New Albany Investment Management

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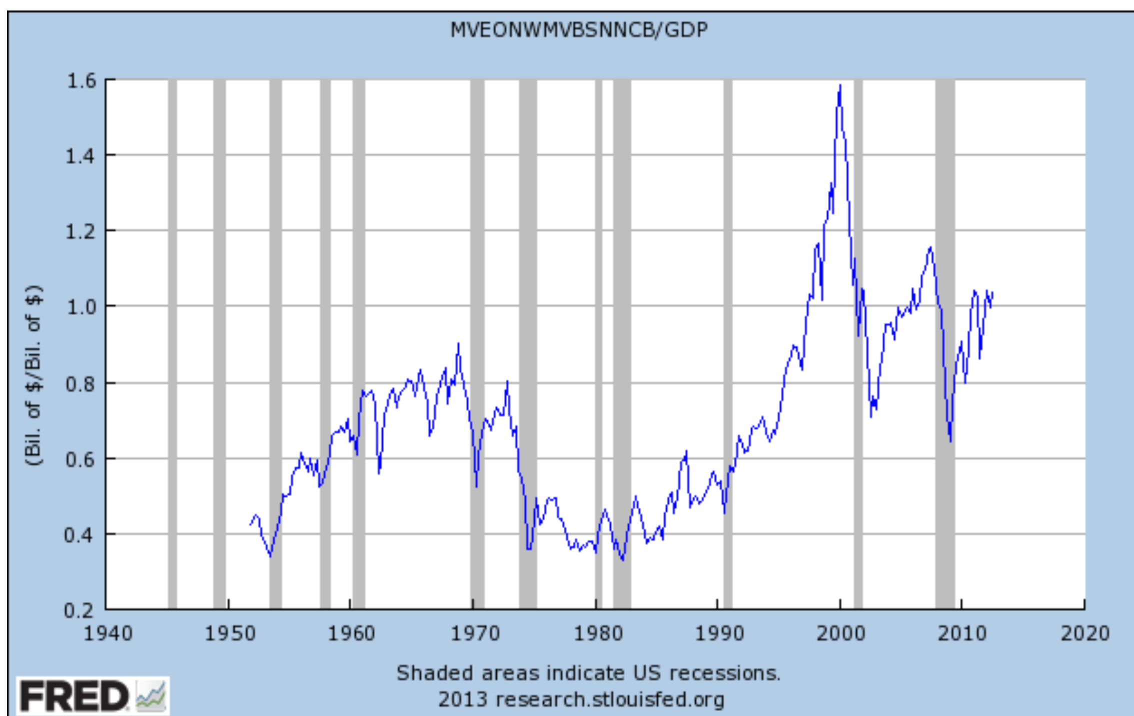
Market Insight
Stocks: Over or Under Valued?

