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CJ Investment Mini-Lessons

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Mini-Lesson: Multiple Contraction and Expansion

I thought the *CJ's* readers might be interested in one significant reason why stocks may decline in the coming months even as the economy continues to "recover." At the rate the Fed has been creating money, it is anything but a forgone conclusion that the US economy has reached the point of self-sustainable growth, but that's tangential to what the Mini-Lesson is teaching.

To understand multiple contraction and expansion, first understand that there are many investment vehicles in our capitalist (for now) economy. Bonds, savings accounts, money market investments, real estate, commodities, and others compete with stocks for the investors' capital, in this case, US$. One old adage says, "Capital moves to the most profitable investments." In a truly capitalistic system, this is true. The high degree of governmental intervention in our markets impacts, but does not negate, this rule.

The question then arises: "How do I measure the return on all these different investments in order to decide how to allocate my investment funds?" One method is to calculate a P/E (price to earnings) ratio on the other investments as a way of determining if one type of investment is overvalued or undervalued compared to stocks. Taking bonds for example (since bonds are the largest group of world financial instruments by far) the interest yield can be considered "earnings." Therefore, if a bond is yielding 5%, the bond's P/E would be 20 (100% (price)/5% (earnings)). A bond yielding 2% would have a P/E of 50.

Current 5-year Treasury bond yields are near 4%, whereas they were around 3% three months ago. For the record, that is a 33% rise in rates in one quarter. Using this as an example, 5-year bonds went from having a P/E of 33 to a P/E of 25, or a multiple contraction of 25%. In order for stocks to remain competitive with bonds for available capital, stock P/E multiples would have to contract a comparable amount. If a stock had a P/E of 40 and earnings of $1, the stock would have to drop from $40/share to $30/share in order to attract new investors. That's a 25% loss to existing holders of the stock! Keep in mind, this type of action translates to multiple *expansion* when interest rates decline, which helped prop up the market since 2001, when the Fed began dramatically dropping interest rates.

If the economy actually reaches self-sustaining growth, the Fed will have to raise rates eventually. In fact, *market* rates are rising now (2004) as described above. Multiple contraction is a serious force working to prevent stocks from rallying along with the economy.

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