INTELLECTUAL AMMUNITION

Debating the Valuation Conundrum

Monday, May 13, 2002
David Gitlitz and **Donald Luskin**

*Following **Donald Luskin's** column last week for* **SmartMoney.com**, *"The New High Plateau: The Valuation Conundrum," **David Gitlitz** challenged Don's thesis that there was no good reason for the surge in equity valuations that began in 1997 -- and persists through today. Here's the dialog between David and Don as it appeared online on* Trend Macro Live!*.*

Clients who want to contribute to the online debate should send their thoughts via email to: live@trendmacro.com.

David Gitlitz
May 12, 2002: 5:35 pm

Don -- Your Friday piece for SmartMoney.com suggests that starting with the second half of the 1990s, stock valuations have maintained what appears to be a "permanently high plateau," and expresses considerable skepticism about whether there is a sufficiently convincing rational explanation for the phenomenon. I would suggest, though, that it might be useful to break down this "epoch" into two separate periods, with the first framed by the accelerated growth phase from late 1996 through the first half of 2000, and the second by the relative stagnation of the past two years. Certainly, to the extent current valuations reflect what appear to be unrealistic near- to medium-term growth expectations, I think it's correct to cast doubt on them. The earlier period, though, corresponded with important changes in the tax and inflation environment which can be seen as having contributed significantly to a secular shift in the value assigned to expected earnings. It remains to be seen how much of this earlier bump in valuation can be sustained, of course, but I do not dismiss the idea that some increment of the increase reflects fundamental factors that could have long-term sustainability.

First, we had the collapse of both reported and expected inflation, as the 12-month moving average of 12-month percentage change in the CPI fell from about 3% in late '96 to 1.5% by late '98. The sustainability of this inflation downdraft was also supported by the dollar strengthening seen in the most sensitive, forward-looking market price signals. After briefly spiking above $400 per ounce in Feb. '96, the daily spot gold price finished the year below $380 on a course that would bring the one-year moving average price to $325 by early '98 and below $300 by early '99. Yes, it's unquestionably the case that under **the Fed's** heavy hand, a healthy scarcity of dollar liquidity evolved into a massively too-tight deflationary dollar shortage which laid waste to trillions in equity market capitalization. But we should not lose sight of the highly market-friendly effects of the shift against long-held expectations of sustained erosion in the purchasing power of the unit of account. For one thing, such a sharp break in the inflation expectations environment can be seen increasing the real value of expected income streams, raising the nominal price investors are willing to pay for a dollar of future earnings, and thus lifting the market-wide p/e ratio.

The pronounced shift in the inflation climate also had important effects in terms of magnifying the impact of the 1997 cut in the capital gains tax rate from 28% to 20%. Capital gains is an unindexed tax, so any decline in inflation also has the effect of reducing the real tax rate. But in combination with the 30% cut in the nominal tax rate, I estimated that the inflation deceleration had the effect of reducing the real effective capital gains rate by close to 50%! The implications for equity valuations resulting from such a sea change in real, expected, after-tax returns are obvious. Also important, though, were the knock-on effects of this shift in the tax/inflation climate, as the lower cost and reduced risk to capital helped set the stage for the explosion in entrepreneurial innovation that in turn contributed significantly to enhanced productivity and rising growth expectations. To the extent this dynamic, capital-rich climate enabled the market to boost the capitalized present value of expected income streams, the incremental increase in equity valuations should be no mystery.

Donald Luskin
May 12, 2002: 6:10 pm

David, in terms of the tax and inflation-expectation drivers that you mention to justify the post 1996 shift into today's epoch of high valuations, I have the following questions for you:

What is there about *this* capital gains tax cut that made it so much more meaningful than the 1979 and 1981 cuts? Neither of them seemed to change valuations much. Perversely, the capgains rate change that seems to have made a real difference was the 1986 *increase*, which coincided with the launch of a new epoch of higher valuations than the previous one (though lower than the present one).

