Stocks Are Overvalued Still

It is confession time: More than a week ago, during one of the many beatings this market has taken, I got off the phone after delivering yet one more jeremiad to a reporter, looked at the screen and said softly to myself, "Enough already; make it stop."

So much for being a heartless bear a cackler who seems to revel in others' suffering. The long-term consequences of this calamity for this country and indeed for the entire world are devastating. I do fear we are at or even past one of those tipping points in history like August 1914 where nothing that comes after will stem directly from what happened before.

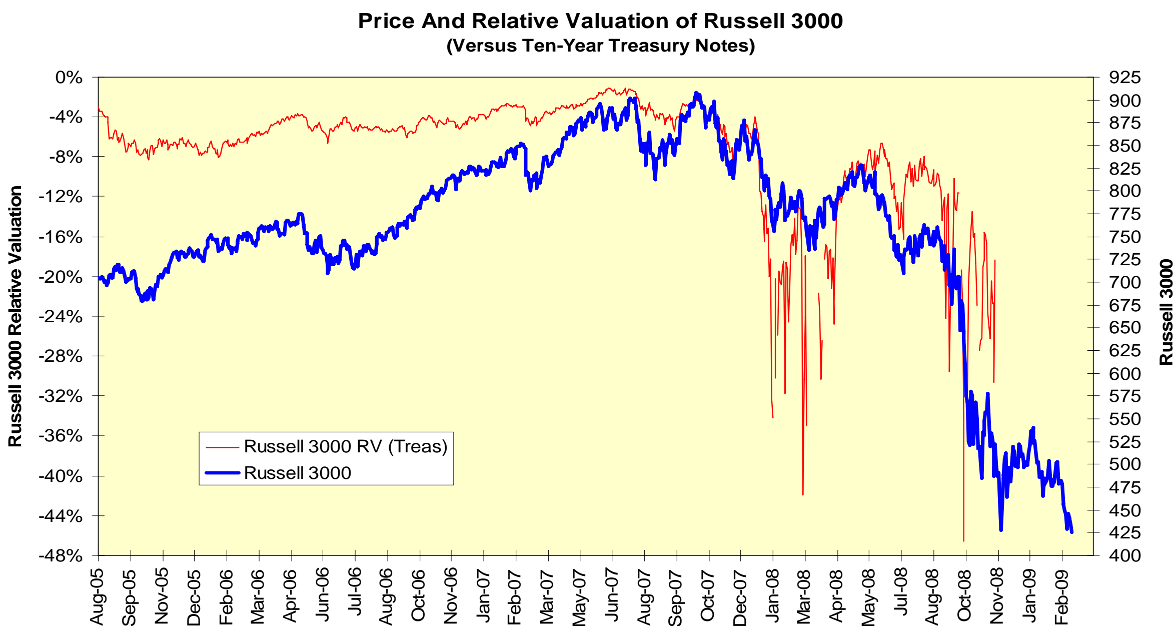
All of this is said in apology for what comes below. Stocks are as overvalued today as they were in the first week of October 2008, and both the global economy and the state of our financial institutions is worse now than it was then.

Relative Valuation

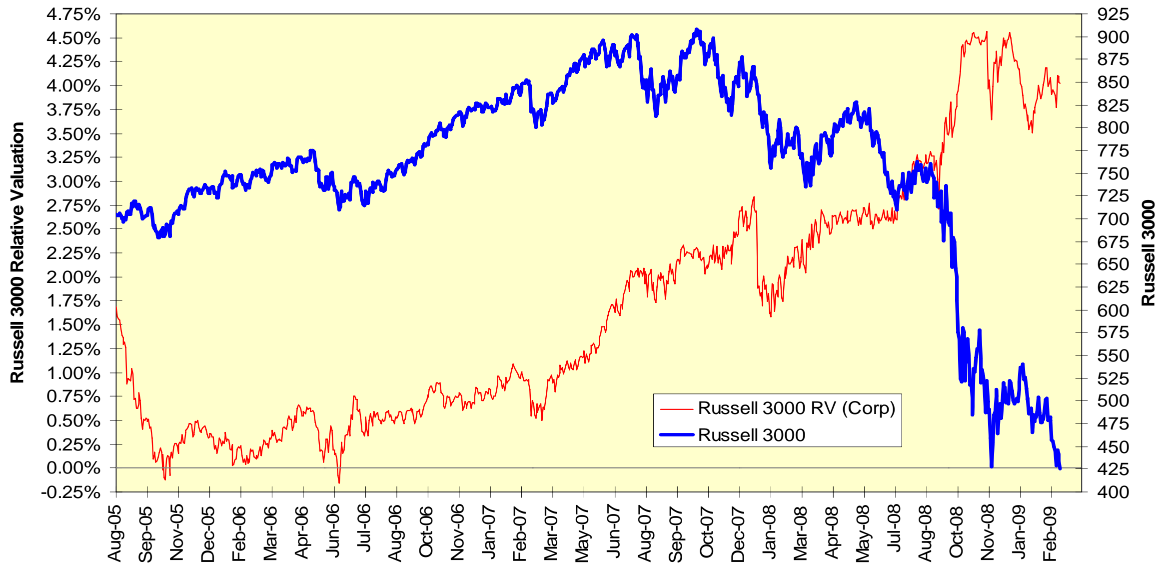
The concept of realized borrowing costs, or sum of Treasury yields plus the option-adjusted spreads on corporate bonds was introduced here in May 2008 and revisited just last month. Let's look at it now in a different perspective, one where the forward-looking price-to-earnings ratio of a given stock index calculated on a top-down basis is compared to a blended realized borrowing cost composed of 40% investment-grade and 60% high-yield OAS levels added to the Treasury yield.

