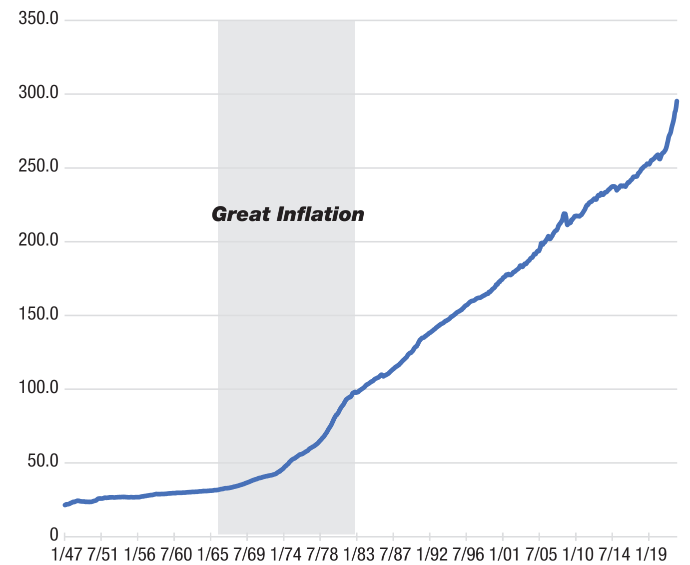
Inflation and Equity Valuation

– Danke Wang, Portfolio Manager

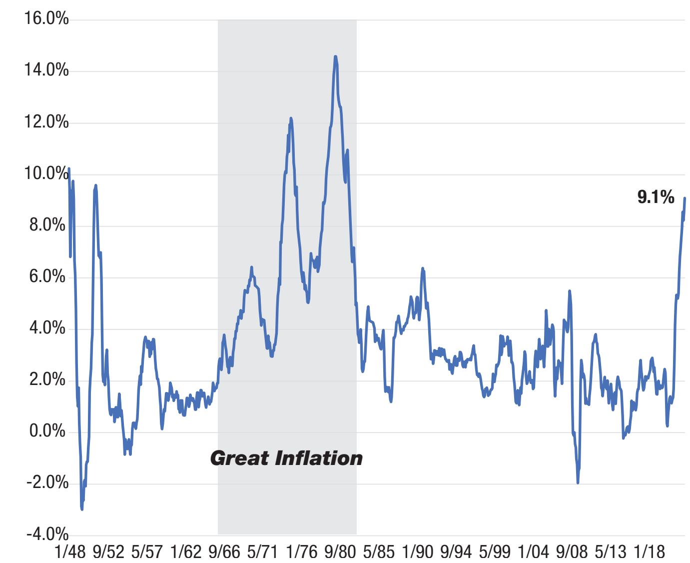
The Consumer Price Index (CPI) number continued to surprise and jumped 9.1% in June, and rose to the highest level in 40 years.