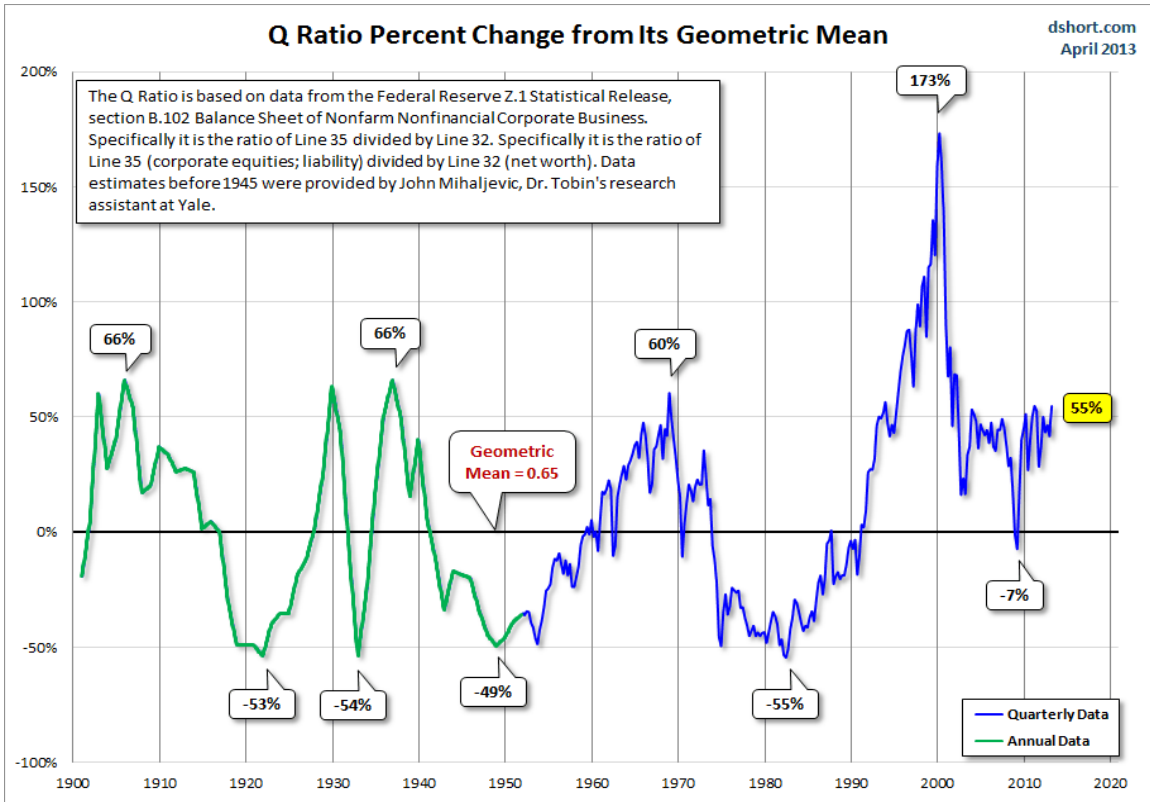
With the US stock market reaching new highs, many are calling price levels another bubble, questioning the sustainability of prices and wondering if the "Sell in May" adage is once again the most prudent course. This week's Market Insight considers six key measures of stock valuation to assess just how expensive stocks currently register. Some indicators show stocks are over valued and others show stocks are undervalued. So which one is correct?

- **Market Cap-to-GDP**: This indicator has been described by Warren Buffet as "probably the best single measure of where valuations stand at any given moment." It compares the total price of all publicly traded companies to GDP. Below is a chart showing the market capitalization of U.S. equities as a percent of GDP since 1954 (gray bars indicate recession periods). According to Mr. Buffet, if the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%--as it did in 1999 and a part of 2000--you are playing with fire. Today, the ratio stands at 1.1, which indicates price levels are not undervalued, but may be approaching overvalued.



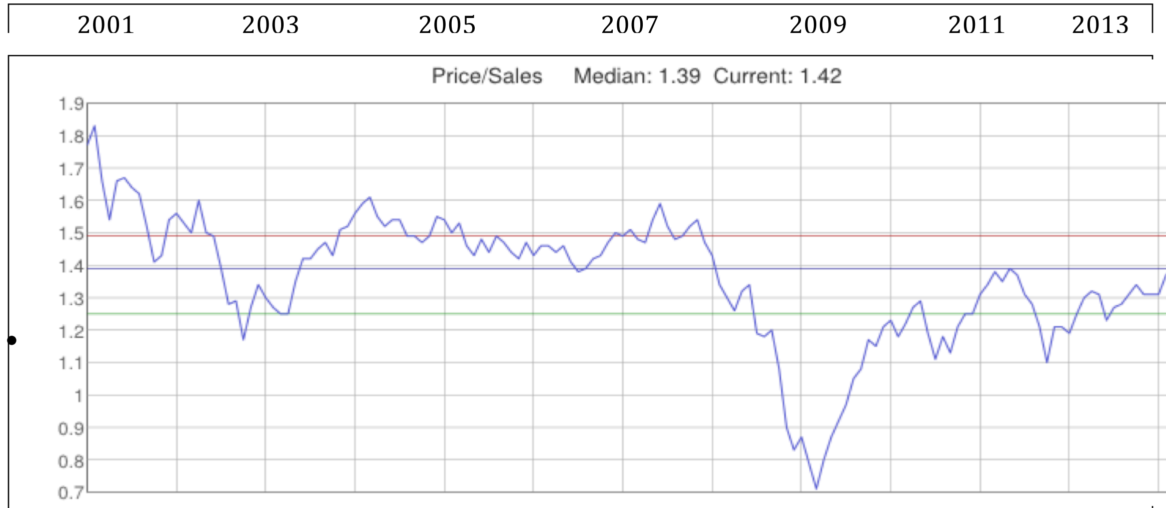
- **Price-to-Earnings**: The P/E ratio is arguably the most common method for determining valuations of both individual stocks and the market as a whole. The P/E ratio divides the price by the earnings of the trailing twelve months. Current market P/E is 18 verses an historical average of 15, and again indicating prices are not cheap. But, this ratio can be problematic as it is combining what has already occurred (previous earnings) with current prices (which reflect future expectations). This can be largely avoided by using other forms of the P/E such as the Q Ratio and Price-to-Sales ratios (Below).

