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## Anyway you look, the value of stock markets is high now

◆ Number of people out of work in the US could approach 40 million on Friday's jobs report.

◆ Revenues of listed companies tend to drop when unemployment rises.

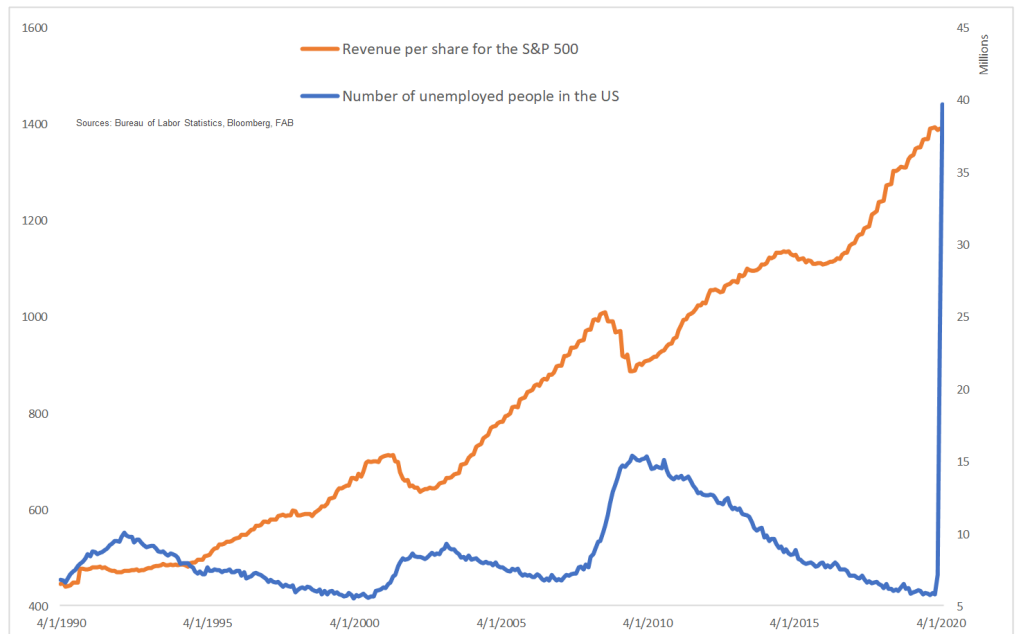
◆ A drop in revenues commensurate with the fall in employment suggests revenues could drop more than 20% in the coming year.

◆ Still, low rates and large amounts of cash are likely to support risk assets.

◆ FAB AAC remains underweight in equities and overweight in gold.

Ultimately, stocks are valued on the ability of a company to generate profits, grow and pay dividends. Analysts and investors tend to try and look into the future to predict how much a company will sell and from that they can derive how much it will need to keep growing, what profit it will make and what it can pay its investors. Armed with these numbers, analysts look at what they would make if they invested in a risk-free asset, US Treasuries for instance, and then they discount their expected gains against that, adding a premium for other risk factors.

While this may be oversimplifying, real stock market analysis is not too distant from it. Unfortunately, applying this traditional method suggests stock markets in the US are beginning to look ever more stretched. Right now, the S&P 500 is trading at 2.2 times the sales per share of its constituents over the past 12 months. In simple terms, it would take 2.2 years of the previous year's sales to pay back the aggregate market value of the stocks in the index. That is a high number.



The highest that ratio has been is 2.32. Hence, if the aggregate sales of the companies in the index were to remain unchanged, the S&P 500 would be at an all-time high according to this measure if it rallies another 5%.

The trouble is that revenues are likely to drop. A simple regression shows that the number of people unemployed in the US has an impact on the sales of companies in the S&P 500. In the 2008 crisis, for instance, the aggregate revenues of the companies in the index fell by 12% as the unemployment rate rose to 10% from 4.5%. This time, the unemployment rate is expected to rise to 19.5% in a report on Friday. To be sure, many of the layoffs in the upcoming report are temporary but Federal Reserve economists still expect the year to end with the US unemployment rate at more than 10%, compared to 3.5% in February. If revenues are to drop by a commensurate amount, they could fall more than 20%.

### If S&P 500 revenues drop to reflect the US jobs situation, there is a lot of pain ahead

It took seven years for the unemployment rate to drop back to where it was before the crisis and three for revenues to recover. If revenues do fully reflect the job loss and the S&P 500 is at the 3080.82 at which it closed yesterday, then the index would be trading at 2.8 times sales.

To be sure, the risk-free rate is at zero and that does support higher valuation. The period of zero-rates in the US increased the average sales multiple by 0.2. But even assuming a never-touched 2.5 sales valuation and inputting a drop of only 10% in revenues suggests that by the end of the year the S&P 500 should be trading at 3,121. The record valuation and the smaller drop in revenues seem hopeful and this market looks a bit too high.

## Investment Strategy Update

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