First, let's dismiss the comparison of these P/E ratios to the ten-year Treasury note yield. Corporations do not borrow at the Treasury yield, and the Treasury yield itself has been distorted by a "flight-to-quality" trade even though the credit quality of all sovereign debt continues to deteriorate under the weight of the various financial bailouts.

If we tried to compare the forward-looking P/E ratio of the Russell 3000, 12.5 at last reading as reported on *Bloomberg*, to the comparable ten-year Treasury note price-to-yield ratio of 33.4, we would find stocks to be so overvalued as to be out of solution. The red line, labeled with an RV here and subsequently, disappears after November 13, 2008.



If we make the same comparison to the blended realized borrowing cost of 15.5168%, a price-to-yield ratio of 6.44, a far more intuitively appealing picture emerges. Here the Russell 3000 was undervalued last in June 2006 and became increasingly overvalued into November 2008.



The present reading is identical to the 4.05% overvaluation of October 8, 2008. This number must be considered further within the context of its trend. Analysts have had months to build higher realized borrowing costs and lowered earnings expectations into their models and have yet to lower their earnings expectations or their risk multiples in recognition of reality. Indeed, the opposite has occurred: The decline in overvaluation between November 13, 2008 and January 20, 2009, Inauguration Day, has reversed and is headed back in the direction of greater overvaluation.

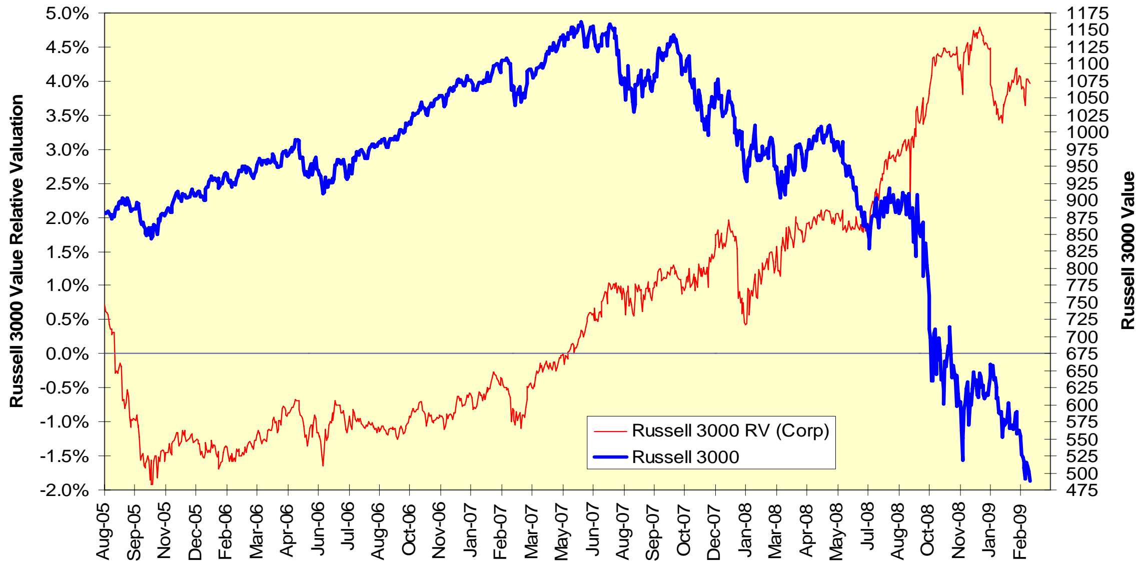
What event or combination of events over the past five weeks leads anyone to conclude earning will rise more than expected, borrowing costs will decline more than expected or investors will become more risk-seeking? Reasonable analysts can and do differ – this is why we have a market – but there is a fine line between having an optimistic outlook and having serious hallucinations.

