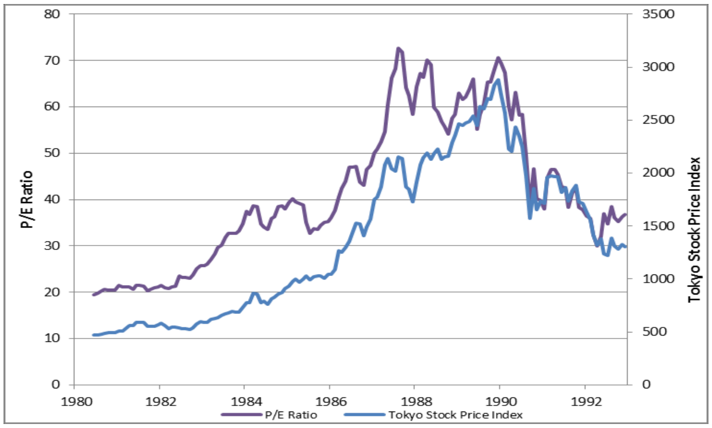
The Market is ___ rvalued…
So What?

December 2013

As year end approaches, a booming chorus of market commentators has emerged offering up opinions on the current valuation of the U.S. stock market, and what it means for investors. Is it overextended? Are we in a bubble? Valuations may be rising, but are they perhaps justified, given historically low interest rates? This got us thinking at Matarin: *Does it really matter?* Is analysis of the market's current valuation truly a useful indicator of its future direction? The bottom line is that in our estimation, while valuation may give a helpful long-term signal, from a market timing perspective, it is not a very useful tool. Below, we highlight several aspects of this issue. The market can stay "overvalued" or "undervalued" for a long time before "normalizing," and being too early when timing a correction can become preventively expensive. Looking simply at either valuation levels relative to historical norms or relative valuation measures of stocks in comparison to competing investment opportunities, are flawed tactics. Ultimately, we conclude that valuation is really most useful to investors as a signpost, but should not be used as a roadmap. It can tell us where we are and give us an idea of what the terrain is like, but it may not tell us where we are going or when and how we will get there.

The market can stay "overvalued" or "undervalued" for a long time before "normalizing"

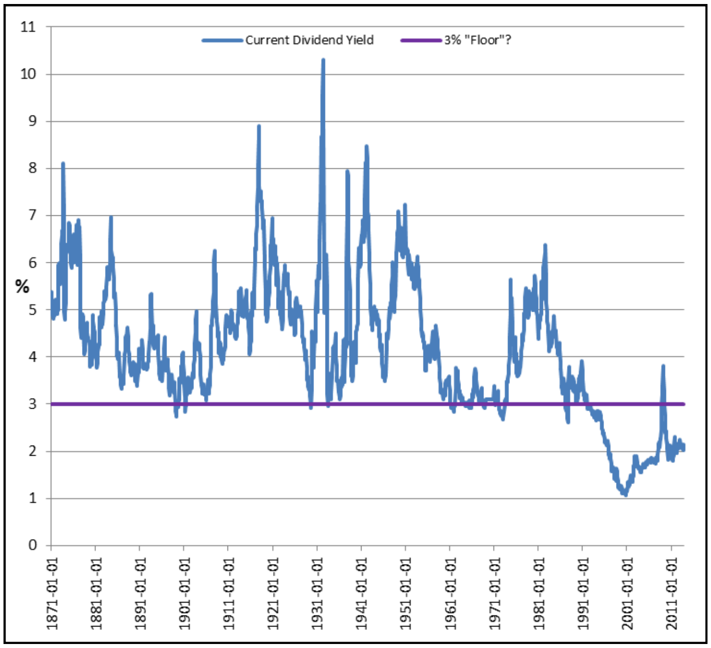
Valuation cycles tend to be many years long, with broad variation in length. So even the most astute market historian can never really tell us where we are in a cycle until after the cycle has ended. Much of the work in market valuation analysis is predicated on the expectation that valuations will mean revert. But the truth is that these metrics are of limited use as a practical market timing tool. Consider the case of Japan during the 1980s, when valuations crept above "normal" valuation levels, giving what might be considered a bearish signal of overvaluation, and then skyrocketed as market P/E levels rose from 20 to 30 to 40 and beyond along with a rising market, as Japanese stocks ended up staying "overvalued" for nearly a decade.



Source: Tokyo Stock Exchange (First Section Stocks)

Previous cycles' most extreme valuation levels may prove to be poor predictors of *this* cycle's highs or lows.

