29 November 2016

Congratulations to those of us who didn't walk away from the Thanksgiving dinner table wishing that we hadn't gone back for second or third portions. Yes, it's a time to be thankful and to look ahead through the remainder of the year and toward 2017.

The surprising stock market rally of the past few weeks is encouraging on one hand, but concerning on the other. Let me explain. Stock prices over time are a reflection of underlying corporate profits. As profits climb, so should stock prices, but as we all know it's hardly a step-for-step progression.

Sometimes, as now, when investors are enthusiastic, valuations stretch. In other words, prices expand simply because investors are willing to pay more in expectation of better earnings results in the future. That change in valuation is an increase in the price-earnings multiple.

What's the price-earnings multiple? It's the price of a stock (or the market) divided by the related profits. So if the price of the stock is 20 and the share profits are $2.00, the multiple is 10. Most stocks sell for multiples between 10 and 20 times. Typically, the faster a company is expected to grow, the higher the multiple that investors will be willing to pay for its shares.

That's also true for the stock market as a whole. Normal price-earnings multiples for the market are in the mid to upper teens. And market multiples also tend to expand during times of low interest rates and contract when rates are higher.

At the moment, market valuations are in the upper teens, probably reasonable in view of the likelihood that 2017 will see an uptick in corporate profits as well as interest rates that will remain toward the low end of historical levels. Even so, there will be occasional knee-jerk reactions to interest rate pronouncements by the Federal Reserve Board.

The bigger concern is whether we will finally move ahead from the recent stagnation in corporate profits. This would help justify the rally

in stocks. Otherwise, we may end up getting more now and less later.