MEICAP Results Pertaining to Price/Earnings Ratios

Similar to interest rates, price/earnings ratios are driven by the Supply and Demand for capital. When the Supply of capital grows, price/earnings ratios go up and interest rates go down. When the Supply of capital shrinks, the opposite is true. The MEICAP model has done an incredible job of modeling P/E ratios for the past 40 years.

The graph at the right displays the model results compared with actual results from 1965. As you can see, the P/E ratios go through trends either up or down according to prevailing economic activity and associated corporate earnings but the general trend is easily identified and the model has exemplified that.

It's very easy to see how investment capital has shifted by viewing this graph. You can clearly see the shortage of investment capital during the late 70s and early 80s after Baby Boomers had spent years already draining their coffers to support their lfestyles. But after that, their accumulating savings expanded the pool of investment capital and P/E ratios rose accordingly (with dramatic spikes along the way).

Stock market investment capital reached its peak in 2001, 2 years before the bond markets. This 2-year difference is a function of the fact that most people favor stock market investments in their early years and bond market investments in their later years. So with the large Baby Boom generation growing older, money devoted to stocks peaked slightly earlier than money devoted to bonds. Again, the model results mirror actual results extremely well.

P/E ratios peaked in 2001 and have already retreated significantly since then. Admittedly, they have come back up during the past year or so (and the graph only includes data up to 2005) but these fluctuations are very normal in stock market activity and vary according to economic conditions and investor confidence. If the economy takes a dip, confidence would erode and stock valuations would bare that out.

You can see by the graph that the long-term trend for P/E ratios is down for the coming 20 years, although not nearly as pronounced as the swing 35 years ago. The other component that needs consideration is the corporate earnings portion and that is covered in the "Stock Prices" page.