

Dan Von Kohorn,  
Vice President  
e-mail: [dan@vkra.com](mailto:dan@vkra.com)

*Despite rising markets, stocks are cheaper today than they were a year ago.*

*Good news: the equity premium is back.*

*Stocks are priced at one of the most attractive levels in 20 years relative to short-term interest rates and 10 year Treasury bonds.*

## Investment Commentary

The economy is in a period of recovery and rapid growth. The S&P is down 2.6% in the first quarter, but up 4.3% from this time last year. However, despite generally rising prices, stocks are cheaper today than they were a year ago<sup>1</sup>. That might sound strange, but it is true in the following sense: earnings have grown faster than stock prices. In 2002, \$100 of stock yielded about \$1.60 in annual earnings; a year ago it was \$4.61; and today it is \$5.11. This “earnings yield” is an important measure of value, similar to the yield on bonds.

Part of the rise in earnings yield is related to rising interest rates as all investments compete for dollars. But interest rates are not rising as fast as the earnings yield so equities have become more attractive.

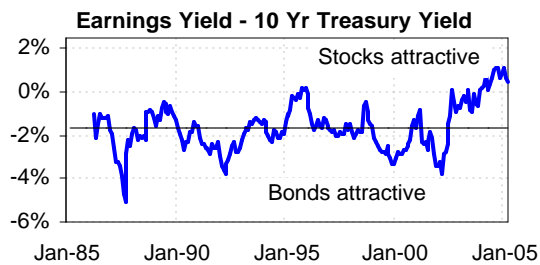
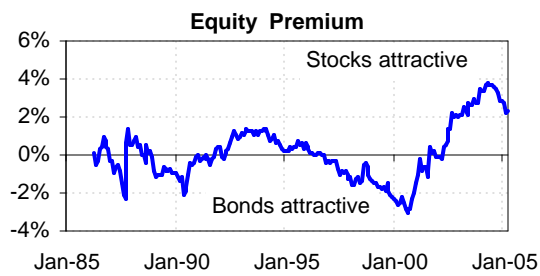
The difference between earnings yield and short-term interest rates is called the equity premium. This premium paid to equity owners varies over time, and generally reflects investors' emotions about stocks. Good news: the equity premium is back.

The pattern of the equity premium demonstrates the psychology of the stock market bubble: even as bonds became increasingly attractive, investors poured their money into stocks. More recently, the opposite has happened.

With stocks earning more than 2% over T-Bills, stocks are priced at one of the most attractive levels in 20 years, relative to short-term interest rates.

What about longer-term bonds? Longer-term bonds tend to pay higher yields, and the equity premium might not be enough to attract equity investments if long-term bonds are paying a high premium.

Like short-term rates, long-term rates have not kept up with the rising earnings yield. This means that the difference between the earnings yield and the 10 year Treasury yield also points to attractive equity prices. In this comparison, the outstanding value of equities compared to 10 year bonds becomes clear: stocks are priced at about the most attractive level in 20 years, relative to 10 year Treasury bonds.



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<sup>1</sup> All references to “stock”, “stock market”, “equities”, and all derived values, are based on the S&P 500 index. Data provided by Bloomberg L.P.