THE P/E REPORT:
QUARTERLY REVIEW OF THE PRICE/EARNINGS RATIO

By Ed Easterling
May 31, 2009 Update
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	AS OF: MAY 31, 2009	REPORTED	ADJUSTED[1]	CRESTMONT[2]
"P"	Closing Price (S&P 500 Index)[3]	919	919	919
"E"	Current Estimate (S&P 500 EPS)[4]	$ 7	$ 56	$ 62
P/E	Price/Earnings Ratio[5]	133.1	16.4	14.8

Notes:
(1) adjusted using the methodology popularized by Robert Shiller (Yale; Irrational Exuberance*), as modified for quarterly data*
(2) based upon historical relationship of EPS and GDP as described in chapter 7 of Unexpected Returns: Understanding Secular Stock Market Cycles*; useful for predicting future business cycle-adjusted EPS*
(3) S&P 500 Index is the value at the date listed in the table
(4) 'Reported' is based upon actual net income for the past year (trailing four quarters); 'Adjusted' is an inflation-adjusted multi-year average; 'Crestmont' see note 2
(5) P divided by E

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CURRENT STATUS (Mid Second Quarter 2009)
The P/E has returned to near year-end 2008 levels and is 'somewhat undervalued'); the stock market remains positioned for nearer-term above-average returns (assuming that the economy is not expected to enter a multi-year period of significant deflation or relatively high inflation). The 'Reported' measure of EPS and P/E, reflecting the most recent four quarters, is becoming more distorted. This is the typical distortion that occurs during earnings cycle troughs. Reported P/E could rise further (or go negative) as the distortion increases. Be aware of the distinction between Reported P/E and the normalized P/Es in media articles and analysts reports that suggest relatively high overvaluation.

NOTE: Crestmont Research does not analyze the stock market or interest rates with a perspective about near-term direction or trends; Crestmont Research focuses on a longer-term, bigger picture view of market history and its fundamental drivers. Occasionally, the analysis indicates that a position has extended beyond the typical range of variation. In those, times, the view can have relatively shorter-term implications. Also in those times, however, markets can take a path that is longer and farther than most investors expect to ultimately be restored to a midrange position of balance of condition.

Details and descriptions about the Crestmont and Adjusted methodologies for P/E and its components are provided later in this report. In summary, the Adjusted methodology, popularized by Robert Shiller (Yale; Irrational Exuberance), uses the trailing ten-year average earnings adjusted for inflation; the Crestmont methodology uses earnings based upon its long-term trend with the economy.

RECENT STATUS

(Mid First Quarter 2009)
The 18.6% year-to-date decline has returned P/E to fairly undervalued (from 'somewhat undervalued') and has positioned the market for nearer-term above-average returns (assuming that the economy is not expected to enter a multi-year period of significant deflation or relatively high inflation).

(Year End 2008)
Despite a modest recovery in the stock market since the most recent report, P/E remains somewhat undervalued and positioned for nearer-term above-average returns (assuming that the economy is not expected to enter a multi-year period of significant deflation or relatively high inflation).

(Mid Fourth Quarter 2008-II)
The declines in the stock market that have continued during the fourth quarter have been significant enough to further change the status: P/E is now fairly undervalued and positioned for nearer-term above average returns (assuming that the economy is not expected to enter a multi-year period of significant deflation or relatively high inflation).

(Mid Fourth Quarter 2008)
The declines in the stock market during October have been significant enough to change the status: P/E is now relatively undervalued and positioned for nearer-term above average returns (assuming that the economy is not expected to enter a multi-year period of significant deflation or relatively high inflation).

(Late Third Quarter 2008)
The reported price/earnings ratio ("P/E") in recent years was distorted downward due to an interim peak in the earnings cycle. The reported P/E ratio has been restored to near normalized levels as the result of the reversion of earnings to near long-term trend levels. The normalized P/E is relatively-high in relation to historical averages, a reflection of relatively-low expected inflation (and long-term interest rates). But, P/E is now highly-vulnerable to decline due to expectations by some toward higher inflation and by others toward potential deflation. Low, stable inflation is required to sustain P/Es at or above 20.

ADDITIONS TO THIS APRIL 30, 2009 UPDATE

Appendix B: ALTERNATE ECONOMIC SCENARIOS
Has the decade of the 2000s been an aberration…thus the long-term trend growth rate (and next decade's growth rate) for the economy will return to 3%? Has the economic growth rate down-shifted to near 2%...thus the long-term trend growth rate for the economy would be significantly below 3%? Is the decade of the 2000s a coincidental period with two recessions…positioning for an upcoming period for above-average growth? Each scenario has important implications for P/E.

Future updates of The P/E Report may include new material, analysis, or charts, which will generally either be highlighted on this second page or included as an appendix.

