Are Stock Prices Headed for a Fall?

By Burton G. Malkiel

There is a disagreement about the sustainability of current lofty stock market valuations. One camp argues that the market is dangerously overvalued. The so-called CAPE ratio—the price-earnings multiple for the market based on cyclically adjusted earnings averaged over the past 10 years—stands at over 25, well above its long-run average of about 15. Today’s CAPE has been exceeded only during the market peaks of 1929, early 2000 and 2007.

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The CAPE does a reasonably good job of predicting 10-year equity returns. High CAPEs predict low future returns. Low CAPEs are often followed by generous stock-market returns. The CAPE is not useful in predicting returns one or two years into the future.

Another group of forecasters are convinced that stocks are reasonably valued. The main competitors for stocks in individual and institutional portfolios are bonds. And yields on fixed-income securities are at all-time lows. Short-term interest rates are essentially zero, and the yield on the 10-year U.S. Treasury bond is only 2.4%. Investors seeking a reasonable rate of return have few places to go other than equities. This camp believes equities are a particularly attractive option in the menu offered by today’s capital markets.

So who is correct? The answer is that both may be.

In principle, stocks should be priced as the discounted present value of the future cash flows from dividends and capital gains. The discount rate that should be used must reflect the rate on low-risk securities, such as 10-year U.S. Treasury issues, plus some premium to reflect the riskiness of the stock market, which at times generates large losses.

If we add three or four percentage points to the current low Treasury yield, we still get a low discount rate that can justify high stock prices. And today’s low interest rates may persist. The world is likely to experience a long period of abundant productive and labor capacity with attendant slow growth, along with low interest rates.

While continued low rates can justify high stock prices, the CAPE follows are correct as well. Long-run equity returns from today’s price levels are likely to be considerably lower than their 10% long-run average.

So what’s an investor to do?

First, recognize that we are likely to be in a low-return environment for some time. Both stocks and bonds are likely to generate lower long-run returns than in the past. If you have established your retirement savings plan assuming double-digit returns, it is time to recalibrate and save more. The same goes for institutional investors hoping to ensure that their pensions are adequately funded.

Second, don’t thinking you can time the market and sell your stocks now, hoping to get back in later after there is a correction. No one can consistently time the market, and you are more likely to get it wrong than right.

CAPE ratios were highly elevated when former Federal Reserve Chairman Alan Greenspan made his famous “irrational exuberance” speech in December 1996, but the market rallied strongly through March of 2000. Stay broadly diversified with a portfolio that is consistent with your age, financial obligations and risk tolerance.

Third, within equity and fixed-income markets, look for opportunities that seem relatively well priced and ensure that they have a place in your portfolio.

All equity portfolios should include emerging markets. Emerging markets, accessible through broadly diversified, low-cost, emerging-market exchange traded funds, represent half of global economic activity. They are growing far more rapidly than the developed economies of North America, Europe and Japan and are likely to continue to do so. They generally have less government indebtedness and much younger populations.

Emerging equity markets also have far more attractive valuations. CAPEs for emerging markets at less than 15 are little more than half the levels in the U.S., and they stand at ratios close to their all-time lows. Just as CAPEs do reasonably well predicting long-run returns in the U.S., so they are also effective predictors in emerging markets, and today they signal generous returns.

Within the fixed-income markets, tax-exempt bonds represent unusual good relative value. The bankruptcy of Detroit and the well-publicized problems of over-indebted Puerto Rico have cast a pall over the entire U.S. municipal bond market, leading to lower bond prices and higher yields.

Tax-exempt bonds of municipalitik with excellent credit sell at yields higher than those available on Treasury securities. Closed-end investment companies that hold municipal bond portfolios are traded on national exchanges at discounts from their net asset values and with yields over 6%. While they employ modest leverage, and therefore do involve some extra risk, they are worthy of consideration in a market where opportunities for generous yields are few and far between.

Mr. Malkiel is the author of “A Random Walk Down Wall Street” (W.W. Norton). The revised 10th edition will be available later this year.