The Consumer Price Index
January 1947 - June 2022



Source: fred.stlouisfed.org

CPI Year over Year %
January 1948 - June 2022



Source: fred.stlouisfed.org

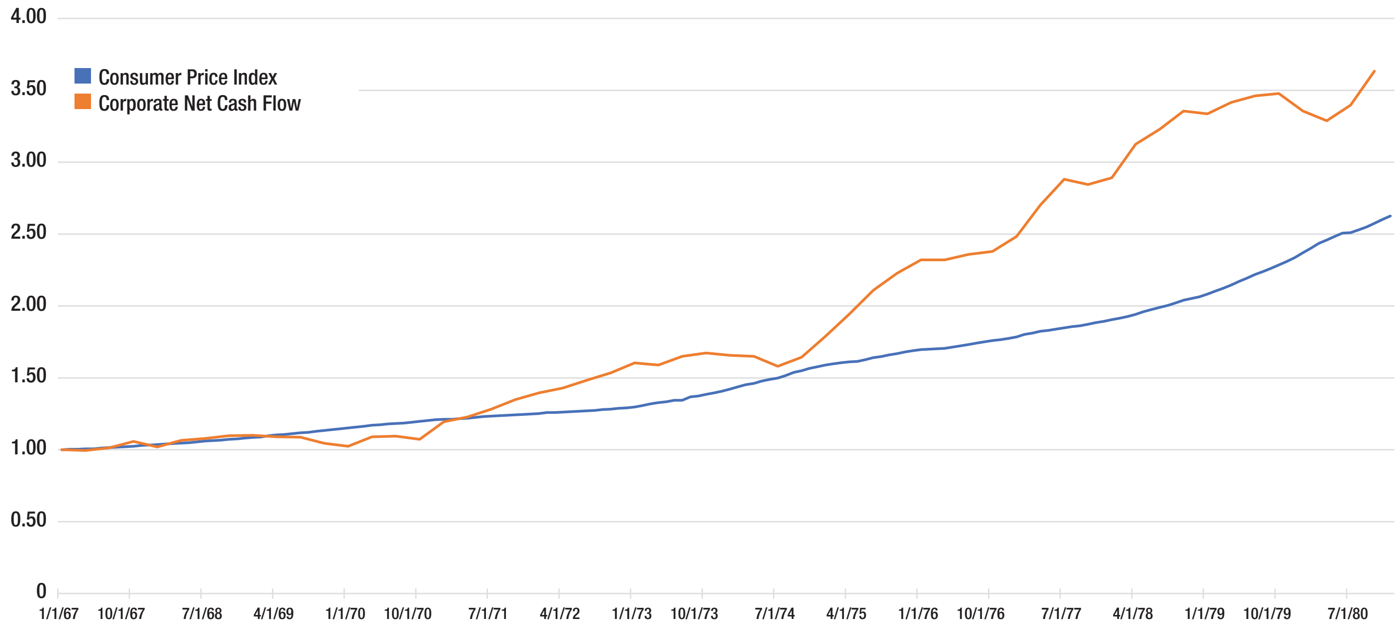
What does that mean for the equity market?

It is widely accepted that moderate inflation levels are needed to drive economic growth. From 1992 to 2019, the year-over-year inflation averaged about 2.25% and exceeded 5% only twice. Investors should be cautious whenever inflation is negative or too high.

The impact of high inflation on equity markets comes in 2 forms: corporate earnings and stock valuations.

Without the backdrop of a recession and earnings dropping, corporate cash flows tend to keep pace with, or even outpace, inflation. That is particularly true when inflation increases, and companies pass on higher costs to customers. An example is the “great inflation” period in the 1970s, when corporate net cash flow grew faster than inflation. In a scenario like this, long-term investors should consider equities as a store of value for inflation protection.

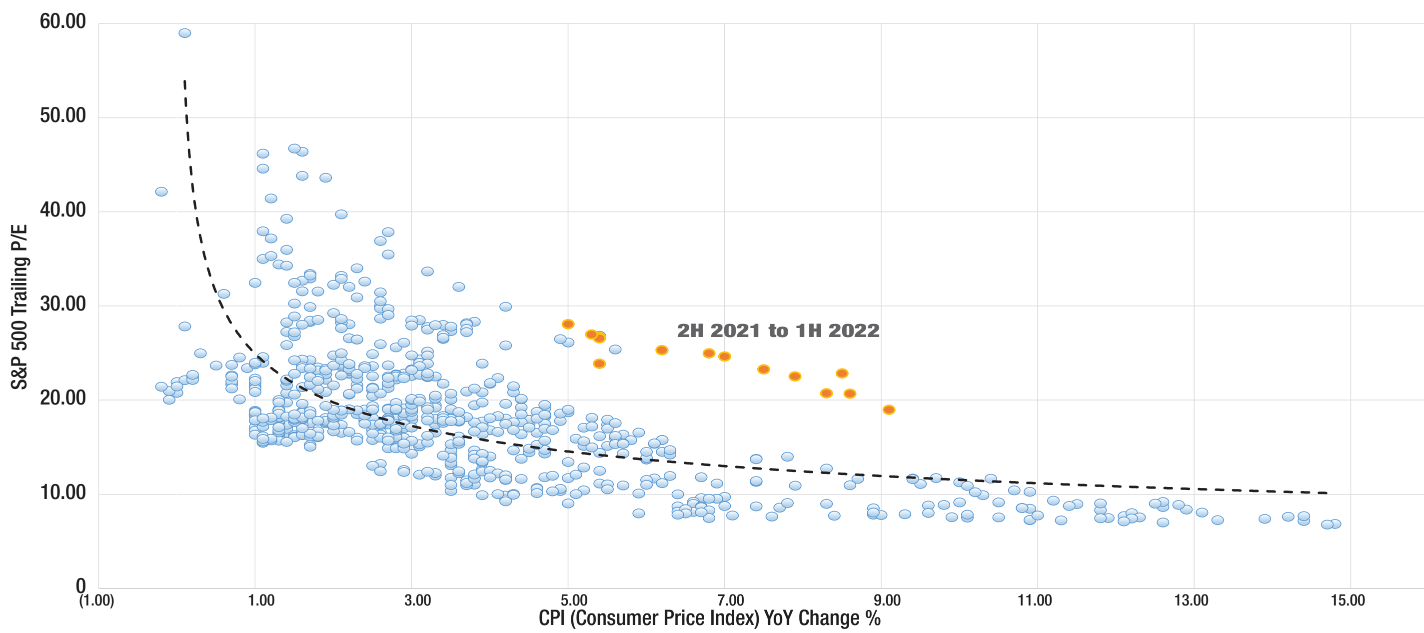
US Corporate Net Cash Flow Growth vs CPI
1967 – 1980



