Prepare for a Difficult Stock Market

The stock market rally that has been under way since last November's election has been fueled in large part by investors' expectations of a more robust business climate, reduced taxes, and a generally more optimistic view of what lies ahead. Although some may have seen that as overlaid with far too much pixie dust, there's little reason to doubt that it erred too much in the direction of best case rather than what is most likely.

With the demise of the administration's effort to overhaul the Affordable Care Act, its prime candidate for change, it is time for a hard look at the other items on Washington's agenda. Most will agree that tax reform and infrastructure are the likely next topics. Both are complex and demanding of extended discussion. And, as with health care, numerous special interests will be involved in shaping this legislation. None of this will be easy and it will take time.

Investors are too optimistic

Yet, even with these daunting tasks ahead, few investors have shied away from the vision of Happy Days Are Here Again. Indeed, the Consumer Confidence Index just hit a multiyear high, reaching a level that typically signals that it's time to protect gains and reduce risk exposure. This is best case planning, an approach that often backfires.

What's the problem? At a minimum, stock valuations are toward the rich end of their typical range of 15 to 18 times earnings. Based on prospective S&P 500 earnings of $130 a share for the current year, the current multiple would be about 18 times, probably not unreasonable in view of still-low interest rates. Even so, there are two iffy assumptions that add importantly to the error potential of this appraisal.

The shakiest assumption is the earnings estimate. It is well known that the initial estimates made by Wall Street analysts are reduced, often substantially, over the course of the year. After an extended period when the S&P earnings plateaued at about $110 a share, it seems overly optimistic to bet the ranch on the analysts' opening earnings number. So it would not be at all surprising to see the actual result come in closer to $120. That would suggest a multiple closer to 20 times.

In addition to concerns about the likelihood that the earnings forecast will be met is the probability of several interest rate hikes before the end of the year. As interest rates rise, stock valuations generally shrink. The good news is that in the early stages of rate hikes, typically below the 5% level, the impact on stocks tends to be muted.

What should investors do now

Since the U.S. market has been a leader in the years since the Great Recession, it would be worthwhile to review domestic holdings and consider reducing those with stretched valuations. At the same time, it may be helpful to redeploy into international markets, where the rebound has been far less brisk.

On the fixed income side, it would be advisable to focus on short to intermediate term maturities. In the area of alternatives, which often serve as shock absorbers since their price movements tend to have a reduced correlation to the stock market, attention should be paid to such vehicles as covered-call ETFs or funds and long-short securities.

In all cases, the goal should be above-average returns on a risk-adjusted basis. In other words, seek to match or approach the market averages with substantially reduced exposure to risk. The likelihood of a beating or even staying even with the averages is low. But with proper asset allocation and selection of holdings, you may well move ahead at a good rate while enjoying a much smoother ride.