Weekly Market Commentary

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Are Stocks Overvalued?

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Highlights

- The recent range-bound pattern of performance of the S&P 500 is remarkably similar to what took place during the early summer months. This pattern suggests that the recent stock market slide may not be the end of the bull market, but it may also not be the end of the pullback either.
- Stocks are not overvalued. The rebound in P/E associated with the end of a recession was, on average, 37% over the 14 months following the low in the stock market. P/Es are currently tracking the average rebound very tightly with further room for improvement.

Back in the summer months of May, June, and July, the stock market, measured by the S&P 500, remained in a range around 900 after investors moved from pricing in another great depression to a typical recession. Now, this fall, the S&P 500 has been in a range around 1050 as investors have moved from pricing in a typical recession to a recovery. The recent pattern of performance of the S&P 500 is remarkably similar to what took place during the early summer months.

The nearby chart of the S&P 500 compares this summer's performance (from April 22 through July 31) and the pattern this fall (from September 1 to now) [Chart 1]. They are nearly a perfect match, with the fall being exactly 150 points higher on the index than during the summer. What this suggests is that the recent slide may not be the end of the bull market, but it may also not be the end of the pullback either. An eventual move down of a few more percentage points in the next few weeks may unfold if the S&P 500 tracks this summer's pattern. The slide may end as we start to get confirmation of the sustainability of the recovery in the form of better labor and spending numbers. The confirmation that the recovery was underway came in the later part of the summer in the form of consistently better than expected economic data.

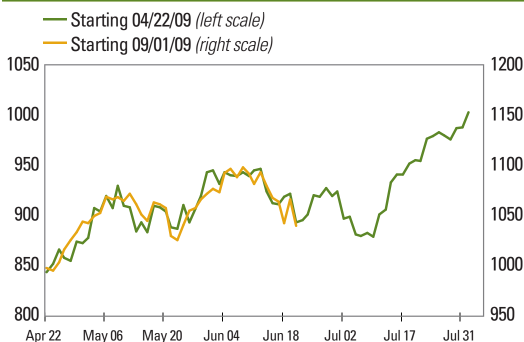
But could this pullback go a lot further? Has the 60% rally since March 9 pushed stocks too far? Are stocks overvalued? Our answer to all of these questions is no. In fact, there is room for a potential rise in valuations in the coming months.

When we discuss valuations we use the forward price-to-earnings ratio (P/E), defined as the price of the S&P 500 divided by the expected earnings of the companies in the index over the next year. This industry standard definition is used in favor of a trailing P/E that uses the earnings of companies over the prior year since it is the outlook for earnings that best measures market participants expectations and drives their decisions rather than what happened in the past.

There are three time periods over the past 30 years of data tracking analysts' earnings expectations that we can study to determine the extent of the rebound in stock market valuation associated with the end of a recession. These are the periods that followed the S&P 500 low point in 1982, 1990, and 2002.

The amount of the rise varied, but, on average, P/Es rose 37% over the 14 months following the low in the stock market. P/Es are currently tracking the

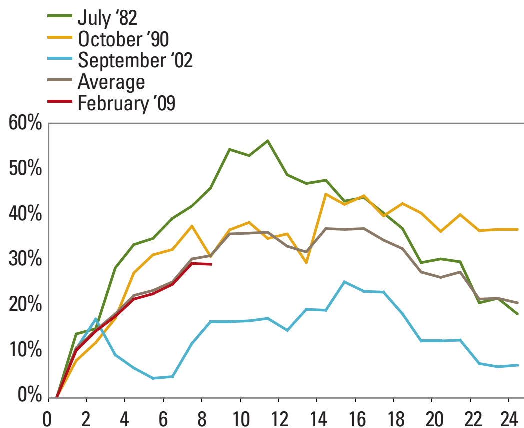
1 Déjà vu
S&P 500 Summer and Fall Consolidations



Source: LPL Financial, Bloomberg
The S&P 500 is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

2 S&P 500 Valuation Tracking Path of Prior Post-Recession Recoveries

S&P 500 Price-to-Earnings Ratio Recoveries in Months from the low in S&P 500 Index



Source: LPL Financial, Factset Research Systems

average of the three prior scenarios very tightly which suggests further room for improvement [Chart 2].

While in 2002 P/Es were at record highs and had no where to go but down, in 1982 P/Es bottomed at record lows and had nowhere to go but up. Also, there are concerns that this recovery may be a jobless recovery and somewhat weak. However, it is worth keeping in mind that looking back to the periods following the 1990 and 2001 recessions that were called "jobless" recoveries at the time, there were questions about the sustainability of those recoveries. So, on balance, the scenarios are comparable and reflect the range of potential outcomes.

Our analysis of the monthly data suggests P/Es may rise 37% from the low of 11.3 in March of 2009. The P/E has already achieved most of that rise. A continued rise in the P/E to the historical average expansion of 37% would produce a P/E of 15.25 as the peak at the end of April 2010, 14 months after the market bottom.

Some may recall that the P/E at the low point for the S&P 500 was actually 10.5. If we use the actual day the market bottomed in each scenario—rather than the month end—the low point was a little lower and the typical rebound in valuations was a bit greater, about 45% over 14 months. The closing daily low in the S&P 500 in early March 2009 put the P/E at 10.5. A 45% gain would lift this daily P/E to 15, not materially different from our monthly approach.

The S&P 500 is tracking the average very closely since the February 2009 low, with room for improvement. A P/E of 15.25 on the 12 month forward estimates 14 months from the start of the rise at the end of April 2010 (we expect to be about $82) suggests a level of 1250 on the S&P 500 at the valuation peak in 2010. This supports our overweight position to stocks, in general.

Of course, valuation is depended upon earnings—if earnings were to fail to recover stocks would be overvalued. Fortunately, 80% of companies have exceeded analysts' estimates so far during the third quarter earnings season and many companies are raising their earnings outlook for the next year bolstering our confidence in the recovery into 2010. We expect earnings to rise to about $75 to 76 in 2010, by year end we expect them to recover back where they were in 2005, about 20% below the peak in mid-2007.

While volatility around the 1050 level on the S&P 500 may continue, we do not believe that stocks are overvalued or that stocks are on at the beginning of another major decline. While our favorite asset classes such as small cap and emerging market stocks are trading at a premium to large cap US stocks represented by the S&P 500, we find the greater outlook for earnings growth justifying their premium valuations.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

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