



THE DANA VIEWPOINT

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Is the Stock Market Cheap, and are Treasury Bonds Risky?

The stock market is once again near an all-time high. Total returns for most of the broad market indexes are in the mid-teens through the first nine months of the year. Most indexes have moved in a fairly narrow range sideways over the last five months. This has happened as we have had two quarters of blowout earnings reports, with actual earnings significantly surpassing the estimates of the professional analysts. The result has been a decrease in the price/earnings ratio of the market indexes. This has been true for ratios based on both trailing and forward earnings.

Forward earnings estimates have risen significantly over the past few months. This is probably to be expected as analysts were apparently too conservative in recent quarters. Growth has been rewarded.

A worrying characteristic of the current market is that it has again become very concentrated this year, and fortunes of individual companies have varied widely. Investors should not be surprised if their managers have a difficult time tracking the indices in terms of performance. Through the first nine months of the year, the S&P 500 Index returned +12.73%, a reasonably strong return even in a full-year period. Through the first three quarters, only slightly more than a third of the companies in the index beat that return, and over 40% of the companies delivered outright negative stock performance! Truly a market of haves and have nots. This should not be overly surprising as many unanswered questions regarding the effect of AI on our economic evolution are far from answered. The companies that provide the infrastructure for AI buildout and implementation have been strong performers. The last Dana Viewpoint talked about how earnings drive prices, and that certainly has been part of the reason for the new highs recently attained by the major indices, regardless of other market and economic concerns.

We do need some relief from higher energy prices and inflation, a top in bond yields, and continued economic growth. If some combination of these outcomes come to pass, maybe the current price earnings ratio of 19 for the S&P 500 will seem like a bargain in hindsight.

On the fixed income side, Treasury bond yields have risen to multi-decade highs. This is a troubling headwind for the markets and the economy. Bond yields are comprised of two major components. A portion of the yield is simply a repayment, or offset, for expected inflation. This isn't a real return; it is just compensation for the fact that you will be repaid in the future with dollars that are worth less due to inflation. The remaining portion of the bond return is called the real yield, or what you earn after inflation.

(CONTINUED ON REVERSE SIDE)

The yield increase on Treasuries so far this year has all been a real yield increase. Virtually none of it is due to an expected increase in inflation. Even though current inflation has been stuck in the 3's, investors expect inflation over the next ten years to average in the low two percent range, an estimate that has not changed significantly as energy prices have shot up this year.

The real yield could be increasing for a number of reasons, some good and some bad. The real yield on Treasuries could be increasing because of the demand for investor fixed income dollars to fund the AI buildout. Real yields could also be higher because investors expect higher returns on other investments and therefore need higher yields to entice them to buy Treasuries. One bad reason why real yields are increasing could be that investors are demanding a higher yield to compensate them for what they perceive to be increased credit risk in U.S. debt securities. This is bad news because all of us pay that added cost through tax payments, and the higher cost of debt makes it more difficult to fund other government priorities. It hardly matters which party controls Congress; government disbursements seem to always rise at a faster rate than government receipts. Sadly, our children and grandchildren will bear the cost of benefits we all receive today. In the meantime, higher yields offer excellent investment opportunities for all investors seeking consistent income.

Random Thought:

“The borrower is servant to the lender.” — Proverbs 22:7

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