Are Equities (and other risky assets) Overvalued?

Its the beginning of the 4th quarter and the 3rd quarter performance results and commentaries from the hedge fund managers are coming in thick and fast. A common thread runs through most of them. Risky assets are over-valued. Some say equities are overvalued, some say corporate bonds are overvalued. Who can tell? I decided to look at the state of the world in isolation of the past, with no memory of 2008, or the first half of 2009, with no memory at all.

Economists expect economic growth to be positive albeit low. In emerging markets the growth expectations are brighter, in developed markets poorer. Economists expect unemployment to rise or not improve. They expect industrial production to slow down from the current rebound from the inventory restocking. Inflation expectations are all over the place. On the one hand they expect monetary policy to be highly inflationary and on the other, excess capacity abounds in most industries.

Looking at S&P valuations, we find PE expectations of 18X for current year, 14X for 2010 and 11X for 2011. This equates to an earnings yield of 5.6%, 7.1% and 9.1% respectively. Earnings expectations continue to be upgraded from the overly pessimistic expectations of the earlier part of the year. Dividend yields, however, are close to 2.2 – 2.3 % p.a. over the 3 years. How realistic are these expectations? The current estimates are based on getting it wrong on the downside earlier in the year and adjusting the estimates upwards as realized numbers are reported. That said, profits are being driven by cost cutting rather than top line growth. The probability is significant that there will be a downturn in profits which will necessitate a revision of estimates to the downside.

Corporate bonds are yielding between 1% to 2% over treasuries depending on rating, (A to Baa). Call it 1.5% on average. Depending on your duration, this is either 1.8% over 1 year or 2.5% over 2 years or 4.8% over 10 years.

3M USD LIBOR is at 0.28%, 1 year US T bill is yielding 0.33%, the 2 year 0.90% and the 10 year 3.26%. The yield curve is steep. The long end has sold off as risk has been transferred from private sector balance sheets to the public balance sheet. Policy makers are keeping short rates low and are likely to keep it lower for longer to spur economic growth.

Real estate valuations are stretched. Rental yields are low. Capital values are low but rentals are even lower. Moreover, real estate demand is highly dependent on the availability of credit, which is generally still scarce and especially so for real estate investments.

Commodities are highly cyclical and dependent on GDP growth. Demand for industrial commodities is expected to be robust in emerging markets and weaker in developed markets.

For the investor asset allocating to the various available markets, and investing with no memory, what are the choices? Also, we assume that the investor is not investing in alpha, hedged, arbitrage, relative value or long short strategies.

Equities appear cheap relative to credit and cash. Earnings yields of over 5% compare well with corporate bond yields of 2.5% to 4.8%. This is not adjusted for default and recovery assumptions. Compare equity dividend yields and the picture changes firmly in favour of credit. You get a higher cash flow yield and seniority of claim.

Compare equity dividend yields and corporate bond yields with cash and treasuries, however, and at least in the short term, risky assets are attractive.

Now add back recent memory. 2005 – 2007 saw a strong rally in risky assets. At the end of 2007 one would have found risky assets attractive and probably buying the dips. This ended in a big bust in 2008 extending into early 2009. At the end of 2008, one would have been deathly fearful of risky assets. There is currently a healthy skepticism over the current market rally. It has not yet reached the stage where the majority is in love with risky assets. So, are expectations and sentiment merely noise?