Which Market Is Overvalued?

One of the odder aspects of the investment business is the differing perceptions bond traders have of themselves and of stock traders; the words “genius” and “doofus” are applied, sometimes silently and sometimes not; you are free to assign which label goes where.

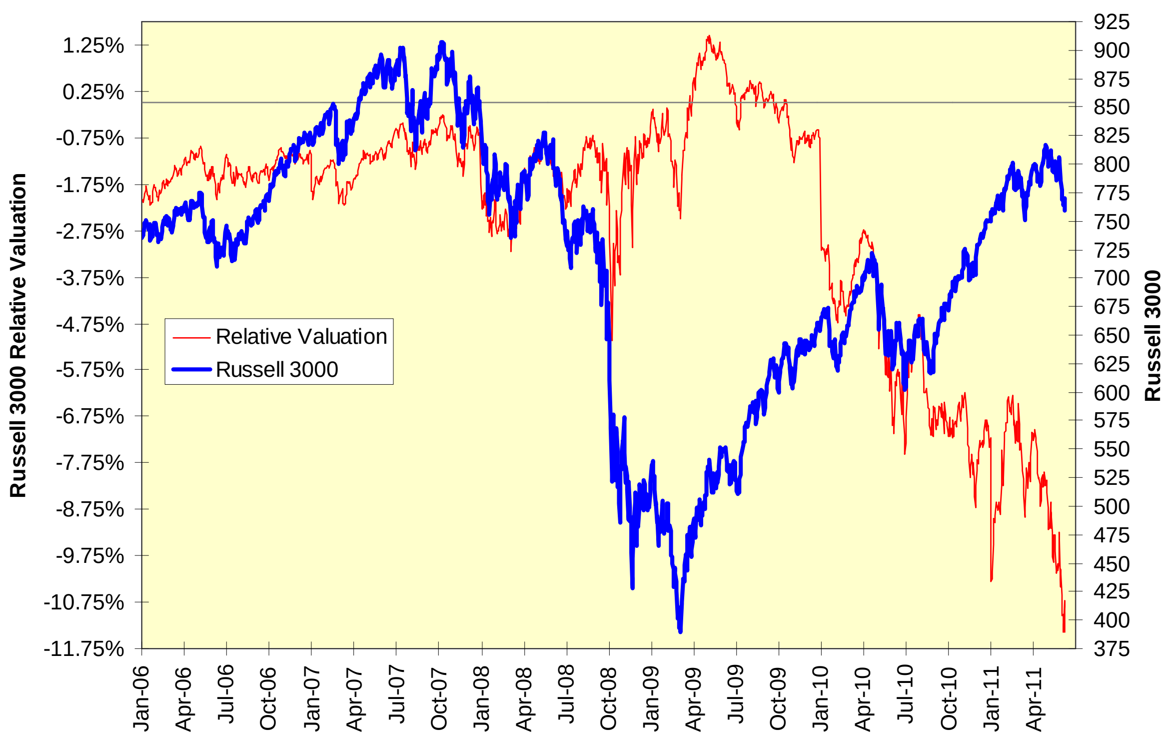
This is perplexing in light of how often credit markets blow up, especially when option-laden products such as mortgages are involved. My theory is stocks have unbounded upside appreciation potential and therefore invite hucksterism while bonds have limited upside potential and therefore invite financial engineers to engage in “product enhancement” strategies that proceed as well as a nine year-old playing with a nitroglycerine-enhanced chemistry set.