Source: fred.stlouisfed.org

Although corporate profits might not be hurt by inflation, equity valuation levels are the second aspect to watch in equity markets during high inflationary periods. Because when inflation turns higher, stock P/E ratios go lower.

S&P 500 P/E vs CPI YoY Change
January 1960 - June 2022



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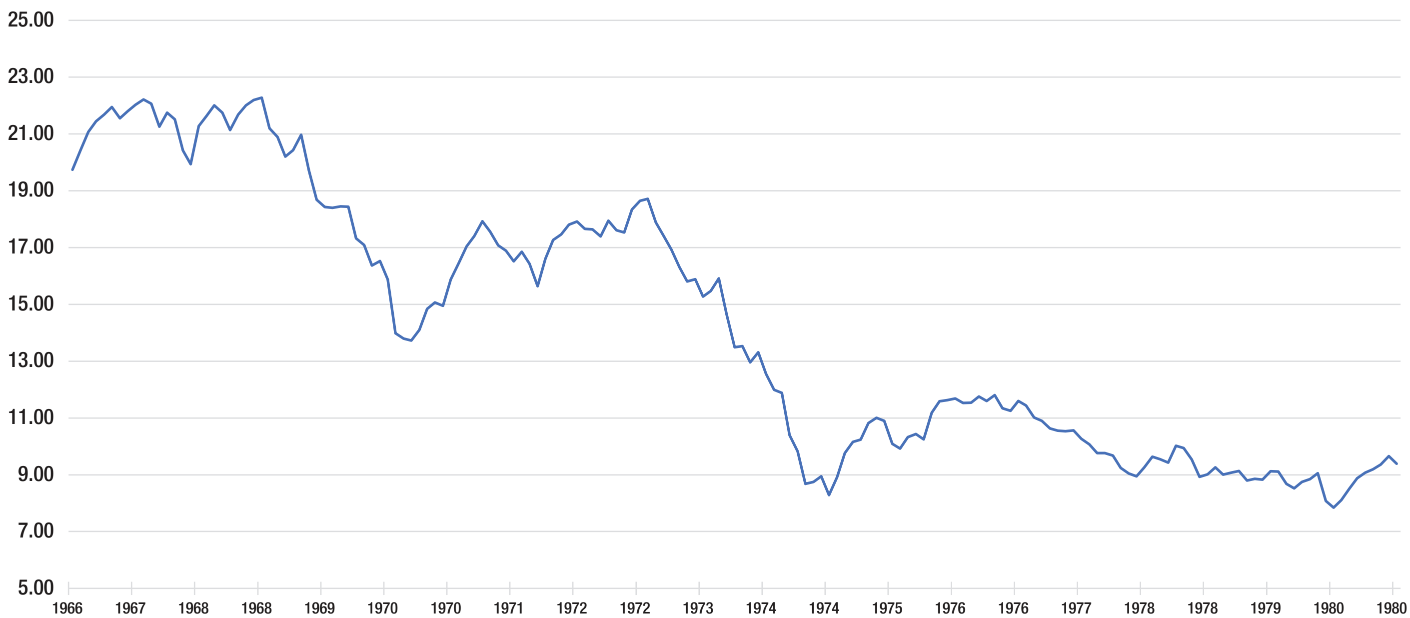
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

For example, from 1966 to 1980, the cyclically adjusted P/E ratio of the S&P 500 index dropped from the 20s to below 10. Such pressure of multiple contraction might happen when there is persistent high inflation which is the biggest concern for equity investors.

