PORTSIDE
INVESTMENT ADVISORS

Depiction

A summary of graphical and quantitative information that is part of the research at Portside Investment Advisors

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November 30, 2019
The Price to Pay

→ *By many historical standards, the US stock market is overvalued today given the fundamentals.*

The US stock market in 2019 (along with others around the world) bounced back from 2018 losses but has done it without increasing profits. What this means, simply, is that the stock market has gotten more expensive.

It gets commonly lost in discussion, but the intrinsic value of a stock is in owning a share of the company's earnings. If the stock price of a company rises without a corresponding increase in profits, it explicitly means an investor is paying more for the same amount of profit. Ideally, investments should be made in companies that are valued at a price reasonable to earnings. Of course, what that reasonable price is the ultimate source of debate and it is what makes the markets.

The stock market at current pricing, in a general sense, is expensive by many metrics. This doesn't mean it won't again appear reasonable or that the prices can't still go higher. But, ten years into this business cycle, helped with unprecedented monetary policy, it is important to be cognizant of what value money is buying. Following are a few pieces of information that examine the current state of stock market value.

Earnings have not been increasing

After rising sharply in 2018 (due to tax cuts primarily), earnings per share for the entire US stock market have not risen for about one year. All things being equal, the value of an equity stake is directly related to the growth in earnings. The flat earnings growth is shown on the first chart below, in the bold line, compared to the market price. What might be more relevant is that if the earnings growth is adjusted for inflation, real earnings have declined this year.

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Source: Bloomberg

Market valuation relative to history

There is no perfect measure for when stocks are expensive, but it is useful to have some historical context. One simple measure, which Warren Buffett has referred to as his favorite, is the *market value of all stocks relative to the value of US gross domestic product (GDP)*. By this measure, the stock market is about as expensive as it has ever been.

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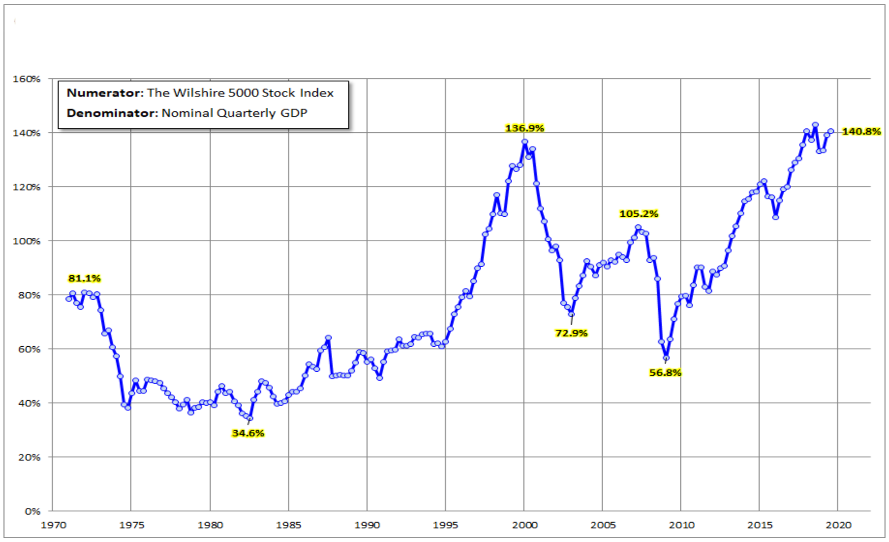
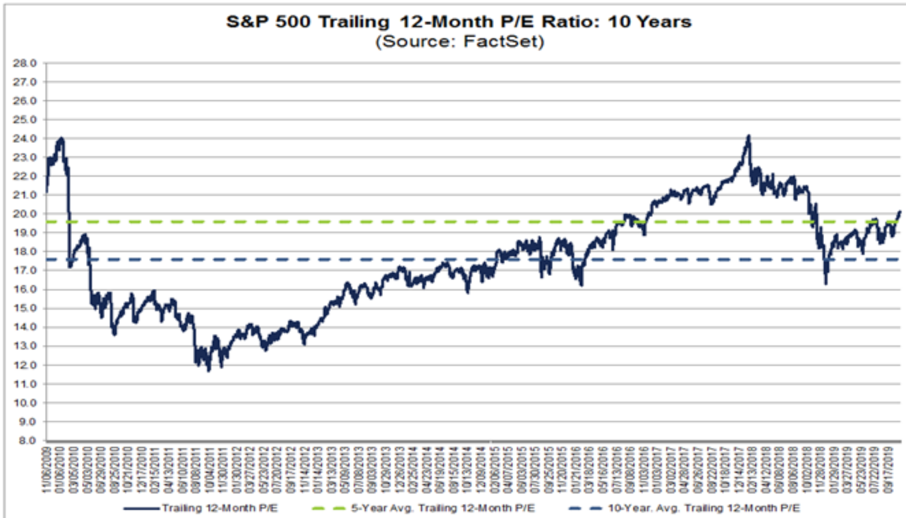