Relative Valuation

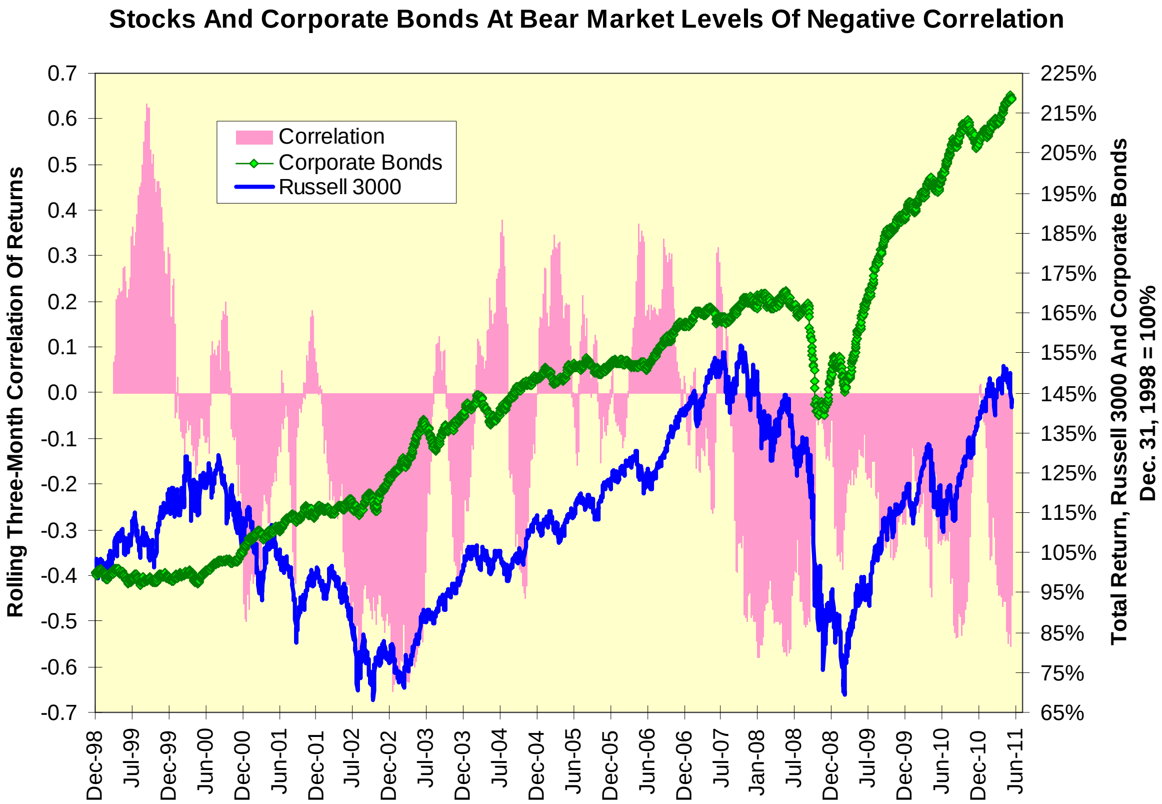
It appears, however, risky bonds have stumbled into a position of overvaluation through a combination of ever-lower Treasury rates and compressed credit spreads (You want to know when genius fails? Ask your local Einstein to spot you $20; your actual creditworthiness will be misjudged every single time. It does not matter if you are a subprime borrower or a large bank; your allegedly measurable risk is actually an unknowable uncertainty).

However, if we map the valuation of the Russell 3000 index relative to the Merrill Lynch Corporate & High-Yield Master bond index, we find stocks have become cheaper relative to corporate bonds all through the post-March 2009 rally. The comparison here is based on forward-looking top-down price/earnings and dividend yield measures for the Russell 3000 and yield to maturity for the bonds. We can argue all day and all night whether the analysts’ earnings estimates are biased (of course they are; they work on Wall Street); once that is done, we have a simple plug-and-chug calculation and the answers are what they are.

Price And Relative Valuation of Russell 3000



Interestingly enough a rolling three-month correlation of returns between the two indices shows we are at a level normally visited only during a bear market. As the bonds’ returns are rising and stocks’ have been falling, we must conclude the debt claim on corporate cash has become quite expensive while the equity claim has become cheaper. Who is the starry-eyed cheerleader now?



The present state of affairs can be restated as bond investors over-paying for the perception of safety and stock investors underpaying for a dollar of dividend income. Viewed on this basis, stock investors remain chastened while bond investors are eager participants in a bubble driven by excess financial liquidity.