Trees Don't Grow To The Sky

The seemingly nonstop rally that's been under way since last November's election may be tempting to join, but years of watching these kinds of things tell me it's best to get off the trolley before it heads in the other direction. The market euphoria we're seeing now is a stretch of enthusiasm that ignores reality. Over time, stock prices are reflections of underlying corporate profits.

There is a longstanding relationship between the two, but as psychology changes prices can vary widely from what might be considered a normal level. Indeed, a normal level is the exception, not the rule. When investors are hopeful, prices may stay in the upper ranges for extended periods and then the pendulum swings them in the opposite direction, often at a distressingly rapid rate. They get to the edge of the cliff . . . and then go over. It's been that way for many decades and sensible investors know that the pattern will repeat in the future.

What we're seeing now is a vote of confidence in the new administration. When prices move up more quickly than underlying profits, valuations expand. A normal level of stock valuations is between 15 and 18 times earnings. When interest rates are low, valuations are high. And vice-versa.

Right now, the Standard & Poor's 500 Index stands at 21.5 times earnings of $109 a share for 2016, but only 18.5 times the consensus estimate of $130 a share for the current year. That may sound like a reasonable valuation, but analysts always put out their most generous estimates toward the beginning of the year and then lower them over the months that follow. Keep in mind the fact that S&P earnings have been essentially flat at $110 or so over the latest four years and it's entirely likely that the estimate for 2017 will soon come under the knife.

It may be wiser to have a plan based on a more conservative view, but the attitude now seems to be betting on substantial tax cuts and a more robust business climate. One of the main problems is that entitlement spending (i.e., Social Security, Medicare, Medicaid) continues to grow every year, leaving a steadily shrinking remainder available for all other government functions. So if taxes are lowered, the government's financial resources dwindle, reducing its ability to fund promised programs. Washington can't spend what it doesn't have, unless there's massive borrowing, which then raises the national debt to even higher levels. Not a good thing.

Huge market surges do occur from time to time. Years ago, a 100-point move was considered a very big deal. These days, a change of that magnitude is largely a nonevent. Even two or three hundred points to the upside rarely raises eyebrows. Yet, when there's an about-face, it tends to happen dramatically, and relentlessly. It will happen.

No one knows how much longer this rally will continue, but it will end. And one can be sure that it's more probable than not that it will be followed by a decline of 10% or more sometime this year. The longer it lasts, the deeper the drop that will follow.