JAG CAPITAL MANAGEMENT LLC

TWO MINUTE DRILL
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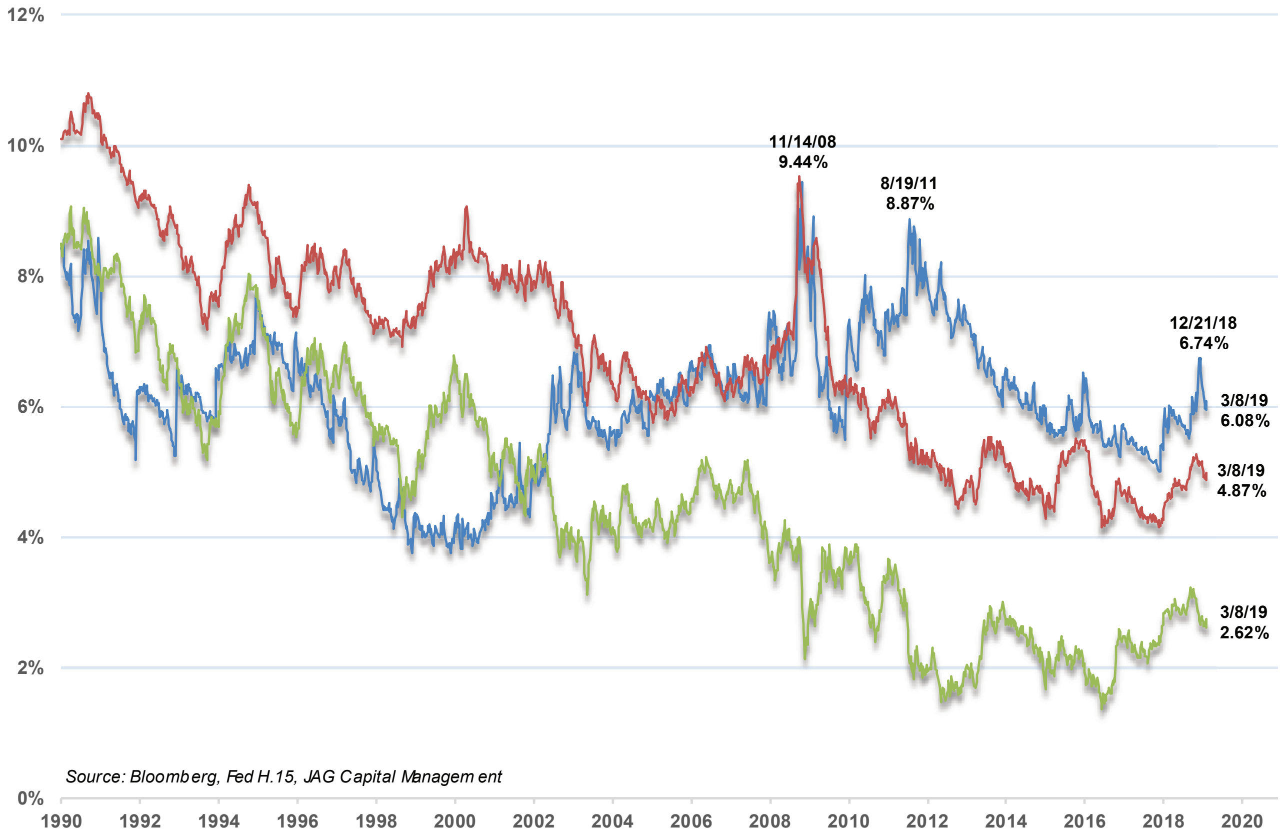
Timely Insights from JAG's Research Team

Total reading time = 2 minutes

Fwd Earnings Yield for S&P 500 (blue line), Baa Yield (red line), 10yr Trsy Yield (green line)



As most experienced investors know, stock market valuations are a terrible timing tool for investors. Bull markets have often persisted for years after stocks have reached above-normal valuations (i.e. late 1990's). Similarly, bear markets can develop even when valuations appear to be undemanding (i.e. late 2007). There are innumerable ways to assess value in the equity markets, but one of our favorites compares the forward S&P 500 earnings yield to bond yields. This allows us to discern whether stocks are attractively valued relative to bonds. The so-called "Fed Model" method of this analysis compares the S&P 500 to 10-year Treasury yields. When the forward earnings yield on the S&P 500 is higher than 10-year Treasury yields, stocks can be assumed to be inexpensive compared to bonds. In the chart above, we see that the S&P 500's forward earnings yield is approximately 6%, a big premium to the 2.6% yield offered by Treasuries. So far so good: stocks appear cheap relative to Treasuries. But it is important to recognize that the principal and interest of Treasury securities are considered "risk-free" if held until maturity. Since equities are anything but "risk-free," we think that investment-grade corporate bond yields offer a fairer basis for comparison. BAA-rated bonds currently yield just under 5%, which reflects the additional yield that corporate bond investors are demanding in return for assuming credit risk. Here again, though, the S&P 500's 6% forward earnings yield comes out on top. **By this measure, we can discern that stocks offer value compared to Treasuries and investment-grade corporate bonds.** By itself, this tells us little about whether stocks will go up or down over the short- or intermediate-term. Stocks could get even cheaper compared to bonds – as they did in August 2011. Interest rates could increase materially, which could make bonds look more attractive than equities. Finally, corporate earnings could come in much lower than predicted, which would throw this indicator on its ear. **With all these caveats in mind, we think stock valuations look relatively attractive as we head into Spring when compared to fixed-income alternatives. At the margin, this tilts our outlook a bit more in the bullish direction over the coming year.**

Disclosures

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