- **The Q Ratio**: A popular method of estimating the fair value of the stock market developed by Nobel Laureate James Tobin and calculated by taking the total price of the market divided by the replacement cost of all its companies. Though not particularly useful as a short-term indicator, the Q Ratio is more appropriate for formulating expectations for long-term market performance. In the chart below, we can see the current Q Ratio is 55%, close to the vicinity of previous market tops, with Tech Bubble peak as an extreme outlier.



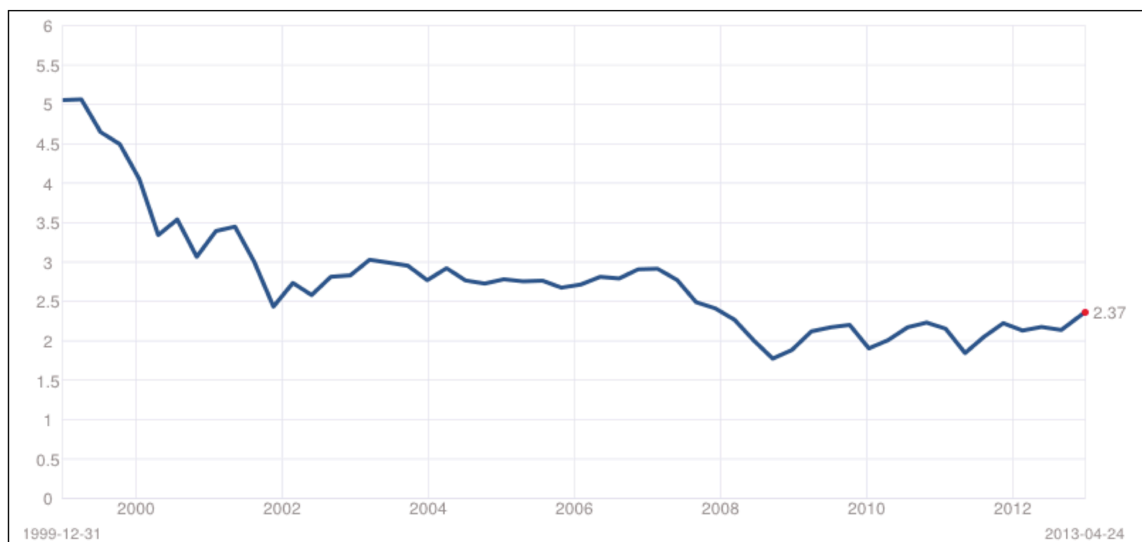
- **Price/Sales Ratio**: This ratio shows how much Wall Street values every dollar of sales. Currently, the S&P P/S is very close to the historical medium of 1.4 and well below the peak during the bubble years of 2000 and 2007. By this measure, stocks appear appropriately valued.

