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Reaction to Fed Chairman Janet Yellen's Comments About U.S. Stock Valuations…

Joe Williams, CFA®, Director of Investment Strategy for The Commerce Trust Company, adds some historical perspective to Fed Chairman Janet Yellen's remarks on U.S. stock valuations.

Q. U.S. stocks were down again yesterday as the markets reacted to Janet Yellen's statement that U.S. valuations were at their high end. Can you put that in perspective for us?

A. Janet Yellen is certainly correct from a comparative historical basis that U.S. stocks are at the high end of their valuations at the moment. Another way of saying this is that stocks are relatively expensive right now. But we also think because of the ultra-low interest rate environment and very low inflation rate we currently enjoy, the current values are justified. There are still fairly priced stocks out there and the market has already rebounded some today.

Q. Where are we in terms of stock valuations on a historical basis?

A. Stock valuations are measured by price-earnings (P/E) ratios. In general, a high P/E suggests that investors are willing to pay a higher price for earnings growth in the future. If you just purely look at valuations over the last 90 years, the average market P/E ratio for the S&P 500 Index is about 17 times earnings. Right now we are at 20 times, which is at the high end of the historical valuation range, but nowhere close to 2000, when P/Es moved above 30 times during the dot-com bubble.

Q. Are the higher valuations a concern?

A . Valuation levels are only a piece of the puzzle when determining if equities are an attractive investment. When you take into account the low interest rates and low inflation, our contention is the equity market is not overvalued. Interest rates have moved higher over the last week around the world but not enough to change our positive outlook for equities.

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