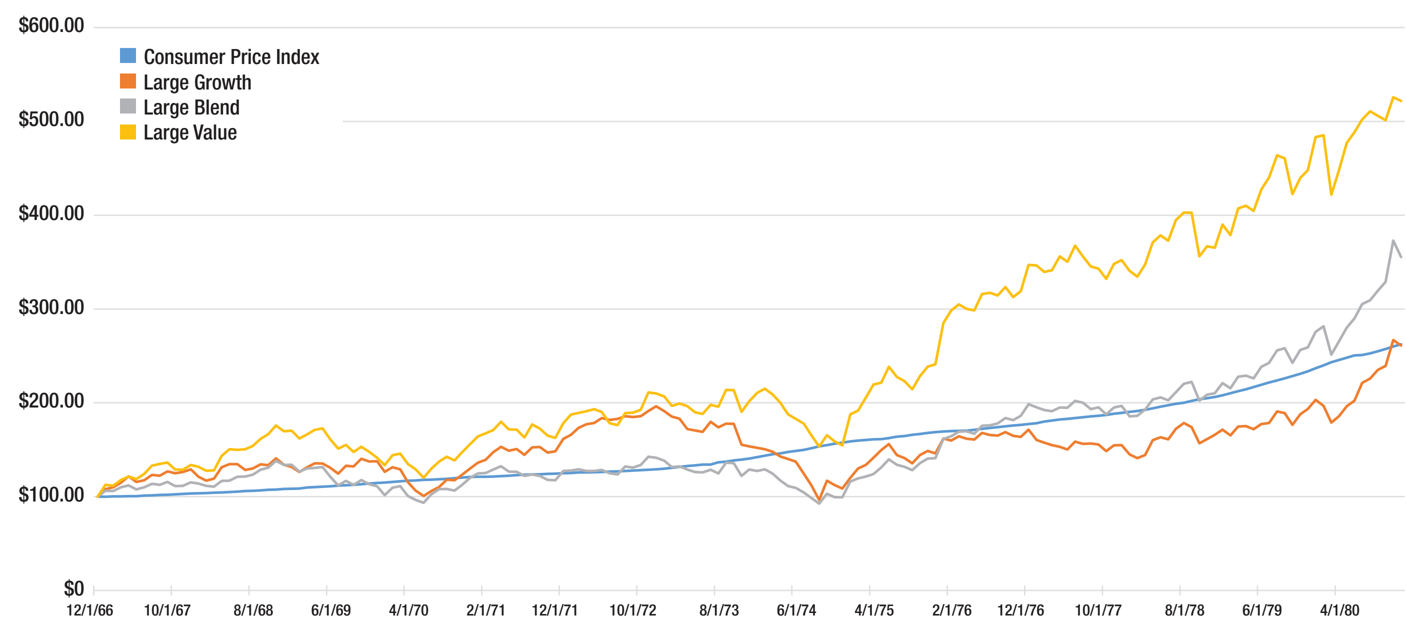
S&P 500 Index Cyclically Adjusted P/E Ratio
1966 - 1980



Source: multpl.com/shiller-pe

As a result, in the high inflationary period in the 1970s, value stocks delivered much better performance than growth stocks and the broad market.

Equities During High Inflation Period – Hypothetical Growth of $100
1967 - 1980



Source: fred.stlouisfed.org, mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html
Fama/French Research Portfolios: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

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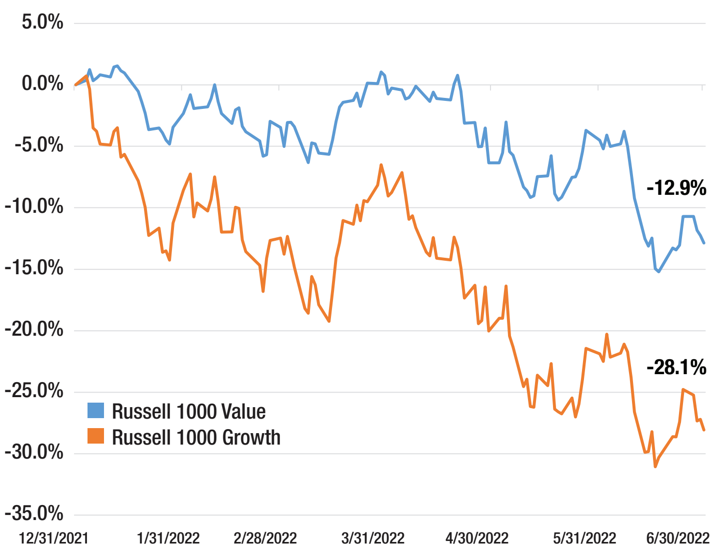
Going forward, the equity discount rate will likely increase due to Fed rate hikes, inflation, and increased interest rate volatility. The relationship between inflation and P/E ratios indicates either the S&P 500 dropping by 37% or earnings growing by 59%. Today's P/E is 59% higher than the historical CPI vs. P/E relationship.

