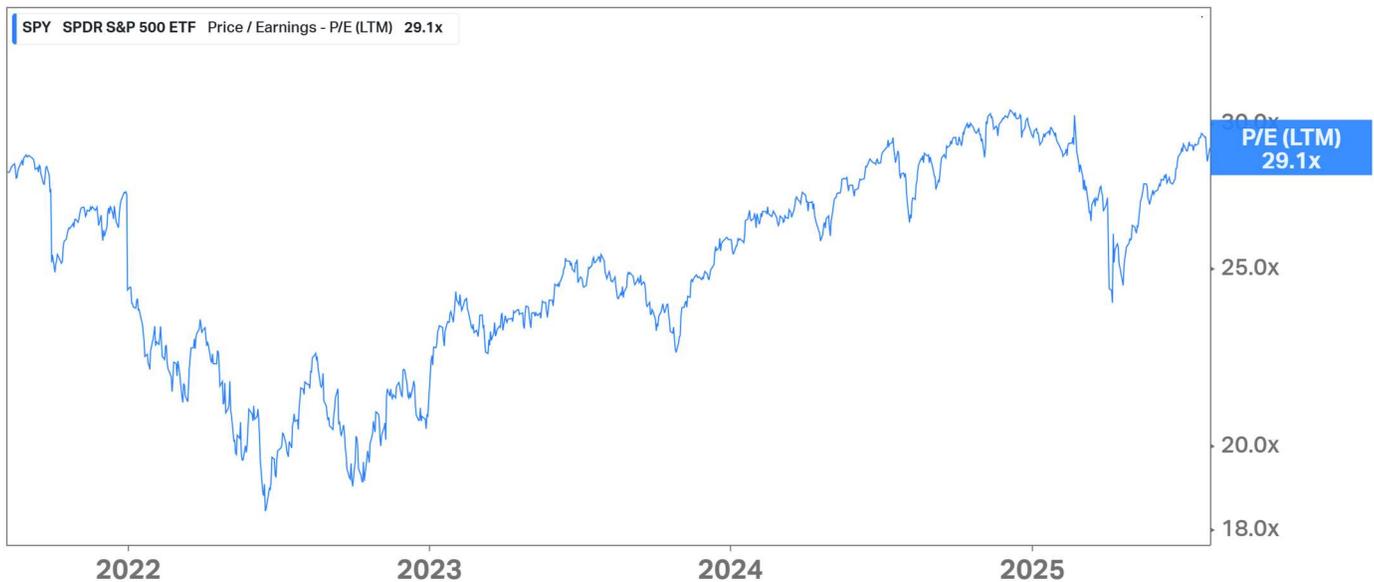


## CURRENTS: Valuations & The Price Of Optimism

US equity markets have surged the last few months, largely setting new all-time highs after a major correction and short-lived bear market in April. In this issue, we explore a couple ways to value the price we pay for an investment.

One of the most common valuation metrics investors consider when analyzing equity markets is the price-to-earnings (P/E) ratio. The P/E ratio tells us how much investors are willing to pay for every \$1 of earnings. Let’s use the P/E of the S&P 500 as an example. As you can see from the chart below, the trailing 12-month P/E ratio of the S&P 500 is approximately 29x—which means investors are paying \$29 for every \$1 of earnings the index generates.



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A higher P/E often signals that investors expect stronger earnings growth in the future, or simply that optimism is running high. Conversely, a lower P/E might suggest more modest growth expectations, or potential undervaluation.

