

Do Valuations Matter?

For the past two years, we have been warning that the stock market is overvalued. While our capitalized profits model is simple, it is more complex than just looking at price-earnings or price-sales ratios. We adjust for the level of the 10-year Treasury yield...the higher the yield the less stocks are worth. So, when inflation pushed bond yields up in 2022, our fair value calculation fell even though earnings continued to rise.

But in the past three years, the S&P 500 has risen faster than earnings and sales, so much so that The Wall Street Journal online put a story on its landing page headlined “Stocks Are Now Pricier Than They Were In The Dot-Com Era.” It led off with a stat that said the S&P 500 is now selling at 3.23 times sales (the median over the past 25-years is 1.7 times).

Price to sales is only one statistic. When we run our model, and include a 4.25% 10-year Treasury discount rate, the market is overvalued by roughly 40%, well below the 62% overvaluation seen in 1999.

Moreover, if the market falls, the Fed will likely cut rates. Our model shows a 2.85% 10-year yield would put the market at fair value. As a result, even though we are fearful the market is overvalued, we do not see a 40% drop in the cards. We would say the market is roughly 20% overvalued and maintain our target of 5,200 for the end of this year.

It is clear that there is a YOLO (You Only Live Once) trade going on, and daily options (no matter how crazy they seem) are being traded like baseball cards. Much like 1999, people have convinced themselves that markets will only go one way. Especially the tech stocks, powered by AI, the top 10 of which make up 39.5% of the S&P 500.

Clearly, economic data are mixed. The Trump Administration is using tariffs as one of many tools in attempts to remake the economy, and change is happening. But tariffs are a tax, and tax increases are not positive for economic growth. Moreover, any reshoring of investment in the US will take time and is still risky because future presidents may not hold tariffs in place. For that matter, the courts might rule them beyond the president’s power.

At the same time, we cannot discern whether earnings attributed to AI are just cannibalization of existing businesses (like search engines) or not. The market was right in the late 1990s. Cellphones, fiber optic internet connections, and faster computers with better operating systems would boost productivity and profits...it was just early. Is AI the magic technology that provides immediate and permanent returns? So far, the jury is still out. Real GDP in the first half of 2025 averaged just 1.4%, and job growth is slowing for a variety of reasons.

In other words, we remain cautious about the market as a whole and especially very expensive and very large market cap companies. There are plenty of sectors and stocks within the S&P 500 that still look attractive. That’s where we are focused.

We will get grief from those who have been bullish and correct. But our approach is rooted in fundamentals, not momentum. The history of markets consistently shows that valuation metrics tend to revert over time. There are price levels that simply don’t justify expectations of historical returns. We think today is one of those times. Back in 1999, some confidently claimed recessions were a thing of the past. They were wrong. We urge caution against excessive optimism today.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-2 / 9:00 am	ISM Index – Aug	49.0	48.8	48.7	48.0
9:00 am	Construction Spending – Jul	-0.1%	-0.3%	-0.1%	-0.4%
9-3 / 9:00 am	Factory Orders – Jul	-1.3%	-1.4%		-4.8%
afternoon	Total Car/Truck Sales – Aug	16.1 Mil	15.9 Mil		16.4 Mil
afternoon	Domestic Car/Truck Sales – Aug	12.6 Mil	12.7 Mil		12.8 Mil
9-4 / 7:30 am	Initial Claims – Aug 30	230K	229K		229K
7:30 am	Int’l Trade Balance – Jul	-\$78.0 Bil	-\$77.8 Bil		-\$60.2 Bil
9:00 am	ISM Non Mfg Index – Aug	50.9	50.8		50.1
9-5 / 7:30 am	Non-Farm Payrolls – Aug	75K	56K		73K
7:30 am	Private Payrolls – Aug	75K	60K		83K
7:30 am	Manufacturing Payrolls – Aug	-5K	-5K		-11K
7:30 am	Unemployment Rate – Aug	4.3%	4.2%		4.2%
7:30 am	Average Hourly Earnings – Aug	+0.3%	+0.3%		+0.3%
7:30 am	Average Weekly Hours – Aug	34.3	34.3		34.3