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BLOG POST

Fair Value or No Value

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One of the most important issues investors must constantly evaluate is whether the stock market represents compelling value or if equities are overvalued. The positioning of portfolios and expectations for future returns are largely determined by what conclusions you come to about valuations. The problem, however, is whether you are a novice investor just starting out or a seasoned professional portfolio manager, there is no clear standard of how to gauge stock market valuations.

History is clear that if you buy stocks when valuations are high, the expected future returns are much lower than if you buy stocks when valuations are low. How you choose to determine valuation can lead to vastly different conclusions. Wall Street consensus valuation models use a discount rate based on WACC (weighted average cost of capital) or the profitability level necessary for a project to move forward. Analysts peg the discount rate for the broad market to short-term interest rates since many large companies and institutions can borrow at very low costs. As a result of the ultra-low interest rates, price-to-earnings ratios can rise without analysts believing the market is overvalued.

While this approach makes sense and is widely followed, it is not necessarily the best gauge of actual valuations of the markets. Another method of valuing stocks is to look at the ratio of total market cap (value of all US listed equities) versus GDP. This valuation method is not impacted by a discount rate and provides a very different look at valuations today. The chart shows that valuations today are higher than they have been since 1970, including the dotcom bubble in 1999. The Buffet Indicator data goes back to 1900 and is a type of price-to-sales versus GDP. That chart suggests only in 1929 were stocks more overvalued than they are today.

Valuations tend to swing like a pendulum over time, moving from undervalued to overvalued and back again. Crestmont Research models suggest the stock market is more than three standard deviations overvalued, a level we would be foolish to ignore, and suggest the pendulum may soon swing in the opposite direction. One of the valuation metrics I track closely is the Tobin's Q Ratio. This compares the value of stocks against their replacement costs. When something trades at a price significantly above its replacement costs you typically see a mean to reversion occur. Tobin's Q ratio is at 120% and has only been higher in 1999 at the height of the dotcom bubble.

There are many arguments as to why the stock market can continue to march higher in the face of nosebleed valuations. You could refer to these arguments as the "this time is different" thinking. The most compelling reason that today is different is the actions of the Federal Reserve to keep interest rates artificially low. Because yields are so low, many investors feel forced into allocating to higher risk assets like stocks and real estate. While this argument makes sense, it will not soften the blow when the stock market is down 30%-40%.

Some argue that stocks are safer today because bonds are even more overvalued. This argument ignores the long term history of the importance of valuations and assumes that status quo will remain; a faulty premise if ever there was one. I would certainly agree that bonds can be viewed as grossly overvalued unless you believe a recession is imminent. Regardless, my recommendation would be to find ways to make your portfolio less dangerous rather than ignoring the risk level that today's valuations represent.

Bear Market or Recession: Chicken or the Egg?

There is a lot of discussion this long into the current bull market as to whether a recession will cause the next bear market, or will a bear market cause the next recession. They are deeply entwined as a slowdown in economic growth leads to lower corporate earnings and less appetite for stocks. Conversely, a 20% drop in stock prices causes a negative wealth effect with falling 401k values, and makes consumers less likely to spend freely. In the end, it really does not matter which comes first as forecasting either is prone to error.

The Laws of Economic Gravity cannot be ignored forever: valuations at today's level are not sustainable indefinitely. The more stretched to the upside the markets become the more pain that will be inflicted when the correction comes. Take heed to make sure your portfolios have sufficient risk mitigation in place.