

Here's a thought. Maybe U.S. stocks aren't as expensive as we think, and everything's going to be fine, that current valuations are justified. That's a possibility. And that's what we're going to look at in this bonus episode of Money for the Rest of Us. We're going to look at different stock market measures and really get down to the crux of what is driving this bull market that we're seeing, this AI-driven bull market.

### **Two Versions of the P/E Ratio**

But first, let's look at a couple of different ways to measure valuations of U.S. stocks. Here are two different versions of the price-to-earnings ratio. One is based on trailing 12-month earnings and that's at 25.4. The other is the Shiller P/E or the cyclically adjusted price-to-earnings ratio. That's at 40.6. That's higher. That's at the most one of the most expensive that it's ever been.

Whereas, you know, almost two standard standard deviations more expensive than average, whereas the trailing P/E is only one standard deviation more expensive than average. And so why is it that the trailing P/E isn't as expensive as the Shiller P/E? Well, it comes down to how the two are constructed. When we divide the price of the S&P 500 index by the earnings over the past year, that is more volatile, where because the Shiller P/E. The CAPE ratio takes the inflation adjusted earnings over the past decade.

And so it smooths it out. It's really kind of compared to, let's say you take a baseball player and you measure their productivity over one season versus over a decade.

And so when we look at the the CAPE ratio, it is more expensive because we're using a broader measure of earnings real earnings over the past decade. The price we're paying is the same for both in terms of the index level. But because earnings growth has been so strong over the past year for the U.S. stock market, that has brought down the trailing 12-month price-to-earnings ratio. You can see the earnings per share increase in the S&P 500 or U.S. stocks here.

We're measuring the MSCI USA Index, same as the S&P 500 size-weighted index, up 61% over the past three years. Just just astounding earnings growth. And because it's been so strong. Again that has lowered the trailing 12-month price-to-earnings ratio. And so it looks more attractive relative to measuring the price-to-earnings ratio over a longer earnings period over a decade, like we do with the Shiller P/E.

### **What Drove the Past Decade's Return**

Now there's kind of another quirk. When we measure the P/E in a different way. Here is the performance of U.S. stocks over the past decade, 15% annualized. We can decompose those into the various components that drove the return. First is the dividend contribution just under 2%. But then the other two drivers are the earnings per share growth. And so when we look at the the real earnings, the Shiller P/E it's grown about 9% per year.

Again, it's smoothed out over time. But because the overall level of the S&P is the same, the valuation increase contribution for for for CAPE is much higher. About 5% of the or five percentage points of that 15% annualized return was because stocks got more expensive based on this Shiller P/E ratio. Whereas if

we look at just using trailing earnings growth. It's grown earnings per share about 13% per year. And so this market is being driven by earnings per share growth generally.

And again it's that recent increase. So what happened over the past three years has had a much bigger impact on the CAPE ratio. The real earnings per share growth over the past decade. More of it is happening in the past three years. And that's why the CAPE ratio looks more expensive. Because again, broader measure, longer period. Looking at a decade, the production over a decade versus one year.

### **Record Profit Margins**

Now, why has earnings been so strong over the past 3 to 5 years? Well, one way to look at it is how profitable are companies their profit margins what their earnings are compared to sales is really the highest since 1961, and that's coming out of the pockets of their employees. The the amount of pay or compensation employees are getting relative to the value being created, it's the lowest ever. Now, over time, employees become more productive because they use technology. And we're in an AI boom right now.

And hopefully employees are learning how to use AI to become more productive. That's one of the the key questions here in this market. Will companies continue to, to massively expand productivity so that their profits increase? But right now, the main driver of the earnings per share increase is profit margins have expanded and much of that is come because the the earnings for employees haven't kept up with those productivity increases. Historically, workers got paid more as they became more productive.

Now more of that profit is falling to the bottom line of these publicly traded companies and even privately held companies. And that's leading to record profit margins or close to record profit margins for companies.

### **Adjusting the Forward P/E for Margins**

Now, those record profit margins allow us to look at the stock market in a way that makes it seem attractive. If we take the forward price-to-earnings ratio. So what is the earnings growth over the next year? Here's a long-term chart of that. We're at a forward P/E of 19.4. It is higher than average. So the market looks expensive by this measure also. But what if we take that forward P/E and divide it by these record profit margins. Well, if we do that, the market looks less expensive. We got record profit margins in that middle chart at at in this case 13.3%. But the forward P/E divided by the margin is one and a half.

