BLOG

UPDATE ON VALUATIONS: ARE STOCKS EXPENSIVE?

From the market bottom on March 9th, 2009, the U.S. stock market, as measured by the S&P 500 Index, has rallied approximately 290%. Investors have experienced a nine-year bull market in stocks—so far resulting in one of the longest lasting rallies ever experienced in U.S. markets. And while the U.S. and global economies remain strong and growing into 2018, investors and economists alike continue to wonder how long the bull market can run.

Fortunately, when looking at the underlying fundamentals of the stock market, we find reason to suggest that the stock market is appropriately valued. There are no so-called "bubbles" in the financial markets, which were the hallmarks of previous stock market corrections (sub-prime mortgages in 2008 and internet stocks in 2000). Indeed, despite the great run that U.S. stocks have had since 2009, the health of the economy and the earnings of U.S. companies have provided a solid foundation for the appreciation we have seen.

To wit, stock market valuations appear reasonable, even after this nine-year market upswing. On a forward basis, the S&P 500 Index trades at 16.4 times earnings. Looking back at the past 25 years, the average forward P/E ratio[1] has been 16.1. On a price to book[2] basis, at 2.9 times, the S&P is exactly in line with its 25-year average. The S&P 500 yields a dividend of 2.0% today—just below the 2.1% average yield over the past 25 years. Putting it all together, we are almost exactly at the mean level for U.S. stock valuations across several different metrics.

We don't invest in stocks in a vacuum. Most commonly, we compare the value of stocks against bonds. When bond yields are high and guaranteed government interest rates are elevated, it often makes sense to shift money out of stocks and into bonds. But we still find ourselves today in an interest rate environment that remains historically low. Just in the past few weeks, the 10 year U.S. Treasury bond has approached a yield of 3%. Short-term cash rates remain below 2%. And while the return to higher rates is a welcome concept for savers and investors, interest rates remain far below their historic averages. Since January of 1962, the average yield on the U.S. 10 Year bond has been 6.23%, according to the Federal Reserve. The takeaway: stocks still look attractive relative to bonds.

Improving earnings are likely to continue to provide support to the stock market. U.S. companies are expected to grow earnings 17.3% in the first quarter, according to the most recent Wall Street consensus estimates compiled by FactSet. The economy remains strong, consumer spending remains robust, and the recent tax cuts passed in December are now starting to be realized by corporate America.

While we don't have a crystal ball regarding the short-term direction of the stock market, we do feel comfortable with the underlying fundamentals of the U.S. economy and stock market. As long as the economy continues to grow and consumers continue to propel spending, corporate earnings will likely remain healthy. With this in mind, we don't believe we are in an "expensive" stock market. Staying the course, and staying invested, is the most likely path to a successful long-term outcome—despite a nine-year rally in stocks.