  The chart below shows the Price/Sales Ratio of S&P



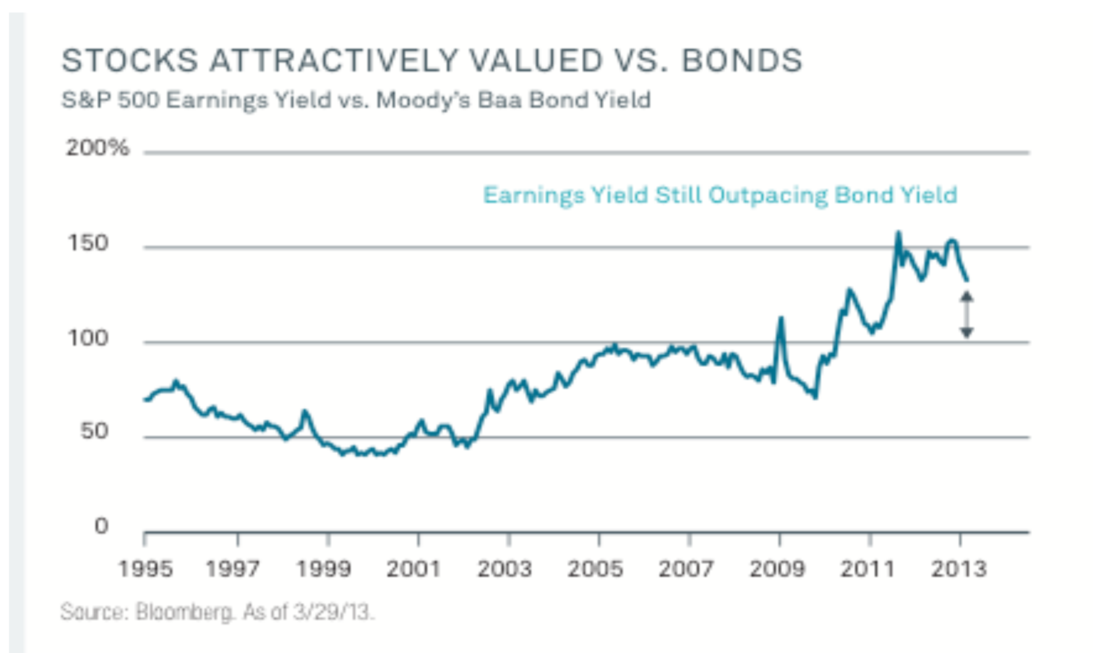
- **Price/Book Value:** This ratio is stated as a multiple of book value or owners' equity. As of late March, the S&P (US large-cap companies) were trading at 2.3x book value and well below the highs reached in 1999 (5x) and 2007 (3X). By this measure, the prices could go higher.

  The chart below shows the historical S&P Price/Book ratio.



- **Earnings Yield of Stocks vs Yield of Bonds Gap:** This measure can be used as a tool to identify how cheap or expensive the stock market is relative to the debt (Bond) market. The earnings yield of stocks (S&P) is calculated by taking the trailing 12month earnings divided by the current index price. When the spread between the stock and bond yield is wide, it is typically better to own stocks. Today the earnings yield of the S&P is 4.6% as compared to Corporate bonds which yield only 3.0% for a spread of 1.6% (or 160bpts).

The chart below shows the historical spread in yield between stocks and bonds. The spread is near its widest level, indicating stocks are cheap compared to bonds.



A wide spread also means companies can utilize cheap financing in the public debt markets to purchase smaller, profitable businesses which can add to earnings. Cheap funding also allows companies the option of repurchasing their own stock through debt-financed share repurchases.

Admittedly, the Fed has played a major role in creating this wide spread through the bond purchase program (QE) that has pushed bond yields down. When rates fall, all other assets (stocks) look more attractive and generally give a lift to prices. So is s this artificial? Maybe so, but as long cheap money is available, it will get redeployed either as direct expenditures or invested- both good for the economy and stocks. Thus, a wide yield gap should buoy stocks at a minimum and potentially give stocks a boost.

Conclusion: These value measurements give conflicting answers as to how cheap or expensive the market is at current levels. Why? They each measure different components of the investment landscape. At best**, these measurements reveal the complexity of factors that influence valuation**. While stock price gains have exceeded earnings growth, valuation metrics do not indicate bubble pricing, rather the **current levels are likely indicative of exceptionally low level of interest rates.** With Cash and Treasuries offering a negative return after inflation, stocks look like a better alternative for now at least. However, the recent large price gains may indeed give pause to the market for several months before likely continuing to grind higher.

Parting thought: Investing is not just about assessing valuation but it also must consider many other factors including domestic and global economic conditions, monetary and fiscal policy. Continuous evaluation of these factors combined with prudent asset allocation and risk management, makes for sound investing.

As always, please contact me with any questions or concerns.

Kind Regards,
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