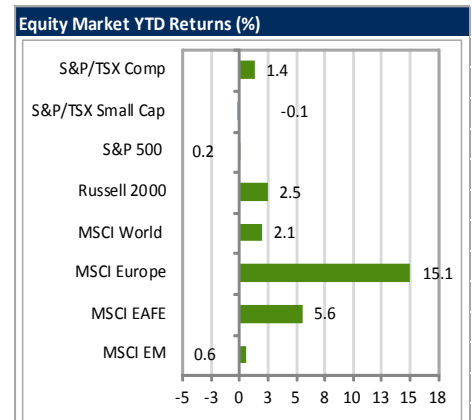


## Are Equities Overvalued?

- This month marks the sixth anniversary of the current bull market, with the S&P 500 Index (S&P 500) up an incredible 210% over the last 72 months. Given the strong gains in this current cycle (not to mention the long duration), some investors are growing increasingly concerned over equity market valuations.
- Currently, the S&P 500 trades at 18.3x trailing earnings, which is an 11% premium to its long-term average of 16.5x dating back to 1954. We typically define an asset/index as being “overvalued” when it trades 1 standard deviation (SD) above its long-term average. Presently, +1 SD on the S&P 500 trailing P/E equates to 21.3x which is well above the current 18.3x level.
- Looking at the S&P/TSX Composite (S&P/TSX) it is currently trading at 19.8x trailing earnings which is a 4% premium to its average since 1994. On an earnings basis, valuations are slightly above their long-term averages.
- However, other more arcane valuation metrics are painting a more worrisome picture. For example, the Shiller cyclically-adjusted P/E (CAPE), which divides the S&P 500 price by the average earnings for the index over the last 10 years, currently stands a lofty 27.5x which is roughly 2 standard deviations above its long-term average of 16.5x. Additionally, the “Buffett Indicator” which compares total US equity market capitalization to GDP is also at an elevated level (see Chart of the Week).
- We agree with the “bears” that valuations have significantly increased and that equities are “overvalued.” Despite this there are a number of factors including low interest rates and the likelihood that we are in a new secular bull market that could lead to continued equity gains in 2015, and over the next decade.

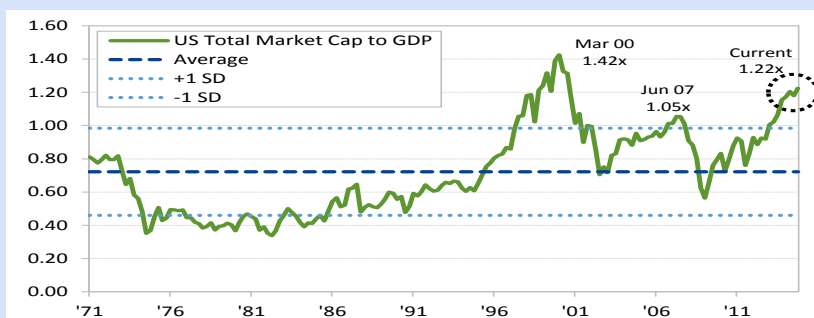


Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	6.5	Overweight
Consumer Staples	3.7	Market weight
Energy	21.3	Market weight
Financials	34.6	Market weight
Health Care	5.0	Underweight
Industrials	8.4	Overweight
Information Technology	2.5	Overweight
Materials	10.9	Underweight
Telecom	4.7	Market weight
Utilities	2.2	Underweight

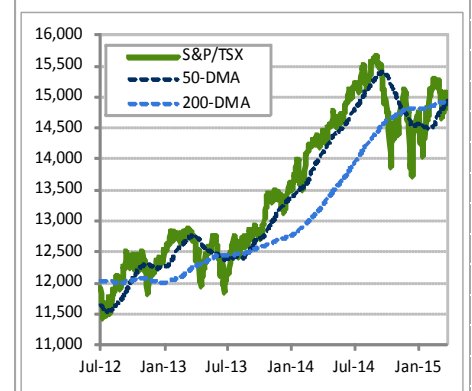
Technical Considerations	Level	Reading
S&P/TSX Composite	14,835.8	
50-DMA	14,924.4	Downtrend
200-DMA	14,912.1	Downtrend
RSI (14-day)	46.4	Neutral

### Chart of the Week

The “Buffett Indicator” Suggests Equities Are Overvalued, But Does It Matter?



