Will Bonds Threaten Stocks?

Who wants, "He should have known better" chiseled into his headstone? Yet after all major downturns, a large number of investors slap their foreheads in self-admonishment and proclaim, yes, they should have known better.

Traders of a certain age can recall vividly how in the post-mortems of the 1987 crash, scolds came out of the woodwork to say we all should have seen the threat posed by higher interest rates, a topic addressed here in April and the subject of the discussion below. And traders of more recent vintage still wonder what we were thinking collectively during the late 1990s technology bubble.

But as Alan Greenspan noted in self-justification in August 2002, bubbles can be hard to recognize when they are happening, harder to deflate without producing collateral damage and besides, discerning a bull market rising for sound fundamental reasons from a self-fulfilling bubble is devilishly tricky to do. If the price of nickel has risen fivefold since 2002, is this a bubble or simply a market with a supply-demand imbalance that can be cleared only through higher prices? I vote for the latter.

Relative Valuation

Let's toss out a few assertions, such as all investments must be made on a relative and not an absolute basis. If we are faced with multiple bull markets – stocks, credit spreads, commodities, real estate – we get forced either into making investment decisions on a "cheapest of" basis, put money into an apparently safe but underperforming asset class, or choose to remain in cash. And investors' collective risk preference, the willingness to pay more to get less, often increases as assets become less attractive on an absolute basis.

As an aside, recent data on mutual fund inflows are fascinating. The U.S. investor has poured money into international funds and into bond funds while eschewing U.S. stock funds. We are willing to chase performance elsewhere and in markets where valuation is tougher to assess or to flee to safety before we are willing to embrace a bull market in U.S. stocks.

This is why all attempts to say whether stocks are overvalued or undervalued on a simple metric, such as the "Fed Model" comparing bond yields to stocks' earnings/price ratio are doomed to fail almost by definition. They are single-variable approaches to multidimensional problems and are no more robust than saying "All two-year olds who eat oatmeal will be successful in life."

Still, you go to war with the models you have, not the models you want. If we use time series of ***expected*** price/earnings ratios maintained by *Bloomberg* since August 2005 and invert them to an earnings/price ratio that can be compared to bond yields, we can calculate a back-of-the-envelope measure of relative valuation between stock indices and ten-year notes.

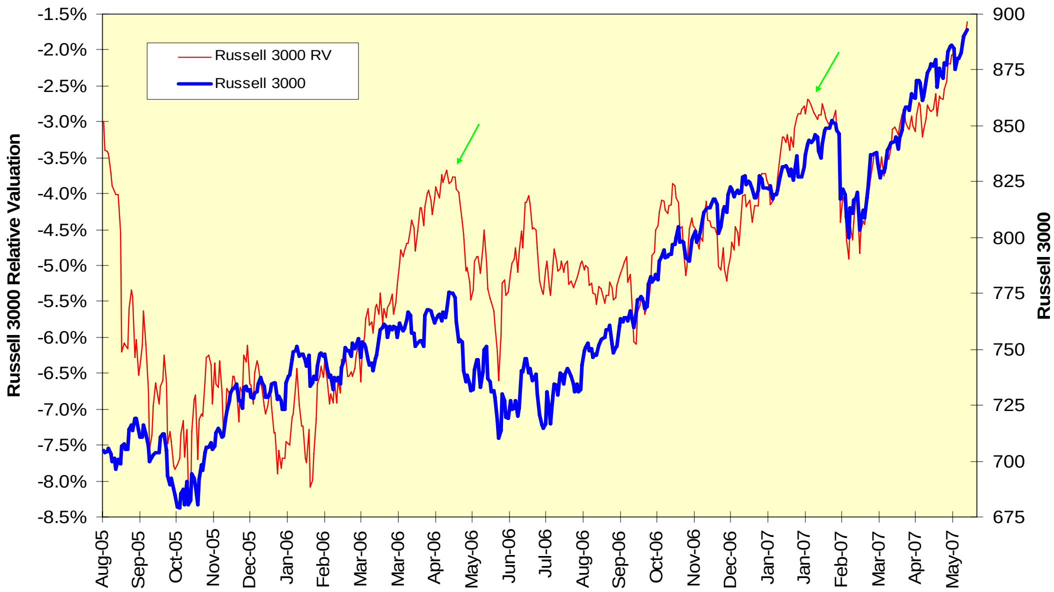
$$RV = \left[1 + \frac{Yield_{ten} - \hat{E}/P}{Yield_{ten}}\right]^{1/10} - 1$$

Valuation And Price

How does this look for the main Russell 3000 index and the Russell 3000 growth and value indices? The relative valuation measure for the main index has had two downturns in its short history, in early May 2006 and early February 2007. These downturns, marked with arrows, preceded stock market downturns.

