Are Stocks Really Cheap?

By Michael Pento *Wed, Jul 14, 2010*

Cash levels as a percent of assets reached a cyclical high of 12% in 1991. Today, that ratio is less than 4%. With mutual funds already nearly fully invested, where will the money come from to take stocks higher?

Perma-shills have been claiming of late that the stock market is now trading at an enticing valuation. Their main evidence for this, as they are fond to claim, is that the forward Price to earnings multiple is 12 times next year's earnings for the S&P 500. And, of course, a 12 PE multiple makes stocks cheap and the overall market a buy.

But for investors who want to accurately assess that number, there are two issues they should be aware of. First, the PE ratio isn't a good measure of the near term direction for the market. And second, nobody knows what the *forward PE* will actually be. Some pundits like to use that forward looking number because, when corporate earnings are projected to rise-as they almost always are-the PE ratio will look better.

So let's get into some real numbers that will help determine if the market is indeed cheap.

For Q1 2010, the PE ratio on the reported trailing twelve month earnings for the S&P 500 is 15.5. Historically speaking, the average PE ratio on the S&P is about 15 times earnings. So therefore, if one isn't promoting an ebullient guess as to what earnings will be in the future, the market is currently just fairly priced on a PE basis. Also, the PE ratio on an inflation adjusted average over the previous ten year period has ranged from 4.78 in December of 1920 to 44.2 in December of 1999. With such a wide range of valuations, it is difficult at best to make a case to buy or sell stocks solely on a PE basis. There are other factors like; the direction of inflation and interest rates that are necessary to consider when evaluating the PE ratio.

Some market cheerleaders also like to use the inverse of the PE ratio called the earnings yield when comparing stock prices to bonds. They say; with the current earnings yield being 6.4% and the Ten year note yielding around 3% that stocks are a great value. Again, there are problems here too. Firstly, investors don't earn the earnings yield as they do with dividends. And as mentioned, the earnings yield is merely the reciprocal of the PE ratio. The fact that the yields on government bonds are significantly below the earnings yield on stocks is merely an indication of the egregiously overvalued state of the U.S. debt market.

Rather than pick one or two statistics like the forward PE ratio or the earnings yield to convey an opinion on stocks, here are several important facts that will help you decide the future direction of the market.

A good metric to determine the valuation of stocks is the dividend yield. The current dividend yield on the S&P is a paltry 2.1%. The historical average dividend yield is a much greater 4.36%. The lowest dividend yield was 1.11%, which was reached in August of 2000. The highest dividend yield was 13. 84%, this was achieved in June 1932. Therefore, on a dividend yield basis, the market is currently significantly overpriced. To add salt in the wound of those low yielding stocks, tax rates on dividends are scheduled to increase significantly in 2011. Maybe that is the reason why all the cash sitting idle on corporate balance sheets isn't being sent back to investors in the form of dividends?

According to the Investment Company Institute, mutual fund cash levels are at a decade low. Cash levels as a percent of assets reached a cyclical high of 12% in 1991. Today, that ratio is less than 4%. With mutual funds already nearly fully invested where will the money come from to take stocks higher?

The Fed's balance sheet is at a record high $2.3 trillion. The unwinding of that balance sheet will send interest rates on their $1.1 trillion In Mortgage Backed Securities (MBS) soaring and will thus further damage the real estate market, stifle earnings growth and depress GDP growth. The Fed must also find buyers for all that MBS debt. This will crowd out investments that would have normally been made into stocks.

Household debt and the Gross National debt have never been at or above 90% of GDP at the same time. For the first time in U.S. history, that is the case today. Along with the massive deleveraging that still lies ahead for both the public and private sectors, the Treasury must auction off close to $9 trillion in debt each year to cover our ballooning deficits and to satisfy rollovers. This will further crowd out investments that could have been better placed into the stock market.

Once you view the real numbers on PE ratios and dividend yields it is hard to make an argument that stocks are cheap. And given the low levels of cash that exist at mutual funds and the crowding out of private investments that is taking place from the government, investors will find it difficult to assume the market can produce a sustainable rally of any real significance.

The only disclaimer here is if the Fed embarks on another doubling of its balance sheet in an attempt to crush whatever life is left in the value of the U.S. dollar. Then, in that case the market may rally in nominal terms. But you had better own precious metals and the companies that pull the stuff out of the ground if you want to earn a positive return after inflation.

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