Source: Bloomberg, Raymond James Ltd.



Source: Bloomberg, Raymond James Ltd.

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**Are Equities Overvalued?**

This month marks the sixth anniversary of the current bull market, with the S&P 500 up an incredible 210% on a price basis over the last 72 months. Since 1950 there have been 10 bull markets which, on average, have returned 170% and have lasted 54 months. Given the strong gains in this current cycle (not to mention the long duration), some investors are growing increasingly concerned over equity market valuations. In this week’s publication we examine valuations for the North American equity markets from a number of different angles and attempt to answer the question, “Are equities overvalued?”

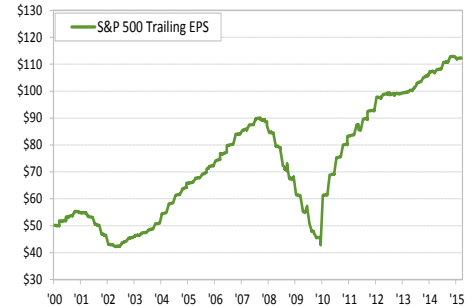
We begin with the most commonly used and straight forward valuation metric – the trailing P/E for the S&P 500 and S&P/TSX. Currently, the S&P 500 trades at 18.3x trailing earnings, which is an 11% premium to its long-term average of 16.5x dating back to 1954. We typically define an asset/index as being “overvalued” when it trades 1 standard deviation (SD) above its long-term average. Presently, +1 SD on the S&P 500 trailing P/E equates to 21.3x which is well above the current 18.3x level. On a forward basis the S&P 500 trades at 17.3x which is a 5% premium to its long-term average since 1990.

A major reason why valuations based on earnings are not at extreme levels despite the strong gains is the result of the dramatic rise in corporate profits. Indeed, S&P 500 operating earnings have risen from US\$42.83/share in December 2009 to US\$112.29/share currently. We believe this crucial piece of the puzzle is often overlooked by the “bears” and those opining that the equity gains are simply a by-product of the largesse by central banks.

Looking at the S&P/TSX, it is currently trading at 19.8x trailing earnings which is a 4% premium to its average since 1994. On a forward basis the S&P/TSX trades at 18.2x which is a 15% premium to its long-term average. The S&P/TSX trading at higher earnings multiples than the S&P 500, in conjunction with its weaker earnings outlook, factors into our preference for US equities. However overall, we believe that these valuation metrics suggest that the North American equity markets are modestly overvalued, and not nearly as extreme as some posit.

As we strive never to be a Pollyanna or be driven by confirmation bias, it is important to keep an open mind and consider other perspectives which may counter one’s beliefs. In the following page we examine other valuation metrics that do just this.

**US Earnings Are Up 150% Since March 2009 Lows**



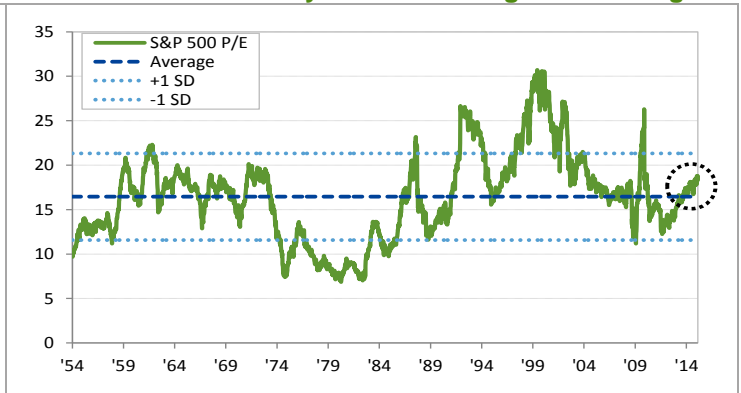
Source: Bloomberg, Raymond James Ltd.

