Markets Get an ‘F’ in P/E

By The Mogambo Guru

12/15/08 Even though the S&P 500 index itself has fallen from about 1,590 a year ago (with a P/E of 18.9) to where the index is actually down by about half, earnings are down by half, too! And we all know what that means for the P/E ratio. It’s no wonder we’re hearing incessant screaming from the Mogambo Bunker Of Doom (MBOD).

"The Next Big Storm to Hit the Markets" is the headline for an essay by John Robson & Andrew Selsby of Full Circle Asset Management, who write, "Above all others, the outlook for corporate earnings is the big issue", and they expect that earnings will "also catch ‘fall off a cliff syndrome’."

Immediately, I think to the Price-to-Earnings ratio of the S&P 500 index, as shown in Barron’s, and sure enough, earnings have been trending down for the entire year, which is, of course, bad news, as is proved when you see that the market value of the S&P 500 is down by about half in the last year, meaning that if you owned the stocks in the S&P 500 for the last year, then you have lost half of your money, and you are probably plenty upset!

So you would think that, you know, the P/E ratio would have fallen, especially since the prices of the stocks in the index (which are the P in the P/E ratio) have fallen by half, and you have lost half your damned money, about which you are still plenty peeved.

But surprise! Even though the S&P 500 index itself has fallen from about 1,590 a year ago (with a P/E of 18.9) to where the index is actually down by about half, earnings are down by half, too!

So this means that although the company made half as much money, and you, the hapless investor, lost half of your money investing in their stocks, both the P and the E went down, and thus the Price-to-Earnings ratio is still at an elevated 19! It’s actually higher! Hahaha!

Anyway, the point is that this current Price-to-Earnings ratio of 19 for the S&P 500 index is so high (audience shouts out, "How high, Mogambo?") that it is still near where, historically, the market soon started down in a huge bear market, and is still high even after losing half its value! Gaaaah! I’m scared!

In fact, you can still have a high P/E of 19, indicating a high price, even if the earnings of the entire S&P 500 fell to a measly 1-cent and the shares in the index sold for a collective 19 cents! Hahaha! It’s weird!

You can tell by their faces that they are aghast that I would be ruining their presentation with my stupidities, and so they immediately get away from P/E ratios altogether, and instead turn to consumption and interest rates, whereupon they write, "consumers have started a spending strike, so any business that sells to them is heading into a huge headwind. This in itself is probably enough to do the damage but there’s more. Credit markets are at worst, closed and at best, much more expensive", which they prove by noting, "Spreads for investment grade corporate bonds are 550 basis points over treasuries; even worse, junk bonds are a huge 20 percentage points above treasuries."

They then cite a statistic that I have never heard of before, perhaps because I am an ignorant and stupid guy, but I was surprised to learn that "Looking forward, companies have no option but to slash capital expenditure, which is to say, slash other companies' earnings, a vicious spiral that carries with it so much potential consequence that the Markit iTraxx Crossover Index is above 1000 for the first time since it was created, inferring that a record…number of companies are on the verge of default."

Now, naturally I have no idea what in the hell any of this means, but I am always very interested in indicators that are in record territory, and I am willing to believe anything bad after hearing the words "on the verge of default".

Then I remember that I am in gold, and I am calmed. Whew!

Of course, I'll be ecstatic when gold zooms in price in response to such fiscal and monetary madness, but right now I am calmed. But really looking forward to ecstasy! And at these rates of monetary insanity, it can't be far away! Whee!

Until next time,

The Mogambo Guru