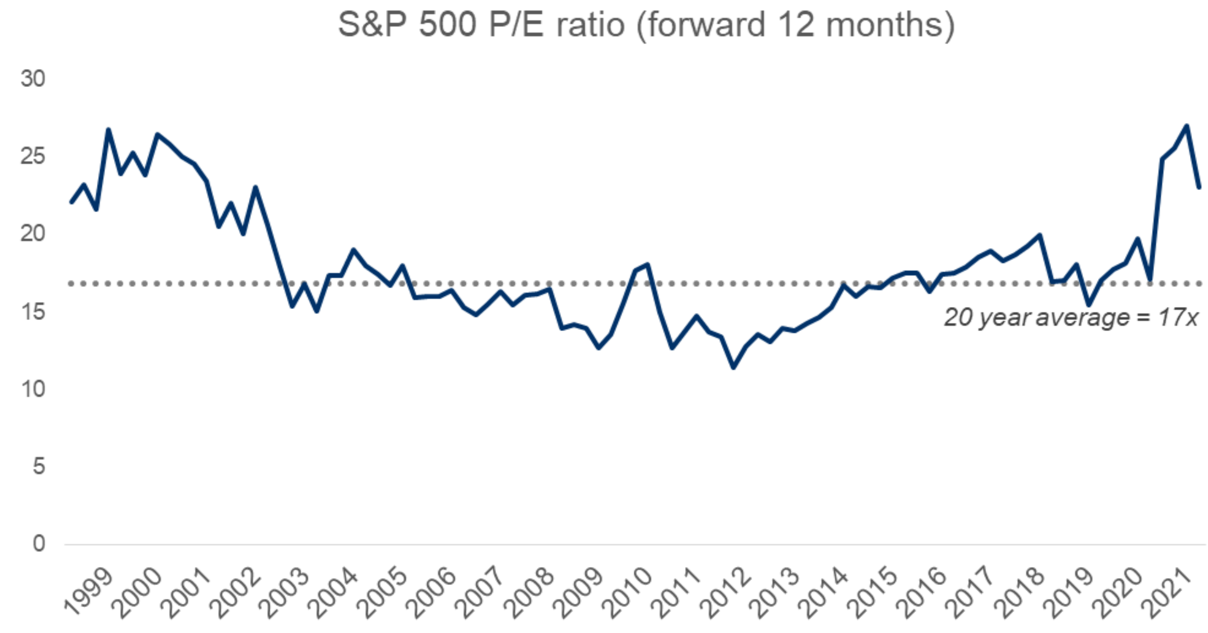
RBC Global Asset Management

INVESTOR **INSIGHTS**

A closer look at stock market valuations

The stock market has rebounded significantly from the depths of the COVID-19 sell-off. However, with the recovery comes the age-old concern for investors: "Is the stock market too expensive?"

Many static measures support the thesis that valuations are elevated. The stock market trades at a price-to-earnings (P/E) ratio of 23x. This means on average, investors will pay $23 for each dollar of earnings a company is expected to generate in the next 12 months. As can be seen below, that's quite a bit higher than the 20 year average of 17x.



Source: Bloomberg, RBC GAM. Bloomberg estimate price-to-earnings ratio quarterly from Mar 31, 1998 to Feb 17, 2021.

However, the chart above only looks at the market on an absolute basis – or the difference over time. To fully dive into the valuation of the market, you have to consider a relative basis. For example, how do stock prices compare to a risk-free investment such as government bonds? To dive deeper, consider two hypothetical scenarios where you are offered two options:

Scenario 1
Option A: You earn $100 with an 80% probability
Option B: You earn $99 with a 100% probability

