



The Q Ratio Sends a Modestly Bearish Long-Term Signal

By Robert Huebscher

July 7, 2009

Strong market performance during the second quarter has claimed a victim. Tobin's Q ratio, one of the most reliable barometers of market valuation, is now 0.72 – up from its March low of 0.33 – indicating the market is modestly overvalued for long-term investors.

Over the short- and near-term the Q ratio indicates the market valuations are neutral. For broad-based equity investors, though, the key to long-term performance is the price at which one enters the market. As we noted in our March 31 [article](#), the Q ratio has been exceptionally accurate – more accurate than the P/E ratio – in forecasting investors' returns.

John Mihaljevic said that, in three of the five other instances since 1900 when Q increased to 0.72 or below, it was higher one year later. Four out of five times, it was higher three years after the initial increase. Looking five and 10 years out, it was higher in only one of five instances and unchanged in another.

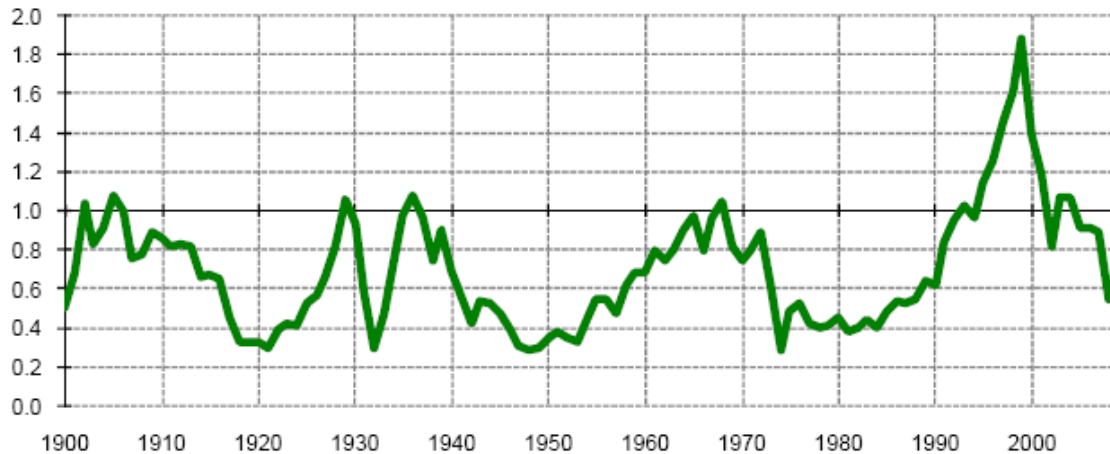
The Q ratio gave similarly overvalued signals of 0.89 at the end of 2007 and 0.70 at the end of the third quarter of 2008, but had dropped to 0.55 at the end of 2008 and 0.61 at the end of the first quarter of 2009.

Mihaljevic is a former research assistant of the late economist and Nobel laureate James Tobin, the original developer of the Q ratio. He now publishes the [Manual of Ideas](#), a quarterly newsletter about the Q ratio and its implications for investors.

Mihaljevic provided the following graph Q ratio values for the last century-plus:



Tobin's Q Ratio, 1900 – June 26, 2009



This chart consists of two data sets: 1900-1944: We use a modified Blanchard, Rhee, Summers series. We adjust the data to reflect the series' upward bias as compared to the Tobin (new) methodology developed by James Tobin and John Mihaljevic. 1945-2009: We use the Tobin (new) series. We believe this combined set of data from 1900-2009 provides the most accurate historical rendering of the Q ratio. Source: The Federal Reserve; Blanchard, Rhee, and Summers; *The Manual of Ideas*.

The Q ratio measures the market value of a company (i.e., its stock price) relative to the replacement cost of its assets. A value greater than one indicates that a company's assets could be purchased more cheaply than the company itself and, hence, the market is overvaluing the company, while Q ratios less than one indicate market undervaluation.

Over the last quarter, 11% of the change in the Q ratio was attributable to an increase in the numerator (the market value). The denominator (replacement cost) *decreased* by 1%.

Mihaljevic noted that replacement cost declined 0.7% sequentially in 1Q09, a reversal from a sequential increase of 0.3% in 4Q08, reflecting deflationary forces at play in the U.S. economy, including rising unemployment, home price erosion, and financial deleveraging. Replacement cost has not recorded a full-year decline in any year since 1900.

"Further declines in replacement cost would therefore be very significant in a historical context," Mihaljevic said. "We will watch the recent deflationary trend closely, but we do not anticipate that replacement cost will in fact decrease for the full year 2009."



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