Stocks' Relative Valuation Conundrum

Those who still believe in Santa Claus might believe financial markets occasionally pass out gifts as well. How else can we explain the eternal search by traders and investors for an alternative that is "cheaper" on a relative valuation basis for any given level of risk?

The answer, of course, is while investors might pay lip service to efficient markets, they believe otherwise. I found in a former life of designing option-based commodity hedges I could present two alternatives to clients, one of which was initiated at a debit and the other at a credit. Even if I could demonstrate the debit alternative was the most efficient, they always took the credit, so much so that I just stopped wasting everybody's time and simply presented the most attractive credit.

So here is a little free advice for all of you aspiring trading strategists: When the first step of a trade involves cashing a check, you will have their full and complete attention.

Stock-Bond Equivalence

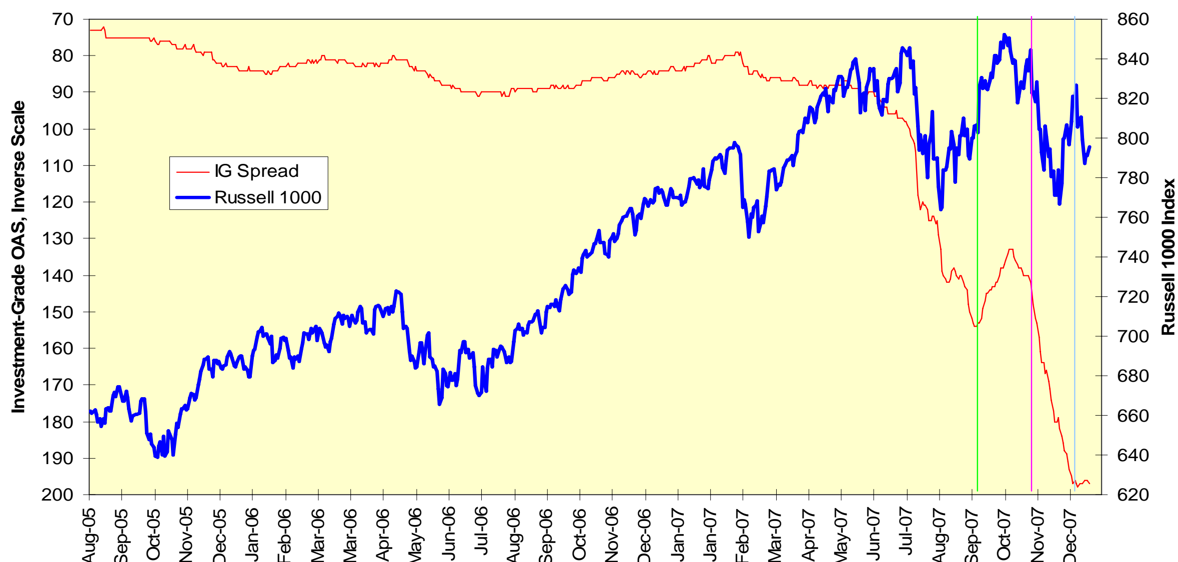
There are several ways to link stock and bond prices. One common way, referenced here last week, is to compare the earnings-to-price ratio of a stock or stock index adjusted for earnings growth against the yield of a Treasury note. This method compares risky stocks against risk-free Treasuries and ignores the distortions produced in the Treasury market by the periodic flights to quality.

I noted in September, these distortions are powerful enough to render the breakeven rate of inflation in the TIPS market suspect, and TIPS and conventional Treasuries both have the credit rating of the U.S. government. Should we really feel comfortable comparing stocks and Treasuries when one market often acts as a refuge from the other? To ask the question is to answer it.

A second way, noted in August 2005, involves comparing the insured yield on a given corporate bond – that is, a bond plus a protective credit default swap – against that company's stock price. The premise here is simple. If the risk of lending money to a corporation rises and bonds stand senior to stock in a corporation's capital structure, then an investor should not be interested in the stock. However, as noted in May 2005, this simple premise can break down when a stock becomes priced for controlling interest in a corporation as opposed to mere ownership.