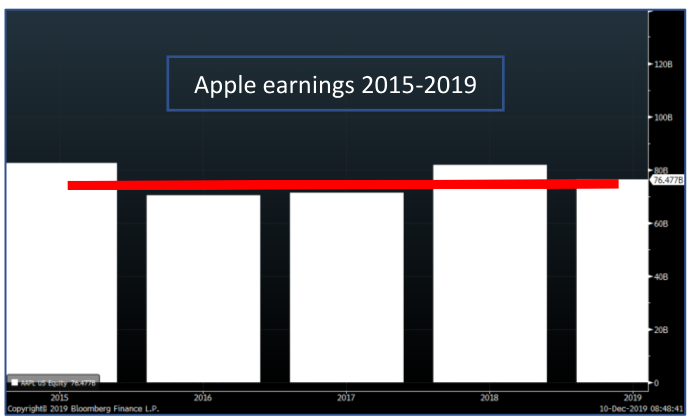
Source: Advisor Perspectives

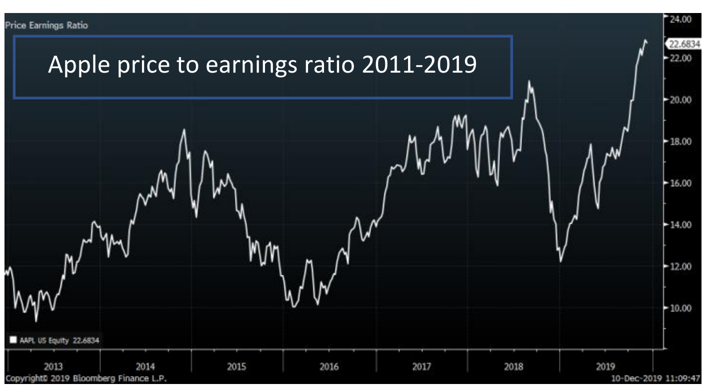
Another common measure, *price relative to sales*, shows that the current market is at the same level last seen at the height of the technology bubble in 1999-2000.

The measure most quoted, *price relative to earnings*, shows that current valuations are above both the five- and ten-year averages. 2017-2018 was a bit of aberration to the high side since the stocks priced in the tax cuts before they were fully reflected in earnings.



We most commonly analyze market segments, not individual companies, but it is interesting to note the change in valuation of the market's largest company, Apple. The price of Apple has risen a lot this year and over the last few years. What is less commonly known is that the total earnings for Apple have been basically flat for the last five years. This means that the price to earnings ratio has gone from about 10 in 2016 to almost 23 currently. Company share buybacks have definitely contributed to this.





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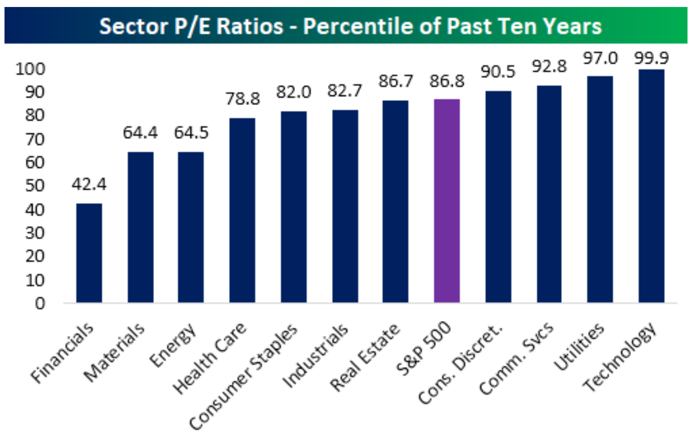
High prices are permeating the market