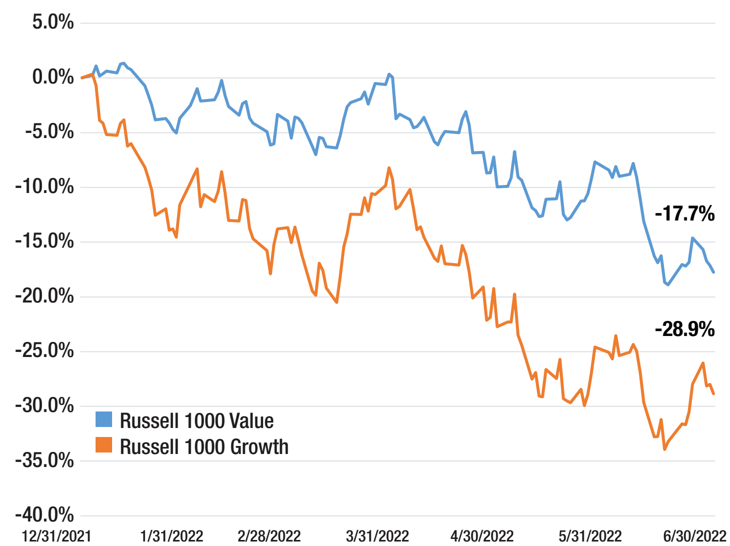
Multiple contraction partially explains the market downturn year to date and the underperformance of growth stocks relative to value stocks. Because value stocks trade at a discount, they are subject to less multiple contraction impact.

Index Total Return
12/31/2021 - 6/30/2022



Source: Bloomberg

Change of Forward P/E
12/31/2021 - 6/30/2022



Source: Bloomberg

Stock duration*

This year, in response to high inflation, the Fed raised interest rates by 75 basis points (bps) in July after a 25 bps hike in March, a 50 bps rise in May and another 75 bps rise in June.

Before the June sell-off (due to recession concerns), the year-to-date market movement was driven mainly by the waning appetite for long-duration (or growth) stocks associated with higher interest rate expectations.

Short-duration stocks usually outperform long-duration stocks during periods with high and rising inflation. Value stocks (especially ones with high levels of current cash flow) or growth stocks with elevated current profitability have comparatively shorter durations and, therefore, less vulnerability to rising interest rates.

On the other hand, fast-growing firms valued entirely on long-term growth expectations have a longer duration. And they can be more vulnerable to the risk of rising interest rates or disappointing revenues.

Until the end of 2021, the S&P 500, which growth stocks have dominated, has essentially become a 30-year zero coupon bond. Such duration risk means that the S&P 500's sensitivity to changes in interest rates is the highest it has been in history.

As of 6/30/2022, companies in Pacer US Cash Cows 100 ETF, on average, trade at a much lower P/E multiple (7.08) relative to the market (18.08 Russell 1000 Index) and generate higher current free cash flow (FCF) relative to their enterprise value (FCF Yield 12.79%). These companies offer attractive value in the current macro environment.

***Stock duration and valuation**

If you spend $100 to buy a value stock with P/E ratio of 5x, your shares should make $20 a year in profits, and you should get the money back after 5 years. In contrast, a growth stock's P/E ratio might be as high as 50x which means low profits today but potentially high growth in the future. Growth investors pay a high price now in the hope of getting the money back in 15 to 20 years. In a way, we can consider the value business as a "short-duration" asset and the growth business as a "long-duration" one.

The same idea can be applied to high free cash flow (FCF) yielding companies relative to low FCF yielding ones. A company with a 10% FCF Yield has a "payback period" of 10 years, whereas a company with 1% FCF Yield will take 100 years to payback. When inflation hits, the current high FCF is more valuable than earnings from growth companies, so high FCF yielding stocks are more attractive.

PACER US CASH COWS 100 ETF
COWZ

Pacer US Cash Cows 100 ETF

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The Pacer US Cash Cows 100 Index was released on 12/8/16.

Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and longterm investments)

Enterprise Value (EV): A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)

Free Cash Flow Yield (FCF/EV): Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.

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