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Will Stocks Ever Be Truly "Cheap" Again?

There appears to be strong agreement among market strategists and economists that, as an asset class, US stocks are expensive. Frequently there is advice attached to that observation: buying or owning expensive stocks is risky and leads to poor subsequent returns over time. Is any of this true?

Let's address this question from several angles. First, what do people mean when they say stocks are expensive? Most metrics compare the market value of companies to some underlying measure of performance, such as dividends, sales, cash flow, or most commonly, earnings, via the price/earnings (P/E) ratio. The average P/E ratio (using reported results for the prior 12 months) for stocks in the US has been in the range of 14-16x for the last 90 years. But for the last 20 years, the average P/E has been nearly 18x; for the last 10 years, nearly 19x; and at present, over 24x. If historical benchmarks are how we should evaluate stocks, then yes, P/E ratios are high, and stocks are expensive. In fact, Goldman Sachs estimates that only 2% of the time has the S&P 500 ever been *more* expensive.

Next, what can investors expect when buying into expensive stock markets? J.P. Morgan research indicates that, historically, forward five-year returns on the S&P 500 have averaged in the low single digits when P/E ratios have been at their current levels (although predictability of returns for periods less than five years long is poor).

A reader could be forgiven if he or she decided to stop reading and sell everything! But there are other elements to consider that muddy these valuation waters considerably.

First, it's possible that historical valuation comparisons may not be apt. The performance of the S&P 500 index is driven by its largest components, particularly technology and communications firms. These businesses are very different from those that dominated the index decades ago. They are more stable, less subject to extreme cyclicality in earnings, have much higher profit margins, and much higher returns on capital because they do not require much capital. Google and Facebook, for example, have no factories and no inventories, and each incremental dollar of revenue costs almost nothing to produce. These kinds of companies simply didn't exist until fairly recently, and they are inherently better businesses than, for example, a manufacturer. If the stock market is dominated by such companies, then the market *deserves* its higher valuation relative to history.

A second consideration arguing for higher valuations (or, that one should not expect stocks to be truly inexpensive very often) is the fact that the large institutions dominating the markets typically have a mandate to be fully invested. The world is awash in liquid capital available for investment, and any portfolio manager waiting for a "fat pitch" opportunity will find competitors eager to step in and buy at higher prices than he or she considers "cheap". Further, material new information is widely disseminated, and much more quickly, than in decades past. With nearly all portfolio managers having access to the same information, and with pressure to avoid holding idle cash, opportunities to buy stocks at less-than-fair value are increasingly short-lived.

Further, when we ask if stocks are expensive, an appropriate answer is: compared to what? A given investment dollar is always going to be placed in one asset or another, even if it's simply cash. Stock market valuations must be considered relative to the alternatives, not in isolation.

And here is where the picture changes dramatically. With bonds being the most immediately available alternative, how do stocks look by comparison? A stock valued at a P/E multiple of 8x might not be "cheap" if inflation and interest rates are in the double digits; a multiple of 30x might not be "expensive" if rates are extremely low and growth in dividends and earnings are strong.

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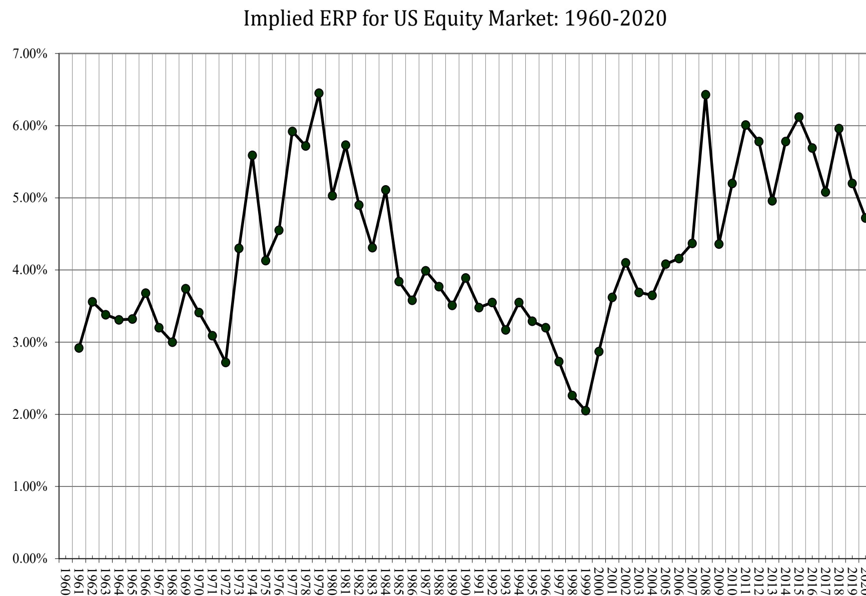
We address this question via the "equity risk premium" (ERP), which is the incremental return over the risk-free asset (US Treasury bonds) that a stock market investor should expect to receive, expressed in percentage terms. The ERP is the "price" of stock market risk. It can be high when rates are low, or low when rates are high, or any combination of the above. The higher the ERP, the greater the *implied* stock market risk – and therefore, the higher the expected return.

At today's rock-bottom interest rates, then, are stocks that expensive? According to research by Prof. Aswath Damodaran of NYU – the "dean" of stock market valuation studies – the currently implied ERP as of July 1, 2021 is 4.4%, comfortably in the middle of its historic range (shown below). In fact, it's notable that today's ERP is not terribly different from where it was in 1982, which was at the dawn of a significant bull market, when inflation was raging, and interest rates were in the high teens. A very good argument can be made that stocks exploded higher after 1982 not because they were cheap at the outset, but because earnings rose sharply while interest rates began a multi-decade collapse.



Research by Goldman Sachs and J.P. Morgan reach a similar conclusion: given prevailing interest rates, stock market valuations are roughly in line with their long-term historical averages, and it would require a significant increase in interest rates and inflation to change that. Unfortunately, such a scenario would be even more painful for bond investors reaching for yield with long-dated maturities. "Everything is relative" in the world of valuation, and stocks appear better positioned for such an outcome.

Everyone would like to have the opportunity to buy stocks when they are undervalued. The difficulty with timing such an attempt is that it's harder to know when they are inexpensive – history may not be as useful a guide – and the market is likely more efficient than in decades past – leading to fewer such opportunities regardless. Holding out based solely on valuation carries a high opportunity cost and could leave investors on the sidelines for a long time.

Sources: A. Damodaran/NYU, Goldman Sachs, J.P. Morgan, Bespoke Investment Group

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