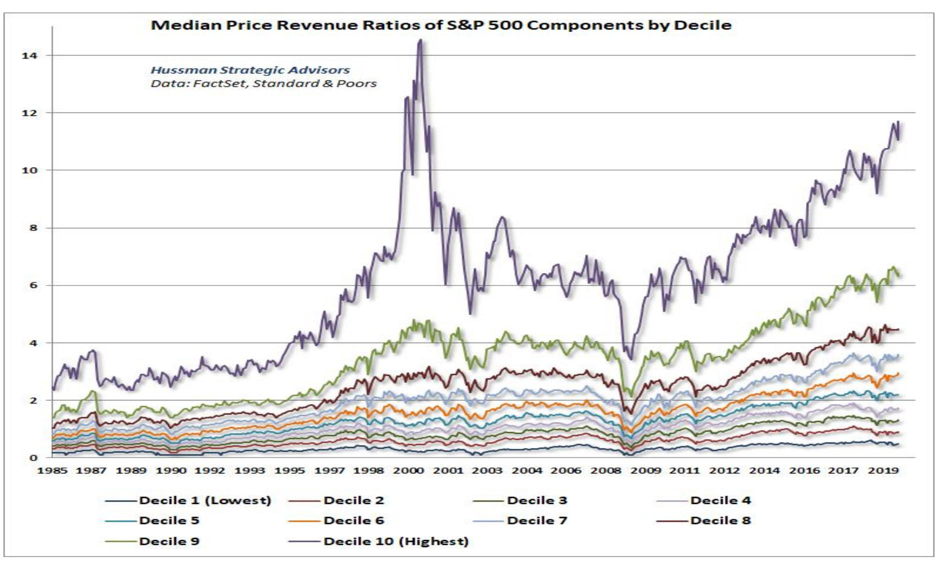
Unlike the late 1990's, when primarily technology and related sector values went sky high, the current market has seen an inflation of valuations across most of the market. Looking at current price to earnings (P/E) ratios by economic sector, most sectors are trading towards the upper end of their range over the current ten-year cycle. There's no question that low interest rates have contributed to this result.

Interestingly, at the high end of valuation, there are both growth-oriented stocks (technology) and conservative sectors (utilities) that are about as expensive as they've been this entire cycle.



Source: Bespoke Investments

Another analysis, comparing the current market to the peak of the technology bubble divides all stocks into deciles ranked by *price to revenue ratios*. The very top decile shows the 1999-2000 market had some companies that were more highly priced. But it shows that all other segments in the current market are more expensive by this metric.



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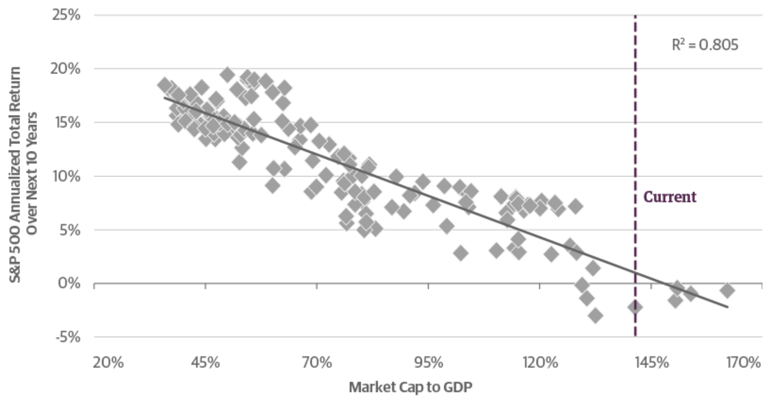
Price (valuation) does matter

When prices are rising seemingly without reason, it can be easy to get carried away with the hype. However, history has shown repeatedly that future returns are very much correlated to cheaper valuations. This first chart shows a distinct relationship between the earlier measure, market value to GDP, and returns over the subsequent ten years. In the few instances similar to now, forward returns for ten years were negative.



Source: Guggenheim

The following chart looks at where price to earnings were at the start of bull markets over the last eight decades. We are currently nowhere near any of those levels.

Dots represent bear market lows.

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Takeaways

→ *An empirical comparison of today's stock market valuations versus historical norms makes it look highly priced, but that doesn't mean certain factors couldn't push prices even higher.*

There is no single definitive way to assess the value of the stock market. But there are currently many pieces of information that say risks have risen given the price of stocks. It is certainly possible that policy makers at the Federal Reserve and other central banks will do everything in their power to continue boosting stock prices. It is also possible that the earnings picture will improve and justify the current prices. Additionally, other factors such as company share buybacks and low interest rates continue to push up prices regardless of value. These are things to watch for, but we believe that right now is a time to stay diversified but be willing to change course, if needed.

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