

Tobin's Q: A Stone's Throw from a Sell Signal

By Robert Huebscher

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One of the most reliable measures of broad market valuation is Nobel Prize-winning economist James Tobin's Q-ratio. Data released less than two weeks ago show that the ratio is generating a bearish signal over the next three, five and ten years. Over the next year, though, the signal is neutral.



"The medium- to longer-term outlook has dimmed as a result of the rise in the S&P 500 since June 30th, 2009," said John Mihaljevic, whose publication, [The Manual of Ideas](#), provides regular updates on movements in the Q-Ratio. Mihaljevic was a research assistant for Tobin.

"If the S&P 500 fell back from 1,150 to 919, the index level on June 30th, the medium- to long-term outlook would move from bearish to neutral," he said.

Q-Ratio measures the market value of a company (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.

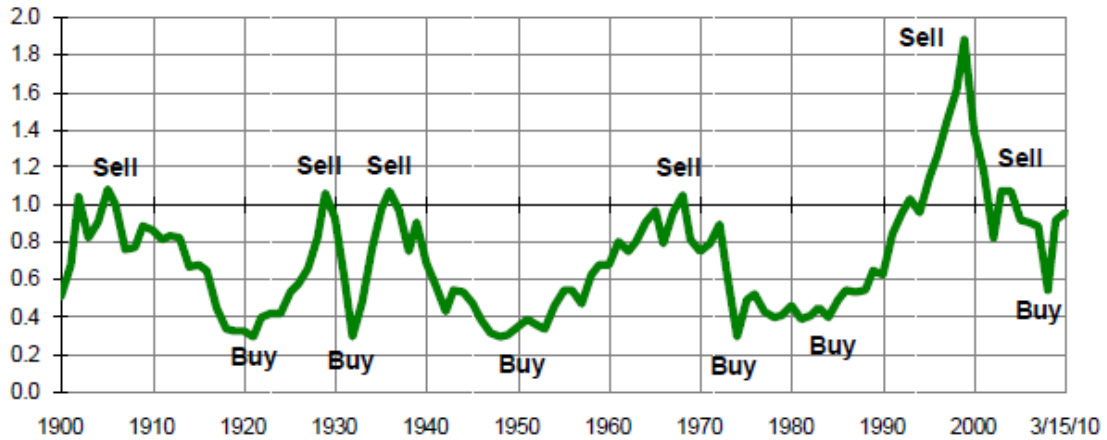
We have written previously several times about the Q-ratio, most recently [here](#).

The Q-ratio increased from 0.88 at the end of the third quarter of 2009 to 0.92 at the end of the year, and Mihaljevic estimates that it had reached 0.96 as of March 15. Most of this rise is attributable to increases in the numerator (market price). The denominator (replacement cost) rose by only 1% in 2009.

Several studies have identified a successful market timing strategy based on buying equities when the Q-ratio is below 0.40 and selling when it reaches 1.00, as shown below:



Tobin's Q Ratio — Historical Buy and Sell Signals, 1900 – December 15, 2009

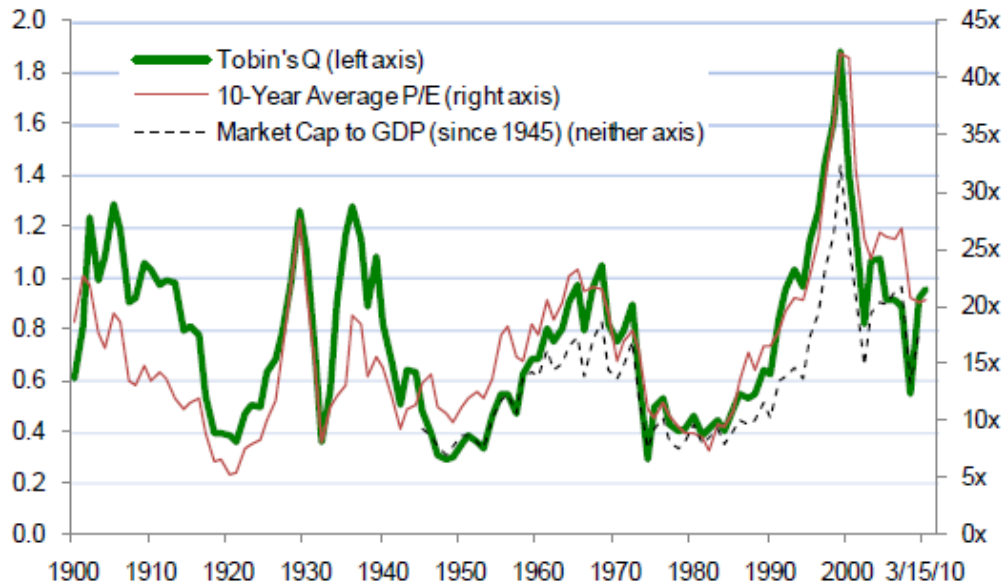


Source: The Federal Reserve; Blanchard, Rhee, and Summers; *The Manual of Ideas*.

Its current level of 0.96 puts the Q-ratio within a “stone’s throw” of generating a sell signal, Mihaljevic said.

Mihaljevic also shows that the Q-ratio correlates quite closely with two other commonly used market valuation metrics, Shiller’s normalized 10-year P/E ratio and the ratio of market capitalization to GDP:

Tobin's Q versus Shiller's Ten-Year Average P/E, 1900–2010



Source: *The Manual of Ideas* analysis, Federal Reserve, Robert J. Shiller.

“All three measures suggest a rather bearish medium- to long-term outlook for U.S. equities,” Mihaljevic said, “but none of the indicators sends a strong signal for an imminent sharp decline in equity prices.”

Just like the Shiller 10-year P/E, the Q-ratio is predictive of market performance over various time intervals, and its predictive power increases with the time horizon.

Mihaljevic’s data – specifically the 1% increase in replacement cost during 2009 – also suggest that deflation concerns are overblown. “So, even in a year of massive deleveraging and an extremely weak economy, the Fed managed to avert deflation,” he said. “In our view, deflation will soon move from a concern by a minority of market observers to no concern at all. In fact, most of us will likely be wishing for deflation if prices begin rising beyond the Fed’s comfort zone, as appears increasingly likely over the next two to three years.”

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