



Investment Outlook

Dow 5,000 Redux

Here I go again! Gosh it was only six years ago that I cemented my place in stock market history by predicting that the Dow would fall from 8,500 to 5,000, instead of going up to 14,000 where it peaked in October of 2007. Well, I could use the standard set of excuses: 1) No one else saw it coming, 2) I was misinterpreted, and taken out of context, 3) I was tired, over-worked, and had family problems, or 4) I had just come out of rehab. But these days what really works is a full confession. I mean, like, uh, it was totally my fault and I take full responsibility. The fact is I was only off by 9,000 points. That's my story, and I'm stickin' to it.

Well, fools rush in. This time though I'm definitely older and maybe a little bit wiser. No magic number, nor a specific target date from the Swami of the Dow. This one will be more conceptual, but still present a "take" that you can criticise or damn with faint praise. And no, despite the title, it doesn't imply that the stock market is headed to 5,000 and that I was always right or just a little bit early. It only suggests that I'm readdressing the critical topic of equity valuation – that mysterious fragile flower where price is part perception, part valuation, and part hope or lack thereof. Press on, Swami.

Let me first announce a fundamental premise with which I think all rational investors would agree: I believe in stocks for the long run – but only if purchased at the right price. That statement packs a real punch. It says that capitalism is and will remain a going concern, that risk-taking – over the long run – will be rewarded, but only from a starting price that correctly anticipates the economy's growth and its share of after-tax corporate profits within it. Acknowledging the above, let's look at a few basic standards of valuation that historically have stood the test of time, to see if at least the price is right.

One of them is what is known as the "Q" ratio, or the value of the stock market relative to the replacement cost of net assets. The basic logic behind "Q" is that capitalism works. If the "Q" is above 1.0, then the market is valuing a company at more than it costs to reproduce it; stock prices should fall. If it is below 1.0, then stocks are undervalued because new businesses can't be created at as cheap a price as they can be bought in the open market. In the short run, this ratio is volatile as shown below but it tends to be mean reverting, which is critical. As long as capitalism is a going concern, "Q" should mean revert to

1.0. If so, then oh, oh what a “Q”! Today’s Q ratio has almost never been lower and certainly not since WWII, implying extreme undervaluation, as seen in Chart 1.

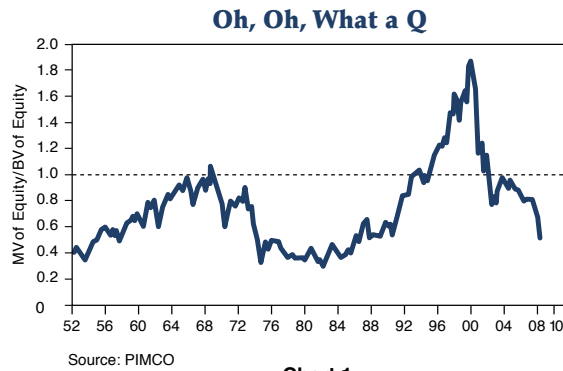


Chart 1

Another long-term standard of valuation comes from the good ol’ P/E ratio, where earnings per share, or E, is compared as a function of P, or price. Chart 2, going all the way back to 1871, shows the same relatively massive undervaluation, not only in the US but elsewhere. This has been a global bear market. Yet here one should be careful. The sage of rationality, Yale’s Robert Shiller, cautions us to look at earnings on an historical 10-year moving average to remove adverse or fortuitous cyclicalities. When measured on this basis, P/E’s are cheap but less so, slightly below their mean average for the past century.

