Priced for Perfection

Stock prices have reached what looks like a permanently high plateau.
Yale economist Irving Fisher, September, 1929

The U.S. stock market continued its powerful advance during the second quarter of 1999. Strong corporate earnings and expanding price/earnings ratios have brought the Standard & Poor 500 Index and Dow Jones Industrial Average to new highs with the S&P 500 Index closing over 1400 and the Dow breaking decisively through the 11,000 level. While the Dow lagged the S&P 500 last year in percentage gain, the Dow was up over 20% for the first six months of 1999, while the S&P 500 showed an increase of *only* 12.34%. The supercharged NASDAQ Composite, influenced by highflying Internet stocks, beat both indices with a 22.69% increase. It appears possible that the major market indices may be headed for an unprecedented fifth straight year of 20%+ appreciation.

The stock market's advance was interrupted by a 7-8% correction when the April Consumer Price Index (CPI) number was released in May. The CPI jumped by .7% - the largest monthly increase in years. The core CPI (CPI less food and energy) showed a more modest increase of .4% for the month. At the start of the year, the yield on the 30-year Treasury bond was 5%, but as fears of inflation grew, the yield rose, reaching 6% with the May release of the CPI number. Signs of economic recovery in Asia, accelerating U.S. corporate earnings, and the May jump in the CPI renewed fears of higher inflation and interest rates. Some investors predicted that the Federal Reserve would reverse the three interest rate cuts of last fall with three rate increases this summer in order to preempt inflationary prices. These uncertainties caused the market to weaken, inducing a 50% sell-off in the leaders of the volatile Internet sector. However, two events occurred which gave encouragement to the bulls: When the Federal Reserve increased interest rates in late June, the Fed also moved to a "neutral bias," signaling that they weren't necessarily intending to raise rates further. (Some investors have overlooked the fact that the Fed increased short term interest rates three times in 1994 when they were in a "neutral bias" mode.) The other bullish factor was that the CPI numbers released in both June and July showed no increase at all, providing some evidence that inflationary fears were overblown.

Market Valuations Now Compared with a Year Ago

A year ago at this time, Bradley, Foster & Sargent, Inc. changed its stance on the market, maintaining that valuations of the leading stock market indices had reached a level that called for caution. It was the first time since the inception of the firm in July, 1994 that we turned from bullish to neutral. At that time, the S&P 500 Index was at 1164 and sported a P/E ratio of 29.5 based on reported earnings for the preceding four quarters. The dividend yield was 1.38%, and price/book value was 6.2 times. Now, twelve months later, the S&P 500 Index is at 1403 with a P/E ratio of 36.6 based on the same methodology. The dividend yield has dropped to 1.19%, and price/book value is 7.5. Last year our caution proved to be justified as the market suffered a 20%+ mini-bear market, precipitated in part by the crisis in Russia and the collapse of Long Term Capital Partners. However, the market has rebounded and is now at even higher levels of valuation. So then, the real questions are as follows: In the words of Irving Fisher, whom we quoted at the start of this commentary, "Have stock prices reached what looks like a permanently high plateau?" Are the historical valuation models and tools, which show the U.S. stock market overvalued by 30-40%, outdated? Or, have the astonishingly good economic times and the powerful seventeen year bull market caused investors to throw caution to the wind, perhaps to create a U.S. stock market bubble, which could ultimately burst and bring price/earnings ratios back to previous historical valuation levels?

"It's Different This Time"

The famous investor, Sir John Templeton, is reported to have once said: "The four most expensive words in the English language are, *It's different this time!*" Is it really different this time? Should we ignore the tried and true rules of thumb and valuation tools which have worked for many decades? One such rule of thumb, which we have written about before, is the Rule of 20. This rule maintains that the price/earnings ratio for the broad stock market indices should be valued at the market's earnings times a multiple determined by subtracting the rate of inflation from the number twenty. For example, if the inflation rate is 4%, the market price/earnings ratio should be 16 (i.e.; 20 less 4). With the CPI running at around 2% (the CPI overstates inflation, according to the Boskin Commission by 1-2%), the Rule of 20 tells us that the market's P/E should be 19 or 20. Well, the operating earnings of the S&P 500 Index are forecasted to be approximately $50 in 1999, which would suggest that the S&P 500 Index should be around 1000. Instead it is 1400, indicating that a decline of 28.5% in the index would be necessary to bring it to fair value. Another valuation tool, which we understand the Federal Reserve uses, is to compare the earnings yield on the S&P 500 Index with the bond yield for the 10-year or 30-year Treasury bond. At the moment, the earning yield on the S&P 500 is 3.6%, while the yield on the 10-year Treasury bond is 5.7%. Using this tool, the S& P 500 index looks to be 36.8% "overvalued." If one uses the 30-year Treasury bond, the "overvaluation" moves to 39%. Clearly, the market is either overvalued, or things are really different this time.

