Can the Rule of 18 predict the market?

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I first encountered the “Rule of 18” when I joined Antares (in one of its earlier incarnations) and entered the world of investment management some 25 years ago. This was the late-1990s and the “Rule of 18” was often discussed and easy to grasp. It is described below:

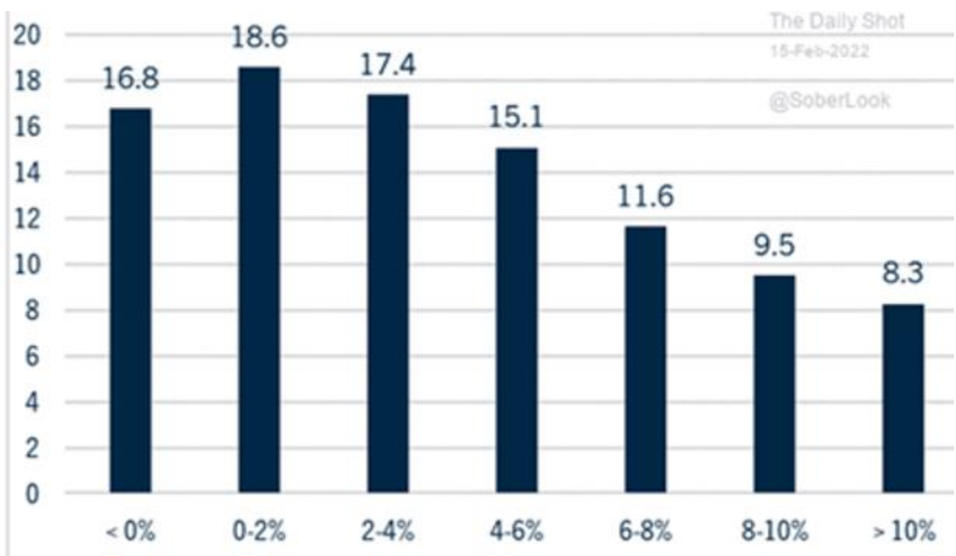
Inflation Rate + Market P/E=18

It’s just a matter of adding the (forward looking) P/E to the current inflation rate, if the number is greater than 18 the market is expensive and if the number is less than 18 its cheap.

As Figure 1 demonstrates, this simple rule has some veracity to it. The column value is the P/E of the S&P 500 and P/E’s are grouped, horizontally, by inflation ranges. A few simple calculations (adding the P/E and the inflation rate) demonstrate the point. For example, with inflation at 0-2%pa, the market P/E has been 18.6x (which when added together is 18.6 - 20.6) yet when inflation has been between 8-10% pa, the market P/E has been 9.5x, (which added together is 17.5 -19.5). Put simply, higher inflation means lower stock valuations.

Figure 1: The rule of 18 – S&P 500 Average P/E by inflation levels

P/E ratio (x)