**S&P 500 Is Up 210% Since The March 2009 Lows**



Source: Bloomberg, Raymond James Ltd.

**S&P 500 P/E Is Modestly Above Its Long-term Average**



### Other Measures Suggest Overvaluation

While traditional valuation metrics are indicating a modest overvaluation in North American equities, other more arcane valuation metrics are painting a more worrisome picture. Below we highlight two metrics which the “bears” use as their key argument that stock valuations are abnormally high. They include:

- Shiller CAPE:** From year-to-year earnings can be volatile. To smooth out these cyclical gyrations some prefer to compare stock prices to average earnings, say over 5 or 10 years. This was first put forward by Benjamin Graham in his seminal book, *The Intelligent Investor*. Later, Yale Professor Robert Shiller refined the concept by adjusting earnings for inflation. Now known as the Shiller cyclically-adjusted P/E (CAPE), it divides the current S&P 500 price by the average earnings for the index over the last 10 years. Currently, this metric is a lofty 27.5x which is roughly 2 standard deviations above its long-term average of 16.5x. While we have a number of reservations with this metric, there is some merit to the argument that this high level could result in lower equity returns in the coming years. In the accompanying table we calculated subsequent 10-year annual price returns broken down by historical CAPE levels. For example, when the CAPE was in the 25 to 30 range, the average subsequent annual price return was a low 2.7% over the next ten years. This seems to be the main argument from the “bears” that the next 10 years will result in low equity returns. On the following page we provide counterarguments to this perspective.
- US Total Market Cap to GDP:** While I’m still “on the fence” over the Shiller CAPE and its usefulness, one valuation metric that I do tend to follow is the total US equity market capitalization to GDP ratio. Known as the “Buffett Indicator” as it was popularized by Warren Buffett, it currently is echoing the message of the CAPE. Given the strong equity gains and modest improvement in US GDP, the ratio currently stands at 1.22x, which is nearly 2 SD above its long-term average of 0.72. Similar to the CAPE it suggests that stock valuations are abnormally high.

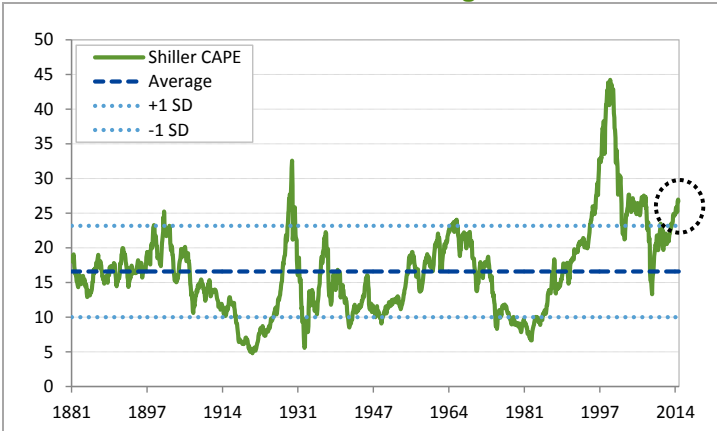
Subsequent 10 Year Annual Price Returns Per CAPE Level

CAPE Range	10 Year Annualized Price Return Per CAPE Range	
	Average	Median
5-10x	7.98%	10.24%
10-15x	5.79%	5.93%
15-20x	3.73%	3.38%
20-25x	2.35%	1.81%
25-30x	2.68%	5.18%
>30x	-0.50%	-0.73%

Source: Bloomberg, Raymond James Ltd.  
 Note: Based on monthly data from 1881 to present

