Stocks' Relative Valuation Attractive

The question whether Treasuries were somehow a "smarter" market than stocks arose in a Columnist Conversation exchange last week and was answered immediately and in a hopefully unintended fashion by someone claiming to be a smart bond trader.

As it is impossible to establish Granger Causation between the two markets, we have to conclude one does not lead the other. Moreover, all capital markets exist in a continuous risk-adjusted relative valuation arbitrage to each other, we would have to believe in long-term systematic inefficiency to believe in one market being smarter than another.

Relative valuation is another matter altogether. In the case of stocks, relative valuation depends on the relationship between forward-looking price-to-earnings ratios, dividend yields and their growth rates and the returns available for other corporate claims such as corporate bonds. This last relationship has been tested in recent months by the intrusion of the government into the relative seniority of bondholders to stockholders, but that is another matter altogether. All of these variables are moving targets; top-down earnings estimates change, usually as a lagging indicator of market price, and corporate bond yields rise and fall both as a function of Treasury yields and credit spreads.

Let's update and modify an analysis from December 2007 on the relative valuation of stocks to corporate bonds. That piece was written when the S&P 500 had been crossing back-and-forth through the 1490 level for weeks and concluded U.S. stocks were being priced not so much for their intrinsic investment value so much as for their control value. I thought sovereign wealth funds (remember them?) would be the likely buyers of U.S. financial assets.

The Current Picture

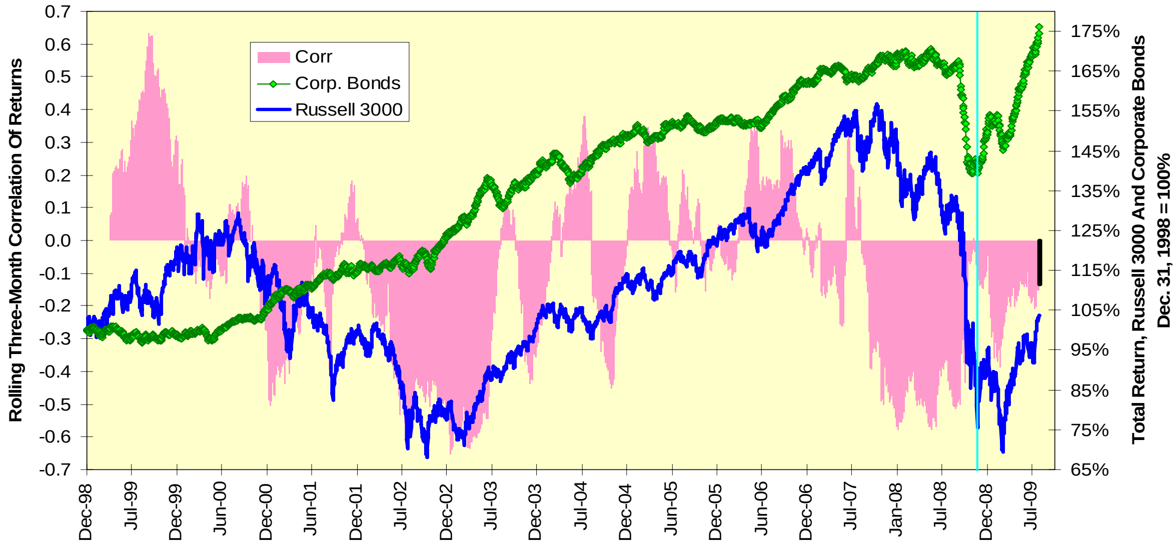
Investment management lives in a strange world. Highly quantitative people use terms such as "growth" and "value" without a precise definition of either, and investments themselves are divided into large-, small- and medium-capitalization categories. They also classify themselves much as our hunting ancestors would with animal totems such as "bull," "bear," "vampire squid," etc. What boars.

Corporate bonds are divided into investment-grade and high-yield, and as some of these classifications are dependent on ratings agencies we should be reticent in adopting them and opt instead for a weighted-average measure of corporate bond risk and return, in this case the Merrill Lynch Corporate & High-Yield Master index. As far as the issue of size mattering, let's say it does not and limit the division of the stock universe into those arbitrary growth and value categories.