Corporate Bond Indices

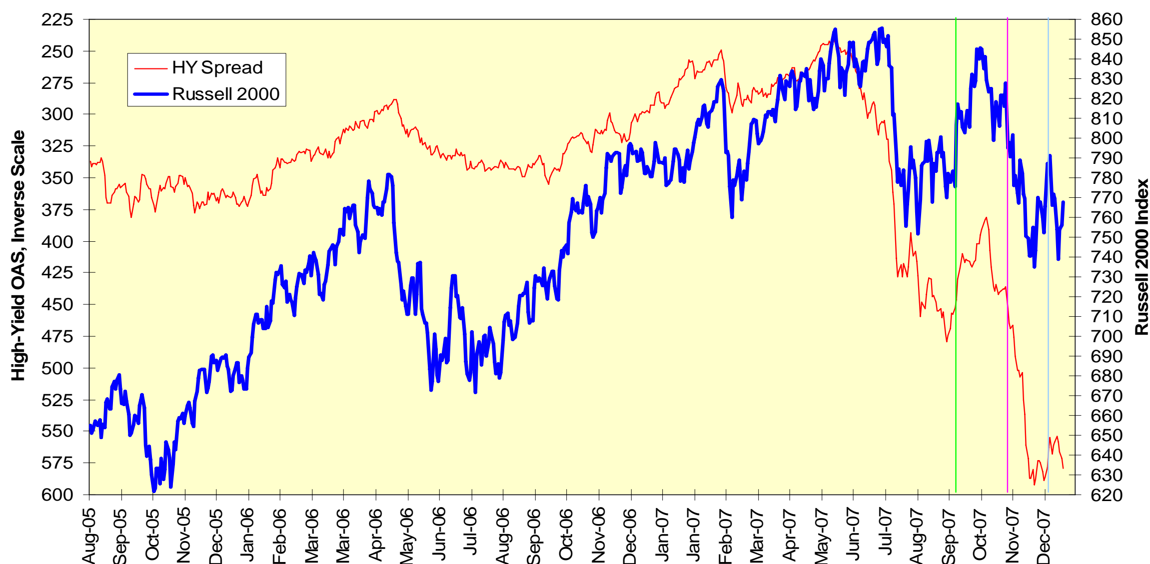
A third alternative is a twist on the second, and that is comparing the spread of a broad class of corporate bonds to a broad stock index. Let's compare the option-adjusted spread for investment-grade bonds, plotted inversely, to the large-capitalization Russell 1000 index. The dates of the three most recent FOMC meetings are marked with green, magenta and pale blue lines here and subsequently.



So long as investment-grade bonds had a stable spread to Treasuries, the Russell 1000 rose. Once the spreads widened in late July, stocks moved into their present trading range. If the Russell 1000 was beholden to corporate credit, it should have fallen severely by now.

As an aside, corporate credit spreads narrowed slightly after the September rate cut, but widened thereafter. The Federal Reserve has done nothing to restore order to this market.

The match between high-yield corporate bond spreads and the small-capitalization Russell 2000 index was even closer until late July. Once again, if stocks were beholden to corporate bonds, the Russell 2000 should be in full retreat by now.



Unless we are willing to believe stocks have supplanted bonds as a less risky asset, we have to conclude stock investors feel they are getting something in return for ignoring the bond market's screaming. That "something," I wrote last May and continue to believe, is a recognition foreign buyers and others willing to price stocks for control will continue to buy U.S. equities. Our trade and budget deficits and our wounded financial intermediaries demand the vast quantities of capital available at the sovereign wealth funds. This put America up for sale and it will be the foreign buyers, not the Federal Reserve, who will end our credit crunch by buying U.S. assets.

