



ASSET ALLOCATION INSIGHTS

Have Stocks Become Too Expensive?

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KEY INSIGHTS

- After the sharp rally in equity markets amid dire economic data, investors may be questioning whether stocks have become too expensive.
- While caution is warranted, we believe that equity valuations remain reasonable relative to bonds.

Stocks have rebounded sharply from March lows despite the alarming backdrop of plummeting earnings expectations and staggering unemployment numbers. This apparent contradiction is prompting many investors to question whether stocks have become too expensive, given dire economic forecasts.

Relative to the alternative, which for most investors is bonds, we do not think that equities are too expensive. To compare the valuations of stocks and bonds, equity valuations can be converted into earnings yields by inverting price/earnings (P/E) ratios.

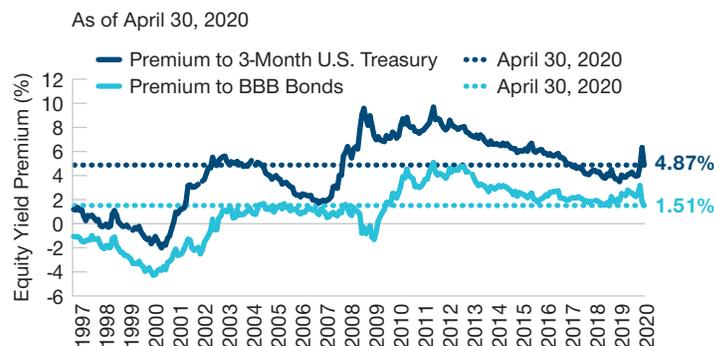
A comparison of the S&P 500 forward earnings yield to BBB rated corporate bond yields from December 2016 to May 2020 shows that, while the yield on stocks has become less attractive on an absolute basis, it remains well above the bond yield—even though earnings projections have fallen considerably over recent months. This signifies that investors still appear to be compensated for the additional risk of owning stocks instead of bonds. Further, an analysis of the equity yield premium since 1997 shows that, relative to history, stocks are priced quite reasonably versus bonds.

We have recently moderated our equity position in our asset allocation portfolios as valuations have become less attractive after the recent market rebound. In our view, caution is also warranted given the heightened level of uncertainty and the depth of the near-term economic shock we are facing.

However, we continue to believe that, despite the bleak economic outlook, equity valuations appear attractive relative to bonds. As a result, our asset allocation portfolios remain overweight to stocks.

Comparing Stocks vs. Bonds

Investors still appear to be compensated for owning stocks.



Past performance is not a reliable indicator of future performance.

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BBB Corporate Bond Yield is based on the BofAML U.S. corporate bond universe. S&P 500 forward earnings yield is IBES earnings estimates over the next 12 months. Earnings Yield= Earnings/Current Price. 3-Month U.S. Treasury yield is based on the benchmark 3-month U.S. Treasury Bill. Equity yield premium compares the forward earnings yields for stocks on the S&P 500 versus the yields to maturity of U.S. Treasuries and BBB bonds.

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