The Corporate Bond Rally

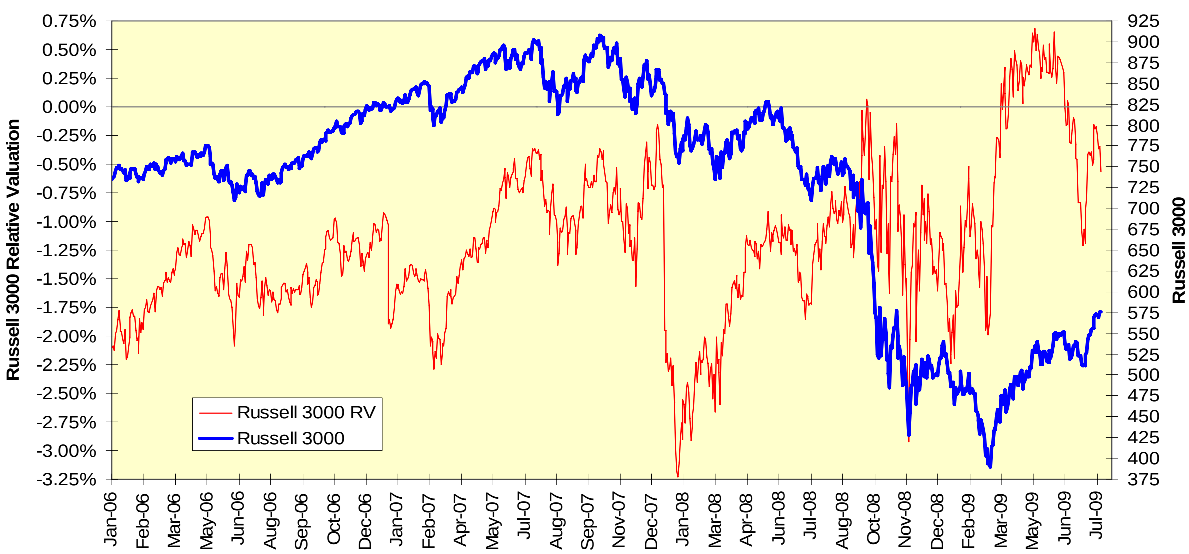
The total return of the corporate bond index bottomed in November 2008, marked with a turquoise vertical line; I noted the advantages of convertible and high-yield bonds that very week. They have been on a tear since March, and even though the total return on the Russell 3000 has been greater, 49.2% to 20.6%, the bonds have had a much lower standard deviation of returns, 0.41% as compared to 1.93%. The ratio of average return to standard deviation of returns since the March low has been .198 for the Russell 3000 and 0.431 for the bonds. The rolling three-month correlation of returns for the two markets has been becoming less negative, currently standing at -0.136, marked with a black column.

Corporate Bond Rally Contributing To Higher Stock Valuations



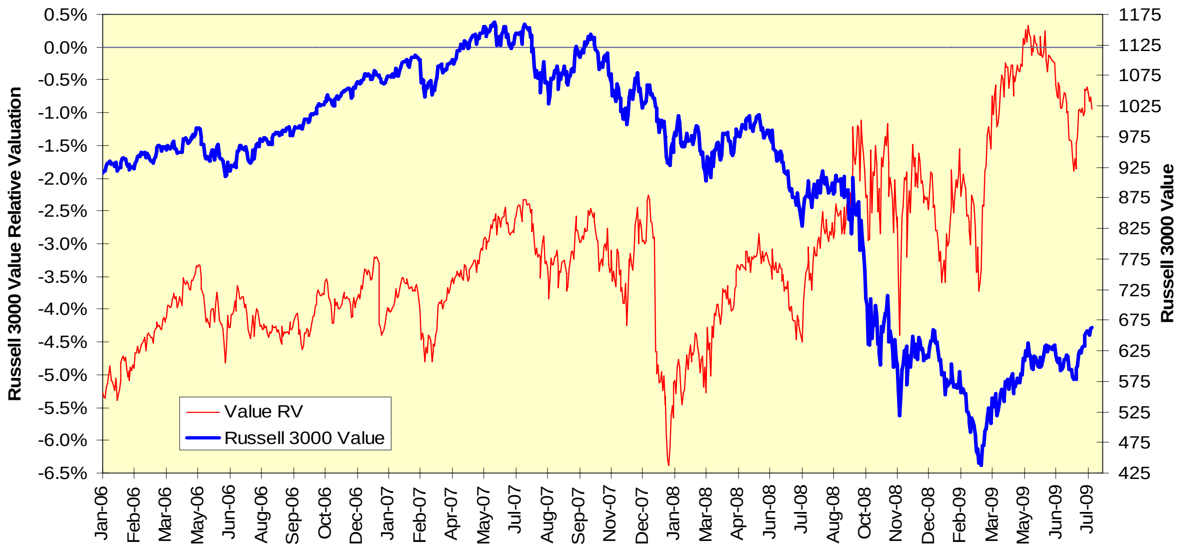
The Russell 3000 as a whole remains slightly undervalued relative to the bonds by virtue of the strong bond rally and rising earnings estimates. Undervalued does not mean "screaming buy;" the market was extremely undervalued when I last presented this analysis in December 2007, and we know how well 2008 turned out for stock investors. Interestingly, the market turned overvalued at the beginning of the trading range in May and reached its recent valuation minimum in mid-July right before the strong rally began.