What is there about the change in inflationary expectations post 1996 that is any different then the ones that have pervaded the market since the mid-1980s, when it became clear that the back of inflation had been broken? Or for that matter, what makes the recent epoch of low inflation (even deflation) better than earlier epochs with similar low inflation rates (say, the 1950s), when valuations were much lower?

And why bother to divide the current epoch into two parts? All the elements you claim for the first part are present in the second part -- unless you want to make the case that expectations for the conquering of inflation gave way to a fear of deflation. But weren't deflationary concerns evident as early as 1997 when the gold price started to collapse, followed by oil and other commodities?

Look, far be it from me to act (now) as though (at the time) I wasn't right in there with the rest of them saying "this time it's different" when the current epoch of high valuation dawned, draped in rhetorical trappings of the New Economy. I was there. It felt different. Yes, I remember feeling that inflation was really dead, dead, dead. I remember the adulation afforded **Alan Greenspan**, who was seen then not just as an inflation fighter but as a crisis-manager and just general all round master of the universe. And I remember the tech-born hopes for higher profit growth rates. But looking back, when you put numbers on the reality of all that, very little of that turned out to be new, different, interesting, or (most important) true. So I am left looking for any tangible explanation beyond the anecdotal of why, in early 1997, we phase-shifted into a new epoch of high equity valuations -- and are still there.

David Gitlitz
May 13, 2002: 12:56 pm

Don -- Don't forget the economic circumstances that were in place at the time of those earlier capgains cuts. In the late 1970s, of course, there was the deadening inflationary malaise of **Jimmy Carter**, while in the early 1980s we had the bone-crushing austerity of **Paul Volcker** to purge the system of Carter's legacy of double-digit inflation. Capgains cuts are not a magic elixir that in themselves can overcome such heavy burdens. I would note, though, that once Volcker lifted his state of the siege in late '82, the **Reaganomics** boom was on, and stock valuations responded accordingly. And, actually, the '86 capgains increase took effect in '87, and by my reading was soon followed by a precipitous decline in p/e multiples.

The notion that the "back of inflation had been broken" by the mid-1980s was true only in relative terms. For most of the period from '84 to '91, inflation was running at more than 4%, and was still averaging close to 3% through '96. Throughout the bulk of this era, the dollar price of gold traded in a range of $350-$400 per ounce, and had been holding above $380 in the two years prior to the onset of its steep decline starting in late '96. Clearly, this was a break from earlier experience when both reported and expected inflation ratcheted down from previous levels but continued to impose risk premiums that resulted in suboptimal levels of wealth creation and capital formation.

I suggested dividing the "New Economy" valuation epoch into two parts to distinguish the late-1996-to-early-2000 period, when the ramping up of valuations could be explained in good measure by positive developments in the tax/inflation setting, from the more recent period, when the maintenance of those multiples seemed far more problematic (although not nearly as problematic as they seemed just a few months ago.) Yes, it's certainly true that even during the earlier part of this period, the dollar's precipitous strengthening gave rise to well-founded concerns about deflation, and was clearly a major factor in the Asia/Russia financial crises of 1997-98. It's also the case, though, that as the world's most capital-intensive, least commodity-dependent economy, the overall pluses for the U.S. in the early phase of the dollar's rising real purchasing power outweighed the negatives. Had the Fed been observing a price rule, the monetary overkill of late-1999 to mid-2000 would have been avoided, along with the bulk of the subsequent damage that was its direct consequence.

Donald Luskin
May 13, 2002: 2:49 pm

David, clearly we are talking about very complicated interactive effects of drivers that are both difficult to quantify and subjective to measure. In the end we live not just in a world of numbers, but in that beauty contest described by Keynes in which perception, and perception of the other guy's perception *ad infinitum*, is the dominant reality. That said, we seem agreed in our judgments that, at present, equity valuations are too high be be justified by the key drivers of wealth creation and capital formation.