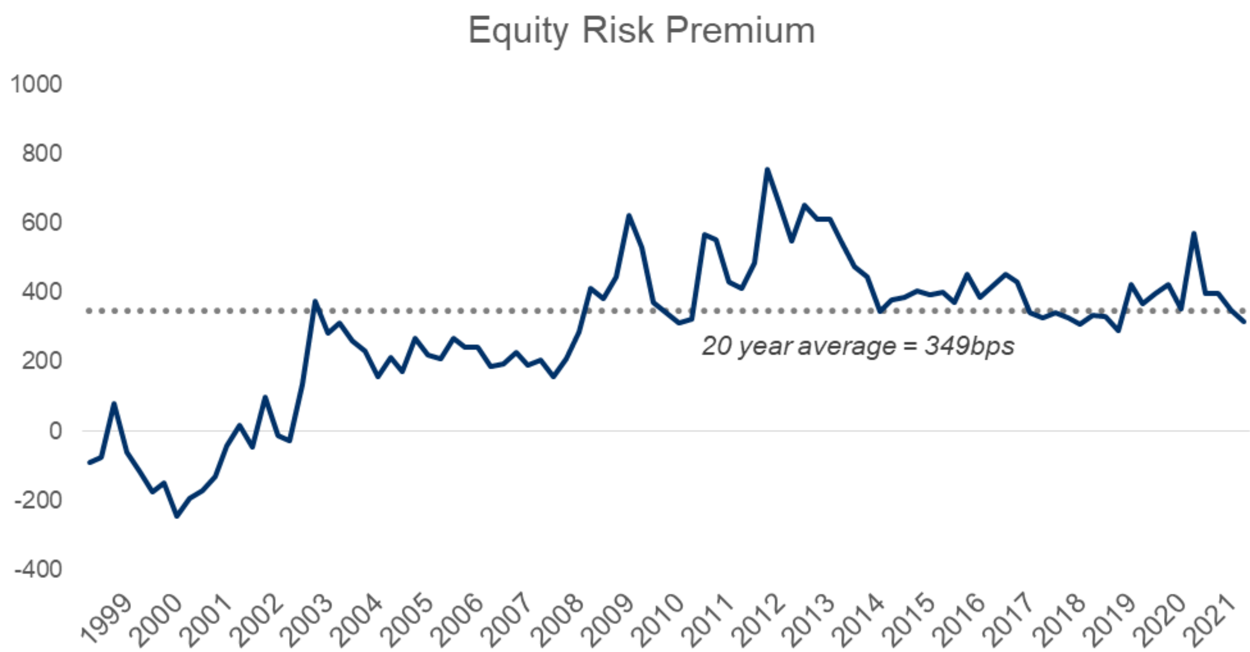
Scenario 2
Option A: You earn $95 with an 80% probability
Option B: You earn $1 with a 100% probability

If you were to look on an absolute basis, you could conclude that Option A looks less attractive in the second scenario. After all, for the same level of risk you could earn $100 in Scenario 1, instead of $95 in Scenario 2.
However, when compared to option B (on a relative basis), Option A looks far more enticing in the second scenario than the first. And that's not because Option A has gotten better - it's because the attractiveness of Option B has decreased so dramatically.

Stocks vs. bonds

If we turn back to the stock market, the relative attractiveness between equities and risk-free bonds is measured by a term called the equity risk premium. The equity risk premium is the compensation you receive for taking on the additional risk of stocks vs. bonds. In the example below, the equity risk premium is calculated as the difference between the consensus earnings yield (i.e. how much earnings the market is expected to generate divided by price) and the 10Y Treasury yield.

As seen in the chart below, investors are still getting strong compensation for holding equities compared to risk-free bonds. This is mainly a function of the low-rate environment we're in, where the attractiveness of government bonds is arguably at one of its lowest points ever. This is supporting higher stock market valuations. When bonds start to look less attractive, the alternative (e.g. stocks) start to look more attractive. A measure like equity risk premium accounts for that, while a P/E ratio does not.



Source: Bloomberg, RBC GAM. Quarterly from Mar 31, 1998 to Feb 17, 2021. Morgan Stanley Equity Risk Premium is calculated as the spread (in basis points) between the S&P 500 Index's next twelve month consensus earnings yield and the 10Y Treasury yield.

In summary, equity markets don't appear cheap on many absolute measures. Particularly so in the U.S., as noted earlier. However, in a world of low interest rates, the relative attractiveness of stocks vs. bonds becomes a key consideration for long-term investors, and a force that supports the case for seemingly elevated valuations. We continue to believe equities provide attractive long term return prospects relative to bonds.

If you're still feeling uneasy about investing in today's environment, consider a dollar-cost averaging (DCA) strategy. It's an effective way for those who have the cash, but are not sure how to deploy into the market.

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