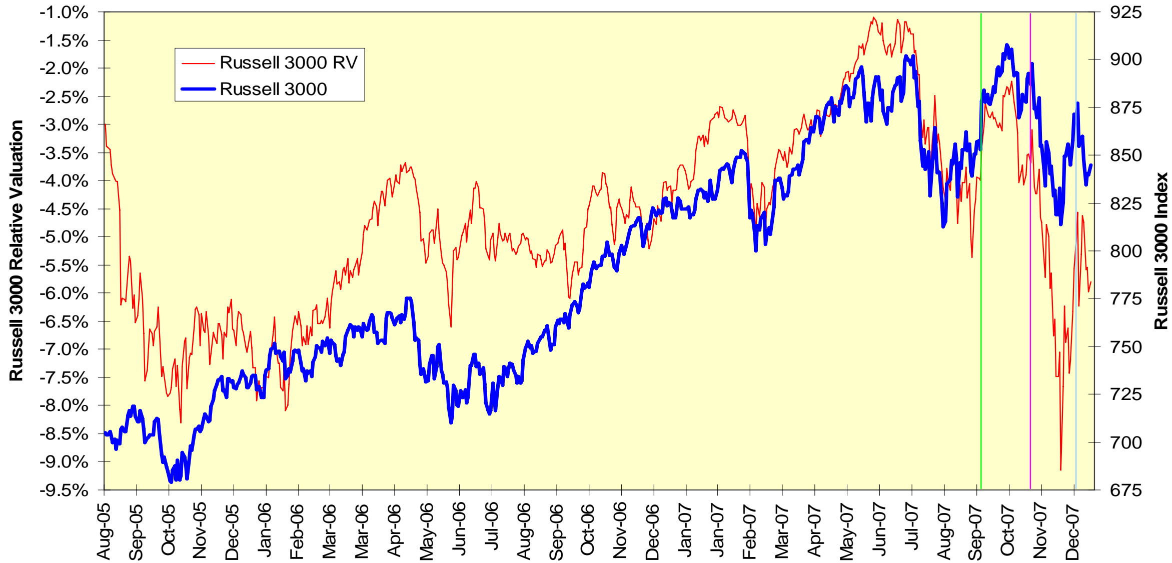
Back To The Fed Model

Let's reconstruct the Fed model at the ten-year horizon by using consensus top-down expected price-to-earnings ratios for the broad-based Russell 3000 index and the Russell 3000 growth and value indices. In each case, the more negative the relative valuation number, the more undervalued the stock index is relative to the ten-year Treasury.

As long-term interest rates plunged in mid-October, stocks looked increasingly attractive by virtue of money fleeing from risky assets to Treasuries. While this may seem preposterous, it makes perfect sense economically; the more one asset is sold in favor of another, the more undervalued it becomes on a relative basis.

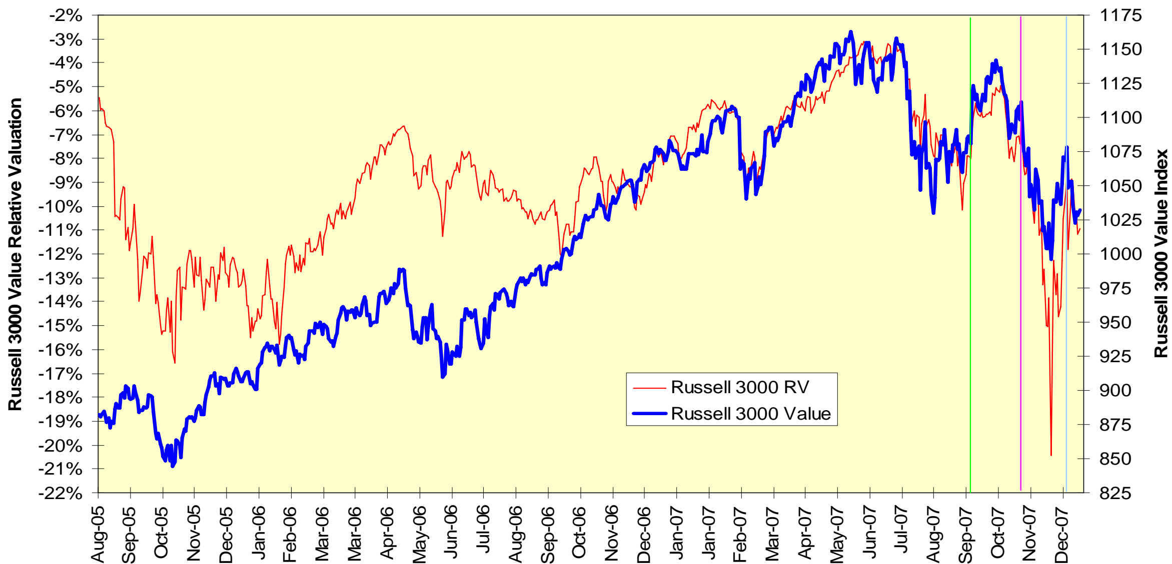
The Russell 3000 itself has been undervalued continuously since Bloomberg began reporting the consensus estimates in August 2005. It is as attractive now as it was throughout much of 2006; this can change quickly if long-term interest rates rise or earnings estimates fall.