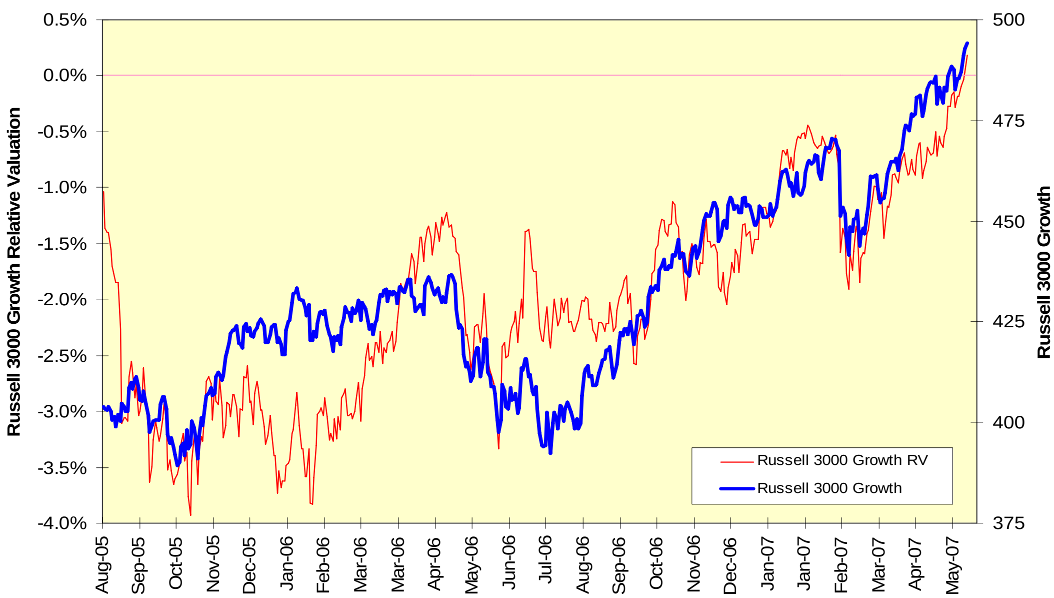
Take heart: The indicator is still climbing and is still somewhat "undervalued" on the measure above. We can interpret this as earnings expectations are rising faster than are long-term interests rates. And once full valuation on this measure is reached, prices can rise further still as the Russell 3000 may be seen as a bargain in relation to other markets. Full valuation is a concept, not a brick wall.

Price And Relative Valuation of Russell 3000



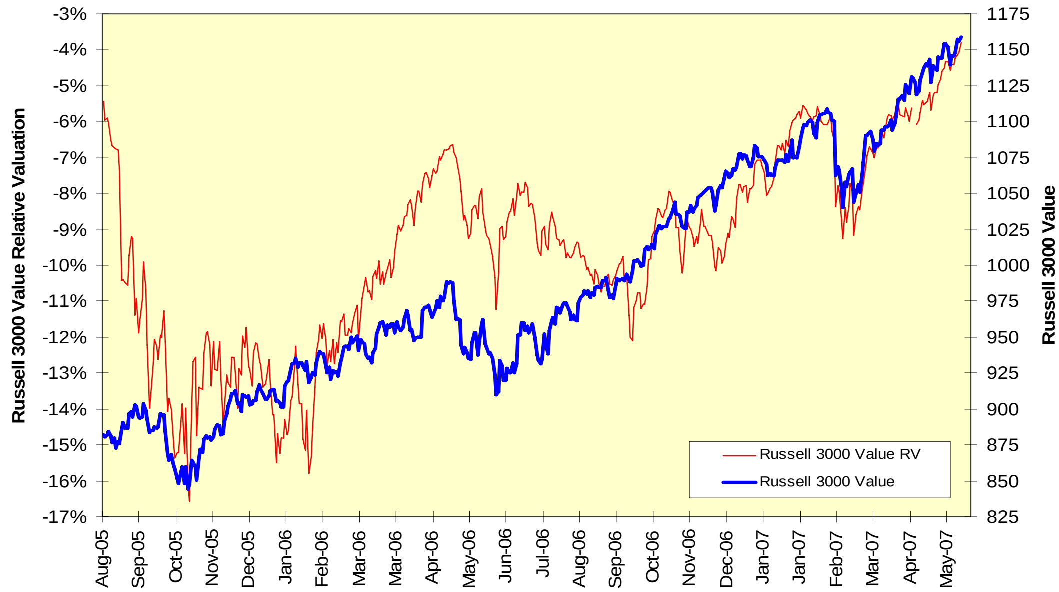
We can illustrate this further with the growth and value indices. The growth index reached full valuation on May 31st, so we should start to wonder about being aggressively bullish on growth issues if interest rates continue to rise or if something comes in to question earnings projections.

