P/E Ratio is the driver of secular stock market cycles. Secular bear markets occur when P/E declines over an extended period due to a trend in the inflation rate toward high inflation or deflation. A secular bear also could be driven by a downshift in the long-term economic and earnings growth rate. Secular bull markets are driven by an increase in the P/E ratio due to a trend toward low inflation price stability. As an indicator, P/E is clearly at levels indicating the early stage of a secular bear market.

Inflation: CPI (1900-2020)

The inflation rate is the primary driver of P/E over secular cycle periods. High inflation and deflation drive P/E lower; a low, stable inflation rate fosters a high P/E. The current low inflation rate confirms the early stage of a secular bear market.

Dividends are paid from earnings, thus dividend yield is directly related to earnings yield (E/P)—the reciprocal of P/E. A low dividend yield indicates and confirms a high valuation level (i.e., P/E). The current low dividend yield confirms the early stage of a secular bear market.

Bonds, as well as stocks, are financial assets. The yield on bonds is driven by the inflation rate, which acts as a discounting rate for the value of future cash flows from financial assets. High yields tend to reflect high inflation and very-low yields tend to reflect deflation; thus such extremes generally correspond to low P/E and the start of secular bull markets. The current low yield on bonds confirms the early stage of a secular bear market. [Note: bond yields did not correlate with inflation before the 1960s; see Unexpected Returns for more details.]