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Not all heroes bear CAPE ratios

A health check on stock market valuations.

David Brenchley

david.b@keplerpartners.com

The artificial intelligence (AI) revolution continues to power stock markets to record highs, yet many are becoming ever more anxious. Bond yields are trading at decade-long highs, the AI infrastructure boom is consuming capital at a record rate, geopolitical tensions are weighing on oil prices and consumers are more negative than they have been for a long time.

Hence, there are a lot of people who are going on the record to suggest we are close to seeing an almighty stock market crash, as bad as or even worse than that seen at the turn of the millennium when the Internet was in its infancy.

It's hard for ordinary investors to know how to take the pulse of markets, so we thought we'd dig into some publicly available data to help out. As ever, even if we are in a bubble, it's impossible for any metric to predict when it will end.

None of these data points should be construed as any kind of advice, merely some helpful pointers to form one's own opinion. If you are worried about markets and your exposure to them, we'd suggest seeking some form of financial advice, or coaching.

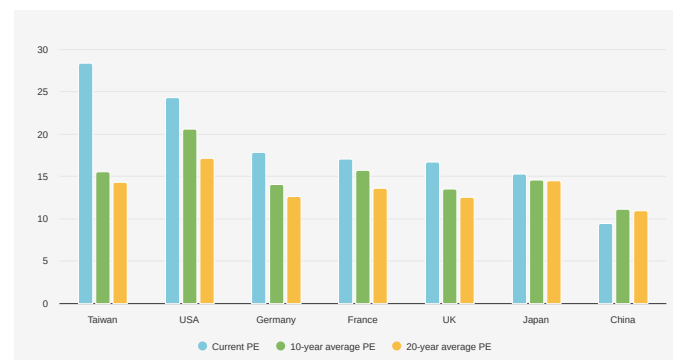
Prices and earnings

We'll start with arguably the best-known measure of valuations, the price-to-earnings (PE) ratio. The PE tells you how much investors are willing to pay for every pound or dollar of earnings, or profits, a company, or index, makes. To make this calculation, you simply divide a company's share price by its earnings per share (EPS).

Investors generally look at two different PE ratios: the trailing PE ratio and the forward PE ratio. The former tells us how much investors are willing to pay for past (usually last year's) earnings, while the latter tells us how much they are willing to pay for future (usually next year's) earnings.

These two PE ratios are telling us two very different stories. The trailing 12-month PE ratio on the MSCI World Index on 30/09/2026 was c. 22.7x. That's significantly higher than its 10-year and 20-year average PE ratios, which, according to the website World PE Ratio, are c. 19x and 16x respectively.

Global price-to-earnings ratios



Source: worldperatio.com

Past performance is not a reliable indicator of future results.

A high PE doesn't necessarily mean a stock or index is overvalued, but it does mean you'll need much higher growth rates to profit. On a PE ratio of 22.7x, it would take you almost 23 years for the company to earn the equivalent of the share price, assuming the company or index's earnings remain the same during that time.

That said, the MSCI World's forward PE on the same date was c. 18x, which is pretty much in line with historical averages. Forward PEs are usually an average of the forecasts of all the analysts who publish investment research on a company. Valuations look more reasonable on a forward PE basis because those analysts think that aggregate earnings are going to be high in the future. Only time will tell if this turns out to be the case, or whether the AI rollout ends up being more disappointing than expected.

Near, yet far

Not straying too far from prices and earnings, the CAPE ratio is another popular valuation metric. The CAPE ratio stands for cyclically adjusted price-to-earnings ratio. If you'll remember, the PE is a simple calculation: share price divided by EPS. CAPE is slightly different in that it divides the share price by its long-term (usually 10-year) average inflation-adjusted EPS.

Introduced by economists Robert Shiller and John Campbell in 1988, the CAPE ratio is generally seen as a more rounded indicator of a company's earnings, since it averages them over a whole economic cycle and adjusts for inflation.

At a c. 26-year high, the CAPE ratio makes the US market look much pricier than its PE or forward PE ratios suggest.

US, Europe and UK CAPE ratios



Source: Barclays

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Some will argue that the CAPE ratio is less relevant than it has historically been, since profit margins are higher than historically. It's also another backward-looking metric that gives little credence to the fact that earnings are forecast to surge higher in the coming years.

A couple of other interesting observations are that European markets tended to track US markets pretty well historically but have lagged a lot ever since the financial crisis, potentially suggesting there's some latent value hiding on the continent.

The UK, by contrast, has more often than not traded on a big CAPE discount to the US, except for times after a big crash,

where its cheaper valuation provides more of a margin of safety. Again, today the discount looks historically large, potentially suggesting some value exists.

Playing with fire

In December 2001, legendary investor Warren Buffett said that the best single measure of where valuations stand at any given moment is the ratio of the total stock market capitalisation to gross national (or domestic) product (GNP or GDP). Ever since, the measure has been known as the Buffett Indicator.

Buffett once said: "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% – as it did in 1999 and a part of 2000 – you are playing with fire."

He also, of course, warned that the metrics, like all valuation measures, should never be used as an accurate gauge of valuation. Indeed, in the past six years, the metric has only been lower than where it was just before the dotcom bubble burst for a brief period in late 2022.