Price And Relative Valuation of Russell 3000 Growth



The value index remains undervalued. Isn't that the value of value, to remain undervalued? Or does value simply provide fodder for those who say, "We look for those stocks undervalued by others, the unloved orphans of the market that we, only we, know how to find?" Have you ever heard money managers describe their style as, "We buy the living daylights out of whatever is going up. On occasion, we might express an interest in what those companies actually do?"

Price And Relative Valuation of Russell 3000 Value

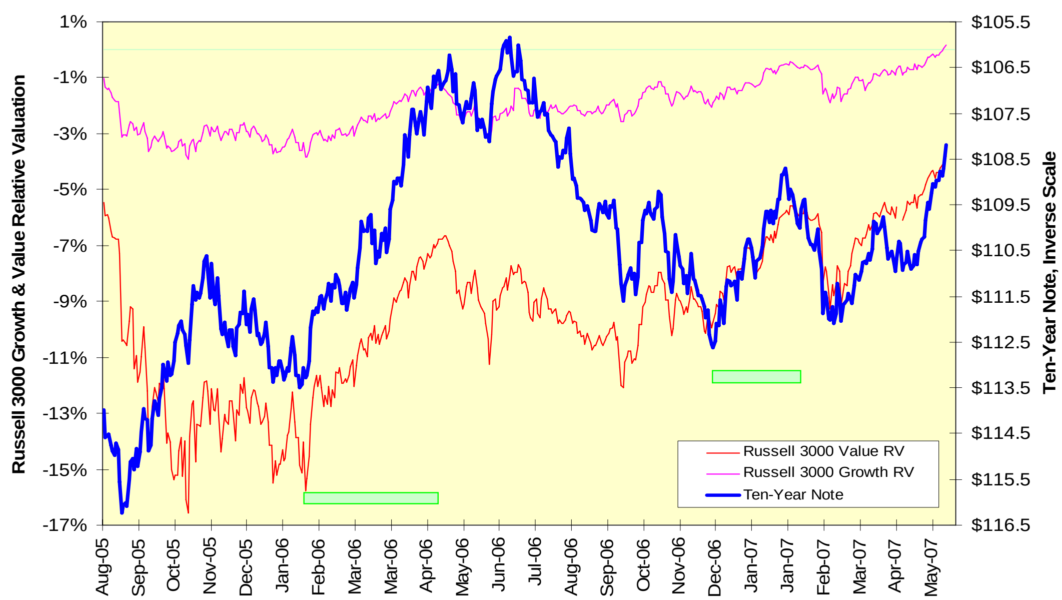


Notes On Notes

As ten-year interest rates are part of the relative valuation measure, how have the prices of constant-maturity ten-year notes, here plotted inversely, moved in relation to the growth and value measures?

We have had two previous upturns in long-term rates over this short data sample, both marked with green rectangles in the chart below. In both cases, relative valuation measures started to turn lower 3-4 months after the upturn in rates began. As the present upturn began in mid-May, a simple project would say relative valuations would peak in September, which historically has been the worst month for U.S. stocks. This is not a forecast; only an observation.

Stock Index Valuation And Bond Prices



Why bring this matter up at all if a simple stock-bond comparison is, as noted, doomed to fail for reasons given? The answer is simple: There is nonsense now loose upon the land that rising long-term interest rates do not matter. They do. The sooner we remind ourselves thereof, the better off we are. Saying, “I know better” sure beats saying, “I should have known better.”