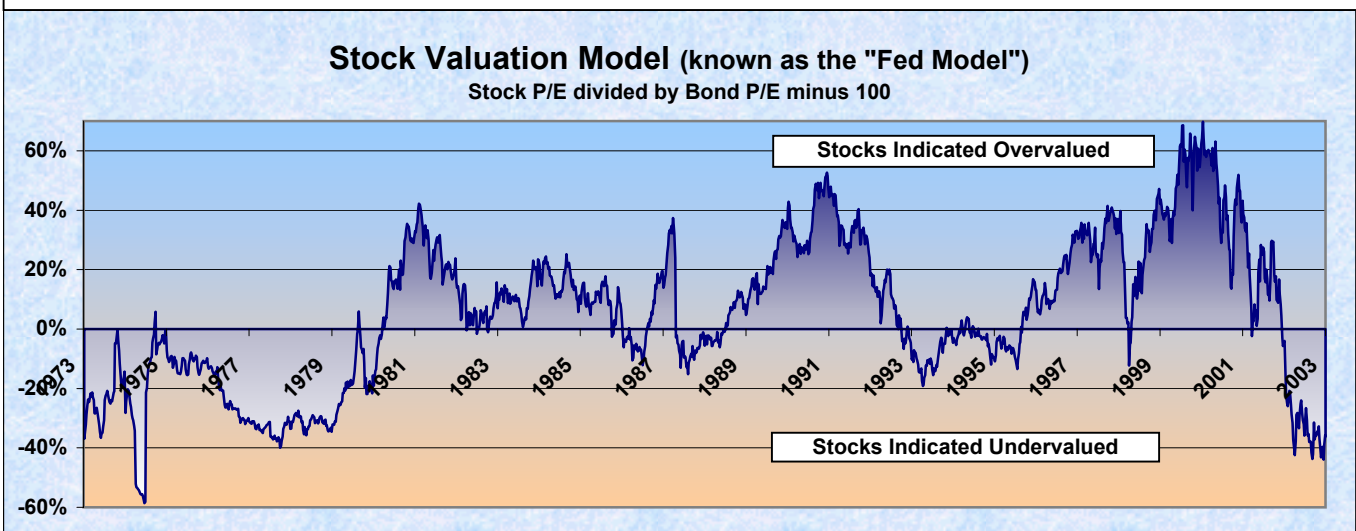


Are stocks still overvalued?

"There is only one thing about which I am certain, and that is that there is very little about which one can be certain."
W. Somerset Maugham, 1874-1965, author

There are dozens of methods to value stocks. One common method is the Price-to-Earnings ("P/E") ratio. Over the last 30 years the P/E ratio of the S&P 500 (based on one-year forward estimated earnings) has averaged 14. This means that for every dollar produced in earnings the market has on average valued each dollar by 14 times. Of course, 14 is not a static benchmark. Over the last 30 years the stock market's P/E has ranged from a low of 6 in 1974 to a peak of 28 in 2000. Currently the P/E ratio is 18. How do we know if 18 is reasonable? After all, a P/E ratio of 18 is still about 30% higher than the 30 year average. Are stocks still overvalued?

To help address this question we can compare the valuation of stocks to the valuation of other investments. While bonds are usually judged by their yields, investors can easily calculate the P/E on bonds by inverting the yield. Bonds don't have earnings per se, but the interest paid on a bond can be viewed as such. This allows for a side by side comparison of stocks and bonds. For example, today the yield of a 10 year Treasury bond is about 3.6%. This equates to a P/E ratio of almost 28. The chart above compares the P/E ratios of stocks and bonds. Over the last thirty years, at least up until about 1998, the valuation of stocks and bonds were similar. Since 1998 there have been large valuation discrepancies. Initially stock valuations rose to heights not seen before and then more recently bond valuations have surpassed even those lofty stock valuation levels. The chart below shows the degree, based on the "Fed Model", to which stocks were overvalued and now perhaps are undervalued relative to bonds.