Price And Relative Valuation of Russell 3000



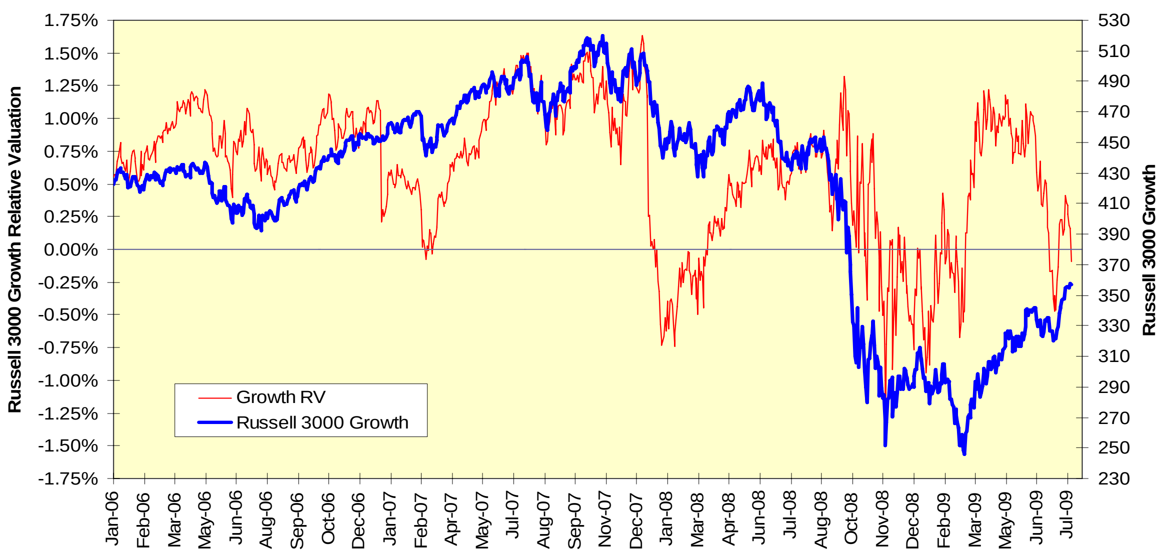
If we look at the value index only, we see the same general relative valuation path over time. As most financial stocks were in the value index by the March low, the closure of the undervaluation discount was fairly spectacular; almost generational, we could say.

Price And Relative Valuation of Russell 3000 Value Index



The growth stock index has spent more time in the overvalued camp, but that is to be expected; what's the point of being high-priced if you cannot act silly every now and then? It moved down sharply from an over- to an undervalued level last week as its earnings estimates remained static.

Price And Relative Valuation of Russell 3000 Growth Index



Where Now?

Much of the cover for the stock rally has been provided by the corporate bond rally. Credit spreads have narrowed from their highs of last winter, and may have further to go. They essentially are retreating down to the levels they reached during the depths of the 2002 selloff in corporate bonds. There are many reasons to sell something; the fact it just rallied a great deal is seldom one of them.

Still, the rally in corporate bonds is taking on that self-fulfilling nature that is part of all bubbles; I noted the role of corporate bond ETFs in driving certain bond yields lower back in June. The bad part about betting on the continuation of a bond rally is the ceiling on bonds is defined; not only are credit spreads unlikely to get back to the levels of 2006-2007, Treasury yields are unlikely to drive lower unless the economy itself weakens and works against the narrowing of these credit spreads.

This suggests the corporate bond and stock rallies are likely to slow in the weeks to come as the markets digest the gains, assess where Treasury yields are headed, and gauge whether further contraction of credit spreads is justified. For those of you who need an animal involved in the discussion, let's use a cautious bull.