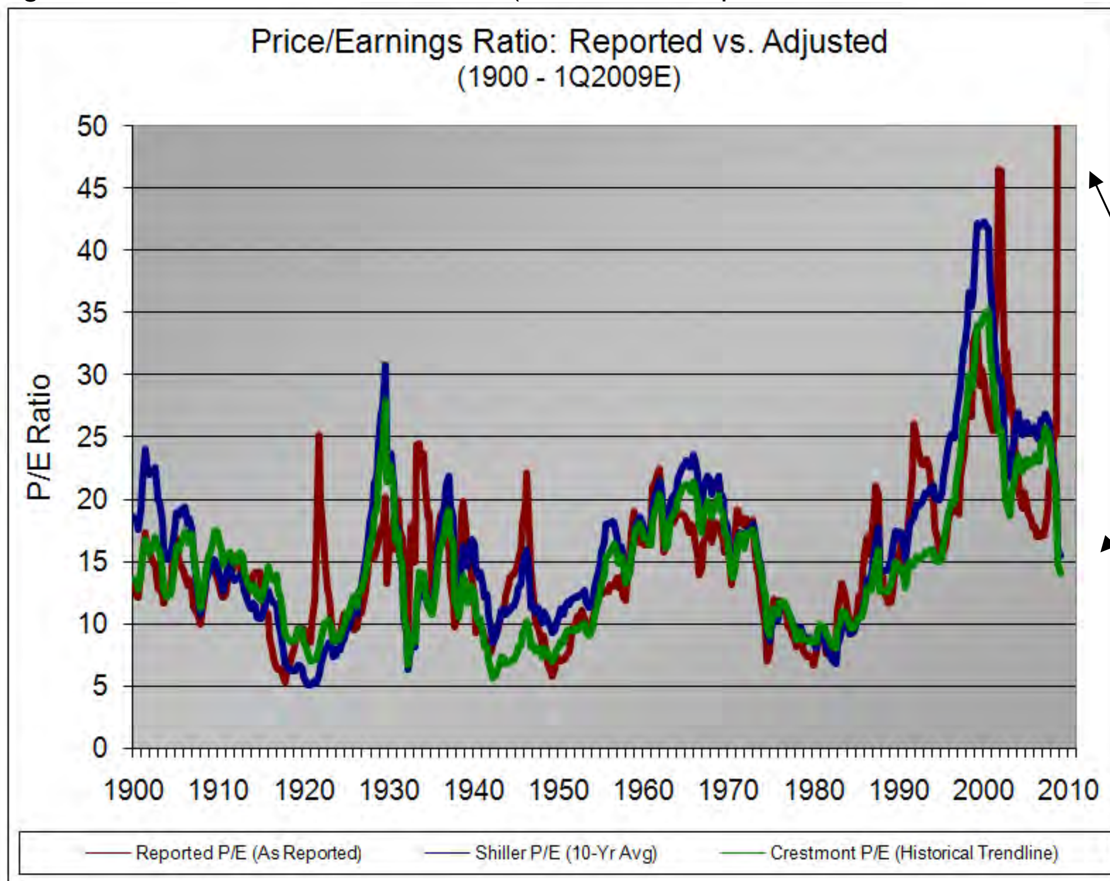
THE BIG PICTURE

The P/E ratio can be a good measure of the level of stock market valuation when properly calculated and used. In effect, P/E represents the number of years worth of earnings that investors are willing to pay for stocks. Although we will discuss later the business cycle and its periodic distortion of ‘reported’ P/Es, most references to P/Es in this report will relate to the normalized P/E that has been adjusted for those periodic distortions.

Stocks are financial assets which provide a return through dividends and price appreciation. Both dividends and price appreciation are generally driven by increases in earnings. Earnings tend to increase at a similar rate to economic growth over time.

Historically (and based upon well-accepted financial and economic principles), the valuation level of the stock market has cycled from levels below 10 times earnings to levels above 20 times earnings. Except for bubble periods, the P/E tends to peak near 25 (the fundamental limitations to P/E are discussed in chapter 8 of *Unexpected Returns*). Figure 1 presents the historical values for all three versions of the P/E discussed in this report.

Figure 1. P/E Ratio: 1900-4Q2008E (4Q08 based upon EPS estimates from S&P)



Note the significant business cycle divergence in P/E.

Similar to the last distortion in 2001, P/E can send a false signal of overvaluation, just as it becomes significantly undervalued.

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What drives the P/E cycle? The answer is inflation—the loss of purchasing power of money and capital. During periods of higher inflation, investors want a higher rate of return. To get a higher rate of return from stocks, investors pay a lower price for the future earnings (i.e. lower P/Es). Therefore, higher inflation leads to lower P/Es and declining inflation leads to higher P/Es.

The peak for P/E generally occurs at very low and stable rates of inflation. When inflation falls into deflation, earnings (the denominator for P/E) begins to decline on a reported basis (deflation is the nominal decline in prices). At that point, with future earnings expected to decline from deflation, the value of stocks declines in response to reduced future earnings—thus, P/Es decline.

Secular market cycles are not driven by time, but rather they are dependent upon distance.

Therefore, for this discussion, assume that there are three basic scenarios for inflation: rising, low, and deflation. As discussed above, rising inflation or deflation that cause the P/E ratio to decline over an extended period creates a secular bear market. From periods of higher inflation or deflation, the return of inflation to a lower level that causes the P/E ratio to increase over an extended period creates a secular bull market.

Secular bull markets can only occur when P/E ratios get low enough to then double or triple as inflation returns to a low level. As a result, secular market cycles are not driven by time, but rather they are dependent upon distance—as measured by the decline in P/E to a low enough level to then enable a significant increase.

Cyclical vs. Secular: Jury Is Still Out

The current P/E is near 15—just below the historical market average. BUT, secular markets are driven by longer-term annual trends rather than momentary market disruptions.

The secular market P/E for 2008 is near 20!... What!... Why!...

The secular analysis for each year relates to the average index across the year; so for 2008, the price (P) in P/E (price/earnings ratio) is the average index for all days of the year. The year 2008 started with the S&P 500 Index near 1500, reached a daily-close low of 752, and ended with the Index at 903; the average daily Index across the year is 1220. As a result, the normalized P/E for 2008 is near 20.

What's the implication? The current P/E is below the average for the longer-term trend—either (1) the result of a significant change in the economic or inflation outlook or (2) the result of an irrational period driven by runaway emotions and market illiquidity. Based upon other indications currently in the marketplace, #2 seems more likely, yet the risks of the first should be monitored closely.

If the stock market recovers significantly in 2009, the average Index for 2009 could present a P/E multiple in the upper teens or higher…making the period in late 2008 just a cyclical (short-term) bear market blip within a longer secular bear market. Of course, that would make 2009 a typical cyclical bull market inside a secular bear market (it has happened many times before).

If the stock market does not recover due to currently unexpected inflation or deflation and if 2009 has the S&P 500 Index near or lower than we are today, the P/E for 2009 will mark itself well below-average and the foundation for a secular bull market will begin to be laid. Yet, if the stock market does not recover due to irrational and illiquid financial market conditions, then we may need to wait a bit longer to determine where we are in the secular stock market cycle.