Market Implied Equity Risk Premium (%)

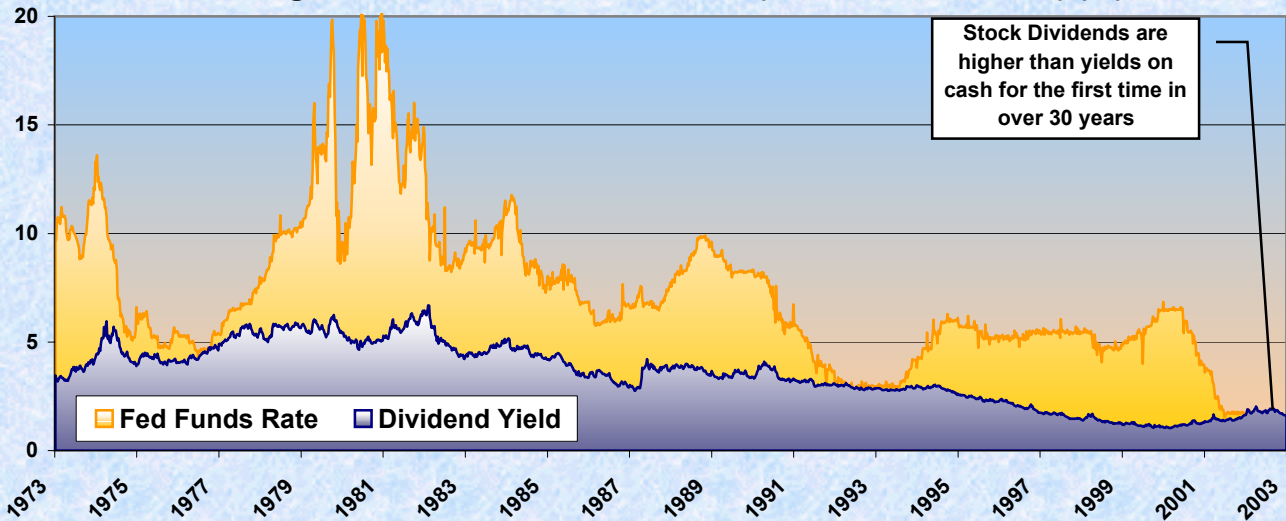


"Markets invariably move to undervalued and overvalued extremes because human nature falls victim to greed and/or fear."
 William Gross, Managing Director, PIMCO, 1997

The risks and rewards of stocks and bonds are not the same. Bonds promise to pay a set rate of interest and have some risk of default, while stocks generally offer a smaller dividend yield and some growth of capital over time. Typically, due to the uncertainty involved, investors demand a higher rate of return to invest in stocks. This higher rate of return demanded by investors is called the Equity Risk Premium (see chart above) and over the last 30 years it has ranged between a low of -3% and a high of 6.5% (current levels). Thus today, relative to bonds, investors in stocks expect to earn a return that's 6.5% more. The high equity risk premium today reflects investor concerns about terrorism and war, corporate malfeasance, a weak economy and general pessimism after suffering through a three-year bear market.

The long bear market has also caused shell shocked investors to hoard cash. Individual investors are currently holding \$1 trillion in money market funds and another \$4 trillion in cash equivalents. While safe from decline, this mountain of cash is earning less than the rate of inflation and investors are losing the purchasing power of their money. Of course, the alternatives to cash are few. Bond prices have been driven up as investors seek higher yields. Interestingly, the dividend yield on stocks is higher than yields on cash for the first time in over 30 years (see chart below). In addition, the new tax law now treats dividends more favorably than interest, making dividend income all the more attractive. Responding to the new tax law, many companies are significantly boosting their dividend payouts. One large national bank increased its dividend payout by 25% and now offers a 4% yield. Another large investment banking company more than doubled its quarterly dividend payout. The combination of lower bond yields, higher (and growing) dividend yields might entice some investors back into stocks.

Searching for Yield: Dividends vs. Cash (Federal Funds Rate) (%)



Madison Financial Advisors