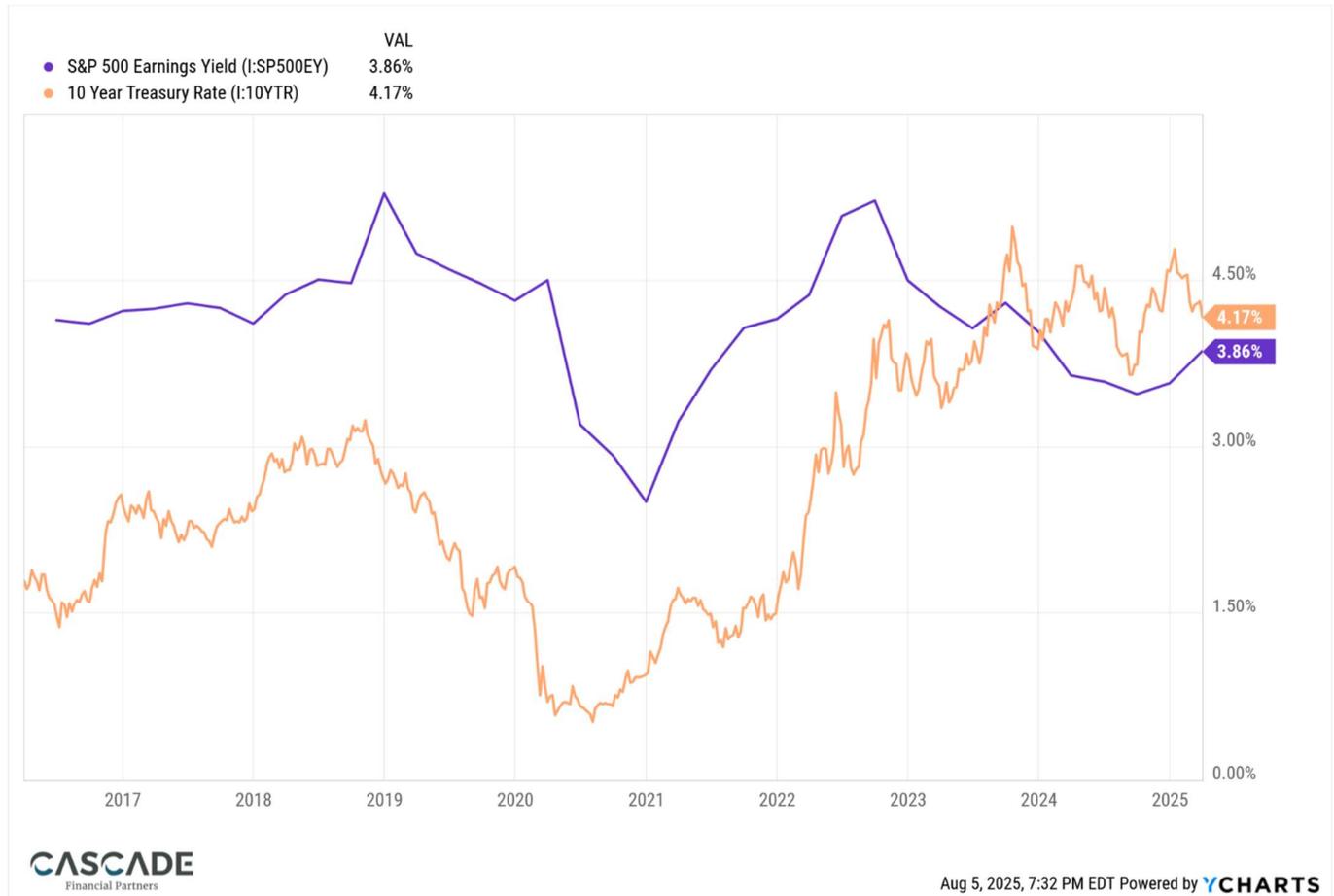
But the P/E ratio on its own can be misleading. It doesn’t tell us much about whether the market is attractive *relative* to other investment opportunities, such as bonds or real estate.

## Why We Prefer Earnings Yield

That's why we often flip the P/E ratio on its head and consider the earnings yield, which is simply earnings divided by price. It's the inverse of the P/E ratio, and it shows how much earnings the index generates for every dollar invested, expressed as a percentage.

This makes it easier to compare the stock market to alternatives, such as bond yields or real estate investments.

For example, the S&P 500's current earnings yield is about 3.8%, while the 10-year Treasury yield is around 4.2%. When earnings yields are higher than bond yields, equities often look more attractive. When they're lower, it's a tougher case to make. Take a look at the S&P 500 earnings yield relative to the 10-year treasury rate the last 10 years.





Overseas, the earnings yield for the MSCI EAFE (Europe, Australasia and the Far East) is approximately 5.2% and 10-year treasury yields are lower. The P/E ratio for the same index is approximately 19x versus 29x for the S&P 500. On a relative basis in both cases, valuations continue to look more attractive overseas.

### **A Real Estate Analogy: CAP Rates**

If the earnings yield sounds familiar, it's because it's a lot like a capitalization rate (CAP rate) in real estate. The CAP rate is calculated as net operating income divided by property price, and it tells us what we earn as a percentage for every dollar invested in real estate.

Just like we compare earnings yield to Treasury yields in stocks, real estate investors often compare CAP rates to borrowing costs. When CAP rates are lower than mortgage rates, that's called negative leverage. When they're higher, you've got positive leverage, which is a much more comfortable place to be.

### **So, Is the US Stock Market Cheap?**

Based upon these valuation metrics, it's expensive, at least based upon historical standards. That doesn't mean stocks can't go higher. They certainly can and likely will if earnings growth surprises to the upside.

We still believe in long-term market growth, and we continue to stay focused on allocation, planning, and discipline. That's where durable returns are built.

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