

From: US GIO <[REDACTED]>

To: Undisclosed recipients;

Subject: Eye On The Market: A look at US equity valuations after the rally

Date: Tue, 09 Oct 2012 20:37:15 +0000

Attachments: 10-09-2012_-_EOTM_-_A_post-rally_look_at_US_equity_valuations.pdf

Inline-Images: image005.png; image006.jpg

Eye on the Market, October 9, 2012

In 2012, rising equity markets have mostly been a function of rising multiples applied to modestly rising earnings. While we have had a normal weighting to US equities in model portfolios since mid-2009, I would've put no more than a 1 in 4 chance on a 17% advance in the S&P 500 this year. After this rally, we're getting questions about where US equity valuations now stand. It depends whom you ask and how they frame the question: as shown below, a Graham-Dodd/Shiller approach makes equities look expensive, while a different approach that adjusts for the cost of money over time makes US equities look cheaper than they have been in 60 years. In the attached note, we focus on the debate. One conclusion: 13x-14x P/E valuations that are simply average become more compelling using the latter model, but at the point of a bayonet: Fed policy has simply lowered expected returns on a lot of the alternatives (cash, Treasuries, agencies, credit, convertible bonds, MLPs, REITs and other dividend-paying stocks). What is striking is the divergent response from institutional investors, who have been adding equities, and retail investors, who in aggregate have been aggressively selling them.

Graham-Dodd/Shiller valuation approach: expensive
S&P Price to ten year trailing average reported earnings



S&P 500 trailing earnings yield, adjusted for the cost of money (using 7 years nominal GDP proxy)



Also, a look at fiscal cliff scenarios that could affect equity markets, and a Wildlife Advisory Alert.

Michael Cembalest

[REDACTED] Morgan Asset Management

This email is confidential and subject to important disclaimers and conditions including on offers for the purchase or sale of securities, accuracy and completeness of information, viruses, confidentiality, legal privilege, and legal entity disclaimers, available at [REDACTED]