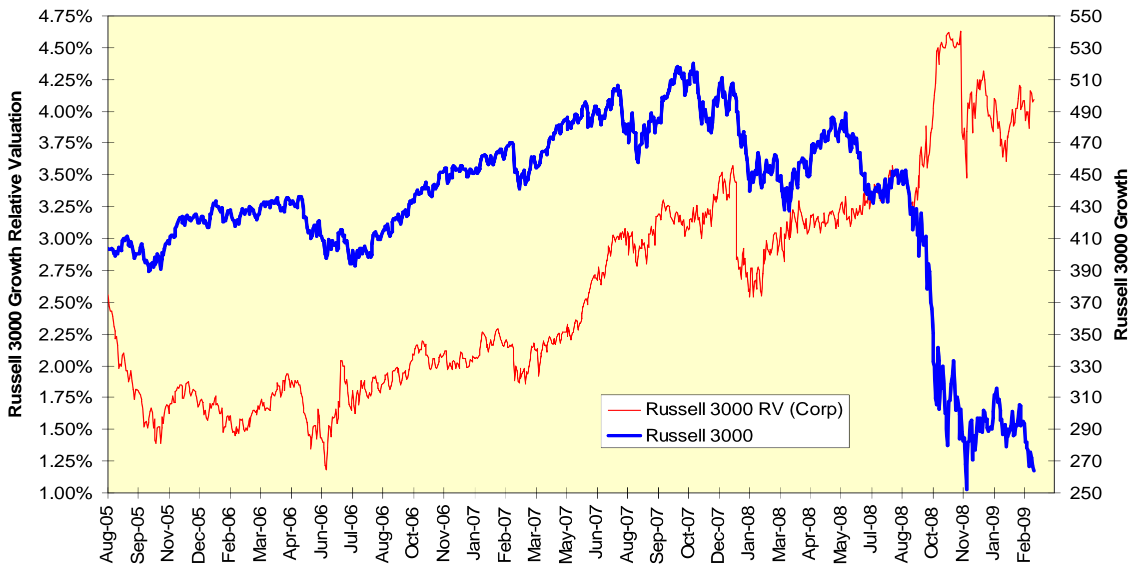
Value And Growth

Index purveyors have amused themselves over the years by creating wholly artificial categories such as mid-cap stocks or attempting to differentiate between value and growth. The definitions are circular in nature – a growth stock is expected to outperform because it carries has higher P/E ratio or similar metric, and a value stock is defined as the opposite – and appallingly imprecise. If investors have learned anything over the past two years it is large-cap growth stocks and small-cap value stocks lose money at similar rates.

These definitions are part of the "wealth management" industry, defined herein as a group of people who managed to lose vast sums of your wealth.

If we compare the forward-looking P/E ratios of the Russell 3000 value and growth indices, 12.26 and 12.72 at present, to the blended realized borrowing cost, we see similar pictures for the sub-indices as we did for the Russell 3000 index as a whole. The value index is 3.96% overvalued, while the growth index is 4.09% overvalued. If this seems like a great deal of work to produce a distinction without a difference, that is the point precisely.





The net result of the exercise is regardless of how we measure stocks, they are overvalued relative to their borrowing costs. All of this is moot, of course, if the economy turns around for whatever reason, if credit spreads contract further and faster than expected or if investors start to throw caution to the winds.

Too many analysts believe if something is cheaper today than it was yesterday it must represent a greater value and offer greater prospective returns. If we could hold all else equal, that might be true. But as we have seen during stocks' retreat back toward the levels coincident with Alan Greenspan's "irrational exuberance" comment of December 1996, if stock prices fall because their earnings outlook has deteriorated or corporate bonds are yielding more or because investors are shell-shocked, "cheaper" simply may be a milepost en route to zero. Citigroup and General Motors certainly are cheaper today; are they better values?

All investments are relative, not absolute. Relative to corporate bonds, stocks are overvalued. I would like to make it stop, too.