these predictable businesses in search of more 'growth' to be well positioned for the predicted strong cyclical recovery, which ultimately took far longer to materialise and which disappointed many investors who had bought these more cyclical and often higher-priced stocks.

Will history repeat itself? Nobody can be sure, but at IML, we believe that the risk/reward trade-off at this current point in time is heavily skewed in favour of companies with more predictable cashflows and dividends as the reality of zero interest rates sinks in. We thus continue to favour these kinds of companies more than ever across our portfolios.