The Buffett Indicator



Source: *longtermtrends.com*, Yahoo Finance, Federal Reserve Bank of St Louis

Still, it is very much higher than it has ever been and currently well above 200%; in fact, it's not too far off 250%. Perhaps that's unsurprising when there's expected to be c. \$10trn of investment into AI infrastructure between 2025 and 2032, an average of c. 3.6% of GDP per year, according to the Brookings Institution. That's far larger relative to the economy than the major US canal, railroad, electrification, highway and telecommunications investment booms.

Relative valuations

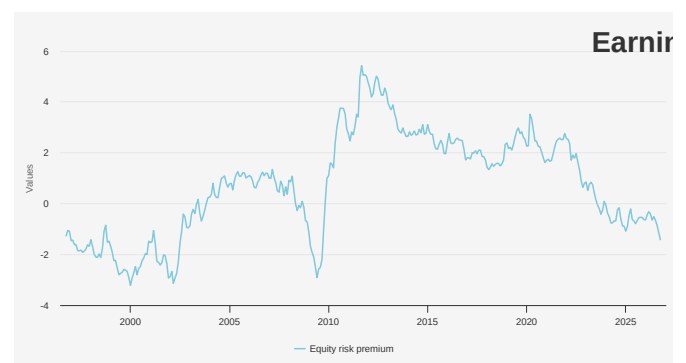
So far, we've outlined valuations of stock markets outright, but there are, of course, other assets that investors can buy. Hence, relative valuations are also important.

Many investors compare the return they might get from investing in shares with safer investments where the return is pretty much guaranteed. In most cases, this investment is a

bond issued by the US government, since it pays a return that is guaranteed as long as the US government doesn't go bust and default, which is highly unlikely.

Here, we have a chart that compares stocks to bonds. It is known as the equity risk premium (ERP) and it shows the earnings yield on stocks minus the yield on government bonds. You can think of this as the extra amount that investors need to earn in order to compensate them for taking the extra risk of owning equities rather than bonds.

US equity risk premium



Source: Eco3min, Robert Shiller, Yale University
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The earnings yield is somewhat analogous to the dividend yield in that it's the return investors could get in the unlikely scenario where a company paid all of its earnings out to shareholders in the form of a dividend. Calculation wise, the earnings yield is, essentially, the inverse of the PE ratio: instead of dividing the share price by the EPS to get a ratio, you divide the EPS by the share price then multiply by 100 to get a percentage.

The chart below from Eco3min then subtracts the 10-year Treasury yield to get the ERP. As you can see, while it's not quite on par with the dotcom bubble, where the 10-year yield was almost three percentage points above the earnings yield, it's very much in negative territory. This would suggest that, all things being equal, bonds potentially look more attractive.

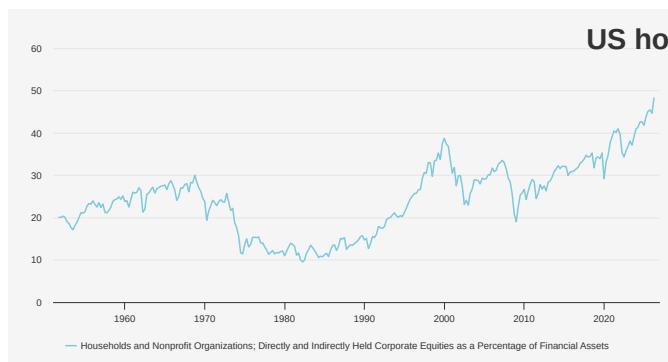
Too much skin in the game

This one is less a measure of valuation but more of sentiment towards stock markets. It shows the vicissitudes of investor

keenness for investing in equities and can be a useful indicator for knowing when we're hitting peak exuberance levels. Valuation alone is not a good judge of when things might tip over the edge.

To make the point, we'll back up to New Year's Eve 1990. At this point, equities accounted for just under 15% of all the financial assets held by American households and non-profit organisations – a historically low number. Over the next 10 years, the S&P 500 returned 431% in both US dollar and pound sterling terms.

Equity allocations as a percentage of total financial assets



Source: Federal Reserve Bank of St Louis, National Bureau of Economic Research

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Fast-forward to the turn of the millennium, New Year's Eve 2000, and the percentage of household wealth tied to equities had risen to almost 40% as stocks had risen inexorably. In the next three years, the S&P 500 lost almost 50% of its value.

Something similar had happened through the 1970s and, undoubtedly, similar will happen again. Our data shows that households and non-profit organisations have never had so much of their financial assets tied to the stock market – almost 50%, as of 01/03/2026.

Having said that, investing is a hell of a lot more accessible – not to mention cheaper – than it has ever been, so the proportion of share ownership probably should be meaningfully higher than it has been in the past.

Conclusion

Overall, we'd suggest a mixed picture in terms of valuation. The CAPE ratio and Buffett Indicators would suggest we're very much in overvalued territory, but they also show that we have been for quite some time and things have yet to move.

In addition, while more people than ever are invested in stocks, this rationally makes sense given the ever-lower barriers to investing these days. In addition, when we pivot towards forward-looking valuation metrics, things look more sanguine (assuming the earnings growth that is currently forecast comes through).

Again, we're putting these metrics together so that readers can make their own judgements around valuations. That said, David Swensen, the late head of Yale's hugely successful endowment fund, put the failure of individual investors during the dotcom bubble down to a lack of rebalancing.

If they'd sold overvalued stocks and recycled the cash they'd raised into underperforming bonds, they would have had a much better outcome when the crash came. Some food for thought, perhaps.

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