Price And Relative Valuation of Russell 3000

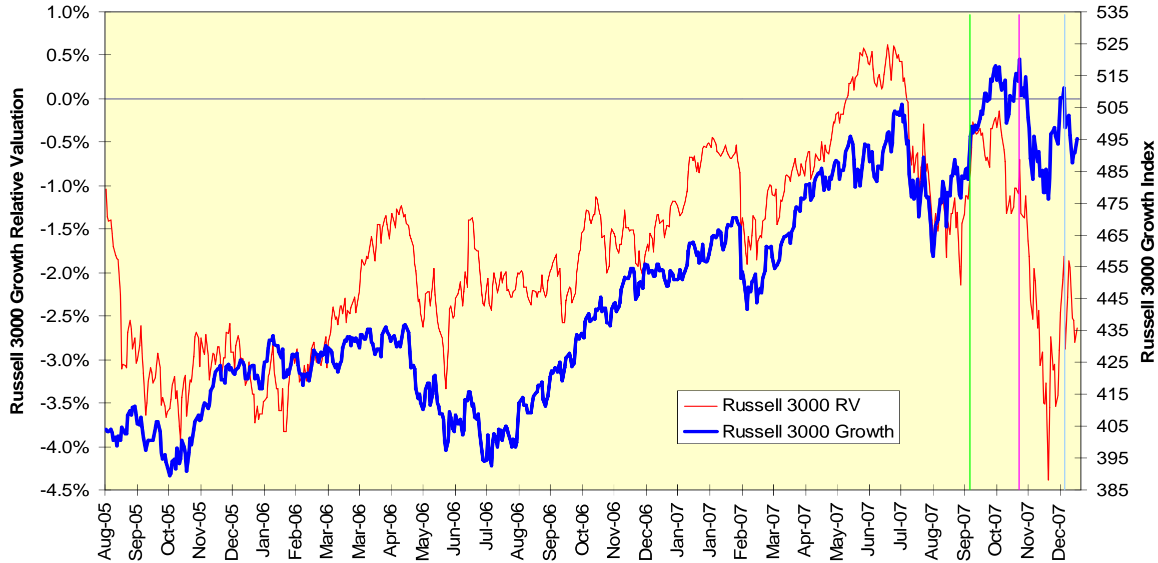


Now comes the fun part. The value index has been cleaving quite closely to its relative valuation measure, and the relative valuation of the value index (sorry) has not become significantly more attractive of late. Restated, lower interest rates have not done the trick nor have earnings estimates expanded.

Price And Relative Valuation of Russell 3000 Value Index



The story looks quite different for the Russell 3000 growth index. Here stocks have become increasingly attractive in the current environment. This is in accordance with conventional financial theory holding growth to be more attractive as long-term interest rates fall. We can surmise as well the market is looking at a strong global economy and saying these stocks will be able to prosper and secure financing regardless of the U.S. financial system's present morass.



A Bullish Conclusion

While I do not dismiss the possibility of some real trouble in the world, I have to concur both with the strong performance of stocks relative to corporate bonds and with the strong performance of growth relative to value. There is plenty of capital in the world, increasingly in sovereign wealth funds, and that capital will do what the increasingly ham-handed central banks have been unable to do, and that is allocate funds to where they are needed. The downside, alas, is more and more of ownership of U.S. assets will be in foreign hands. But just as we financed much of the rest of the world in the 1950s and 1960s to everyone's benefit, and just as we bailed out various Third World debtors in the 1970s, 1980s and 1990s, we will be "bailed out" here.

Is that the end of the world? Hardly; just look at my list from last month of how well those Third World markets have done relative to us. It gives us something to look forward to, does it not?