We're in a period with many daily (often hourly) pixels. Patience may be a virtue, yet extraordinary insights about the likely direction are the only way to predict the future course. Without extraordinary powers, the best plan is a diversified, non-correlated portfolio with a few engines to counterbalance the weaker components of the portfolio.

BACKGROUND & DETAILS

As described further in "The Truth About P/Es" in the Stock Market section at www.CrestmontResearch.com, P/E ratios can be based upon (a) trailing earnings or forecast earnings, (b) net earnings or operating earnings, and (c) reported earnings or business cycle-adjusted earnings.

> (a) The historical average for the P/E is 15 based upon reported trailing earnings. If forecast earnings is used, the average P/E is reduced by approximately one multiple point to 14.
>
> (b) Substituting operating earnings for net earnings would further reduce the average by almost three points to 11.
>
> (c) Although the effect of the business cycle is muted in longer-term averages, the currently-reported P/E varies significantly due to the business cycle (more later).

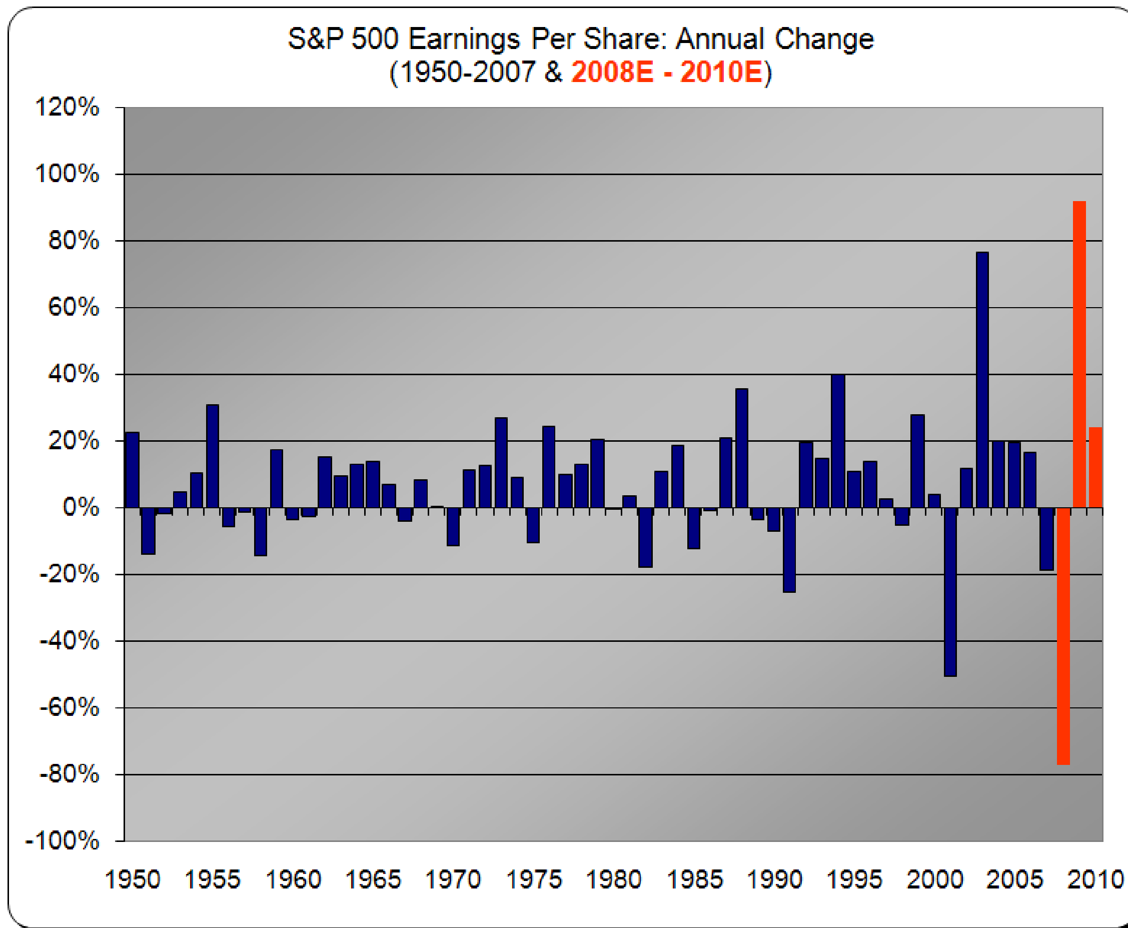
It is important to ensure relevant comparisons—that is, P/Es that are based upon trailing reported net earnings should only be compared to the historical average of 15. Too often, writers and analysts compare a P/E that is based upon forecast operating earnings to the average for trailing reported net earnings. Although long-term forward operating earnings data is not available, the appropriate P/E for that comparison would be closer to 11.

Yet the most significant distortion from quarter-to-quarter or year-to-year is due to the earnings cycle, or as some refer to it, the business cycle.

The Business Cycle

As described further in “Back To The Horizon” and “Beyond The Horizon” in the Stock Market section at www.CrestmontResearch.com, corporate earnings progresses through periods of expansion that generally last three to five years followed by contractions of one to two years. The result of these business cycles is that earnings revolves around a baseline relationship to the overall economy. Keep in mind that the business cycle is distinct from the economic cycle of expansions and recessions.

Figure 2. EPS: S&P 500 Companies (1950 to 2010E)



Note how the pattern of the earnings cycle—three to five years up followed by one or two of declines—appears to again be repeating…

The business cycle is not dead yet.

