Stocks Undervalued by 65%

Market turmoil and a cycle of shrill headlines and worrisome "breaking news" convinced many to evacuate the equity markets. That was a mistake. The odds of recession are low, but the stock market seems to have priced one in, anyway.

We use a capitalized profits model to value stocks, dividing corporate profits by the 10-year Treasury yield. We compare the current level of this index to that from each quarter for the past 60 years to estimate an average fair-value. Not only are 10-year yields low (2.2%), but corporate profits are growing strongly. As a result, and *hold onto your hats*, this top down model says that the fair-value for the Dow is currently 40,000.

However, we think the Treasury market is in a bubble. So, instead of a 2.2% yield, we use a more conservative discount rate of 5% for the 10-year Treasury. This generates a "fair value" of 18,500 on the Dow and 1,940 for the S&P 500. In other words, the US equity markets are currently undervalued by about 65%.

Obviously, there are many moving parts to this model. Interest rates could go higher than 5%, profits could fall or both could happen. Profits, for example, are now 12.9% of GDP, the highest in measured history (back to 1947) except for one quarter in 1950.

So what does our model say if profits revert to the historical mean of about 9.5% of GDP? Even in that scenario, *and assuming a 5% yield on the 10-year Treasury*, equities are about 21% undervalued, with fair value at 1430 for the S&P 500 and 13,700 for the Dow.

The problem with this scenario is that it takes the worst of both worlds: a major decline in profits *and* a surge in interest rates. In the real world, a large decline in profits would normally be accompanied by a drop in bond yields. In other words, our model says the risk of investing in equities today is very low.

This is the opposite of what was happening back in 1999/2000. Back then, the market was over-valued and an ounce of gold traded for roughly 4 shares of Intel (INTC). Today it is trading for about 75 shares. Stocks look cheap and we think fears about the economy are overblown.

Yes, it would be good to trade the ups and downs of this market, but we don't know anyone who can do that consistently. Rather, we focus on valuation, risk and reward. And right now, we believe the reward outweighs the risk by more than many people seem to believe. Fear will not disappear overnight, but the model says it is overblown and stocks are extremely attractive.

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