Honeymoon and then what?

The market rally following November's presidential election took most Wall Street observers by surprise. Indeed, what was especially disarming was the response of the market futures late in the evening as the data pointed toward an unexpected result. For a short time, the numbers were suggesting a plunge of historic proportion, but then a strange thing happened. The futures did an about-face and headed higher. On the next day, the result was a triple-digit gain.

Talk about a bipolar investment community, but here we are and the world is still with us. Yet the reality is that more often than not the averages have risen in the aftermath of a major election, as investors express their optimism about changes that might be to their benefit. This honeymoon effect was quite evident in November, though the enthusiasm began to moderate over the last few weeks of the year.

This is not a unique pattern. First, there is hope. Then, there is reality. The latter is on the way and that is typically reflected in an increasingly somber view of the possibilities.

Rewinding about 12 months, we found ourselves in the midst of an unexpected plunge in stock prices. Drops are never comfortable, but they are regular parts of the long-term equation. In most years, you can bet on an interim pullback of 10% or so. Six of the latest eight years have had pullbacks of more than 10%, but six of the eight ended the year with double-digit gains. The worst two were flat, not down, for the full 12 months.

All of which says that there will be rainy days and storms, but they are always followed by better weather.

The extreme cases of market difficulty were 2001-2002 and 2008-2009, when the Dow Jones Average submarined near the 7,000 level and conjured images of the end of the world as we know it. But as always what seemed like the blackest of times was followed by recovery. And here we are now nearing the 20,000 mark. So much for doomsday sayers!

As we look ahead, we have hopes and we have concerns. Our hopes come from the economic improvement that has been under way since the Great Recession of the 2008-2009. Business has improved, jobs have returned, and some folks — not all — have regained some comfort in their lives.

But things have changed. Yes, some jobs were lost to countries with far less costly labor, but far more have been lost to advancing technology. Machines have replaced many people, though some of the new jobs are for those who are running the machines. These days, you either improve your skills or find a book to read. Once again, the constant is change.

One of our concerns is market valuation. With averages hovering near historic highs, there are those who worry that it's not a good time to get aboard, much less be aboard. Although history never provides perfect guidance, it suggests that we should not be losing much sleep over this metric.

Why? Because normal market valuations (price divided by underlying earnings) are usually in the mid teens. At the end of 2016, the market valuation was about 17 times forward earnings, i.e., those estimated for 2017. That's a bit higher than the norm, but when prevailing interest rates are low, valuations tend to be higher.

How does this compare with prior valuations? At the market peak of 2000, the valuation stood at over 27 times. It was an accident waiting to happen and it most certainly did, which is why 2000-2010 was a decidedly poor period for stocks.

The situation was quite different in 2008-2009. At the peak of October, 2007, the market valuation was just under 16 times. Without knowing more, that seemed eminently reasonable. The hitch, of course, was that the banking system was perilously close to freezing, so even though stock prices were not excessive, the fear of a complete credit impasse ruled the day.

That, too, has passed, but it brings to mind the need to look beyond the problems of the moment. The problems of the moment weigh heavily on investor psychology and that largely determines market movements over the short term. The good news is that when investor psychology turns negative, prices become more attractive and opportunities increase.

When groceries are on sale, shoppers load up their carts. When stocks are on sale, investors can be so scared that they are tempted to sell.

If you know nothing else about investing, take care to remember that people tend to sell when they should be buying and they buy when they should be selling. Emotion often rules the day and prompts actions that are counterproductive. Once again, it's best to ignore the excitement of the moment and focus on the horizon.