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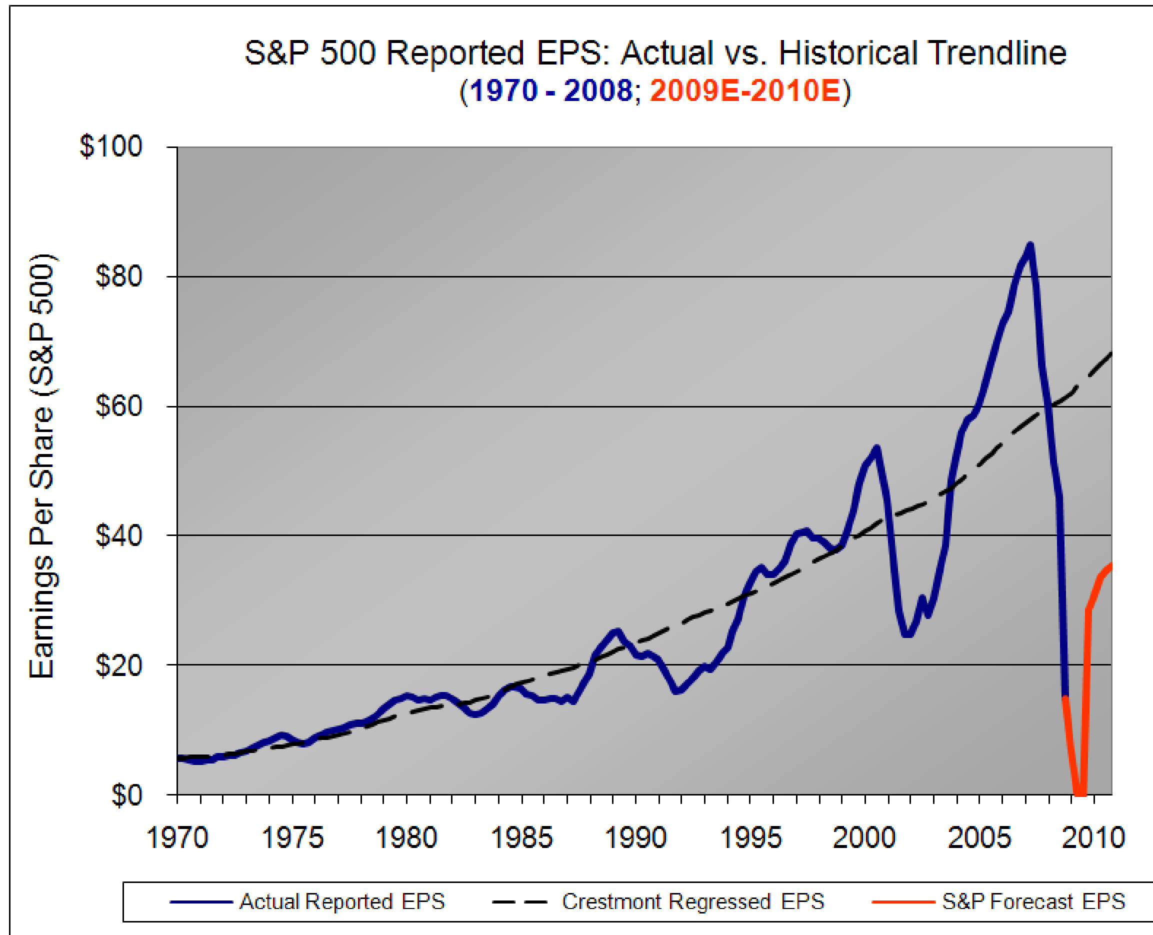
For example, looking back over the past six decades, Figure 2 presents the annual change in earnings historically reported by the S&P 500 companies and forecasted by Standard & Poors. This graph highlights the surge and decline cycle of earnings growth that is driven by the business cycle.

When the reported amount of earnings is viewed on a graph, the result is a generally upward sloping cycle of earnings growth. Since earnings ("E") grows in a relatively close relationship to economic growth (GDP) over time, there is a longer-term earnings baseline (as discussed in chapter 7 of *Unexpected Returns*) that reflects the business cycle-adjusted relationship of earnings to economic growth (GDP). Figure 3 presents actually reported E for the S&P 500 over the past four decades compared to the longer-term baseline.

Figure 3. EPS: Reported vs. Trend Baseline (1970 to 2010E)



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The past few legs of the cycle have swung more dramatically than it has in the past.

Will that accentuation continue? Or, will we finally get back on track?

If history is a guide, we shouldn't be surprised if EPS for 2009 and/or 2010 exceeds current estimates…

Why does this matter? Because if you only look at the P/E ratio reported for any quarter or year, the ratio during peaks and troughs will be quite distorted when compared to the more stable long-term average. About every five years or so, the reported P/E will reflect the opposite signal in contrast to a more rational view of P/E valuations. For example, the reported value for P/E in early 2003 reflected a fairly high value of 32 just as the S&P 500 Index had plunged to 800 (E had cycled to a trough of $25 per share). A P/E of 32 generally screams "sell" to most investment professionals; yet, in early 2003, that was a

false signal! A more rational view using one of the business cycle-adjusted methods reflected a more modest 18. In a relatively low inflation and low interest rate environment, the scream should have been “Buy”…

Several years later, in 2006 (after an unusually-strong run in earnings growth), E peaked at $82 per share as the S&P 500 Index was hesitating at 1500. Most market pundits were recommending a strong “buy” due to a calculated P/E of *only* 17. Yet, using the rational business cycle-adjusted methodologies, the true message was “STOP”—P/Es were saying sell, with P/E more than 25.

Well the pundits were actually (sort of) right—P/Es did expand… Yet it was due to (what should have been expected) the normal down-cycle in E rather than the pundit-promoted increase in the stock market. So now that investor’s stock market accounts are down almost 50%, they were handed explanations that the earnings decline was unexpected and the fault of the financial sector…

Many of the same pundits had been hopefully-predicting that E will be back to its recent lofty levels soon. Again they are right—the reported P/E is now at 131 and may even go higher. Not necessarily due to a rally in the market, but due to further predicted declines in E over the next quarter or two. Of course (now that the market is down dramatically), those pundits have turned cautious since the reported P/E is so high.

