Equity Valuations

We have discussed equity valuations in past reports, mainly because current valuations are the primary driver of future returns. Investing at high price multiples, whether based on price-to-earnings, price-to-book values, etc., could subject investors to a reversion to the longer-term valuations. That is, equity prices could fall to valuations that are more in line with longer-term averages.

Of course, there is no magic formula or universally accepted method for determining when equites are "expensive" or when overall price levels are due for a reversion to the mean. Equity prices can remain at elevated levels for some time, particularly in a bull market, so market timing can be difficult. But if history is any guide, we know that eventually, market values tend to revert to longer-term norms.

One popular measure of equity valuations, although not without criticism, is to compare the ratio of U.S. gross domestic product (GDP) to the market capitalization of a broad equity index, such as the Wilshire 5000, which measures the total capitalization of 5000 publicly traded companies. The rationale for the comparing GDP to the total market capitalization of an index like the Wilshire 5000 is that over the long-term, corporate profitability should be roughly in line with economic growth, or GDP.

Chart 1 below illustrates the historical relationship to the Wilshire 5000 Index market capitalization and GDP. The chart begins in 1971 and goes through today. The right-hand index measures market value in trillions of dollars. As we can see, the blue line (i.e. the market value of stocks) sometimes falls below the green GDP line, suggesting that stocks could be undervalued. Conversely, at times the blue line shoots above the green line, suggesting that stocks could be overvalued.

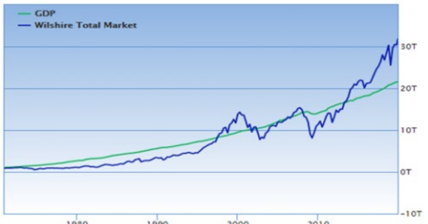
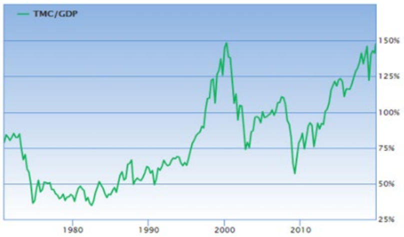


Chart 2 below simply takes the ratio of the blue market cap line and the green GDP line from Chart 1. As chart 2 shows, we are currently approaching valuations (i.e. stock market capitalization to GDP) not seen since the waning years of the tech boom in the late 1990s, when equity valuations reached roughly 150% of GDP.



What stands out from the charts is where we currently stand today in terms of the blue line's gap above the green line (in either absolute or percentage terms). Not only is the market cap for stocks above the value of GDP, its been trending above GDP for some time. However, it's difficult to make an investment decision, or more precisely, an investment timing decision, based on the valuation metrics shown in the chart.

The reason, in our estimation, is the unprecedented intervention in the financial markets by global central banks after the financial crisis. Their policies have effectively kept interest rates low, which in turn has buoyed asset prices. Twenty years ago, investors had alternative to equities, given that government bond yields were as high as 7%. Today, they hover at or below 2%. Simply put, investors have fewer places to go today, so it's difficult to gauge how long the positive gap between market capitalization and GDP can go. This uncertainty about the future path of equity prices is why we suggest following a tactically managed strategy, whereby a portfolio is positioned to rebalance across various asset classes and incorporate hedges against heightened volatility if needed.