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Comparative Advantage

Five ways stock-market values come out ahead

By GARY C. BYRNE

UNDER ATTACK BY AN ARMY of pessimists, the stock market has stumbled and lately rebounded. The tactical question now is whether the rebound is temporary -- a bear-market rally -- or the first leg of a new bull market. The strategic question is whether stocks are selling for attractive values. As with all questions of value, we must ask, "Compared to what?" Here are some answers.

Compared to Short Rates

Short-term interest rates are the lowest in a generation and a half. Money-market funds began in 1975 and their yields have never been lower. The Federal Reserve's discount rate is the lowest since 1948. In fact, it has been lower only once since 1914, and that was during World War II. In 1934, during the middle of the Great Depression, the discount rate was twice as high as it is today. Short-term rates establish the alternative to stock-market returns for investors, and for companies they establish the cost of borrowing.

During the past 12 months, Americans added $457 billion to their savings accounts and investors contributed another $174 billion to their money market accounts. But savings and money-market accounts paying 1% to 2% interest will not even match historic rates of inflation. Compared to these short-term rates, people want higher yielding investments.

For the first time ever, the dividends on the stocks of the Dow Jones Industrial Average pay a 35% higher return than the Merrill Lynch Ready Assets money-market account. Now, investors can get a higher yield than their money-market account and participate in the stock market's upside.

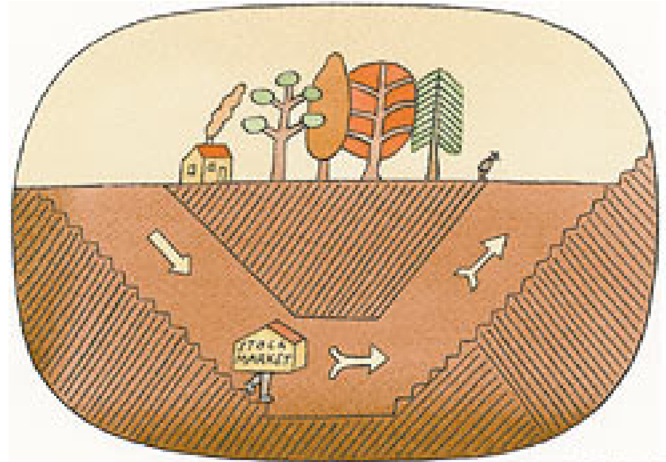
Normally, investors have to accept a lower dividend yield from stocks to participate in the market. A year ago, the Dow had to rise 2.5% plus its dividend to match the return from a money-market account. Now, the Dow can actually drop and still beat money-market returns.

Compared to Bonds

Ultra-blue-chip stocks with a Triple-A rating normally trade at a significant premium to bonds. Over the past 10 years, these companies have had earnings yields (the inverse of the P/E ratio) about 25%

higher than the yield of the five-year Treasury note. Now, these companies trade at a discount of more than 25% to the five-year note. The last time blue-chip stocks were this cheap relative to bonds was in 1993, a great time to have purchased stock.

The balance sheets of major companies have improved dramatically. The companies that make up over 35% of the Nasdaq 100 have increased working capital by more than $50 billion in the last five years. Their working capital is more than 300% higher now than just five years ago; and their stock price to working capital has dropped by more than 50%. Working capital at the 10 largest companies in the S&P 500 has increased by 150% over the past five years, while stock prices are up only 20%.



Maris Bishof

Compared to History

The principal pessimistic argument against the stock market is that P/E ratios are higher than historical averages. But P/E ratios are only meaningful within the context of interest rates, because interest rates influence both corporate earnings and price-earnings ratios. The five-year Treasury note is now at its lowest yield since 1962, and P/E ratios should be extremely high. However, they're not. To be at the 40-year average the price of the S&P 500 should be at least 20% higher than it is currently.

The "Investor Comfort Index" is at its highest level since 1955. This index measures the risk premium investors are demanding from the market due to geopolitical and other concerns. Normally, investors require a risk premium of 1.5 to 2 to enter the market. This means their expected return from the stock market must be almost double the assured return they can get from money-market funds. In 1999, investors committed to the stock market even though the risk premium was less than one. This is one reason the market was so terribly overvalued.

Now, the situation has gone full circle. Investors are requiring a return of 4 to 1 to enter the market. This means the market is the cheapest it has been since 1955, the last time the risk premium was over 4. Once geopolitical and other concerns moderate, the economic upside to the stock market will be extremely good.

Compared to Earnings

With low inflation, low interest rates, and high productivity, corporate earnings should continue to grow impressively once the recession is past. Over the past 10 years, the nation's gross domestic product grew at an annual rate of about 3.6%. Corporate profits on the 30 Dow Jones Industrial companies, however, grew at an annual rate of more than 10% per year, and that includes the reported results from the recession year of 2001.

Meanwhile, the price of the Dow Index grew at an annual rate 20% slower than the rate of profit growth. In other words, profits over the past decade on the Dow grew faster than the price of the Dow. Eventually the price will catch up with the profits.

Compared to Prior Economic Policy

The nation's fiscal policy has finally become stimulative after several years of being increasingly de-stimulative. The members of the Federal Reserve Board's Open Market Committee had a difficult job beginning in the late 1990s. Starting in June of 1999, they raised interest rates to slow an overheating economy. However, at nearly the same time they had to begin increasing liquidity because of concerns about computer glitches that were expected to throw a monkey wrench into a lot of computer programs on New Year's Day, 2000. Then they raised rates once again to sop up the extra liquidity.

They stopped raising rates in June of 2000. But, even though they began to lower rates in January of 2001, the lower rates were not powerful enough to overcome the lack of liquidity in the economic system as well as a de-stimulative fiscal policy. Now, there are low interest rates, liquidity is increasing, and finally fiscal policy is beginning to stimulate the economy.

This triple combination is an 180-degree turn from two years ago -- and will finally allow the nation's economy to return to solid growth.

Meanwhile, the stocks of the nation's best companies are becoming extremely attractive. Now, only eight companies of the Dow 30 trade at P/E rates higher than the five-year Treasury note; and only four have higher P/Es using 2003 expected earnings. This means the return on the five-year Treasury note, which has no growth, is higher than the return on almost all the components of the Dow, which has grown at a compounded annual rate of more than 10% for the past decade.

Today the stock market provides far better returns than alternative money-market instruments. If the Dow 30 simply rise 6% per year during the first decade of the 2000s, the index will end 2009 at 20,400. That wouldn't be a bad return for an index whose dividend is currently 35% higher than money-market funds.

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