If history and economics are reasonable guides, this may again be another one of those periods of reverse signals that occurs every five years or so…

METHODS

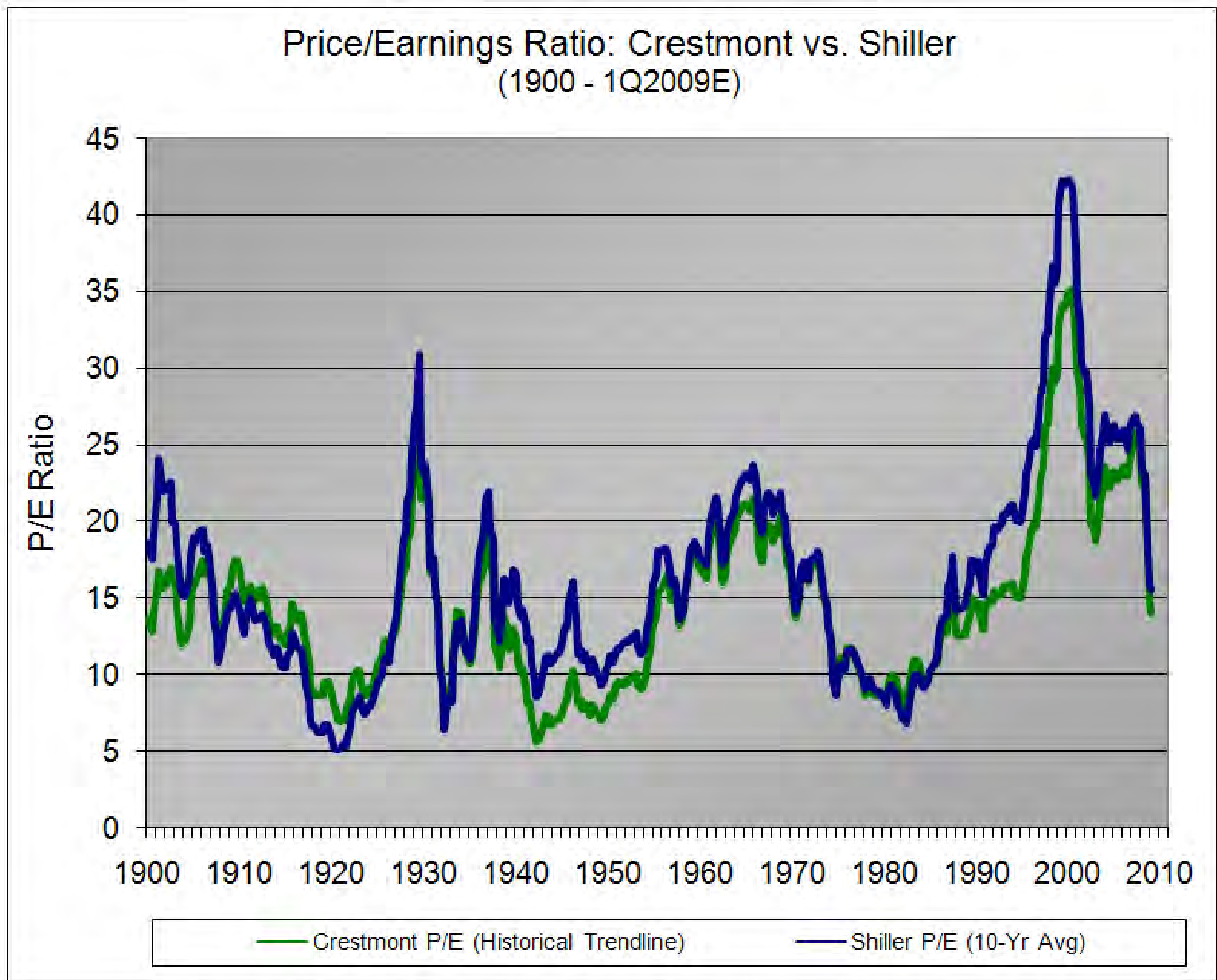
To adjust for the variability of earnings across business cycles, a rational methodology is needed to reduce distortions and provide a normalized reading about the long-term level and trend in earnings. The most recognized methodology is the one popularized by Robert Shiller (Yale) in Irrational Exuberance and on his website. To smooth the ups and downs in earnings, his methodology creates an average of the reported earnings for the past ten years. To eliminate the effect of inflation, all earnings values are adjusted-forward and increased by the impact of inflation. The result is a ten-year average for E. Using the current stock market index value, we have a more rational view of the current P/E valuation of the stock market.

For historical values, whether it relates to a month or a year in the past, Shiller also adjusts the stock index value by averaging the closing price for each day during the period. The stock index adjustment reduces historical distortions caused by significant intra-period swings by the market.

Crestmont has developed a complementary methodology—one that is fundamentally-based—that produces similar results, yet also provides forward-looking insights. The

approach is explained further in Chapter 7 of *Unexpected Returns*, yet in summary, it uses the close and fundamental (not coincidental) relationship between earnings per share ("E") and gross domestic product (GDP) to adjust for the business cycles. The baseline E for each period essentially is based upon mid-point values for E across the business cycle—peak and trough periods of actual earnings reports are adjusted back to the underlying trend line to reduce the intra-cycle distortions.

Figure 4. P/E Ratio Methodologies: Crestmont vs. Shiller



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The historical relationship between Crestmont and Shiller is similar, as reflected in Figure 4, yet the Crestmont approach enables analysts to estimate an expected level of E based upon future economic growth (which is fairly consistent over time). Also, by comparing reported E to baseline E, analysts and investors have a better understanding of the current position in the business cycle and magnitude of divergence above or below the long-term trend.

DISTANCE, NOT TIME

Secular bull markets can only occur when P/E ratios get low enough (due to high inflation or significant deflation) to then double or triple as inflation returns to a low level. As a result, secular market cycles are not driven by time, but rather they are dependent upon distance—as measured by the decline in P/E to a low enough level to then enable it to have a significant increase.

The table that follows in Figure 5 provides a representation of the 'distance' that would be required to reposition for a secular bull market. The scenario presents the typical historical starting point for secular bulls (i.e. P/Es below 10).