And that's really the lowest it's been in a very long time. And so by that measure it looks like well the market's cheap

### **Record Price-to-Sales**

Now there's a relationship here. When we have the the price-to-earnings ratio, if we multiply that by the profit margin, that gets us price-to-sales which is essentially a record high. So let's let's break that down. We have the the price-to-earnings ratio. So we have the price divided by earnings. And then we have the profit margin which is earnings divided by sales. Well, the earnings cancel each other out as as if we multiply that and that gets us the price-to-sales.

So we have record price-to-sales because profit margins are so high. Yet if we take that that P/E and divide it by the margin, the stock market doesn't look as expensive. And the point is that what matters here is that we're at record profit margins. And why is that? It's because workers' compensation hasn't caught up to the level of productivity. And and that's going to be worked out between workers and companies.

### **Market Concentration**

But there's another risk in the stock market today that that's driving a lot of what we're seeing here in terms of profit margins and how expensive the stock market is. It's the level of concentration in the stock market, 41% of the U.S. stock market is made up of the top ten companies the S&P 500. This is a size-weighted type index, and so we have very high concentration close to 50% in just ten names.

Now if we look at the earnings contribution of those ten names, they make up 36% of earnings. And so much of the earnings is coming from the biggest companies. Now we can compare that to the dot-com bubble, which was the last time we had 26% of the, the the index weight was in the top ten holdings, but only 16% of the earnings. So in that way there was much greater distortion. The question is, again, with these top ten names, will they continue to be able to deliver high profitability and strong earnings growth?

And again, that all comes back to AI. How is this AI build-out coming along? Will it lead companies to increase productivity, expanding their profit margins?

### **Which Measure Is More Accurate?**

Because here's the thing. If profit margins actually fall and the companies are not able to deliver, workers get a greater share of the value added, then that means that the more accurate measure of the stock market right now is that CAPE ratio, where we're looking at the price divided by real earnings over the past decade. So we have a broader earnings sample. And so the stock market is more is is much more expensive than if we just use the trailing P/E which based is lower.

But it's also based on very high profit margins and very strong earnings per share growth over the past three years. And so if it turns out that margins will expand, then that trailing P/E ratio is the more accurate measure versus the CAPE ratio. And there's there's no way really to know that.

### **The CAPE Ratio and Future Returns**

What we do know is that when we look at the CAPE ratio, we can categorize it into the fifth most expensive. We break it into fifths. Let me show you a chart here. When the Shiller P/E has been this expensive 40.7, it. The real return over the next decade has been zero. And that's the risk here is that the profit margins don't expand. They actually shrink. We get a drop in earnings or a slowdown in earnings. And that's what we've seen when the market has been this expensive in the past. And in the U.S. has underperformed.

### **How I'm Positioned**

So as investors, what do we do? Well I tell you what I've done. I've underweight U.S. stocks. I still have exposure. But AI is going to benefit all companies around the world. And so I've emphasized areas that

are that are more attractive. And that is essentially as non-U.S. stocks, including small cap stocks. There's also areas in the bond market that are attractive right now if one wants to pull some risk off the table. Treasury Inflation-Protected Securities are yielding over 2%.

One can invest in a bullet-share TIPS ETF by iShares that has a fixed maturity date. They could build, they could invest in individual TIPS, and they can lock in two, 2.5% yields on a real basis plus inflation.

And so that's a way to actually protect some capital and capture some of the profits that we've seen in the stock market over the past 3 to 5 years. So we don't know how it's going to turn out, but it's important to look at different ways to measure the stock market and look under the hood. What's what's driving it? How fat are profit margins? What are different ways to look at the price-to-earnings ratio? And that's what we do at Money for the Rest of Us.

And we take a deep dive into it with our premium community. Money for the Rest of Us Plus, where we have tools that help you analyze markets, we do a monthly investment strategy report looking at what happened, where are we now and where are we heading? And I go ahead and you can check that out at [moneyfortherestofus.com](http://moneyfortherestofus.com). This is a bonus episode of Money for the Rest of Us. We just finished up a listener survey.

One of the things they pointed out is they want more content from us, that they miss us when we're gone, when we're only doing a podcast episode twice a month. And so we'll be doing some bonus episodes, mini episodes. This was one of those. Everything I've shared is just is been for investment education only. Thanks for listening. Please share this video or the podcast with others. Thanks.