For example, dividend yields have been lower in recent history than they had been in the past because payouts have declined in favor of other tools of remunerating shareholders, such as buybacks. In fact in the past, dividend yields below 3% were quite uncommon, and when they did occur, subsequent market returns were quite poor. Consider the extremes in the graph below. During the 1900s, you have dividend yields falling below 3%: in 1929, before the stock market crashed; in 1961, followed by a period of below average market returns; in 1987, followed by another crash. How many investors in 1992, seeing yields fall below that tried-and-true 3% level, assumed wrongly that prices were set to fall again, causing dividend yields to rise back above the 3% threshold? By contrast, we now know that over the next five years stocks returned over 20% per year and that dividend yields have only been back above that 3% floor quite briefly during the extremes of the 2008-9 financial meltdown. The example of dividend yield clearly demonstrates why investors should exercise caution in using previous cycles' highs and lows as guides for the future.



Sources: Federal Reserve Bank of St. Louis, Bloomberg

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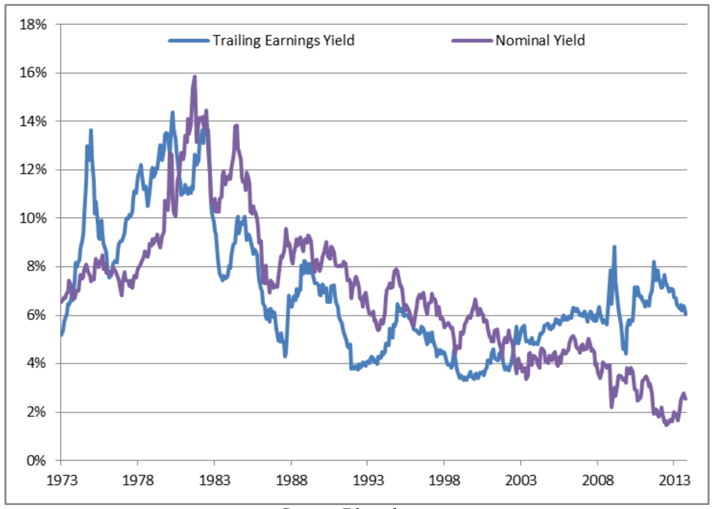
Looking at relative valuation measures of stocks in comparison to competing investment opportunities is a flawed tactic

It may seem intuitively reasonable that commentators often compare the returns available on equities to those in the bond market. Given that the two asset classes "compete" for space in investor's portfolios, it seems intuitive that when returns on stocks (the earnings yield) rises above the returns on bonds (the interest yield) that investors will shift their portfolio from stocks to bonds or vice versa (this is the concept which is referenced by the "Fed Model"). But relative yield comparisons across stock and bond markets are also not useful measures for *timing*, and indeed the Fed model has not held up empirically over time.

The current cycle is a pronounced example of the limitations of such comparisons. The spreads between earnings yields and interest rates are historically wide, and they have been for some time. Neither recent declines in earnings yields nor increases in bond yields have come close to correcting the extent of that dispersion. The persistence of this dispersion has bested doubters for many years running. The driver of the protracted spread between bond and earnings yields has been the outside force of Federal Reserve action in keeping rates low, even as corporate profits and the stock markets have risen. The stock market has been strong, but not at the expense of the bond market because of the Fed's "irrational" purchases. So long as Federal Reserve policy remains aggressively easy, this phenomenon should persist. The fact that the spread between earnings yields and interest rates is wide today tells us nothing about whether or when it should contract.



Source: Bloomberg

But even more basic assumptions about the relationships between stock and bond yields, used for the assessment of the relative value of each, have failed investors over the years. In *Against the Gods*, Peter Bernstein describes how in the 1950s, "a relationship sanctified by over eighty years of experience suddenly came apart when investors discovered that…high grade bonds would for the first time in history produce more income than…risky common stocks." So, if valuation is accepted as a signpost but not a map, it must also be accepted that sometimes the signposts move.

Valuation should not be used as a roadmap, but it can give us an idea of where we are now, and what the terrain is like

If valuation is a failed tool for market timing then what are we left with? At Matarin we've found over the years that in forecasting more intermediate-term shifts in the stock market, it is most helpful to look at the underlying fundamentals, for example, drivers of future economic growth, future inflation and investor sentiment. Valuation analysis may be helpful to the forecaster as well, because it can give us a sense of when these other market forecasting indicators are most likely to be successful. When the market is under- or overvalued, short-term "catalysts" such as investor sentiment become more important, and fundamentals become less important. As valuations get richer and richer or more and more depressed, the market starts to trade heavily on emotion, and investors are more and more likely to overlook the fundamentals. In these situations, fundamentals, while always of key importance at the end of the day, may be less helpful for short- or intermediate-term timing. But right now, we view the market valuation to be reasonable – it is close to its long-term average.

Currently, our forecasts of future economic growth and inflation are painting a very positive picture for the stock market because we expect stronger than average economic growth with lower than average inflation, creating an environment in which stocks tend to thrive. However, we have to temper our overall forecast of stock market returns because investor sentiment is extremely bullish (a contrarian signal which makes us cautious). In fact the percent of investment newsletter writers that are bearish has reached its lowest level since 1987, according to Investors Intelligence. By putting all of the pieces of our forecast together, we are moderately bullish for 2014 expecting the stock market to return between 8 and 14%.