Note that this analysis does not include the dynamic of 'time'. As we continue forward in time, the normalized level of earnings ("E") will increase and naturally close the gap without the declines presented below.

This is not a prediction—I hope that we avoid a move to lower P/Es and keep this secular bear in hibernation. The result would be approximately 6% total returns from the stock market including inflation; yet, it would avoid the devastatingly-low returns marked by full secular bear markets (see "Waiting For Average" at www.CrestmontResearch.com for a tally of the future expected return).

Nonetheless, since one of the most common questions is "when will this secular bear market end," the table in Figure 5 seeks to answer that question and to highlight that secular market cycles are determined by 'distance' and not by 'time'.

Figure 5. Distance To The Next Secular Bull?

	AS OF: MAY 31, 2009		ADJUSTED[1]	CRESTMONT[2]
"P"	Closing Price (S&P 500 Index)[3]		919	919
"E"	Current Estimate (S&P 500 EPS)[4]		$ 56	$ 62
P/E	Price/Earnings Ratio[5]		16.4	14.8
	Historical Secular Bull Start	10.0		
	Implied S&P 500 Index		560	620
	Distance Away		-39%	-33%

Notes 1-5: see footnotes in Figure 1

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POTENTIAL DISTANCE

As reflected in Figure 6, the current level of the stock market valuation, as reflected in the P/E, provides the potential for relatively-attractive gains if financial markets stabilize, economic growth continues on average at historical growth rates, and inflation remains relatively low. A P/E of 22.5 is used as a mid-range for P/Es in low inflation and low interest rate environments.

Figure 6. Stock Market Gain/Loss To Low Inflation P/E Levels

	AS OF: MAY 31, 2009			CRESTMONT[2]
"P"	Closing Price (S&P 500 Index)[3]			919
"E"	Current Estimate (S&P 500 EPS)[4]			$ 62
P/E	Price/Earnings Ratio[5]			14.8
		P/E	EPS	
	3-Year Restoration (2Q2012)	22.5		
	Projected Normalized EPS[2]		$74	
	Implied S&P 500 Index			1665
	Annual Compounded Gain			21.9%
	5-Year Restoration (2Q2014)	22.5		
	Projected Normalized EPS[2]		$82	
	Implied S&P 500 Index			1845
	Annual Compounded Gain			15.0%

Notes 1-5: see footnotes in Figure 1

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CONCLUSION

Although today's P/E is below 15, the stock market remains in secular bear market territory—yet relatively undervalued under the expectation of a relatively low inflation and interest rate environment. It is historically consistent for secular bear markets to present shorter-term periods of strong returns (cyclical bull markets) followed by periods of market declines (cyclical bear markets).

The only way to reposition into a secular bull market is to experience a decline in the stock market relative to the growth in earnings due to significant inflation or deflation. This can occur either by a significant decline over a short period of time (e.g. the early 1930s

secular bear market) or by minimal decline over a longer period of time (e.g. the 1960s-1970s secular bear market).

This report assesses the current valuation level in the context of the longer-term market environment. The goal is to help investors and market spectators to assess more quickly the current conditions. For the full year 2008, the annual P/E (based upon the average index across the year) is 20. That is significantly higher than the normalized P/E using only the year-end index. Annual values are used for longer-term secular market analysis; the current normalized P/E is more relevant for investors' shorter-term analysis. If the market stayed at current levels for the rest of the year, the annual P/E for 2009 would reflect the current value near 13. Thus, the 'current' look at the market (i.e. relatively undervalued) is a reasonable assessment of the valuation level available to investors today, even if the annual values do not yet reflect the significant declines.

In this environment, as described in chapter 10 of *Unexpected Returns*, investors should take a more active "rowing" approach (i.e. diversified, actively managed investment portfolio) rather than the secular bull market "sailing" approach (i.e. passive, buy-and-hold investment portfolio over-weighted in stocks).

Ed Easterling is the author of Unexpected Returns: Understanding Secular Stock Market Cycles*, President of an investment management and research firm, and a Senior Fellow with the Alternative Investment Center at SMU's Cox School of Business where he previously served on the adjunct faculty and taught the course on alternative investments and hedge funds for MBA students. Mr. Easterling publishes provocative research on the financial markets at www.CrestmontResearch.com.*

APPENDIX A
EARNINGS HISTORY & FORECASTS

Why does the version of "earnings" matter?

Stockholders generally value the stocks of publicly-traded companies based upon their future cash flows, which is largely based upon future dividends (academics employ the principles of the so-called Dividend Discount Model). To grow, companies need to retain a certain amount of their earnings; the remainder of the earnings is available to pay dividends. Dividends are paid from net earnings—net earnings are also the basis of historical P/E ratios.

History confirms the basic economic principles: Earnings go through a cycle of above-average growth followed by short-term declines. Some of the short-term declines occur due to one-time charges, yet other factors also impact profit margins. Analysts have been pressured to develop a measure of earnings that is less volatile than reported earnings—a measure that is now known as 'operating earnings per share'. Although 'as reported' earnings are based upon detailed accounting principles (known as GAAP), 'operating earnings' is a measure of profits that is developed by adding-back subjectively determined charges that reduced earnings. There are agreed standards for 'as reported' earnings; there is not a standard for 'operating earnings'.

As reflected in Figure 7, there are several measures of earnings. Two of them vary significantly; one of them is fairly stable.

"As Reported" earnings reflects the past and projected (by S&P analysts) net income from the five hundred large companies in the S&P 500 Index. This measure is based upon Generally Accepted Accounting Principles (GAAP) and is the measure that historical averages are based upon.

