



## Are Stocks Overvalued?

### Description

Since Trump's surprise electoral victory, stocks have soared higher, and there are no signs of them slowing down anytime soon. The TSX, like all three U.S. indices, hit a record high in recent weeks, and according to some measures, these highs now see stocks as being massively overvalued. Many pundits are worried that a market correction is on its way, particularly considering that Trump has yet to implement his planned fiscal stimulus and that the health of the economy remains questionable.

### Now what?

A crucial but also blunt measure for determining whether a market is under or over valued is the price-to-earnings ratio, or P/E. The **S&P/TSX Composite Index** is now trading at about 15,497, and after factoring in collective 2016 earnings for all companies listed on the index, it is now trading at a daunting 52 times earnings.

After accounting for normalized earnings, where corporate income is adjusted to smooth out seasonal changes and one-off disruptions, the ratio falls to a more realistic 24 times earnings. This appears expensive when it is considered that the TSX has a cyclically adjusted P/E of 20.

Even in 2007, when the U.S. housing meltdown erupted, triggering the Global Financial Crisis, the S&P/TSX Composite Index only had a P/E of 18.

This tells that there is clearly a considerable gap between valuations and corporate earnings, indicating that stocks are expensive.

It should be noted that because of the surge in commodities and the increasingly positive economic outlook, corporate earnings should improve over the course of the year, causing this gap to close.

Furthermore, the market P/E is not the "be all and end all" of determining if stocks are overvalued.

Another important measure is commonly known as the Buffett ratio. It essentially measures the relationship between the value of stocks and a country's economic output by dividing market capitalization by gross domestic product.

In a [previous article](#), I found that this ratio for the S&P 500 was at a sky-high 123%, or 53% higher than the long-term average of 70%, meaning that U.S. stocks were overvalued.

Whereas with the S&P/TSX Composite Index at 15,497, the Buffett ratio comes to 115%, or roughly 43% higher than the long-term average for the index. This illustrates that Canadian stocks are expensive in comparison to their historical means, although they're certainly not as expensive as U.S. stocks.

### So what?

More importantly, now is not the time to grow fearful or overreact. Any correction should be viewed as an opportunity to acquire high-quality companies at discounts to their true value. Investors should also remember that markets tend to gyrate wildly over the short term, but for the long term, they have a history of moving ever higher.

This becomes evident when considering that even after the U.S. housing meltdown, Global Financial Crisis, and commodities slump, the TSX has grown by 21% in value over the last 10 years.

That trend becomes even clearer when considering some of Canada's top stocks.

For the same period, **Bank of Nova Scotia** ([TSX:BNS](#))([NYSE:BNS](#)) delivered a total return of 78% after including dividends. This was despite its price plunging to under \$30 per share in 2009 at the height of the Financial Crisis. Even after allowing for the prolonged slump in crude, energy stock **Enbridge Inc.** ([TSX:ENB](#))([NYSE:ENB](#)) has yielded an impressive 222% over that period.

This highlights the importance of investing in companies that have wide economic moats, that operate in oligopolistic markets, and possess solid businesses that continue to grow. Long-term investors should ignore the market chatter and sensational headlines and maintain their course.

### CATEGORY

1. Investing

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2. NYSE:ENB (Enbridge Inc.)
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mattsmith

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