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It's Shiller vs. Siegel in the battle over equity market valuations.

Julie Verhage, Bloomberg | 2 June 2015 00:28

Even if the S&P 500 is only up about 2 percent year-to-date, it's still sitting at record levels. This means economists, analysts, and investors are inevitably asking one big question: Are stocks overvalued?

Over the weekend, Goldman Sachs published a massive research piece asking if equity market valuations are in “dangerous territory.” To answer the question, the bank pits Nobel laureate Robert Shiller and Wharton professor Jeremy Siegel against each other. First, though, a preface. U.S. equities look expensive by a number of measures, Goldman notes. For a start, the typical stock in the S&P 500 trades at 18.1 times forward earnings, which ranks in the 98th percentile of historical valuation since 1976. The overall index has an aggregate forward price-to-earnings multiple of 17.3, which is a rise of 64 percent since September 2011, compared with the median expansion of 48 percent during nine previous price-to-earnings expansion phases.

You can see the trend in the below chart from Goldman’s note.
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This next Goldman chart shows that after each of the three prior first interest rate hikes from the Federal Reserve, price-to-earnings multiples contracted by an average of 8 percent. This is concerning, Goldman says, since earnings multiples have been a key driver of returns over the past few years. Because of this, the bank’s analysts expect dividends to be the sole contributor to the 2 percent total return they are forecasting for the S&P 500 during the next 12 months.

With those stock market metrics in mind, Goldman turns to Nobel Prize winner and Yale professor Robert Shiller to ask whether equities are overvalued. Shiller points out that one metric he looks at is sitting at levels it hasn’t seen since 2000.

When asked how worried he is about the prospects for the market over the next six months, Shiller says that his concern has risen with the market and that there could very well be a correction in the next year, although the timing of such market events is inevitably difficult. He advised people to both save more and diversify their investments because their portfolios probably won’t do as well as they had hoped — even over the longer term.

Next, Goldman talks to Wharton professor Jeremy Siegel, who has continued to be on the bullish side with his buy and hold strategy.

Siegel says he believes stocks are only slightly above their historical valuations today and the level is “completely justified” due to low interest rates. To those that claim the stock market is in a bubble, Siegel says he is in complete disagreement. “In no way do current levels that are nowhere near those highs (of March 2000) qualify as a bubble,” he says.

Siegel adds that there isn’t much that would dissuade him from holding equities over the medium term and recommended investors allocate 50 percent of their portfolios
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One of the indicators in (my stock market confidence indices) series is based on a single question that I have asked individual and institutional investors over the years along the lines of, “Do you think the stock market is overvalued, undervalued, or about right?” Lately, what I call “valuation confidence” captured by this question has been on a downward trend, and for individual investors recently reached its lowest point since the stock market peak in 2000. The fact that people don’t believe in the valuation of the market is a source of concern and might be a symptom of a bubble, though I don’t know that we have enough data to prove it’s a bubble.

(https://www.moneyweb.co.za/wp-content/uploads/2015/06/460x280.png)

Of course, Shiller and Siegel are also well-known friends so there is at least one place where they are in agreement and that is the bond market. Both economists said it was fair to say bonds are overvalued and some concern is justified, although neither of them would commit to calling it a bubble. Shiller said that historically the bond market doesn’t tend to crash like the stock market. Siegel steered away from calling it a bubble due to his expectation that both short- and long-term rates will remain low.

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