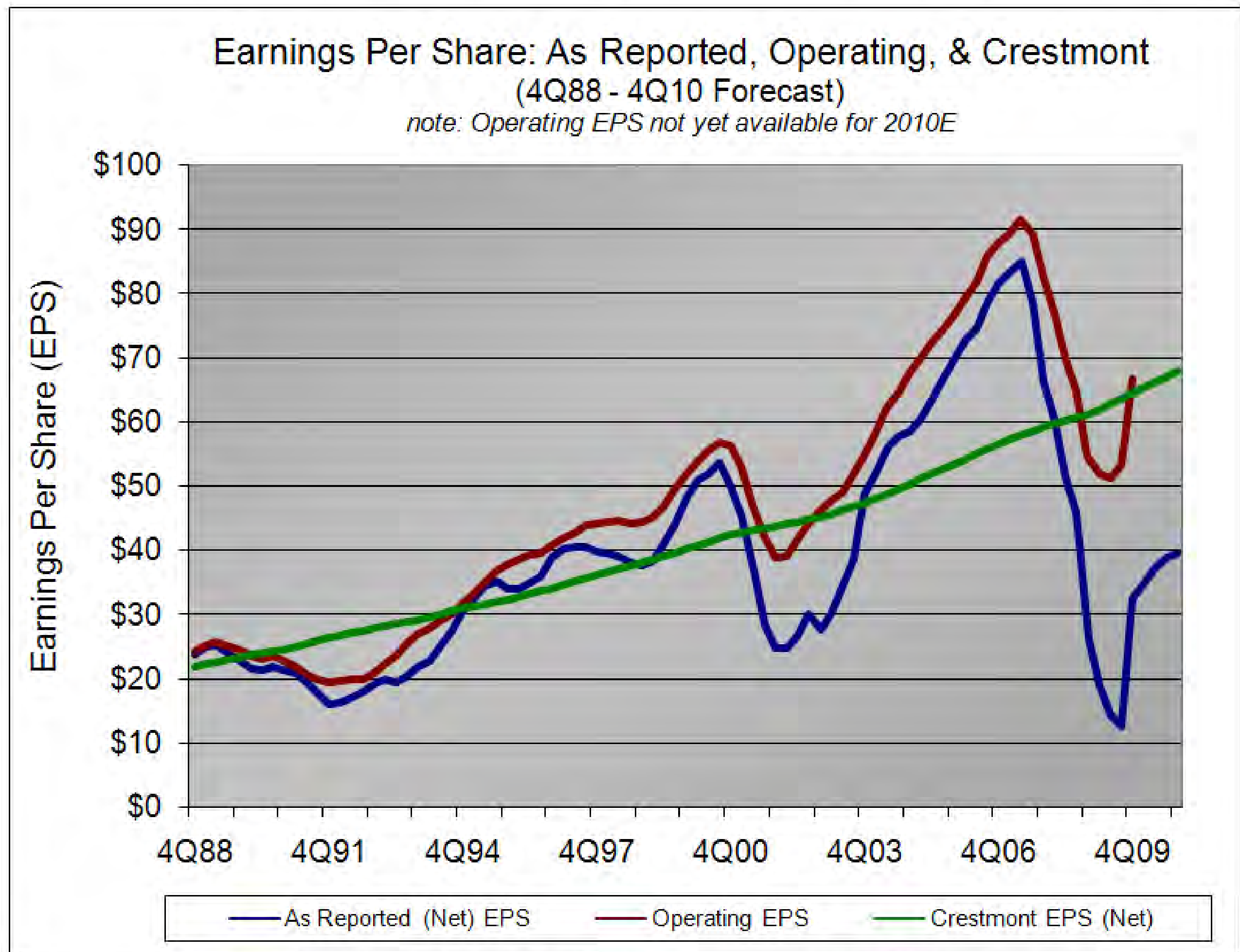
"Operating" earnings reflects a subjective measure of earnings (by other S&P analysts) that adds back certain costs and charges. It attempts to reduce the impact of the business cycle and one-time charges, yet it is generally considered to be an optimistic view of earnings. *This measure of earnings per share (EPS) is NOT comparable to the long-term average P/E, since operating earnings excludes a variety of costs and charges that reduce the funds available for dividends.* On average, 'Operating EPS' is 16% more than 'As Reported EPS'. Since operating earnings is often viewed on a projected basis, the historical average price/earnings ratio (P/E) based upon "Operating EPS" is closer to 10. This contrasts to the historical average P/E based upon 'As Reported EPS" of 15.

"Crestmont" earnings is based upon the long-term relationship of earnings to economic growth. As described in *Unexpected Returns*, the relationship is fairly consistent over time and is a good measure of the baseline for earnings. 'As Reported EPS' has for decades varied around the Crestmont baseline. Crestmont has found that the market tends to anticipate the long-term trend and the market resists the temptation to fully-adjust to the

short-term business cycle of earnings. In other words, the market tends to stall at the highs in the earnings cycle (e.g. 2007) and tends to resist declining when earnings are near cycle lows (e.g. 2002).

Figure 7 presents EPS from Standard And Poor's for "As Reported" and "Operating" (actual prior to 4Q08; forecast for the balance of 2008 and 2009-2010) and from Crestmont through 2010.

Figure 7. Earnings Per Share: As Reported, Operating EPS, & Crestmont EPS



NOTE: On an annual basis, the historically-consistent value for the P/E in 2008 is near 20 (i.e. average daily index of 1220 and annual earnings of $61). Although the long-term charts will reflect a P/E slightly below the level that would be expected for the current economic (expected inflation) conditions, the current level of the stock market suggests a valuation that is fairly attractive for long-term investors in the stock market.

