

Wall Street is beginning to look like La La Land

Although it seems as if the stock market can only go higher, that kind of thinking often leads to trouble. After an eight-year rally from the depths of early 2009, the leading averages continue to climb into new high territory, apparently in expectation of a substantial upturn in underlying corporate profitability. Whether that's a reasonable possibility or fantasy is another story.

For the past couple of years, corporate earnings have been on a broad plateau, though each year we hear that this is when a new upsurge will begin. That has yet to happen. What's more, Wall Street's analysts regularly begin the year with earnings estimates that promise substantial improvement. But in the months following the estimates are continually whittled down.

So here we are again looking for better times and stock prices already rising. The problem is that prices are rising, but earnings have yet to follow suit. The net result is increasingly stretched valuations and like a rubber band there comes a time when it snaps back.

At a minimum, one can look forward to a pullback of 10% or so sometime this year. That's an annual event that happens more often than not. It could be worse, especially if the recent upsurge is protracted. At this point, a much healthier possibility would be for stock prices to move sideways for an extended period, allowing earnings to expand and start bringing valuations down to less lofty levels.

The alternative would be a steady march higher, increasing the probability of a far more troubling downswing. Earnings disappointment might begin the spiral, but a more likely scenario would be an important geopolitical event sparking a correction. These kinds of things are not predictable, but with valuations stretched and prices moving up while hardly missing a beat, a word to the wise should not be ignored.

At this juncture, a thorough portfolio review would be in order. Identify and uproot less promising holdings. Ignore the euphoria of the crowd. What goes up will come down. And then go up again. This is no time to join the party.