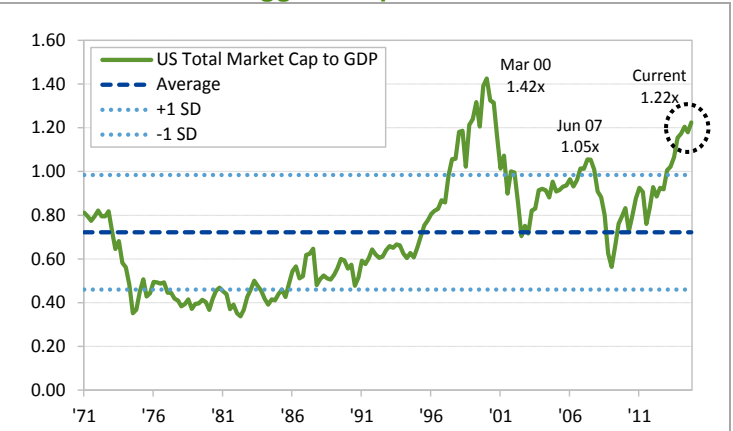
It is clear that some equity valuation measures are signalling a significant overvaluation of North American equities. However, as we address on the following page, there a number of reasons why we are less concerned over these readings, and why we maintain our long-term bullish outlook on equities.

Shiller CAPE Is 27.5x Versus Average Of 16.5x



Source: Bloomberg, Raymond James Ltd.

Buffett Indicator Suggests Equities Are Overvalued



## Secular Bull Cycles And Interest Rates

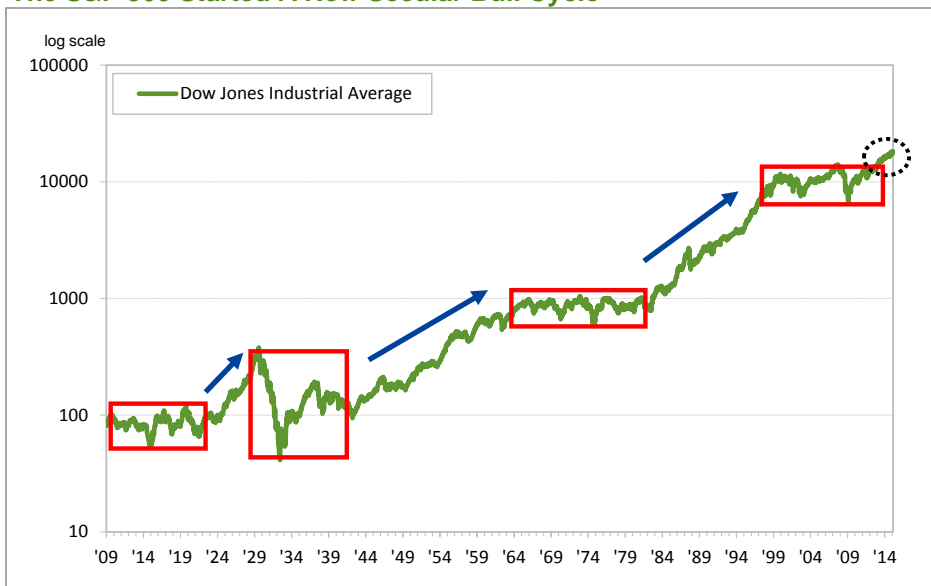
We believe there are a number of factors that help to counterbalance the implied message of the previous valuation metrics:

- First, valuations alone are not sufficient to drive investment decisions and performance. Stocks can, and often do, overshoot on the upside (and downside). Provided the economy continues to improve and central banks maintain accommodative policies, equity valuations can remain high for a while.
- Second, just looking at equity valuations in isolation does not provide a full and complete picture. With bond yields near record lows, stocks look attractive on a relative basis, which is a major support for stocks and valuations going higher. In effect, the US Federal Reserve and other central banks are pushing investors increasingly to equities given the depressed yields investors can earn from bonds.
- Finally, and most importantly, we believe the US equity markets started a new secular (i.e., 10 to 15 years) bull cycle in 2013, when the S&P 500 broke above its 2000 and 2007 highs. We are strong believers that equities trade in secular bull and bear cycles that typically last 10 to 15 years each. The accompanying chart captures this clear trend of alternating bull and bear cycles. If correct, this augurs for continued solid equity returns over the next decade.

## Conclusion

We agree with the “bears” that valuations have significantly increased and that equities have become “overvalued.” However, we believe the overvaluation is much less than the “bears” put forward and more importantly, that there are a number of supportive factors that could lead to continued equity gains in 2015, and over the next decade.

### The S&P 500 Started A New Secular Bull Cycle



Source: Bloomberg, Raymond James Ltd.

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