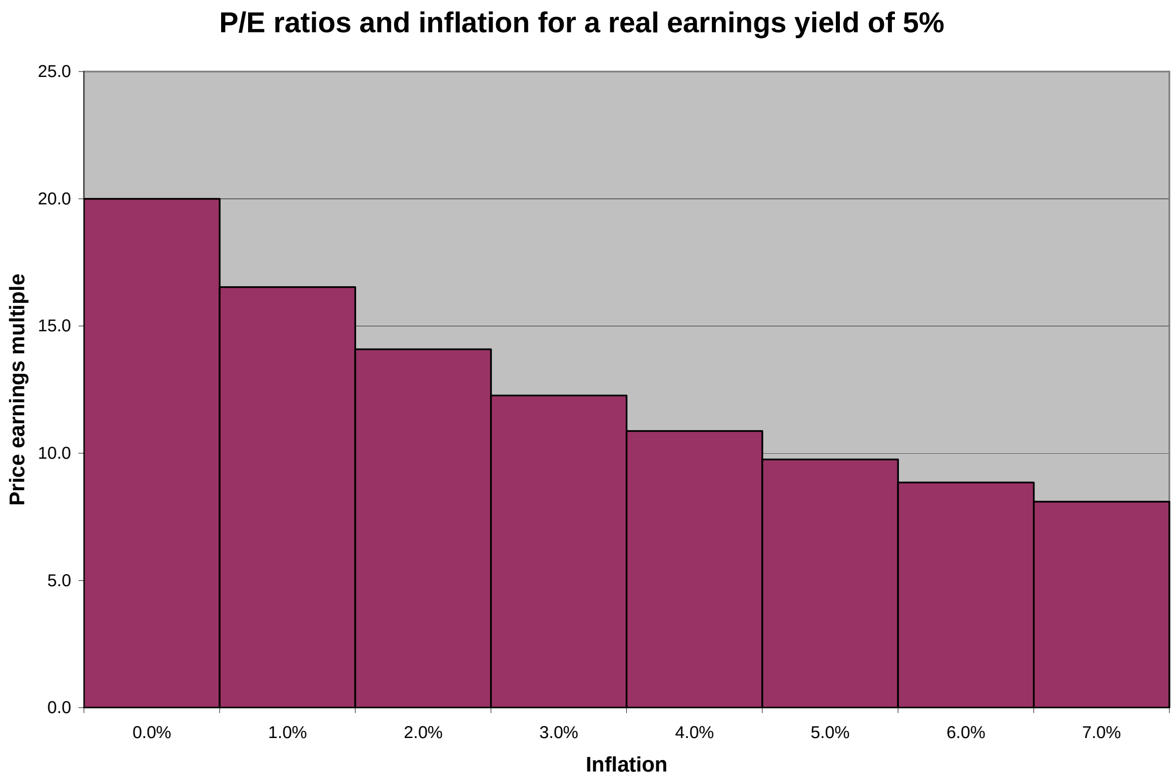
A TAMRIS Perspective

Price multiples, real earnings and inflation

Equities are priced for real rates of return. The following chart (chart 1) shows the price multiple for a 5% real earnings yield at various rates of inflation.

As inflation moves up so should the price multiple fall. Providing the real earnings yield remains the same the price should not change.

Chart 1



What the chart also implies is that following periods of high inflation with inelastic prices that market prices as well as price earnings multiples should also expand as the previous inflation component of the earnings yield becomes real.

What this also means is that following a period of low inflation when prices are relatively inelastic that prices should fall as inflation rises. In a period of low growth, weak consumer demand and rising inflation equity valuations will fall as once real components of the earnings yield now become inflation components.

The second chart shows rising inflation and a declining real earnings yield component. A stagflation environment is bad for stocks.

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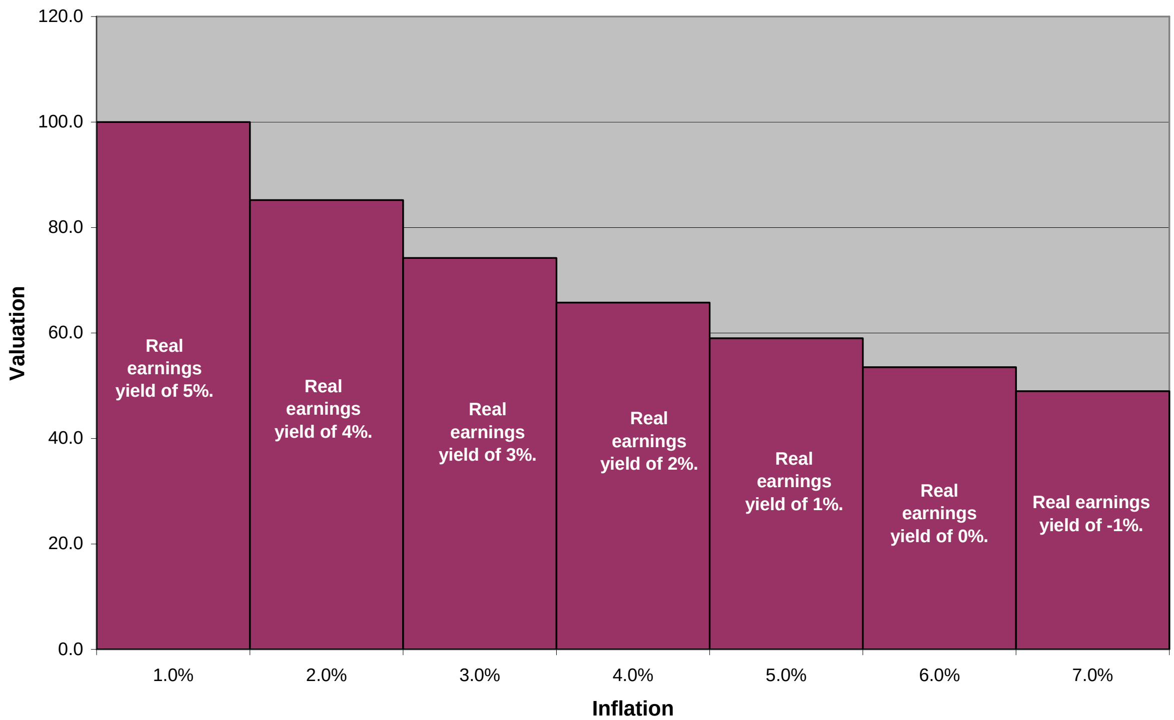
Rising inflation, falling valuations



By implication a long period of low inflationary growth poses a high level of risk for stocks and a long period of high inflation and low growth low risk and high potential returns.

Central banks should be wary of all factors that may risk rising inflation from a low inflationary base. This includes asset price booms whose overhang also puts in place a risk of a lower growth environment.

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