The Stan Clark Financial Team's

PERSPECTIVES

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Asset allocation

How earnings yield helps forecast stock market returns

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As part of our "Behind the Numbers" series, we discuss how the price-to-earnings (P/E) ratio can be a good predictor of individual stock returns. You might ask: "Can P/E ratios be used to tell us something about the overall market?" Good question! The overall market consists of all the individual companies grouped together. So, if we calculate an overall market P/E, it might just give us some insight into stock market returns.

According to Jeremy Siegel, professor of Finance at the University of Pennsylvania's Wharton School, and author of *Stocks for the Long Run*, investors can project their returns with techniques similar to those a bond investor would use. A bond promises to pay a fixed amount per year, so the expected return of the bond is the coupon divided by the price of the bond. For example, let's say you have a bond that is selling for $1,000. It pays you $20 per year. That works out to an expected return on that bond of 2%. While stockholders have nothing guaranteed, they do have a claim on all future earnings of the company. Some of these earnings are paid out as dividends, while the rest are reinvested in the company to increase its value. So, just like the expected bond return we calculated earlier, the expected stock return should be similar to the stock's *earnings yield*.

Let's take a closer look at concept of earnings yield. The earnings yield of a stock is the earnings divided by the stock price. Sound familiar? It should. It's the inverse of the P/E ratio, which is price divided by earnings. It's the same thing, really – but stating it this way makes the concept easier to grasp. The earnings yield for the stock market is the sum of all companies' earnings divided by the value of the stock market.

There is a big difference between bond yields and stock earnings yields. No matter whether there is significant economic growth or massive inflation, the bond payments will not increase. Stock earnings, on the other hand, are much different. Earnings are not guaranteed and can be highly variable. But stocks represent ownership of real assets, such as machinery, property and patents – in other words, things that produce real goods and services which, in turn, generate profits. Over long periods of time, there is overwhelming evidence that company earnings will keep up with the rising prices of goods and services. Profits will rise with inflation. As a result, the return on stocks can be described as a good hedge against inflation – unlike bonds. Think of the inflation hedge as a benefit, offsetting the earnings' variability.

Currently, the projected S&P 500 earnings for 2022 are about $209, and the index is about 4204. This works out to an earnings yield of about 5%. Siegel has found that "the earnings yield is an excellent predictor of long-run real stock returns." If these earnings grow just at the rate of inflation, the expected long-term returns of the stock market should also be around 5%, *plus* inflation. If you figure inflation averages 2%, this would equate to a total return of 7%. This is significantly more than the 10-year U.S. bond rate of approximately 1.6%, with no increases for inflation.

Canadian stocks offer a higher earning yield, about 6% on the forecasted earnings next year. The forecasted earning yield of the Canadian and U.S. stocks in our Disciplined World strategy is about 6%.

In summary, earnings yield gives us an idea of what to expect for returns. It also gives us a simple comparison to bonds for valuation purposes. The bottom line is that, for long-term investors, stocks provide much greater opportunity than bonds. ■

Source: "Earnings, Inflation and Future Stock and Bond Returns," Proceedings of the American Philosophical Society, Vol 158, No. 3, September 2014.

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