Once in a long while, a paradigm shift does occur. One of the best examples of this is the correlation between bond yields and dividend yields of stock. From the dawn of the U.S. stock market in the 19th century, dividend yields on stocks were higher than bond yields. Always. It was a simple matter of logic. Stocks were riskier than bonds, so investors demanded a greater yield from stocks than from bonds. This rule of thumb held throughout the first half of the 20th century until the mid 1950's. At that time, investors in the stock market bid up stock prices to levels where the dividend yields were lower than bond yields. As the decades have passed, the margin between dividend and bond yields has steadily widened. Investors have accepted lower dividend yields for 40 years, because the accepted wisdom currently is that stocks, while more volatile, produce greater long-term returns than bonds. One of the factors which seemed to have caused this paradigm shift is our tax structure. Taxes on capital gains have become significantly lower than income taxes. As dividends and interest from bonds are taxed at rates as high as 40%+ (federal and state income taxes combined), most investors prefer to receive their investment returns in the form of stock price appreciation. When they take their gains, federal and state capital gains taxes amount to *only* 20-25%. This has caused many companies to dedicate their cash flow to buying back stock, thereby boosting earnings per share, rather than increasing dividends. It may also have induced investors to be willing to pay more for equities (valuing them at a higher P/E ratio) in relation to inflation and interest rates, causing a new paradigm. In short, this time it may be different.

The Ten Year Japanese Bear Market

During the last several days of 1989, the Nikkei Index of Japanese stocks traded on the Tokyo stock market hit 40,000. At these valuation levels, the Nikkei Index was valued at a price/earnings ratio of 80. The dividend yield was .38%, and the price/book was 6 times. There was much talk about how Japan was different and how the valuations there were different. One of the reasons used to justify these valuations was that earnings were understated. Another one was that "Japan, Inc." - the interlocking web of corporate share ownership, supported the market undergirded by the Japanese government. It was said that the government would never let the market crash. Another key reason was the low level of inflation and interest rates (1%), which supposedly justified huge P/E ratios. However these reasons proved illusory as the stock market began to drop. Here is how the Nikkei Index fared over the past ten years:

	Nikkei Index
December, 1989	40,000
March, 1990	30,000
September, 1990	20,000
August, 1992	14,309
October, 1998	13,000

With major Japanese structural reform underway and the Japanese government having provided an enormous fiscal stimulus to the economy this year, the Nikkei Index has risen to 18,500 over the past six months. There are differences between the Japanese business model and the U.S. model, and the terrible ten year bear market with Japanese stocks down 67% can not be easily compared to the U.S. However, Sir John Templeton's statement about being cautious in concluding, "Things are different this time" rings true.

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Perhaps it might be helpful to think of the stock market as a three-legged stool. One leg of the stool is the growth of corporate earnings. The second leg is interest rates, which are most influenced by inflation. The third leg is investor sentiment, which usually is most affected by aggregate demand for stocks and the liquidity to pay for them. The three legs of the stool look like this:

First Leg:	**Corporate Earnings**	*influenced by*: U.S. economic growth globalization technology fiscal and monetary policy political climate
Second Leg:	**Interest Rates**	*influenced by:* inflation monetary policy fiscal policy strong currency political stability
Third Leg:	**Investor Sentiment**	*influenced by*: liquidity/monetary policy fiscal policy retirement flow of funds employment foreign demand for U.S equities

The seat of the stool is the stock market's valuation. At the moment it is very high - with some sectors significantly overvalued. Yet each leg of the stool is very strong. Rarely have conditions in the U.S. economy been better, and corporate earnings are accelerating. Although interest rates on long-term Treasury bonds are now higher than they were a year ago, inflation remains low, giving investors grounds for hoping that interest rates have peaked. There is excellent liquidity in the stock market, and U.S. demographic trends can provide strong aggregate demand for U.S. equities. Although there is much speculation going on in the Internet sector of the market, this has not seemed to infect the rest of the market.

Overvaluation, in and of itself, does not usually cause a bear market. Market downturns generally occur because one or more the legs of the stool become wobbly and will not support the stool. We cannot foresee at this time which leg of the stool may weaken, but we do know that the stock market is currently priced for perfection.

On the other hand, perhaps it *is* different this time. Perhaps. Perhaps there is a new paradigm of equity valuations at a permanently higher level. Perhaps. It is not clear. But the future is never clear. A good part of the business of investment management is limiting the damage when you are wrong. So we will continue to exercise prudence and caution. We will stick to our craft of investing in high quality, growth companies at reasonable prices. We will maintain our discipline of proper asset allocation. And we will keep analyzing the market to see if a "new era" in equity valuation is emerging.

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