Are Stocks Overvalued?

Stock markets have been on a tear, with all three leading indexes in record territory. But valuations have also climbed, leading many to question if a correction is imminent.

As of the end of March, the S&P 500 was up 10% for the year and 28% since its October 2023 low.*

For equity investors, it's been a nice ride. Stocks have scored eye-popping gains in recent months, with the S&P 500 increasing 23%, the Dow Jones Industrial Average (DJIA) up 19%, and the Nasdaq composite gaining 24% in the six months ended March 31, 2024.* Several non-U.S. markets have also been steaming ahead, including Japan's Nikkei 225 index, which finally managed to top its previous record set way back in 1989.

The strong performance reflects a resilient economy with low unemployment, strong corporate earnings, robust GDP growth, and moderating inflation. It also reveals investors' expectations of lower interest rates to come. But the rally may be getting ahead of itself. Stock valuations have climbed precipitously in recent months, approaching levels not seen since the dot-com bubble in the late 1990s. Many investors are wondering if stock prices have overshot their mark and are headed for a fall.

What's in a Valuation?

Stocks are valued in different ways, based on a company's assets, book value, cash flow, sales, and dividends. The most widely used valuation metric is the price-to-earnings ratio, or P/E. It indicates what multiple investors are currently willing to pay for each dollar of the company's earnings per share. There are many varieties of the P/E ratio, depending on what earnings are used. Some use historical earnings and some use projected earnings. Some focus on current earnings and others look back at historical averages to better identify a trend.

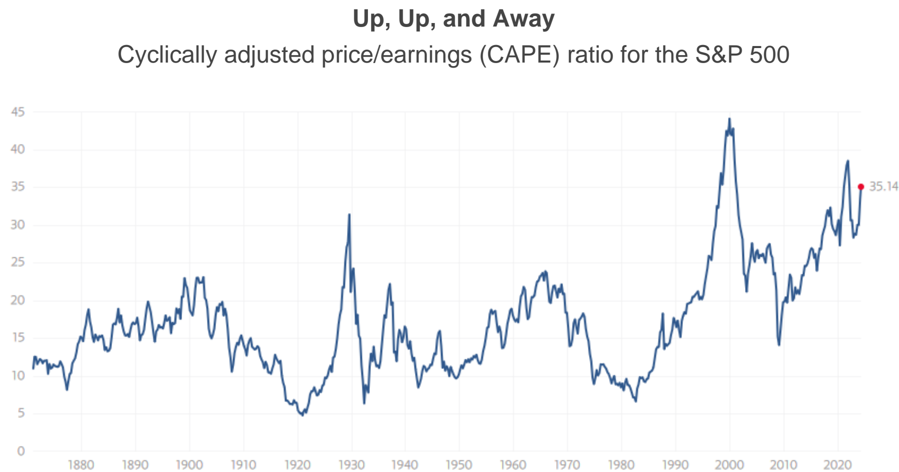
A commonly used hybrid is the cyclically adjusted P/E -- or CAPE -- ratio. It uses a moving average of 10 years of earnings, adjusted for inflation. By this measure, stocks do indeed appear to be overvalued. The S&P 500 had a CAPE ratio of 35 as of March 2024 -- more than double the long-term average of about 17. In the past 100 years, it has hit this level only three times: in 1929 before the stock market crash, in 2000 before the dot-com crash, and in late 2021 following the pandemic run-up.[1]

Using an alternative earnings metric, however, paints a different picture. Employing trailing 12 months of earnings -- the PE-TTM ratio -- the S&P 500 ratio came in at 28.5 as of March 13, 2024. This compares with a 20-year average of 24.7 -- still high but far from bubble territory.[2]

There are yet other ways to gauge whether or not the market is overvalued, each producing a different result. There is also the fact that the current run-up has been driven largely by a handful of mega-cap stocks -- the so-called "magnificent seven" (Microsoft, Apple, Nvidia, Amazon, Alphabet, Meta, and Tesla) and may not be representative of the overall market.

Up, Up, and Away

Cyclically adjusted price/earnings (CAPE) ratio for the S&P 500



Source: Morningstar. For the period ended March 2024.

Although the general consensus among stock prognosticators is that the market is currently overvalued, there is little agreement as to how much. Some say we are headed for a crash, while others foresee a continued run-up with a few bumps along the way. And just because stocks are expensive now doesn't mean they can't get even more expensive. Anyone heeding former Federal Reserve chairman Alan Greenspan's famous warning to investors of "irrational exuberance" back in 1996 would have missed out on three of the market's strongest performing years ever.

In short, determining whether the market is overvalued is not that simple. Ratios alone don't tell the whole story. The U.S. and global economy, wars in Ukraine and the Middle East, the outlook for inflation and interest rates, and of course politics -- all play a role. Another factor believed to be driving current valuations is AI and how it might boost productivity and corporate earnings. Some speculate that if AI were to really take off, it might drive markets to new peaks just as the advent of the Internet and cell phones did years earlier.

Time in the Market, Not Market Timing

The takeaway here for investors is to avoid putting too much faith in predictions. Forecasts depend heavily on the data and assumptions being used. They also vary widely and are often wrong. Even the experts cannot foretell the market's random walk.

You should also avoid trying to time the market -- usually a losing strategy, even for

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the pros. A better alternative over the long run may be a buy-and-hold strategy. Over time, stocks have outperformed other asset classes, though past performance is no guarantee of future returns.

Talk to an investment professional to find an investing strategy that best suits your particular needs.

* Google

[1]Morningstar. Shiller PE Ratio.

[2]GuruFocus, PE Ratio (TTM) for the S&P 500, as of March 13, 2024.

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