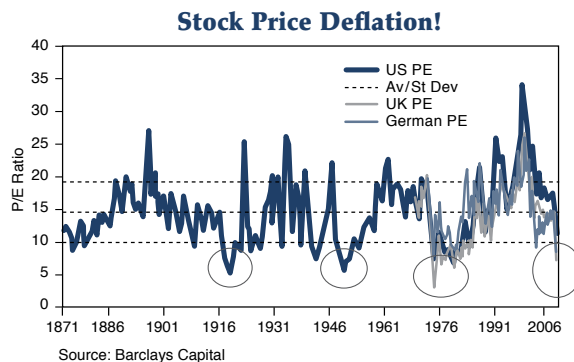


Chart 2

Professor Shiller may be on to something, although even his 10-year approach may not be enough to adjust for our future economy and its functioning within the context of a delevering as opposed to a levering financial system. Recent *Investment Outlooks* and indeed, discussions in PIMCO’s Investment Committee and Secular Forums for the past several years have pointed to the necessity to view current changes as not only non-cyclical, but non-secular. They are, in fact, likely to be transgenerational. We will not go back to what we have known and gotten used to. It’s like comparing Newton and Einstein: both were right but their rules governed entirely different domains. **We are now morphing towards a world where the government fist is being substituted for the invisible hand, where regulation trumps Wild West capitalism, and where corporate profits are no longer a function of leverage, cheap financing and the rather mindless ability to make a deal with other people’s money.** Welcome to a new universe stock market investors! In this rather “sheepish” as opposed to “brave” new world, here are some considerations that may affect Q ratios, P/E’s, and ultimately stock prices for years to come:

- 1) Corporate profits have been positively affected for at least the past several decades by several trends that appear to be reversing. Leverage and gearing ratios – the ability of companies to make money by making paper – are

coming down, not going up. In addition, the availability of cheap financing – absent government’s chequebook – will likely not return. Narrow yield spreads and low real corporate interest rates are gone. Last, but not least, the historical declines of corporate tax rates, shown graphically in Chart 3, will not likely continue downward in a Democratically-dominated Washington.

Corporate Taxes at the Bottom



Chart 3

2) Globalisation’s salutary growth rate of recent years may now be stunted. While public pronouncements from almost all major economies affirm the necessity for increased trade and policy coordination, and avoiding the destructive tendencies of one-off currency devaluations as a local remedy for global problems, investors should not bank on the free trade mentality of recent years to support historic growth rates. Already we are seeing separate ad hoc policy responses with very little cooperation. Not only does the EU’s approach differ from that of the US, but France is in many

ways an odd man out within its own community. Asia is legitimately suspicious of any US endorsed approach given the failure of America’s capitalistic model.

- 3) Animal spirits, and with them the entrepreneurial dynamism of risk-taking has likely experienced a body blow. Not only have dancers on the financed-based dance floor been shown the exit à la Chuck Prince, but those that remain have been publicly chastened and handcuffed. Golden parachutes, options, executive compensation and bonuses themselves are now at risk. Care to climb to the throne of this new world? Well, yes, egos will always dominate, but the rules will be changed and hormone levels lowered.
- 4) The benevolent fist of government is imperative and inevitable, but it will come at a cost. The champion of free enterprise, Ronald Reagan, knew that growth of the private sector was in no small way dependent on deregulation and the lowering of tax rates. Now that those trends have necessarily come to an end, no rational investors should expect innovation and productivity to be unaffected. Profit and earnings per share growth will suffer.

My transgenerational stock market outlook is this: stocks are cheap when valued within the context of a financed-based economy once dominated by leverage, cheap financing, and even lower corporate tax rates. That world, however, is in our past not our future. More regulation, lower leverage, higher taxes, and a lack of entrepreneurial testosterone are what we must get used to – that and a government chequebook that allows for healing, but crowds the private sector into an awkward and less productive corner. Dow 5,000? We don't have to go there if current domestic and global policies are focused on asset price support and eventual recapitalisation

of lending institutions. But 14,000 is a stretch as well. One only has to recognise that roughly 20% of bank capital is now owned by the US government and that a near proportionate share of profits will flow in that direction as well. Better to own corporate bonds than corporate stocks, but that's a story for another *Investment Outlook*.

William H. Gross
Managing Director

IO Podcast...

To download Bill Gross' **IO Podcast**, remember to check pimco.com or iTunes.com.

The services and products provided by PIMCO Australia Pty Ltd are only available in Australia to persons who come within the category of wholesale clients as defined in the Corporations Act 2001. They are not available to persons who are retail clients, who should not rely on this communication. Investors should obtain relevant and specific professional advice before making any investment decision. The information contained herein does not take into account the investment objectives, financial situation or needs of any particular investor. Before making an investment decision investors should consider, with or without the assistance of a securities advisor, whether the information contained herein is appropriate in light of their particular investment needs, objectives and financial circumstances.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity.

This article contains the current opinions of the author but not necessarily those of the PIMCO Group. The author's opinions are subject to change without notice. This article is distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission. ©2008, PIMCO.

P I M C O

PIMCO Australia Pty Ltd

ABN 54 084 280 508

AFS Licence 246862

Level 19, 363 George Street

Sydney, NSW 2000

Australia

612-9279-1771