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ARE THE MARKETS OVERHEATED?

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Are The Markets Overheated?

The most widely used metric to compare attractiveness of stocks versus bonds is the Fed model wherein the earnings yield of stocks is compared with bond yields. Currently, the earnings yield for stocks is about 6.50% compared to 4.56% for 10-year treasuries making stocks more attractive. What this implies is that stock valuations are not stretched in the US. Stock valuations are equally attractive in the international and emerging markets. In terms of forward P/E, the US stock market as measured by S&P trades at 15x 2007 earnings while developed international markets trade at 13x and emerging markets trade at 11x next years earnings – all at median or below median levels.

Money managers have in recent times lowered their cash flows. While some bears might indicate that it is a sign that markets are overheated, it can be argued that money managers are finding opportunities because of the reasonable valuations of stocks – especially the larger cap, high quality companies.

Some bears observe that shorts are creeping up on the S&P 500 Index and Nasdaq as a sign that the markets are due for a correction. The trading horizon for shorts typically tends to be short-term and will tend to cover their shorts if markets continue to rise causing it to go even higher. It is debatable if short term traders can be considerd smart money.

However, what market observers are worried about is that we are in the midst of the second longest bull market run. In addition, low volatility in stocks and bonds has caused these observers to worry about the mispricing of risks in the markets. What is causing this market to run for so long? Primary reasons have been low inflation, low interest rates, increasing profitability, and synchronized global recovery. Are these factors still present? For the most part yes – although inflationary pressure may be on the rise and global interest rates have steadily climbed but are still at reasonable levels. Profitability continues to be strong and global economy is chugging along albeit slowing compared to recent years.

What can upset the markets in the near term? Rising inflation and interest rates can impact the markets significantly. As such, oil prices could be the key going forward. However, it is in the interest of OPEC to keep oil prices below levels that would choke the demand for oil and cause significant slowing global economy. Thus, it is difficult to envision an environment where oil prices stay more than $80 for sustained periods of time resulting in higher inflation and higher interest rates. The world has shown that it can tolerate sub-$80 prices.

It is not clear we can dismiss the possibility of a small correction in the markets in the short-term. However, short-term corrections are part and parcel of investing in the stock markets. Studies have shown that market timing is pretty much impossible to achieve on a consistent basis. Chasing the markets has not proven to be a winning strategy.

Going by the indicators of shorts increasing, investors would have exited the markets in late 2004. If investors were to pull out their money in November 2004, they would have missed out an annualized return of 12.31% from 12/01/2004 to 11/21/2006 as measured by Russell 3000.

We at Beacon Pointe meet with hundreds of money managers (the real smart money or at least more informed money) that run money in various assets classes (stocks, bonds, real estate, private equity, and hedge funds) and we are in a much better position to assess where the smart money is put to work. We gravitate to managers that focus on high quality companies that perform well over the long-term and especially so when things slow down. So, even if there is a slowdown coming soon, we are confident that our clients' money (and ours) are in safe hands. It is important to keep in mind that great long-term capital appreciation comes not just from participation in bull markets but, more importantly, by protecting capital in down markets.

We believe that having the global valuations at current levels, with low interest rates, reasonable inflation, and moderate global economic growth prospects, it makes sense to stay invested. The returns we show to our clients include the worst bear market in many years (S&P down by -45%) and our clients still came out ahead by staying invested. We are nowhere near the egregious valuations that existed in the late 90s and early 2000. As such, our stance is to navigate around the noise and stay invested. A fully diversified portfolio will enable our clients to achieve their financial goals over the long-term with lower volatility.