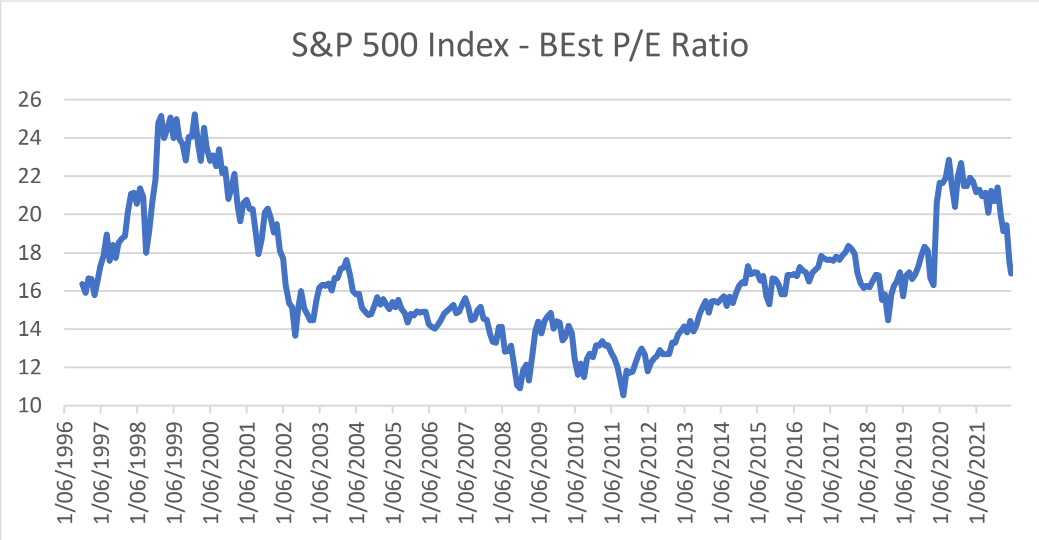
Prevailing inflation rate

Source John Lynch, Comercia Wealth Management; 15 Feb 2022

When I wrote my latest quarterly report in mid-April, we had already seen a decline in market multiples over 2022 (the S&P500 P/E had fallen from 22x to around 19x).

At the time of writing I flagged that with inflation running at ~5%; a fall to 13x would imply a decline of ~30% all else being equal. Since then, as Figure 2 highlights, the US market has fallen to around 16.5x P/E and now appears to be factoring in some of the higher inflation expectations.

Figure 2: S&P 500 Bloomberg Estimated P/E Ratio (x)

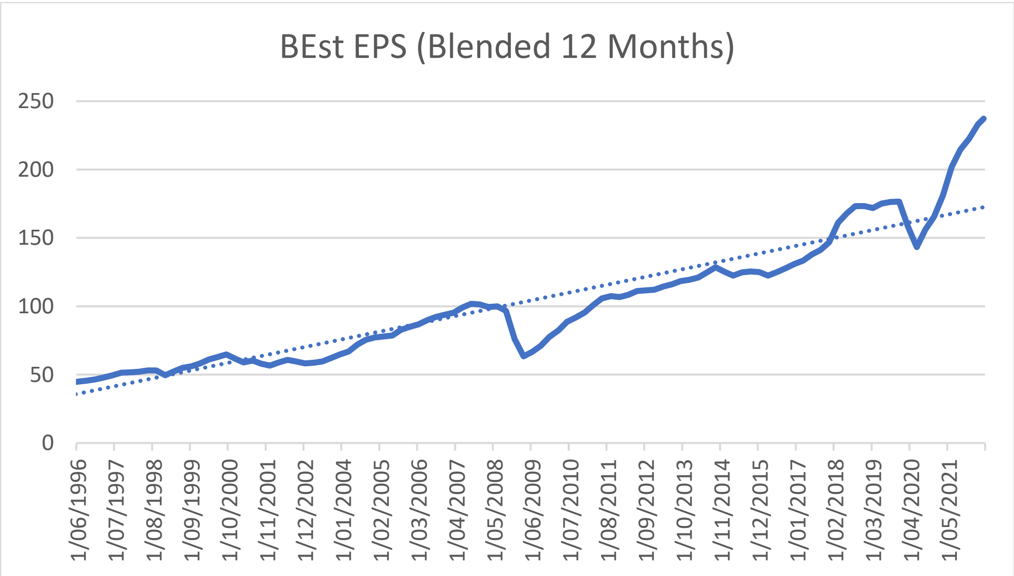


Source: Bloomberg (using Bloomberg earnings estimates), May 2022

As a point of comparison, the Australian market trades at around 14x P/E and, at this stage, inflation rates are lower than those experienced in the US.

But attention also needs to be given to the “E” (earnings) in the P/E equation. As illustrated in Figure 3, the last 12-18 months have seen an acceleration of EPS growth in the market, well above the historical trend. Time will tell if these earnings can be sustained or if the next chapter is about the re-basing of earnings back to the long-term trend or potentially even lower, and that is not good news for the market.

Figure 3: S&P 500 Bloomberg Est EPS



Source: Bloomberg (consensus earnings per share S&P 500); May 2022

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