APPENDIX B
ALTERNATE ECONOMIC SCENARIOS

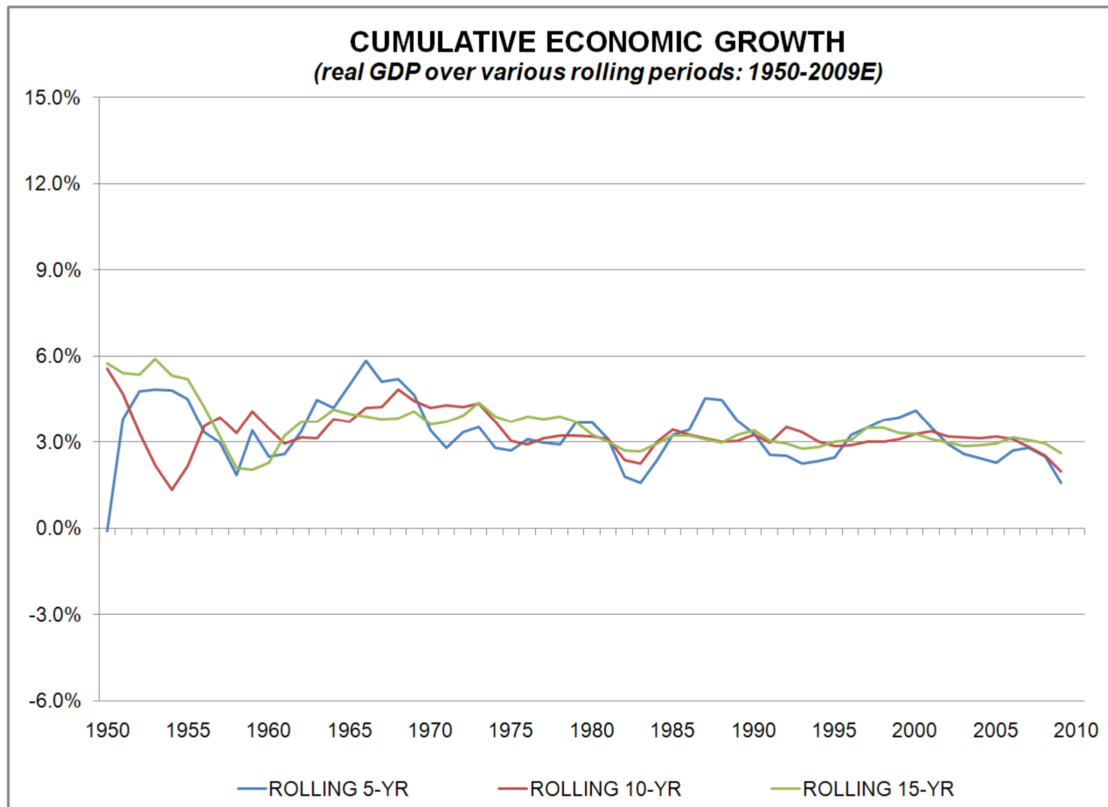
Consternation [con-ster-na-tion]
A sudden overwhelming fear and alarm resulting from the awareness of danger that results in confusion and dismay…

And so it was for Alice falling through the looking glass, now we confront a new frontier of uncertainties. One is an outlook that leads to high clouds; the other explains our current circumstance and may lead to further declines in the financial markets (particularly the stock market).

IS A PRIOR 'GIVEN' UNCERTAIN NOW?

During the last century, real economic growth averaged near 3%. The last three completed decades delivered 3.2%, 3.0%, and 3.1% respectively. Yet, the soon-to-be-completed decade (2000-2009) is likely to post real economic growth near 2%. Is this an aberration or a new trend?

Figure B1: Rolling Periods: GDP-R 1950-2009E



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Aberration

Aberration is our first scenario. Numerous economists were consulted and various data were evaluated—there do not appear to be generally-recognized reasons that explain the sudden shift in real economic growth during the current decade to near two-thirds of both the historical average and prior three decades. The most reasonable explanation is that the decade of 2000 includes two recessions that coincidentally bookend the period. A graphical review (Figure B1) of economic growth history using 5, 10, and 15-year rolling periods (through the estimated trough of 2009) reflects a common pattern. Thus, the decade of 2000-2009 could be a statistical anomaly.

Trend

Trend is our second scenario. Trends don't require an explanation to be valid…maybe the reason will be known some day in the future. What are the implications IF 2% is the new trend growth rate?

Stocks are simply financial instruments—a payment today for the right to future cash flows. It sounds hard and cold, yet that's it. We invest in financial instruments to get a return. The level of return is determined based upon market rates (driven by expected inflation) and the probability of losses. For this discussion, let's eliminate the impact of a change in inflation and the probability of losses…so it only leaves the future cash flows. For stocks, the future cash flow stream (over the longer-term) is driven by economic growth. Therefore, if economic growth slows, the future cash flows (i.e. dividends from earnings) from stocks also are reduced.

So to get the same level of investment return, an investor must pay a lower initial price for the reduced cash flows to produce the same expected return. What? …to get similar returns, an investor must pay less if there are lower cash flows to make the same return?

Yes. The impact on stock market valuations—if we have down-shifted to 2% real economic growth—is a drop in the average P/E of about 6 points. As a result, the average would decline below 10 rather than the historical 15 (assuming a repeat of historical inflation cycles). The natural peak during periods of low inflation would be below 20 rather than near the mid-20s.

Few economists, financial analysts, nor this author conclude that this has occurred, yet with the uncertainty of the expected future real economic growth rate, this issue should be better understood.

Reversion

Reversion is our third and final scenario. Hope springs eternal…

Maybe the long-term trend is not lost. This scenario assumes that the factors of economic growth will continue at nearly the same rate: working population growth may not decline

due to delayed baby boomer retirements and productivity won't show a proclivity to fall. As a result, we may be due for a surge in economic growth (typical of post-recession periods) that restores the long term average to *average*. That would portend a period (maybe a full decade) when quite a few years deliver real economic growth that exceeds the historical average 3% rate (maybe 4%, to restore the long-term average to the average).

CONCLUSION

Has the decade of the 2000s been an aberration…thus the long-term trend growth rate (and next decade's growth rate) for the economy will return to 3%? The implication for P/E is an average near 15 and peak near 25…

Has the economic growth rate down-shifted to near 2%...thus the long-term trend growth rate for the economy would be significantly below 3%? The implication for P/E is an average below 10 and peak below 20…

Is the decade of the 2000s a coincidental period with two recessions…positioning for an upcoming period for above-average growth that restores the long-term average to average? Since the long-term growth rate of 3% would remain intact, P/E should average 15 and peak near 25, yet the psychological impact on the market of such rapid growth could drive a near-term overshooting of the fair value level…